

Is An Independent Nonprofit Sector Prone to Failure? An Austrian School Analysis of the Salamon Paradigm and the Lohmann Challenge

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Introduction

Nonprofit organizations have traditionally been considered a meaningful substitute for the services provided by the bureaucratic welfare state (Berger, Neuhaus, and Novak, 1996), a vibrant but largely overlooked “independent sector” characterized by a spontaneous ordering of associations that are founded neither on the state’s compulsory power nor the search for private monetary profit (Cournelle, 1965). Lester Salamon’s body of work – which is extensive – suggests otherwise.¹ Salamon argues that the U.S. has a long, established history of efficient institutional linkages between the nonprofit sector, which he calls the “voluntary sector,” and the state. Rather than a substitute, Salamon sees nonprofits in an effective “partnership” with the state, a viable form of “third party” governance. He argues that the independent sector is in fact not so independent. On its own it is prone to failure.

Salamon points to the aftermath of the September 11th attacks as an example:

Revealing though this episode has been of the remarkable strengths of America’s “third,” or nonprofit, sector, however, it simultaneously revealed the sector’s limitations as well. Private voluntary groups, though highly effective in mobilizing individuals to act, are far less equipped to structure the resulting activity. In short order, fragile systems of nonprofit response were severely challenged by the enormity of the crisis they confronted in the aftermath of September 11. Individual agencies, concerned about their autonomy, resisted efforts to coordinate their responses, either with each other or with government

¹ See, for example, Salamon (1981, 1987, 1989, 1992, 1993, 1995, 1999, 2002a), Salamon and Abramson (1982) and Salamon and Anheier (1996a, 1996b). We will pay special attention to Salamon (1987), as it provides the clearest discussion of his own theory of government-nonprofit partnership, one which continues to influence his most recent work.

authorities. Individuals in need of assistance had to navigate a multitude of separate agencies, each with its own eligibility criteria and targeted forms of aid. Inevitably, delays and inequities occurred; many individuals fell through the slats, while others benefited from multiple sources of assistance. What is more, misunderstandings arose between donors, most of whom apparently intended their contributions to be used for immediate relief, and some agencies, most notably the Red Cross, that hoped to squirrel the funds away for longer-term recovery, general institutional support, and other, less visible, disasters down the road. What began as an inspiring demonstration of the power of America's charitable community thus became a demonstration of its shortcomings as well.

In this, the story of the nonprofit sector's response to the crisis of September 11 is emblematic of its position in American life more generally. Long celebrated as a fundamental part of the American heritage, America's nonprofit organizations have suffered from structural shortcomings that limit the role they play. This juxtaposition of strengths and limitations, in turn, has fueled a lively ideological contest over the extent to which we should rely on these institutions to handle critical public needs, with conservatives focusing laser-like on the sector's strengths and liberals often restricting their attention to its weaknesses instead. Through it all, though largely unheralded and perhaps unrecognized by either side, a classically American compromise has taken shape. This compromise was forged early in the nation's history, but it was broadened and solidified in the 1960s. Under it, nonprofit organizations in an ever-widening range of fields were made the beneficiaries of government support to provide a growing array of services – from health care to scientific research – that Americans wanted but were reluctant to have government directly provide. More than any other single factor, this government-nonprofit partnership is responsible for the growth of the nonprofit sector as we know it today.

During the last twenty years, however, that compromise has come under considerable assault (2002a, pp. 4-5).

Salamon's work attempts to show not only how the nonprofit sector can support and improve the modern welfare state, but more importantly, how the welfare state supports and effectuates the nonprofit sector. In an era where much of the postcommunist literature, having witnessed the collapse of real-existing socialism, has turned not toward free and open markets, but instead toward the market-based welfare

state (as witnessed by the work of Joseph Stiglitz (1994) among others²) Salamon's work keenly anticipates this postcommunist justification of the state, in his advocacy of "third-party government." To him, the evolution of "third-party government" was misinterpreted, or worse, outright ignored, due largely to defective *economic theory*.

Salamon is not the only theorist of the nonprofit sector critical of the standard economic approach. In his intriguing work, *The Commons: New Perspectives on Nonprofit Organizations and Voluntary Action*, Roger A. Lohmann (1992, pp. 159-76) agrees that the standard theory fails to understand the nature of nonprofit organization, but for reasons which differ substantially from Salamon. Our paper offers a critical assessment of the coherence of Salamon's paradigm from a largely Austrian economic perspective (that is, one in the tradition of Ludwig von Mises and F.A. Hayek) and also explores the potential for Lohmann's suggested revisions.

We shall proceed by first discussing the motivation behind Salamon's theoretical challenge, one that is rooted in a critique of Burton Weisbrod's economic analysis of nonprofits. We shall then discuss in some detail Salamon's own attempt to rectify the shortcomings of the Weisbrod model. Although Salamon provides the major focus of our paper, we shall also explore Lohmann's criticism of the economic theory of nonprofits, which encompasses the attempts by Weisbrod and Salamon. We shall argue that some of Lohmann's criticisms are generally correct in spirit, but his own proposed revisions to mainstream economic analysis (such as his attempt to rectify the classical distinction between "productive" and "unproductive" labor) are unfortunate and can be better

² See Prychitko (1990, 2002a) for a criticism of the welfare state alternative, and Boettke (1993, 2001) for a criticism of post-communist policies in general.

developed using the insights of Austrian economic theory. We conclude with a discussion of the political economy of the nonprofit sector in general.

A Salamonic Paradigm? Voluntary Failure And Third Party Government

Salamon argues that

The widespread neglect of the massive growth of government-nonprofit relationships that characterized the 1960s and 1970s was a product not simply of a lack of research but, more fundamentally, of a weakness of theory. Both the theory of the welfare state and the theory of the voluntary sector were deficient, moreover – the former because of its failure to acknowledge the reality of “third-party government” and the latter because of a view of the voluntary sector that emphasized its role as a substitute for the state. Neither perspective left much room for a flourishing government-nonprofit partnership. To come to terms with the reality of widespread government-nonprofit cooperation, therefore, it is necessary to reshape the conceptual lenses through which this reality is perceived, to replace traditional theories of the welfare state with the concept of “third-party government,” and to replace prevailing “market failure/government failure” theories of the nonprofit sector with a theory that acknowledges the possibility of “voluntary failure” as well, of inherent limitations of the voluntary sector. Equipped with this alternative set of theoretical lenses, the widespread partnership between government and the nonprofit sector comes into focus not as an aberration, but as a reasonable adaptation to the respective strengths and weaknesses of the voluntary sector and the state. Rather than a phenomenon to be shunned or discouraged, cooperation between government and the voluntary sector emerges from this analysis as a reasonable model to be promoted and improved (1995, p. 6).

“More than any other single factor,” Salamon contends, “this government-nonprofit partnership is responsible for the growth of the nonprofit sector as we know it today” (2002a, p. 5), and he has developed a wide reputation for a large body of empirical work that appears to support his theory. Recently, however, the methodology behind his empirical research has been strongly challenged by Smith (2000, pp. 42-49).

We attempt a largely theoretical challenge in this paper. Salamon believes his theory provides a new “paradigm” – in the Kuhnian sense (1987, p. 36; cf. Salamon and

Anheier 1996b, pp. 1-7, 119-123) – to explain the evolution of the government-nonprofit partnership, and to justify and promote its continued development. Although the present authors do not share Salamon’s ideological project, our paper has a different focus.³ Rather than engage in an argument over competing ideological visions, we wish instead to examine Salamon’s paradigmatic *theory*. He attempts to engage in a theoretical reconstruction of economic analysis -- specifically the notions of market failure and government failure – and adds to that his new notion of “voluntary failure.” Salamon argues that the (few) economists who have studied the nonprofit sector (most notably, Weisbrod [1977, 1988]) view the complex interconnections between markets, nonprofits, and the state with the wrong theoretical lenses.⁴ In this literature, nonprofit and philanthropic organizations emerge in response to both market failures (due to free rider problems) and government failures (due to programs being devised which meet the demands of the “majority” of constituents and thereby leave the demands of others left unmet).

³ Salamon advances the normative claim that “cooperation between government and the nonprofit sector makes a great deal of sense both conceptually and practically. These two massive sets of institutions share many of the same basic objectives and have strengths and weaknesses that are mirror images of each other. Under the circumstances, the recent efforts [i.e., the Reagan reforms] to dismantle or significantly curtail, this partnership seem singularly ill advised even if they are largely unintended. A more sensible approach would be to find ways to make this partnership truly work, not only for the “partners” but also for those being served.... The chapters presented in this book were originally written with this end in view.... Now the challenge is to build on that start and set in motion a more basic effort to make government and the nonprofit sector not merely interconnected sets of institutions but true “partners in public service” (1995, pp. 12-13). We applaud Salamon for at least making his ideological program explicit. Our own ideological vision differs, as we prefer both a robust and open market and nonprofit sector, and a substantial limitation on the powers of state compulsion.

