Is an Independent Nonprofit Sector Prone to Failure?

Toward an Austrian School Interpretation of Nonprofit and Voluntary Action

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Introduction

Nonprofit organizations have traditionally been considered a legitimate alternative source for the services provided today primarily by the bureaucratic welfare state (Berger, Neuhaus, and Novak, 1996). Taken together, nonprofit organizations can be viewed as a vibrant but largely "independent" sector characterized by a spontaneous ordering of associations that are founded neither on the state's compulsory power nor on the capitalist's search for private monetary profit (Cornuelle, 1965). In an extensive body of work, however, Lester Salamon, one of the leading scholarly investigators of nonprofit organizations, questions the "independence" of the sector.[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 or alternative source of services, Salamon sees nonprofits as being 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, and that on its own it is prone to failure. Salamon points to the aftermath of the September 11th attacks as evidence:

> 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 nonprof-

Boettke, Peter J. and David L. Prychitko. 2004. Is an Independent Nonprofit Sector Prone to Failure? Toward an Austrian School Interpretation of Nonprofit and Voluntary Action. *Conversations on Philanthropy I*: 1-40. ISSN 1552-9592 © 2004 DonorsTrust.

it 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 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, 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. Salamon's theory of third-party governance is recognizable as a species of postcommunist scholarship seeking new foundations for strong state action in social and economic planning. Much of today's postcommunist analysis—epitomized by the work of economist Joseph Stiglitz (1994), among others[2]—has turned not toward free and open markets but instead toward the market-based welfare state. Salamon's longstanding advocacy of "third-party government" strikingly resembles this postcommunist justification of the state and likewise relies on an economic critique. Salamon proposes that the rise and evolution of "third-party government" was missed, misinterpreted, or, worse, ignored outright by scholars, largely because of 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, 159-76) agrees that the standard theory fails to understand the nature of the nonprofit organization, but he argues this for reasons that differ substantially from Salamon's.

This paper outlines 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), examines the potential for Lohmann's suggested revisions, and begins to explore how Austrian economic theory can advance our understanding of the social role of nonprofit voluntary organizations.

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 Salamon's attempt to rectify the shortcomings of the Weisbrod model. We shall also explore Lohmann's criticism of the economic theory of nonprofits, which encompasses the attempts by Weisbrod and Salamon. We argue that although some of Lohmann's criticisms are generally correct in spirit, his 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 developed using the insights of Austrian economic theory. We conclude with a preliminary discussion of the political economy of the nonprofit sector in general.

A Salamonic Paradigm? Voluntary Failure and Third Party Government

First we must more clearly describe Salamon's approach. Again we will let Salamon's written words speak for him:

> 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, 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, 5), and he has developed a wide reputation for a large body of empirical work that appears to support his theory.[3]

Salamon believes his theory provides a new "paradigm"—in the Kuhnian sense (1987, 36; cf. Salamon and Anheier 1996b, 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 perspective, our purpose here is not to engage in an argument over competing ideological visions.[4] We wish instead to examine Salamon's paradigmatic theory. Salamon attempts to engage in nothing less than a theoretical reconstruction of economic analysis, specifically targeting the notions of market failure and government failure. To this mix he adds 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 through the wrong theoretical lenses.[5]

The standard literature posits that nonprofit and philanthropic organizations arise in response to both market failures (due to free rider problems) and government failures (due to development of programs that meet the demands of the "majority" of constituents but leave unmet the demands of others).

Burton Weisbrod's thesis (1988, 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; in specific cases, however, particularly with respect to 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) the provision of public goods by employing its coercive powers to tax free riders (i.e., those who would enjoy consuming a public good but who have little or no incentive to voluntarily pay to obtain it).