⁴ Salamon seems unaware of Boulding’s work (1981), which is not founded on the market failure/government failure analysis. A former professor of ours in the 1980s, Boulding’s work, particularly on knowledge transmission processes, fits nicely in the Austrian tradition.

Salamon's Object of Criticism: The Weisbrod Model

Burton Weisbrod's thesis (1988, pp. 16-42) is a fairly conventional application of market and government failure analysis to explain the existence – and persistence – of nonprofits in a generally free market system. In short, Weisbrod argues that markets are generally efficient; but in specific cases, particularly the production of public goods, the free market alone cannot be expected to generate socially efficient outcomes. Theoretically, at least, government intervention can be used to influence and improve upon (in the sense of generating an optimal or socially efficient result) through its coercive powers to tax free riders – that is, to force those who would enjoy consuming a public good, but have little or no incentive to voluntarily pay to obtain the good. Weisbrod suggests that government intervention in this way tends to work well when consumer demand is homogeneous. In principle, it is a straightforward exercise to determine who gains from the production of a public good (think of, for example, the common textbook case of national defense), to tax them appropriately, and use those tax revenues to subsidize the production of the public good. On the other hand, when consumer demand is heterogeneous, or diverse, the task becomes much more complex. While it might be assumed that most “everybody” in the country enjoys at least a certain level of national defense production, not “everybody” enjoys or free rides from the services provided by Alcoholics Anonymous, MDA, the Sierra Club, or the Little Sisters of the Poor. While these services *might* display some public-good-like characteristics (although we aren't convinced of that), the state cannot effectively, or, rather, efficiently, account for, and accordingly tax and fund, all the confoundedly diverse demands behind these and a panoply of other services. In Weisbrod's view, free riders in the market will prohibit – if

only unintentionally – the optimal production of these services. This typically leads to a call for government intervention to improve upon the outcomes of an otherwise spontaneous market process. But, Weisbrod argues, the government will also fail to generate specific taxes on specific people to ensure an optimal allocation – that is, to improve upon the market outcome. Hence, he maintains, nonprofits arise in response to *both* market and government failure. They emerge as a “substitute” for state intervention in light of efficiency failures in the market place.⁵

Salamon (1987, p. 39; 1992, p. 125; Salamon and Anheier 1996, pp. 9-10) chides Weisbrod for failing to acknowledge an empirically robust *partnership*, for viewing the two as substitutes rather than symbiotic complements. Salamon suggests that the real-existing partnership between nonprofits and the state is an anomaly from the perspective of standard theory, something that simply cannot be explained or predicted in traditional analytical constructs. Against Weisbrod, Salamon advances the claim that the partnership is fundamentally a response to inefficiencies in the “voluntary,” nonprofit sector. “Given a welfare state that is characterized by an extensive pattern of third-party government,” he writes, “the persistence of a voluntary sector and widespread government–nonprofit cooperation are not anomalies at all: they are exactly what one would expect” (1987, p. 43).⁶

⁵ In a recent paper Glaeser and Shleifer (1998) explore the question of when entrepreneurs may decide to enter as a for-profit or not-for-profit entity. They argue that this decision relates to the incentives that potential entrepreneurs face, such that under certain conditions even a self-interested entrepreneur will opt to enter as a not-for-profit entity.

⁶ Salamon’s terms can be confusing: aren’t market organizations voluntarily formed, and funded? So why distinguish between the “market sector” and the “voluntary sector”? What clarity does that add? In our view, the market sector would at least be seen as a subset of the voluntary sector. (At the same time, were one to use these terms, why not label the state sector as the “compulsory sector”?) For now we shall stick with Salamon’s terms: by “market sector,” he means the traditional for-profit marketplace; by “voluntary sector” he means the panoply of nonprofit organizations; and by “government sector” he indeed means the state’s legitimate monopoly of coercion. Finally, his term “third-party government” has nothing to do with

At the core, then, of Salamon's self-described paradigm is the notion of efficiency, and its converse, inefficiency. By advancing claims that a set of institutions – market, voluntary, or state – are failing, Salamon's approach necessarily employs particular assumptions about the potential efficiency characteristics of those institutions. He needs some benchmark for *success*. Precisely what does Salamon mean when he speaks of voluntary-sector failure – i.e., just how might nonprofits be inefficient, or how might they be judged “inherently limited”? What scientific basis does he provide which allows him to conclude that the merging or “partnership” between nonprofits and the welfare state are not only the *consequence* of voluntary sector failure, but also an efficient *improvement* within that sector? To be sure, Salamon recognizes that answers to these kinds of questions “is more conceptual than empirical” (1987, p. 35) – we can't simply go off, willy nilly, and measure “the” results. We instead require some theoretical framework to give us clues as to *what* (and how) we should be measuring, and how the results are causally related to earlier institutional events and developments. In this sense Salamon's metaphor of needing new theoretical “lenses” is most apt. But does Salamon's new theory provide insight and clarity? Has he firmly established the notion of voluntary-sector failure, and the efficiency-enhancing role of the state among nonprofits? We already know Salamon's ideological sentiments encourage a more robust linkage between nonprofits and the state, but has he developed a consistent, positive theory that provides the kind of conceptual framework – a paradigm, in his words – that matches his ideological hope with empirical possibility? We shall see that he has not.

political parties. It is his label for the institutional partnership between the federal government and other organizations, including nonprofits, one whereby the federal government “increasingly relies on a wide variety of “third parties” – states, cities, special districts, banks, hospitals, manufacturers, and others – to carry out its purposes” (Salamon 1981, p. 19). He also does not clearly distinguish nonprofit associations from not-for-profit firms. The importance of a clear distinction will be discussed in a later section.

We suggest that not only is Salamon's theory defective, but so, too, is the theory that critically influenced Salamon's – that of standard economic analysis, including Weisbrod's. Salamon draws from a theoretical model in neoclassical economics – welfare theory – that cannot deliver the goods. This is a strong claim on our behalf, one which requires us to discuss the standard economic analysis of “market failure.” What do economists mean when they say that a market “fails”? And what do they mean when they say that state intervention can potentially improve upon market failure? What, if anything, does government failure mean in this context? Let's carefully discuss the theory of market (and government) failure, for Salamon's case for the nonprofit-government partnership cannot be understood without some exposure to the alleged efficiency (and inefficiency) characteristics of markets.

Success and Failure: A lesson in basic economic theory

So far we've used the terms “public goods,” “market failure,” “government failure” and so on rather freely, as if our readers already understand these terms. While this is standard parlance among economists, others often adopt these concepts loosely, and erroneously, for the terms have specific meanings. To understand the Salamon paradigm we need to be better acquainted with the standard economic paradigm he is reacting against.

So, imagine an idealized economy in which all participants enjoy several limiting assumptions, including: full and complete information; zero transaction costs; prices that they take as given (i.e., beyond any one individual's, or coalition of individuals', ability to manipulate). Standard economic analysis has established that individuals within this hypothetical economy will harbor the ability, and the incentive, to freely exchange their

property – goods and services – until *all* mutually-beneficial exchanges have been exhausted. Once reached, any further exchange or redistribution of goods, though beneficial to one (or some) parties, will reduce the utility or well-being of other parties.⁷ The free market, under these severely limiting assumptions, is considered capable of generating a socially-optimal outcome. Although the term “efficiency” has varied meanings, in the theory of standard welfare economics, efficiency is synonymous with Pareto-Optimality – the complete exhaustion of all mutually-beneficial exchange possibilities.

In the economics literature there are formal proofs that under conditions of *general competitive equilibrium* the economic system will achieve simultaneously production efficiency (i.e., all least cost technologies will be employed), exchange efficiency (i.e., all mutually beneficial gains from exchange will be exhausted), and product-mix efficiency (i.e., individuals will receive the bundle of products they are willing to pay for). The Two Fundamental Welfare Theorems follow from these: (1) an economy in general competitive equilibrium is Pareto Efficient, and (2) any Pareto Efficient distribution of resources society desires can be achieved through the market mechanism. When economists speak of “market failure” it is against *this* standard of the

⁷ This is the notion of Pareto Optimality. Generally, in the Pareto Optimal market outcome, all prices are equilibrium prices, which reflect equalities between the marginal rates of substitution in consumption and the marginal rates of substitution in technical transformation. That is to say, different demanders have the same marginal values for a specific good, and different producers have the same marginal cost of producing that good, and those marginal values and marginal costs are equal to the (given) equilibrium market price of that good. For example, if the equilibrium price of a loaf of bread were \$3.00, then consumers will purchase bread until they value the last (“marginal”) loaf at \$3.00, and bakers will produce up to the point that the last (“marginal”) loaf produced cost \$3.00. In this scenario, there is no longer room for mutually beneficial trade. Other things constant, any given consumer would value *one more* loaf of bread less than \$3.00; but any given baker could produce *one more* loaf of bread at a cost higher than \$3.00, so all bargaining possibilities have been fully exhausted.

first and second welfare theorem that we are referring. Real-world markets, however, might fail to succeed in fully reaching this optimum.

Market failure, therefore, has a rather refined and specific meaning to economists. Market failure refers to cases when voluntary exchange fails to reach this *Pareto-Optimal* or “efficient” outcome. The production of a good that creates a negative externality, such as pollution, is a common example.⁸ The Weisbrod case for nonprofits focuses, however, on the potential for markets to generate *positive* externalities, and, more specifically, *public goods* problems. He views the nonprofit sector as a corrective to both market and government failure.

Suppose the production of a good generates a positive externality. But not only that. Suppose the good is such that (1) my consumption of the good does not reduce the amount available for any other consumer (economists call this “non-rival consumption”) and (2) it is technically impossible to keep free riders from enjoying their free ride. In this case, we’ve hit the defining characteristics of a public good.⁹ National defense is a traditional textbook example. Tax-supported public education, though not a pure public

⁸ A negative externality or “spillover cost” occurs whenever a voluntary exchange between two parties negatively affects (reduces the utility, or well-being) of a third party not associated with the exchange. That party bears some of the cost of the others’ actions, without being compensated by a corresponding benefit. The outcome therefore fails to meet the Pareto-Optimal notion of efficiency: the traders gain, but others lose. In this sense, the market *overproduces* goods that generate negative externalities, because the trading parties fail to account for all the additional costs (the “social” marginal costs) of production. The counterpart to negative externality is, of course, positive externality, a kind of spillover benefit. Here, a third party enjoys a benefit of other traders’ actions, without paying. Your landscaped and well-maintained lawn is a benefit to me across the street, although I don’t pay a penny for the landscapers you hired. In principle, I, the free rider, would be willing to pay something to see your lawn in good shape, if not even nicer shape. With positive externalities, the market *underproduces*. More production would occur if free riders were to actually pay for the goods that they, too, enjoy. If they have no incentive to pay, potentially mutually-beneficial exchange opportunities remain unexploited. This outcome, too, therefore fails to reach the Pareto-Optimal (what we shall simply call “efficient”) level of output. A crucial part of all of this – known formally as the theory of welfare economics – is that *the concept of market failure makes sense only against the benchmark of the Pareto-Optimal, or fully efficient, ideal*. Pareto Optimality is the ideal against which standard economic theory evaluates market efficiency and market failure.

⁹ Is your well-maintained lawn a public good? Not if, for example, you can plant spruce trees at the front of your yard, erect a fence, etc to keep others from viewing your prized property.

good, also is said to have significant spillover benefits that are nonrival and nonexcludable – not the education itself, but the fruits of having better-educated people as neighbors and coworkers. In the former, my sense of security of a national defense program doesn't reduce, in principle, the amount of defense available to others; once the defense service is produced, it is impossible to keep other citizens from also enjoying that sense of protection. In the latter example, others in society are said to gain by having children in school (from quieter neighborhoods in the daytime to smarter and more productive citizens), and it is impossible to keep them from enjoying those benefits.

The concern, then, is over the incentives participants might have in a free market have to produce an *efficient* – that is, Pareto-Optimal – level of output of a public good. Standard economic theory concludes that the incentive will be nil. This is not to say that *no* public goods will be produced in the free market; rather, it suggests that the level of output that is produced will necessarily fall short of the efficient level. Free riders, being impossible to exclude, will exist, and therefore the market fails to fully exhaust mutually-beneficial exchange opportunities. Even if it produces defense (through private militias) or education (through privately chartered schools) the market system will underproduce – it will fail to produce “enough” -- not in the sense of fairness, or justice, or what have you, but in the *refined* sense of the “optimal” or “socially efficient” outcome.¹⁰

Thus the concern with public goods, situated against the benchmark of the fully-efficient market ideal.

The theory of the public goods problem contains a clear solution – that is, a clear theory of economic policy to rectify the problem and propel the market towards the

¹⁰ Salamon doesn't seem to appreciate this point, which will become clear when we discuss his notion of “voluntary failure.”

efficient outcome. Indeed, the theory of the policy solution is, in a sense, as “simple” as the modeling of the situation that gives rise to the problem in the first place. We offer a basic discussion of the public goods model and the policy solution in the appendix to this paper.

At the same time, the pure theory, and its policy solution, become outright untenable. If our readers have even a little difficulty with our two-person example in the appendix, think of several thousand if not millions of potential “demanders” of a public good. How in the real world would policy makers – even making the unrealistically heroic assumption that they are exclusively concerned not merely with the “public interest,” but in particular with maximizing economic efficiency and generating an “optimal” outcome – come to know what each individual would be willing to pay for any particular level of output? How would they unearth that information in a world where free-riding is a possibility? Moreover, just what does it mean to be a “demander” for a good when the individual voluntarily refrains from spending her money on that good in favor of other goods and services? How, in other words, could we possibly expect policy makers to determine what the “optimal” level of output is – in the real world – and tax all beneficiaries according to their own individual values? These are thoroughly Hayekian questions, to which we shall return. For now, suffice it to say that “market failure” means a failure of the voluntary exchange process to hit a purely hypothetical optimum, therefore “government failure” – to be consistent – means a failure of the state’s powers to compel its citizens to also hit the purely hypothetical optimum.

Weisbrod’s work has the virtue of using the market failure concept correctly. It seems to us that he also uses the concept of government failure generally correctly. He

suggests, however, that the problem lies with appropriately taxing highly diversified demands across heterogeneous public goods:

Dealing with diversity – which is fundamentally a problem of information – is a major problem for government. If all consumers had identical demands for public action – whether for trust-type, consumer-protection services, or for other collective goods – this problem would disappear. When demand is diverse, though, whatever quantities and qualities of services government provides will oversatisfy some people and undersatisfy others. Can the nonprofit form of institution respond? (1988, p. 25).

Claiming that the calculation and taxation problem would “disappear” with relatively consistent demand is a ridiculous and unusually strong statement -- even for an economist! The point we wish to advance is that we – citizens, economists, policy makers, whoever – cannot possibly know people’s unexpressed “demands” in real-existing economies, *regardless* of whether or not we have apriori beliefs that those demands might be homogeneous for some goods and heterogeneous for others.¹¹ We have here the all-too-common instance of misplaced concreteness, a confusion of the model with reality. When the model doesn’t mirror reality (and trust us, we don’t harbor ideas that models can mirror reality!), welfare economists tend to conclude that *reality fails*.¹²

How does any of this relate to the viability of the nonprofit sector?

We figure if you followed us thus far, you are probably asking that very question. And our response is clear: Weisbrod suggests nonprofits can mitigate government failure.

¹¹ See Boulding’s “The Economics of Knowledge and the Knowledge of Economics” in Boulding (19??), and Hayek’s “Economics and Knowledge” and “The Use of Knowledge in Society,” in Hayek (1948, pp. 33-56 and 77-91) for a general discussion of the assumptions of our knowledge in economic theory. On the particular issue of positive externalities and public goods, see Heyne, Boettke, and Prychitko (2003, pp. 323-43) and Wagner (1996).

¹² This is one among many examples in economic theory. See Machlup (1958).

Alas, however, he doesn't demonstrate that nonprofits generate the optimal outcome in light of government failure, *nor* that nonprofits come "closer" to the optimal outcome. In fact, he *cannot* demonstrate that real world nonprofits do either. He, nor any other economist, knows what the Pareto Optimal point is for *any* aspect of society. This is not an argument against nonprofits. Instead, it is an argument that questions the value, and purpose, of the Pareto-Optimality benchmark that undergirds the market failure/government failure analysis.

Salamon's Notion of Voluntary Failure

Salamon's new paradigm is critical of the market failure/government failure explanation of nonprofits, too, but for fundamentally different reasons than ours. He seeks not to radically question standard welfare theory, but to revise it to account for yet a *third* form of failure – that of the voluntary sector itself. Standard economists chatter a great deal about failure in the market and state sectors, but if the voluntary or "third" sector is a significant one, perhaps it, too, is prone to failure.

But that project must be taken on with great care. We haven't come across any mention of Pareto Optimality in Salamon's writing, negative or positive.¹³ His objection, it appears, is over the implications of the data. His reading of Weisbrod suggests, to him, that the standard theory cannot account for the *empirical* interconnections between the welfare state and nonprofit organizations, that is, for the *fact* that nonprofits are often involved in the direct *delivery* of services, being supported through compulsory state actions through subsidies and other measures. Salamon claims this "partnership" remains

¹³ Although he does occasionally use the term "optimal," as in "So long as sole reliance is placed on a system of voluntary contributions, ..., it is likely that the resources made available will be less than those society considers optimal" (1987, p. 45). Elsewhere he talks about the voluntary sector's "limited... ability to generate an adequate level of resources" (1987, p. 48). It is completely unclear precisely what "optimal" or "adequate" mean in his new paradigm.

a factual anomaly in the Weisbrod model. But “not only does this partnership have deep historical roots,” Salamon maintains, “it also has a strong theoretical rationale” (1989, p. 204). He goes so far as to say that this “partnership” had been a “central organizing principle of the American welfare state” (1989, p. 205),¹⁴ and he believes to have established the theoretical explanation.