Weisbrod suggests that government intervention of this nature 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, for example, of 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 is much more complex. Although it might be assumed that most "everybody" in the country enjoys at least a certain level of national defense, not "everybody" enjoys or rides for free on the services provided by Alcoholics Anonymous, the Muscular Dystrophy Association, the Sierra Club, or the Little Sisters of the Poor. While these services *might* display some characteristics of public goods (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 prevent—if only unintentionally—the optimal production of these services. This shortcoming 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 place 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 marketplace.[6]

Salamon (1987, 39; 1992, 125; Salamon and Anheier 1996, 9-10) criticizes Weisbrod for failing to acknowledge an empirically robust partnership between nonprofits and criticizes the state for failing to recognize that nonprofits and the state are not mere substitutes for each other but are in fact symbiotic complements. Salamon suggests that the existing partnership between nonprofits and the state simply cannot be explained or predicted in traditional analytical constructs. Rejecting 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, 43).[7]

At the core of Salamon's self-described paradigm are the notions of efficiency and its converse, inefficiency. By advancing claims that a set of institutions—market, voluntary, or government—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? Just how might nonprofits be inefficient, or how might they be deemed "inherently limited?" What scientific basis does Salamon 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 are "more conceptual than empirical" (1987, 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. Nevertheless, we believe (and can argue in detail) that Salamon fails to establish firmly the notion of voluntary-sector failure and the efficiency-enhancing role of the state among nonprofits. Salamon's ideological sentiments favor a robust linkage between nonprofits and the state, but we do not believe he has 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 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.

Weisbrod, Salamon, and most other commentators on the economics of the nonprofit sector draw upon welfare theory, a theoretical model in neoclassical economics that, in our estimation, cannot deliver the goods. This is a strong claim on our behalf, one which requires us to reexamine the standard economic analysis of "market failure."

Success and Failure: A Lesson in Basic Economic Theory

What do economists mean when they say that a market "fails?" And what do they mean when they say that state intervention can alleviate market failure? What, if anything, does government failure mean in this context? Let's briefly examine 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.

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 better understand these concepts, we must first imagine an idealized economy in which all participants enjoy several limiting assumptions, including the following: full and complete information; zero transac-

tion costs; prices that they take as given (i.e., beyond any individual's or coalition's ability to manipulate). Standard economic analysis has established that individuals within this hypothetical economy will exercise the ability and the incentive to exchange goods and services freely, 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.[8] 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 simultaneously achieve production efficiency (i.e., all least-cost technologies will be employed), exchange efficiency (all mutually beneficial gains from exchange will be exhausted), and product-mix efficiency (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 first and second welfare theorem that they are judging. Real-world markets, however, might not succeed in fully reaching this optimum.

Market failure, therefore, has a rather refined and specific meaning to economists. Market failure refers to cases where 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.[9] The Weisbrod case for nonprofits focuses, however, on the potential for markets to generate *positive* externalities, and, more specifically, *public goods* problems. *Government failure* comes into play in the context of solving the problems associated with using state action to optimize delivery of public goods. While market failure means a failure of the voluntary exchange process to hit a purely hypothetical optimum, government failure, to be consistent, must mean a failure of the state to compel its citizens to act in ways such that the hypothetical optimum delivery of public goods is realized.

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. Relying on these concepts, Weisbrod views the nonprofit sector as a remedy for both market and government failure, especially in the delivery of highly diversified or 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, 25).

Our problem with this approach, and that of welfare theory in general, is the misplaced concreteness that too readily allows the confusion of economic models with reality. Even if problems of calculation and taxation could be solved in instances of homogeneous demand for certain goods (and we treat this hypothesis with enormous skepticism), there is simply no way that citizens, economists, policymakers, or anyone else can possibly know people's unexpressed "demands" in real, existing economies, *regardless* of whether we have *a priori* beliefs that those demands might be homogeneous for some goods and heterogeneous for others.[10]

How Does Any of This Relate to the Viability of the Nonprofit Sector?

If you have followed our outline thus far, you are probably asking that very question. The critical claim that Weisbrod makes is that nonprofits can mitigate government failure. 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 of these things. Neither he, nor any other economist, knows what the Pareto Optimal point is for *any* aspect of society. Hence, our approach to understanding the existence and action of nonprofit organizations seriously questions the value, and purpose, of the Pareto-Optimality benchmark that undergirds the market failure/government

failure analysis. This is not an argument against nonprofits. Indeed, if we are to arrive at a more vigorous and theoretically viable understanding of nonprofit action, we must confront head-on the supposition that nonprofits emerge merely to make up for failures of the market and the state.