His case rests upon his concept of “voluntary failure” (and, because he juxtaposes this concept against market and government failure, an implicit acceptance of Pareto Optimality). But Salamon apparently misunderstands the objective of the government economic policy solution to the positive externality and public goods problem. He claims that

The central problem with the theory of the welfare state as it has been applied to the American context is its failure to differentiate between government’s role as a provider of funds and direction, and government’s role as a deliverer of services....

Far from the bureaucratic monolith pictured in conventional theories, the welfare state in the American context makes use of a wide variety of third parties to carry out governmental functions. The result is an elaborate system of “third-party government”... in which government shares a substantial degree of its discretion over the spending of public funds and the exercise of public authority with third-party implementers (1987, p. 41).

Salamon conflates the case for government *taxation and funding* of goods associated with positive externalities and public-good characteristics with government *production* of those goods. That is, he observes a world where these two functions are often separate – and labels that phenomenon “third-party government” – and also claims that standard welfare economics *cannot conceptually explain* this separation. (Hence the empirical

¹⁴ Which, he regrets, since the Reagan years had begun to lose its coveted place as the central organizing principle. See Salamon (1989, 1993). At the same time, he has hope for other forms of nonprofit-state collaboration, as in the German corporatist model and the proposals set forth in the U.K. Home Office Scrutiny Report (Salamon and Anheier 1996b, pp. 121-22).

“anomaly” he sets out to explain in his new theory.) Unfortunately Salamon shares a common but erroneous belief that the standard economist’s case *necessarily* involves a combination of government funding and production, but that just isn’t so. James Buchanan stated it clearly in one of the early, landmark works on the subject:

Collectivization, or public organization, refers to the provision of the good, its financing and distribution among separate demanders. Nothing in the discussion implies anything at all about the actual *organization of production*. Whether or not the good is purchased from privately organized firms and individuals in the domestic economy, purchased from privately or publicly organized supplying agencies abroad, or produced directly by government itself should depend on an efficiency calculus which compares these various alternatives. Collectivization of the supply, to meet individuals’ private demands, says nothing about the relative efficiency of producing the good in any one of the several ways. This is a self-evident point, and it would not be necessary to mention here were it not for the widespread confusion that seems to exist (1968, p. 186).¹⁵

Salamon’s hope to now explain “third-party government” with a new paradigm – one that can finally begin to account for this “anomaly” (in other places, “aberration” [1995, p. 6]) – is without theoretical support. Simply stated, there is no anomaly at all, for nothing in standard economic analysis suggests, as a general principle, that government intervention used to correct for market failures necessitates government *production* of those “failed” goods and services. Rather, standard analysis typically suggests that the government can improve the efficiency of the market by forcing free

¹⁵ Buchanan’s point became conventional textbook material on the theory of public goods, long available before Salamon embarked upon a new paradigm. Thus Jack Hirshleifer (1980, p. 542) writes:

According to some welfare theorists, the various difficulties in private supply of public goods dictate that they be “publicly” (i.e., governmentally) provided instead. Indeed, some have thought that the concept of public goods serves to define the proper scope of government: “Private goods” ought to be privately supplied, and “public goods” ought to be publicly supplied. But in fact we do observe private firms supplying public goods. Television broadcasting is the obvious example, but even lighthouse services have at times been privately provided. And on the other hand government agencies, while supplying public goods like national defense, are also in the business of producing a vast range of private goods. Among the many examples are electric power (TVA), irrigation water (the U.S. Bureau of Reclamation), insurance (Social Security), education (public schools), and of course postal services (the U.S. Mail).

riders to pay for the goods that they enjoy – that is, by taxing them. The specific organization of production – determining property-rights arrangements as to who will produce and supply the good or service in question, is an altogether separate matter, one that, in the standard analysis, rests with the relative costs and technical efficiencies of the private sector as compared to the public sector. Salamon’s conflation of the two is an unfortunate misunderstanding of basic economic theory, and leads him to misinterpret the implications of the data.

Now, that in itself doesn’t allow us yet to entirely reject his concept of “voluntary failure.” The standard “paradigm,” as it were, has already accounted for and explained non-government production of public and other goods with significant positive externalities. Its theoretical “lenses,” as it were, have already observed what Salamon otherwise considers unobservable.

Perhaps, on the other hand, his “voluntary failure” concept can be fitted *into* the standard analysis, and thereby provide greater clarity – and, with that, the normative defense of government-nonprofit collaboration that Salamon has tried to develop over the years.

As mentioned above, Salamon advances claims that the voluntary sector is “inherently” limited; it will likely offer services that “will be less than those society considers optimal”; it “has serious drawbacks as a generator of a reliable stream of resources to respond adequately to community needs.” He at least *implicitly* accepts the Paretian benchmark when he acknowledges the possibility of both market and government failure. To be consistent, then, he must accept that same benchmark to meaningfully speak of the “voluntary failure” to generate an “adequate” and “optimal”

level of nonprofit services. Otherwise, what else do these terms mean? To suggest that government-nonprofit collaboration *improves upon* the voluntary sector's outcomes, that it *overcomes* its inherent limitations, requires some kind of benchmark of success that is consistent with the other two failure concepts. But Salamon develops nothing of the kind, in his 1987 paper or after. He instead undertook a tremendous amount of empirical work.

Again, we think the entire welfare economics framework is flawed with unrealistic assumptions, and unrealizable goals and expectations for policy makers and government bureaucrats. Adding the voluntary-sector failure concept does not seem to improve the theory. At this level, we side with the spirit of some of Lohmann's criticisms, which we shall turn to shortly. In our view, the Pareto framework in general, and the effort of Weisbrod to apply it to nonprofits in particular, is an exemplar of misplaced concreteness. But at least Weisbrod's effort and those of mainstream economists in general have the "virtue" of clearly articulating – at the purely conceptual, theoretical level – what optimality and failure mean.

Although Salamon accepts in principle the notion of market failure and social optimality, and advances claims that "third-party government" can propel the for-profit and nonprofit sectors toward a socially optimal outcome, he, however, has not clearly articulated what *he* means by these concepts. *If* he has the Pareto-Optimal criteria in mind, he hasn't made any effort to demonstrate that the modern welfare state's funding of nonprofit services has propelled the our system closer toward the socially optimal outcome – none of his empirical work has demonstrated, nor can demonstrate, that a government-nonprofit partnership is closer, further, or at a social optimum; *nor* has his

work demonstrated that the wonderfully robust panoply of nonprofits, being disentangled from the state (a more recent development he laments), has pulled the system further away from the socially optimal result. Salamon's addition to welfare theory – voluntary failure – has not demonstrated that the nonprofit sector fails to reach Pareto Optimality nor, equally important, how the partnership between that sector and the state can – even in pure theory – bring us closer to the Pareto Optimum. Yet he raises these kinds of claims without a methodology that provides him with either clear theoretical or empirical measures of the social optimum.

Perhaps, on the other hand, our reading is all wrong. Perhaps Salamon has not offered a theoretical demonstration because he *doesn't* accept the Pareto-Optimal criteria. Perhaps he has a completely different understanding of what a social optimal outcome means. But that does not square with his acceptance of the standard “market failure” concept. And it clearly raises the obvious question of why hasn't he bothered to articulate – if only at the conceptual level – what he means when developing his own optimality criteria.

Salamon is indeed correct that the “real answer” to the questions that he seeks to address in his body of research is “more conceptual than empirical,” but the bulk of his work since formulating his theory has been predominantly empirical, guided by his concept of voluntary failure. If his conceptual framework is flawed, and we have just argued it is, then his selection and interpretation of the empirical data is also in question. On this point we find additional support in Smith (2000).

Toward an Alternative Theory: Lohmann on The Commons

We've focused on both the knowledge assumptions and the theoretical coherence of the failure project. Roger A. Lohmann (1992, pp. 159-160) also questions the failure theories of Salamon and Weisbrod, and the economic theory of the nonprofit sector in general, on the basis of the model's assumptions. His criticism differs from what we have provided so far, which suggests his proposed alternative reformulation of the theory is worth exploring.