Salamon's Notion of Voluntary Failure

Salamon's new paradigm is critical of the market failure/government failure explanation of nonprofits, too, but for reasons fundamentally different from 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 Salamon adds that if the voluntary or "third" sector is a significant parallel institutional sector, perhaps it, too, is prone to failure.

The project of proposing voluntary failure would seem to require, then, a careful adaptation of the standard welfare theory of "failure" in the context of the voluntary sector. Nevertheless, we haven't come across any mention of Pareto Optimality in Salamon's writing, negative or positive.[11] His case for voluntary failure, it appears, depends on the implications of data rather than theory. Salamon's 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, supported through compulsory state actions through subsidies and other measures. Salamon claims that this "partnership" remains a factual anomaly in the Weisbrod model. "Not only does this partnership have deep historical roots," Salamon maintains, "it also has a strong theoretical rationale" (1989, 204). He goes so far as to say that this "partnership" was a "central organizing principle of the American welfare state" (1989, 205),[12] and he believes that these observations establish a sufficient theoretical explanation.

Salamon's 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 he 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, 41).

Salamon calls for a distinction between the case for government *taxation and funding* of goods associated with positive externalities and public-good characteristics and government *production* of those goods. Nevertheless, he fails sufficiently to distinguish funding from production. He observes a world where funding and production/delivery are often separate and labels that phenomenon "third-party government." He then claims that standard welfare economics cannot conceptually explain this assignment of government function to external nonprofit institutions—hence the empirical "anomaly" he sets out to explain in his own theory. Unfortunately, Salamon shares a common but erroneous belief that the standard economist's case necessarily involves a combination of government funding and production.

James Buchanan, in one of the landmark works on the subject, stated clearly that funding and production of public goods can be legitimately separate functions:

> 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, 186).[13]

Salamon's hope to explain "third-party government" with a new paradigm—one that can finally begin to account for this "anomaly" of government funding and third-party production/delivery of public goods (in other places, he calls it an aberration [1995, 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. Instead, standard analysis typically suggests that the government can improve the efficiency of the market by forcing free riders to pay, through taxes, for the goods that they enjoy. The specific organization of production—a matter of 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 interpretation of nonprofit production of public goods as an extension of legitimate functions of government is an unfortunate misunderstanding of basic economic theory, and it leads him to misinterpret the implications of the data.

Now, that in itself doesn't require us to reject entirely Salamon's concept of "voluntary failure." The standard "paradigm," as it were, has already accounted for and explained nongovernment 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, however, Salamon's "voluntary failure" concept can be fitted into the standard analysis, and thereby clarify and shore up the normative defense of government-nonprofit collaboration that he has tried to develop over the years.

Salamon advances claims that the voluntary sector is "inherently" limited, that it will likely offer services that "will be less than those society considers optimal," and that 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 speak meaningfully of a "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 depends upon a tremendous amount of empirical work to justify his theoretical conclusion that third-party government is a reasonable arrangement in light of market, government, and voluntary failure.

Here we would reiterate our observation that the entire welfare economics framework is flawed with unrealistic assumptions as well as with unrealizable goals and expectations for policymakers and government bureaucrats. Adding the voluntary-sector failure concept does not noticeably improve the theory. Some of the criticisms made by Roger Lohmann seem to be on point here, and we shall turn to his account shortly. In our view, the Pareto framework in general, and the effort of Weisbrod to apply it to nonprofits in particular, is an example of misplaced concreteness. Weisbrod's effort and those of mainstream economists in this regard have at least the "virtue" of clearly articulating at the purely conceptual, theoretical level what optimality and failure mean. Salamon's effort only muddies the waters.