While our criticism focuses on assumptions regarding the knowledge available to both citizens and to the economic theorists developing real-world "solutions" to less than Pareto-Optimal outcomes, Lohmann criticizes the failure project because it seems to graft a theory of narrow self-interest and profit-seeking onto a social domain that substantially differs from commercial market activity -- the domain that Richard Cournelle has called the "independent sector," Salamon calls the "voluntary sector," and Lohmann himself refers to as "the commons."¹⁶ Assumptions of pursuing one's narrow self-interests might be suitable for the study of competitive commercial activity (the for-profit sector), but he stresses -- correctly in our view -- that human action in general is not exclusively of the narrow self-interested variety, encompassed by *homo economicus*. "The calculus of costs and benefits," Lohmann laments, "has become a universal index to what is rational" (1992, p. 15). But rationality is much richer than that: "The pursuit of common goods is

¹⁶ "The term *commons* as used in this book may refer to a club or membership organization; social movement; political party, religious, artistic, scientific, or athletic society; support group; network; conference of volunteers; or to several other forms of what we think of as nonprofit or voluntary social organization. As developed here, the term is an ideal type; it distills an essential set of related characteristics that are seldom if ever empirically observable in pure form. As an ideal type, we should expect to find in any empirical commons evidence of altruistic motives and behavior; philanthropy; charity; patronage; various forms of donations and gift giving; and programs that involve search, investigation, learning, and other ways of expanding common endowments" (1992, pp. 17-18). "Commons are not places any more than are markets or states" (1992, p. 62).

rational behavior, albeit distinguishable from the self-interested pursuit of profit that characterizes markets” (1992, pp. 272-73). Reducing rationality to an overly restricted view of rational choice and calculative utility or profit maximization leads, at best, to an economic theory that treats nonprofits “as if” they were for-profit firms (1992, p. 16, 38), which, of course, “in the process dissolve[s] the very thing that is to be explained” (1992, p. 129). (This is remarkably similar to the Hayek’s and Coase’s critique of standard economic theory of perfect competition: by assuming for-profit firms act “as if” they faced perfect and complete information and zero transaction costs, there would be no reason for for-profit firms to exist at all.) Seemingly unconcerned with that contradiction, the standard economist’s approach also systematically undermines the potential efficiency of nonprofits compared to the ideal efficiency characteristics of competitive, for-profit firms:

This particular construction of the theory of nonprofit organizations begins with the critical assumption that nonprofits are a flawed or incomplete form of for-profit organization. Advocates of this position tend to assume, based on the absence of a consistent performance measure, that nonprofit organizations as a class are inherently more inefficient in the conduct of their affairs than comparable for-profit organizations (1992, p. 26).

Lohmann proposes that a theory of nonprofits ought to more clearly *understand* the interactive nature of individuals organized in nonprofit associations rather than “treat them as rather odd, intangible, and inefficient forms of productive enterprise” (1992, p. 164), for those are evaluative categories that are not so much the conclusions of careful research as they are biases already embedded into the theory’s starting assumptions.

Homo economicus would rarely find value in establishing or joining nonprofits unless, perhaps, he has something up his sleeve!¹⁷

We appreciate and agree with Lohmann's call for moving beyond the narrow neoclassical modeling of nonprofits. He believes that "some of the independent research efforts and work in nontraditional disciplines may have major implications for the rethinking of nonprofit studies" (1992, p. 8), and that "it is unlikely that these conceptual problems can be resolved within economics alone" (1992, p. 39). Lohmann's work is refreshingly eclectic, and draws from the theories of meaningful action found in Max Weber and Alfred Schutz (1992, pp. 47-48), the hermeneutics of Hans-Georg Gadamer and Richard Bernstein (1992, p. 262), and Kenneth Boulding's call for an economic analysis that can account for the motives of love and fear, as opposed to a purely maximizing calculus (1992, p. 170). As two (outlier) economists who have been inspired by the work of all of these individuals, and have tried to draw their work into Austrian economic theory, we must admit we have a somewhat partial bias toward Lohmann's efforts.¹⁸ That said, we find that Lohmann unfortunately wishes to resurrect some fundamentally flawed assumptions of classical economic theory. In other words, he slips not by pointing toward non-economic social theories, but instead by a peculiar return to classical economic theory.

¹⁷ So far we have been using "nonprofit" as a catch-all term, as most of the literature does. But it is important to distinguish "nonprofit" organizations from "not-for-profit" firms, both of which compose the independent or voluntary sector, in the following way: Nonprofit organizations are those that do not typically charge a market price for their services; not-for-profit organizations are firms that do charge a price for their services (like hospitals), and in principle can therefore calculate the expected and realized monetary "profit" or "residual" of their collective efforts. Cf. Lohmann's appeal to Anthony's distinction between Type A and Type B organizations (1991, p. 34). Lohmann's "commons" is that sector composed exclusively of nonprofit associations.

¹⁸ See, for example, Boettke (1995a, 1995b), Prychitko (1995b, 1995c), and Boettke and Prychitko (1996). Lohmann's appeal to the role of producer cooperatives (1992, p. 143) also finds a sympathetic ear with one of us. See, for example, Prychitko and Vanek (1996).

Is unproductive labor common in the commons?

Lohmann puts it the following way:

An adequate economic model for analysis of the commons ought to begin by studying actual economic institutions, like donations and endowments, and by adjusting or suspending three conventional economic assumptions: scarcity, production, and maximization. The economics of common goods does not require rejecting the concept of scarcity entirely. However, acknowledgment of the moral and rational consequences of affluence or social surplus is important (1992, pp. 160-61).

Lohmann supports what he calls “existential” scarcity – basically, the universal fact that people must choose, as wants exceed what is available (1992, p. 161). So far so good. That’s all what economists mean (or should mean) by the term. He questions the role of models wedded exclusively to maximization (1992, p. 163), and suggests it should lose its “privileged position” as a universal approach to social action. We generally agree with him here, too.¹⁹ He slips a bit – as many non-economists do – with his use of the term “surplus,” but our concern lay chiefly in his use of the term “production.”

He calls back to Adam Smith’s *Wealth of Nations*:

Nonprofit economics grounded in failure theory treats nonprofit organizations by analogy with (as if they were) the profit-oriented firms of microeconomics.... Adam Smith’s distinction between productive and unproductive labor,..., is ignored or overturned in the contemporary concept of volunteer labor [cites Weisbrod]. Such an approach is defensible in the analysis of revenue-generating nonprofit firms like hospitals; nursing homes; and some museums, theaters and concert halls, where clear-cut prices are exchanged for recognizable products. However, the rationale for treating “unproductive” (nonrevenue) membership clubs; donative charities; and a broad range of other religious, scientific, or artistic commons as if they were commercial firms is highly questionable. Yet because of the widespread commitment of nonprofit economics to the market firm analogy, no other economic models of the commons have received serious consideration. *A major project confronting nonprofit and voluntary action researchers, therefore, is to begin the construction of a genuine economics of*

¹⁹ Alchian provides a strong critique of the maximization modeling even of for-profit activity in his classic 1950 paper, one which clearly had an early influence on Boulding (1958) and has inspired more recent work in evolutionary and new institutional economics.

common goods premised on more plausible and relevant assumptions (1992, p. 160; our emphasis).

We agree especially with Lohmann's last point. Note that the instrumental nature of mainstream economic theory is not concerned with the descriptive realism of its assumptions, but with its ability to make accurate predictions. Lohmann's argument here suggests that instrumentalism has largely run its course – at least with regard to nonprofits – and, moreover, as mentioned earlier, proceeds with biases that tend to already cast doubt on the viability and value of nonprofits before the research is undertaken.

But we are troubled with his appeal to Adam Smith. Is Smith's distinction between productive and unproductive labor something that a new economic approach to nonprofits ought to reconsider? It, and Smith's corresponding definition of wealth, has been a source of discussion in the nonprofit literature, including the work of Bruyn (1991, pp. 322-325), who himself laments that Smith denigrated the service sector and created a strictly material notion of wealth that he believes haunts us to this day.²⁰

Smith, and the early classical in general, confined "wealth" to material goods production.²¹ Smith dichotomized material goods from services, and argued that labor used to produce material goods was categorically different from labor employed for services, if only as an analytical convenience. For Smith, labor is *productive* if it

²⁰ "Since productivity has always been associated with material wealth in the industrial society, many economists question the degree to which services actually generate wealth and are of value to society," laments Bruyn (1991, p. 324). "The issue, finally, as more and more social scientists are coming to realize, is finding a way to measure social wealth" (1991, p. 325). We shall suggest such a measure will be impossible.

²¹ See Kirzner's (1976) discussion of the evolution of economic theory, from the science of wealth (as found in Smith and the classical) to the neoclassical science of economizing and maximizing (with Lionel Robbins, a subject of criticism by Lohmann [1991, p. 151]), to a more comprehensive theory of human action in general, in the work of Mises and the Austrian School.

increases the output of material goods (wealth); it is *unproductive* if it only provides services.²² Productive labor is that which creates vendible commodities.

Lohmann supports Smith's distinction because of his reservation that the mainstream economics literature "equates all types of human behavior with production," which he believes "must be explicitly rejected in the case of the commons" (1992, p. 162). He regrettably supports Smith's distinction and argues that because nonprofits are not producing vendible commodities (recall, nonprofits -- as we are using the term -- don't produce anything for sale on the market), the labor involved in nonprofit associations (the commons) is "unproductive" and *therefore not amenable to the standard profit-maximization analysis*. In other words, it's a fundamentally different category of labor that can't be pigeon-holed into the standard maximization model. It is, using Smith's term, *unproductive* labor. For Lohmann, the neoclassical treatment continues to ignore this crucial distinction.

²² Smith:

There is one sort of labour which adds to the value of the subject upon which it is bestowed: there is another which has no such effect. The former, as it produces a value, may be called productive; the latter, unproductive labour. Thus the labour of the manufacturer adds, generally, to the value of the materials which he works upon, that of his own maintenance, and of his master's profit. The labour of the menial servant, on the contrary, adds to the value of nothing. Though the manufacturer has his wages advanced to him by his master he, in reality, costs him no expense, the value of those wages being generally restored, together with a profit, in the improved value of the subject upon which his labour is bestowed. But the maintenance of a menial servant never is restored. A man grows rich by employing a multitude of manufacturers: he grows poor, by maintaining a multitude of menial servants (1937, p. 314).

The labour of some of the most respectable order in the society is, like that of menial servants, unproductive of any value, and does not fix or realize itself in any permanent subject, or vendible commodity, which endures after that labour is past, and for which an equal quantity of labour could afterwards be procured (1937, p. 315)

Smith continues by citing "the whole army and navy.... churchmen, lawyers, physicians, men of letters of all kinds" as well as "players, buffoons, musicians, opera-singers, opera-dancers, etc"

The Austrian Contribution

In our view, returning to Smith's distinction won't solve a thing. There's of course the peculiar irony that the promotion of the nonprofit sector would imply, if we follow Lohmann, the exalting of "unproductive" labor! But much more importantly, the distinction makes absolutely no sense, and this is precisely where an Austrian understanding of wealth, production, and ultimately calculation can contribute to the kind of alternative theory of nonprofits that Lohmann seeks.

What is wealth?

In its most broad sense, wealth is simply *anything* that a person values. Smith and the classicals developed an economic theory to try to explain material wealth, which leads him to make the distinction between labor that produces material things – vendible commodities – and labor that produces services. But in the subjective theory of value, wealth is whatever a person strives for: it of course consists of material things (from food, water, and shelter to fast cars, video games and money), but it also consists of the nonmaterial (such as love, respect, intelligence). As we put it in our textbook (Heyne, Boettke, and Prychitko 2003, p. 18), equating wealth strictly with material things makes no sense in a theory of choice, and must be rejected at its root.

What is production?

The creation of wealth. Of course, we typically picture the construction of new buildings, roads, bridges as productive activities. New *things* have been created. But production is not be limited to the production of new things. Simple acts of trading already produced items (as a barter, for example) is productive because it increases the wealth of both trading parties. Each individual in a voluntary trade sacrifices something

they value for something they value more highly – each individual gains (or, at least expects to gain) more by engaging in the exchange, otherwise it would not be voluntarily undertaken. Most modern economists have this understanding of wealth and production in mind, even if they tend to focus largely on the production of material wealth (see Heyne, Boettke, and Prychitko 2003, pp. 17-20).

Why doesn't the productive/unproductive labor distinction make sense?

Because the restriction of wealth to material things is simply too limited. Mises stated this clearly in his 1933 work, *Epistemological Problems in Economics*:

Because the classical economists were able to explain only the action of businessmen and were helpless in the face of everything that went beyond it, their thinking was oriented toward bookkeeping, the supreme expression of the rationality of the businessman (but not that of the consumer). Whatever cannot be entered into the businessman's accounts they were unable to accommodate in their theory. This explains several of their ideas – for example, their position in regard to personal services. The performance of a service which caused no increase in value that could be explained in the ledger of the businessman had to appear to them as unproductive. Only thus can it be explained why they regarded the attainment of the greatest monetary profit possible as the goal of economic action. Because of the difficulties occasioned by the paradox of value, they were unable to find a bridge from the realization, which they owed to utilitarianism, that the goal of action is an increase of pleasure and a decrease of pain, to the theory of value and price. Therefore, they were unable to comprehend any change in well-being that cannot be valued in money in the account books of the businessman (1981, p. 175).

[W]ith the scheme of the *homo economicus* classical economics comprehended only one side of man – the economic, materialistic side. It observed him only as a man engaged in business, not as a consumer of economic goods (1981, p. 180).

Mises argued that economics, as a theory of choice, cannot restrict itself to the calculative rationality personified by businesspeople – call it simply *homo economicus* – and claim universal applicability. Mises would call for a *praxeology* (1981, p. 180) – a general

theory of choice that does not succumb to distinguishing choice in a heterogeneous way, and would later attempt a full-blown praxeological theory (1966).

Calculation

One of Mises's greatest achievements was in developing a theory of economic calculation. In the Austrian tradition, calculation has a refined meaning. It is not merely measurement, as in some input-output flow chart. (After all, the Soviet planners could measure how much land, labor, fertilizer, tractors and so on it took to generate a ton of wheat on the collective farms. What they couldn't do was calculate the value added of that effort to determine whether they used those resources efficiently and productively. Lacking market generated prices, they had no way of solving, with Mises, "the task of allocating [scarce resources] to those employments in which they can render the best service" (1966, p. 207).) This makes for an economic and social disaster, for the efforts of planners *can't* coincide with the interests of the socialist system's citizens. They lack the knowledge to plan the economy successfully because they lack the ability to calculate.

Measurable data – call it simply information – does not in itself allow for rational economic calculation, as Mises employs the term. In fact, he goes so far as to say "the distinctive mark of economic calculation is that it is neither based upon or related to anything which could be characterized as measurement" (1966, p. 209). This might sound strange – indeed, it does sound strange -- but Mises argues that measurement implies a fixed unit of measure (say, the length of a yardstick), but calculation *requires market-generated prices*, and prices themselves are not immutable units; they change over time, whereas the yardstick doesn't.

This language can be confusing to non-economists, so we shall save a lengthy discussion and jump to the bottom line: Economic calculation, as Mises and Austrian economists in general use the term, is only possible with monetary prices established in markets. *Calculation of profit (or loss)* -- the residual or added monetary value of a firm's activity -- can *only* be determined by market prices. Mises insists that "money prices are the only vehicle of economic calculation" (1966, p. 201; also see pp. 208-209, 229).

Just what is calculated?

Mises insists that "Monetary calculation is not the calculation, and certainly not the measurement, of value" (1981, p. 160). Monetary calculation allows decision makers -- say, for-profit entrepreneurs -- to calculate the expected monetary *residual* of their efforts -- the total revenues from the total costs of their efforts. It also allows them to assess after the fact whether their expectations were realized (in the form of a monetary profit or loss). Monetary calculation does not generate an objective measure of value -- for value, in an economic theory of choice, resides in the eyes of the choosers (though, admittedly, it can have an intersubjective dimension).

Can not-for-profit organizations calculate?

Yes. Recall our distinction between nonprofit organizations and not-for-profit firms. Not-for-profit organizations that face market prices for their inputs, and charge a market price for their service or product. As long as their inputs and outputs are priced through the voluntary exchange of providers and recipients (the "market mechanism," as it were) the expected residual (or profit, distribution issues aside) can be calculated, as well as the realized residual (the actual profit or loss).

For these kinds of not-for-profit organizations, ones that price their services, calculation can and does occur. The donors themselves can receive, in principle, a calculative measure of the (monetary) value added that occurs, or fails to occur, in specific not-for-profit organizations, and therefore have a guide that frames their choices accordingly. (Now, there are important incentive issues that can be raised –specifically principal-agent issues -- but that is separate from the calculation issue. Our remarks focus solely on whether or not a calculation problem exists in the philanthropic sector. These enterprises earn a profit, which can be calculated, but the profit is not owned by an entrepreneur. They might *make* profit, but the profit is not *for* any individual in particular.)

Most non-commercial voluntary organizations, including the millions of grassroots associations in the Commons, however, do not calculate.

And *here's* what Lohmann is really trying to point out. Voluntary organizations and associations may, and surely do, purchase or lease inputs on the market, and are therefore guided by prices at that stage, but they don't price their "product" or service (however they define it). They can provide *measurements*, and, if encouraged, a rational assessment of their outcomes (using both quantitative and qualitative means), but they have no way of *calculating* the realized results against the expected results. Nonprofit organizations and associations cannot, in other words, calculate the residual or the monetary value-added of their endeavor, ex ante or ex post. In this sense, *nonprofit* is a better term for those that don't price their service or product. There is no calculated monetary profit.

We suggest that the distinction between calculative and noncalculative action is more productive, as it were, than Smith's distinction between productive and unproductive labor. But perhaps there is a troublesome aspect of these kinds of nonprofits: calculation does not and cannot exist. If we stick with Mises's definition and understanding of calculation – which we want to do – there is either calculation or there isn't. There are no “proxies for calculation” – issues of trust, reputation, satisfaction and so on might serve as effective guides to action, but they cannot serve as sources for calculation itself. Market prices are a necessary and sufficient institution that allows for calculation (although inflation can severely distort that role). Pseudo-calculation means, in effect, *no* calculation in the Austrian perspective. Without a priced service, the agents of nonprofit organizations and their donors might engage in “pseudo-calculation,” but let's understand that that really means no calculation. We suggest it would be vain for theorists or practitioners to try to discover or invent some kind of pseudo-calculative proxy for price and thereby claim that they've “solved the calculation problem” in the nonprofit sector. This also implies that the search for a calculation of “social wealth,” or even a standard measurement, is problematic.²³

²³ Mises (1981, p. 159):

Therefore it is absurd to want to apply the elements of this calculation to problems other than those confronting the individual actor [in the market process]. One may not extend them to *res extra commercium*. One may not attempt by means of them to include more than the sphere of the economic in the narrower sense. However, this is precisely what is attempted by those who undertake to ascertain the monetary value of human life, social institutions, national wealth, cultural ideals, or the like, or who enter upon highly sophisticated investigations to determine how exchange ratios of the relatively recent, not to mention the remote, past could be expressed in terms of “our money.”

Does this imply that this set – the largest set – of philanthropic enterprise will tend to be inherently wasteful?

Salamon, of course, has his own (problematic) answer to this question, related to his use of the voluntary failure concept. At first blush our suggestion that individuals in nonprofit organizations are engaged more in a noncalculative activity might be troublesome for economists who consider calculation to be a necessary condition for rational and effective human activity.

In a sense, when studying the nonprofit sector we are moving from the domain of economics (and calculation) to the broader realm of praxeology, the general theory of human action, as Mises himself distinguished these terms (1966, p. 234). And *this* is what Lohmann really has in mind, and justifiably so. *Economics* is that subset of praxeology that deals with calculative action (1966, p. 199), but not all human action is “economic” and calculative (1966, p. 231). We are moving in part into that realm of human action that straightforward economic theory, with its emphasis on calculation, can’t quite capture. Economics is, Mises insists, the most elaborated subset of a more general theory of human action (1966, p. 3). But economic calculation is not synonymous with human action, and it would be a great mistake to claim that only calculative action delivers rational and efficient outcomes.

The following statements by Mises (1966, pp. 214-15), which we shall quote at length, should help clarify what’s at stake in our exploration of the nonprofit sector (please forgive our bracketed interjections):

Economic calculation cannot comprehend things which are not sold and bought against money. [Like the services of nonprofits]

There are things which are not for sale and for whose acquisition sacrifices other than money and money's worth must be expended. He who wants to train himself for great achievements must employ many means, some of which may require expenditure of money. But the essential things to be devoted to such an endeavor are not purchasable. Honor, virtue, glory, and likewise vigor, health, and life itself play a role in action both as means and as ends, but they do not enter into economic calculation.

There are things which cannot at all be evaluated in money, there are other things which can be appraised in money only with regard to a fraction of the value assigned to them. The appraisal of an old building must disregard its artistic and historical eminence *so far as* [my emphasis] these qualities are not a source of proceeds in money goods vendible. What touches a man's heart only and does not induce other people to make sacrifices for its attainment remains outside the pale of economic calculation.

However, all this does not in the least impair the usefulness of economic calculation. Those things which do not enter into the items of accountancy and calculation are either ends or goods of the first order. No calculation is required to acknowledge them fully and make due allowance to them. All that acting man needs in order to make his choice is to contrast them with the total amount of costs their acquisition or preservation requires. [And here Mises turns to a rather remarkable example!] Let us assume that a town council has to decide between two water supply projects. One of them implies the demolition of a historical landmark, while the other at the cost of an increase in money expenditure spares this landmark. The fact that the feelings which recommend the conservation of the monument cannot be estimated in a sum of money does not in any way impede the councilmen's decision. The values that are not reflected in any monetary exchange ratio are, on the contrary, by this very fact lifted into a particular position which makes the decision rather easier [yes, easier!]. No complaint is less justified than the lamentation that the computation methods of the market do not comprehend things not vendible. Moral and aesthetic values do not suffer any damage on account of this fact.

The last passage is rather remarkable not because Mises argues that calculation is not required to make a rational decision to possibly spare the landmark – which is the point we are trying to make -- but because he makes a case for a town council – of all things – to be able to embark upon the decision rationally and efficiently!

Be that as it may, this hits the heart of the issue. Nonprofits are not isolated islands of human activity. Like another institution, the family, participants in nonprofits

are themselves embedded in the institutional matrix of the market economy. Nonprofits have prices to guide them, particularly when purchasing or leasing inputs. In this way they can coordinate their resource demands with the supplies of resource providers, they can and do participate in the knowledge-disseminating features of the market process. They cannot *calculate* the value added of their efforts (like Mises's tax-supported councilmen above, whom he is not criticizing, even though their efforts are supported by the power to tax), but they can determine whether their specific goals and efforts are worthwhile. Nonprofits have to persuade the donors that their effort is worthwhile, of course. Rather than persuade them with the lure or calculated signal of monetary profit, they must resort to non-calculative but measurable or assessable means. There is no *inherent* inefficiency (in the sense of plan fulfillment) created by the lack of calculation itself.

We suggest that the managers of nonprofits, the social entrepreneurs, and their donors are also able to make such decisions as to the effectiveness of their activities even though they cannot calculate the value added in a monetary sense – calculation being, again, a dollar measure of the total costs of their efforts and the total benefits of their efforts, the difference being monetary profit (or loss). We would add that they would have a greater incentive to do so as well (at least compared to Mises's councilmen), because they cannot rely upon the power to tax. Instead, they must depend upon the voluntary contributions of their donors. (This of course is problematic in our society – many nonprofits often bypass the responsibility of persuasion and voluntary exchange and instead seek support from the state, not unlike many business enterprises.)

The Bigger Picture: Governance and the Nonprofit Sector

We feel the theoretical alternative to Lohmann's productive/unproductive labor concept should be jettisoned in favor of the distinction between calculative and noncalculative rationality. With Lohmann, we feel the nonprofit sector is viable (and, we should add, productive!). This leads us back to raising the normative issue of whether The Commons should be a largely independent sector, or whether its "partnership" with the state is a promising development.

Independence and constitutional constraint

The theoretical alternative to Salamon's "third party government", we suggest, would build on the distinction between the financing and provision of so-called public goods that Salamon's considers so anomalous to standard economics. As we argued above, it is not anomalous in the least, and the distinction is in fact crucial to keep in mind. James Buchanan (1975) has distinguished in his work between the protective state (national defense, courts, and police), the productive state (provision of public goods such as roads and bridges), and the redistributive state (interest group politics, rent-seeking, and welfare policies). In the Buchanan constitutional political economy project, the task is to at one and the same time empower the protective and productive state yet constrain the redistributive state through constitutional construction. The problem, of course, is whether such a balancing act can indeed be accomplished once the power to tax is established. Unless there are strong constraints on the expansion of state power, the natural proclivity of the state would be to use its power of tax to benefit some at the expense of others.

In a free society, the voluntary sector plays a crucial role in reinforcing the constitutional constraints to make sure that government is limited to those activities, and only those activities, which it has a reasonable claim to engage and use its coercive power of taxation and monopoly provision. Now that is not the primary purpose or goal of nonprofit and philanthropic enterprise. Voluntary-sector associations are organized to serve particular human needs. Rarely – if ever – do the agents of such associations have in mind the objective of limiting the compulsory powers of the state. But that’s precisely what makes this function so elusive. A robust, interconnected system of nonprofits and other civil-society associations-- as an unintended consequence – function to reinforce constitutional constraints on the state. And it’s this unintended, though systematic feature, of the voluntary sector that is ignored by standard analysis, and by Salamon’s approach.

Many people misunderstand the argument made by economists such as Buchanan or Friedman or Hayek concerning the role of government. Their concern is less with the scale of government than the scope. Of course, the absolute size of government can be a concern given fiscal realities. But the primary concern is the activities government attempts to tackle. There are those activities which government should not be involved with in a free society. In the United States, for example, the general population would object strongly if government attempted to take over the financing and production of religion and perhaps even news services, but they don’t object to government financing and provision of educational services. It is not our purpose here to debate these issues, but simply to argue that Salamon’s lack of conceptual clarity leads him to err in explaining the functional significance of the voluntary sector in a society of free and

responsible individuals. The voluntary sector ceases to serve this function when organizations within it partner with the coercive powers of the state. It is at that juncture that neither government nor market shortcomings can be overcome by this “third sector” because, instead, nonprofit organizations are transformed into rent-seeking entities which are dependent on tax-finance rather than the voluntary contributions of individual donors. Certainly these organizations provide goods and services, but are the necessary feedback and disciplinary mechanisms in operation to ensure that good intentions are channeled in a direction which generates desired results?

Institutions and information

Hayek’s work encourages readers to consider the capacity of learning within alternative institutional settings. Essential to the learning process is blunt and continual feedback to actors so they may become informed about the effectiveness of previous actions. It is precisely because in social interactions human intentions do not automatically equal the realized results that a results-orientation must trump considerations of intentions and moral intuition in economic analysis. Actors must be disciplined to align their behavior with desired outcomes, and they must be continually informed about how best to align their behavior. In a for-profit setting actors receive signals through the price system that aligns their incentives appropriately. In the political setting of democratic politics, political actors are disciplined in theory through the vote mechanism. In the nonprofit sector, actors must rely on the signal of voluntary contributions and construct measures of output to show that desired results are in fact being achieved. This is an admittedly

difficult project, not only for the real-world participants within this sector, but also for theorists who strive to explain the coordinating properties of the sector.²⁴

Politics also does not work as smoothly as theory might predict. The vote mechanism is not as effective at disciplining politicians because of various public choice problems. Markets, while undoubtedly very effective at disciplining actors, cannot be relied upon to price many products that are nevertheless essential to creating a vibrant and just community. Thus, it is important to delineate the appropriate role of government and look at the functional significance of nonprofits in filling in the gap left by government and the market. But again, this voluntary sector can only serve this role if it is denied access to the power of tax.

Cooperation and competition

Hayek (1979), building on the work of Cornuelle (1965), argues that an independent nonprofit sector has great potential for ensuring social cooperation by mobilizing individuals to work to improve community environment, health, education, work opportunities, and even the basic codes of conduct we rely on in our daily intercourse. Ironically, Cornuelle contends, as the voluntary sector gained the power to accomplish more things due to technological innovations in the 20th century, ideological shifts led to a situation where more of these activities were turned over to the government rather than the voluntary sector. Hayek suggests that in order to buck this trend we need to insist on restrictions on the scope of government activities and to separate not only finance and provision of those services done by the government but also to challenge the monopoly of

²⁴ See Boettke and Rathbone (2002) for a discussion of the difficulties facing the philanthropic enterprise.

provision.²⁵ It may indeed be the case that certain goods and services cannot effectively be provided by the market (given the current technological stage of development), but this should not be seen as a justification either for coupling finance and provision, let alone monopoly status in provision. In particular, Hayek warns that claims to monopoly provision by the state are made not in order that citizens will be better served, but instead to enhance the powers of the government (see 1979, p. 56). As such even when it has been established that the government should finance and produce a particular good or service, the claim to be a monopoly provider must be denied. The most harmful abuse that consumers face in their everyday life is not enduring high prices, but “the political coercion to make uneconomic use of resources” (1979, p. 59).

Competition, whether in the for-profit market setting or amongst nonprofit entities attempting to meet the needs of particular populations, ensures that actors will constantly be under pressure to respond more effectively in the production and distribution of the products under consideration. None of these processes will hit a hypothetical Pareto-Optimal outcome. Rather than compare markets, the nonprofit sector, and the state against an unattainable benchmark, however, we suggest that a positive theory ought to adopt a comparative-institutions analysis, one which addresses the dissemination of knowledge among participants as well as their incentives to act on that knowledge in ways to further coordinates their plans. We suggest, with Hayek, that monopoly privilege

²⁵ As he argues at one point, emphasizing the scale/scope issue, “In recent times it has been seriously maintained that the existing political institutions lead to an insufficient provision for the public sector. It is probably true that some of those services which the government ought to render are provided inadequately. But this does not mean that the aggregate of government expenditure is too small. It may well be true that having assumed too many tasks, government is neglecting some of the most important ones” (1979, p. 53). Hayek does argue that we should worry about the scale of government, but the issue of scope may indeed be the more important. Government must be restricted to those tasks that it can accomplish with reasonable effectiveness and strictly prohibited from engaging in those activities which it cannot accomplish in an efficient manner. The clarity of this delineation is clouded by the coercive power to levy taxes and to establish a monopoly in provision of the good or service under consideration.

and the coercive power to tax to finance one's activities thwart the learning process and lead to ineffective use of resources and the inability to effectively meet the demands of the target population, *compared against* the free market and the independent voluntary sector. Those who advocate a partnership between business and government on the one hand, and the voluntary sector and government on the other, as well as government taking on more and more responsibilities in our economic life, fail to recognize "that every step made in this direction means a transformation of more and more of the spontaneous order to [sic] society that serves the varying needs of the individuals, into an organization which can serve only a particular set of ends determined by the majority --- or increasingly, since this organization is becoming far too complex to be understood by the voters, by the bureaucracy in whose hands the administration of those means is placed" (1979, p. 53).

We suggest, then, that the sort of "third party government" advocated by Salamon would distort the incentives for innovation, for filling in the gap left by for-profit firms and traditional government bureaucracies. It would not invigorate the voluntary sector. His lack of conceptual clarity has led Salamon into an error in analysis about how the voluntary sector can most effectively meet the demands of its constituency.

Appendix: The Standard Economics of the Public Goods Problem

The textbooks typically model the public goods problem with the simplifying assumption of only two demanders. (Once you understand the two-demander case, the n -demander case becomes apparent.) Suppose the public good is defense. Demander A, for whatever reason (ranging from his psychological state to the amount of property he owns) is willing to pay, say, \$3,000 per year for one “unit” of defense services, \$2,000 a year for a second “unit”, and \$1,000 per year for a third “unit” and nothing for a fourth “unit.” Demander B, for whatever reason, has different tastes. (People can, and do, have different tastes.) She’s willing to pay \$2,000 per year for one unit, \$1,000 per year for a second unit, and nothing for a third. Suppose also that the cost of producing any additional unit of defense service is \$3,000 per year, and that the for-profit provider of the service can, at best, charge the break-even price of \$3,000 per unit.

Now, it might turn out that both parties wait to see what the other party will do. That is, each hopes to free ride, and therefore nothing gets produced. Or, at the \$3,000 price, A decides to “subscribe” to 1 unit of defense service. His tastes dictate no further purchases. But once the unit is deployed in the area, not only does A benefit; B also enjoys the full benefit of a unit of defense service without having to pay. In the model, we – as economists and would-be policy devisers – *already know* not only A’s marginal benefit from the service (\$3,000). We also know B’s marginal benefit: it’s \$2,000. (How do we know that? It’s already built into our assumptions. A values 1 unit at \$3,000, and B values it at \$2,000.) How can we conclude that the free market “underproduces” the public good? Well, *taken together*, the “social marginal benefit” to the demanders is \$5,000. Yet, the cost of producing the defense service is only \$3,000.

The for-profit firm collects only \$3,000 from A, and acts accordingly; having no power to “tax” demander B (or any other demanders in the *n-person* case), it voluntarily produces only 1 unit of defense service. Because both “demanders” value the good more than its additional cost of production, there’s room for further beneficial trade to *all* parties – A, B, and the firm itself. The firm could profitably expand its output, with *no* harm to A or B. B’s free riding prohibits – if only unintentionally – this outcome.

What, then, is the “optimal” level of output that this market fails to hit? Graphical analysis would clearly show that it’s 2 units. Recall that A values a second unit at \$2,000. B values a second unit at \$1,000. Taken together, the “social marginal value” is therefore \$3,000, and that is *exactly* the marginal cost of producing a third unit of defense service.

What to do? The standard policy solution is already at hand. *Because we have all the necessary information at our disposal*, we could propose that the state steps in and taxes both A and B. A is forced to pay a tax of \$2,000 per unit (that’s his marginal value placed on the second – and in this case optimal – unit of defense service) and B is forced to pay a tax of \$1,000 per unit (that’s her marginal value placed on the second unit of defense service). Nobody free rides; everybody pays not their “fair share” per se or the “just price,” or what have you, but rather a tax that reflects the additional value they place on the optimal level of output. Those taxes go – in our example – to subsidize the for-profit defense firm. A pays a total of \$4,000 and B pays a total of \$2,000, which adds up to \$6,000 revenues for the firm. With \$6,000 the firm would produce 2 units of service.

In this simple scenario, while the market failed, state intervention propelled the market to its optimal, or socially-efficient outcome. This all appears fairly straightforward in the 2-person case. Actually, however, so-called public goods are rarely if ever a problem for markets in small-number cases. Social pressure might be enough to encourage B to give up the urge to free ride. In *n-person* cases (where *n* is stylistically large, such as 5,000 or 5,000,000) an individual enjoys greater anonymity, and the concern for the market provision of public goods is greater.

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