Salamon accepts in principle the notions 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. However, he has not clearly articulated what he means by the concepts of optimality and failure. If he has the Pareto-Optimal criteria in mind, then he hasn't made any effort to demonstrate that the modern welfare state's funding of nonprofit services has propelled our system closer toward the socially optimal outcome. None of his empirical work has demonstrated, nor can it demonstrate, that a government-nonprofit partnership is closer to, farther from, or at a social optimum; nor has his work demonstrated that the disentangling of the wonderful panoply of nonprofits away from the state (a more recent development he laments) has pulled the system farther away from the socially optimal result. Salamon's addition to welfare theory—the concept of voluntary failure—has not demonstrated that the nonprofit sector fails to reach Pareto Optimality. Nor, toward an equally important goal, has this concept explained how the partnership between the nonprofit sector and the state can, even in pure theory, bring us closer to the Pareto Optimum. He makes these kinds of claims without introducing a methodology to provide either clear theoretical or empirical measures of the social optimum.

Perhaps Salamon has not offered a theoretical demonstration because he doesn't accept the Pareto-Optimal criteria. He may have a completely different understanding of what a socially optimal outcome means—but that does not square with his acceptance of the standard "market failure" concept. In addition, 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 in asserting 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, as we argue, flawed, then his selection and interpretation of the empirical data are also in question. On this point we find additional support in Smith (2000).

Toward an Alternative Theory: Lohmann on the Commons

We have thus far questioned both the knowledge assumptions and the theoretical coherence of the "failure project." Roger A. Lohmann (1992, 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, and 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 for apparently grafting a theory of narrow self-interest and profit-seeking onto a social domain that substantially differs from commercial market activity. This domain still claims no universally accepted defining terminology: although "nonprofit sector" is a common usage, Richard Cournelle (1965) first proposed that it might be called the "independent sector," Salamon calls it the "voluntary sector," and Lohmann himself refers to it as "the commons."[14] Lohmann's effort to rename and create a distinct theoretical space for the sector is important: while assumptions that individuals pursue narrow self-interests might be suit-

able for the study of competitive commercial activity (the for-profit sector), Lohmann stresses—correctly in our view—that human action in general is not exclusively of the narrow, self-interested variety stereotypically ascribed to *homo economicus*. "The calculus of costs and benefits," Lohmann laments, "has become a universal index to what is rational" (1992, 15). Lohmann asserts that rationality is much richer: "The pursuit of common goods is rational behavior, albeit distinguishable from the self-interested pursuit of profit that characterizes markets" (1992, 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, 16, 38), which, of course, "in the process dissolve[s] the very thing that is to be explained" (1992, 129). This logic is remarkably similar to the critiques of standard economic theory of perfect competition made by F. A. Hayek and Ronald Coase: if we assume for-profit firms act "as if" they faced perfect and complete information and zero transaction costs, we dissolve any reason for for-profit firms to exist at all. Lohmann likewise observes that the standard approach of economists leads to contradictions in market theory and also systematically underrates 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, 26).

Lohmann proposes that a theory of nonprofits ought to understand more clearly the interactive nature of individuals organized in nonprofit associations rather than "treat them as rather odd, intangible, and inefficient forms of productive enterprise" (1992, 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 had something up his sleeve![15]

We appreciate and agree with Lohmann's call for movement 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, 8), and that "it is unlikely that these conceptual problems can be resolved within economics alone" (1992, 39). Lohmann's work is refreshingly eclectic, and draws from the theories of meaningful action found in Max Weber and Alfred Schutz (1992, 47-48), the hermeneutics of Hans-Georg Gadamer and Richard Bernstein (1992, 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 utility-maximizing calculus (1992, 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 modest bias toward Lohmann's efforts.[16] That said, we find that Lohmann unfortunately wishes to resurrect some other fundamentally flawed assumptions of classical economic theory. In other words, he falls short not by pointing toward non-economic social theories, but instead by a peculiar return to classical economic theory. Once again we will see that a critical stumbling block for nonprofit theory exists in our understanding of the organization of production by nonprofit firms.

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, 160-61).

Lohmann supports what he calls "existential" scarcity—basically, the universal fact that people must choose, as wants exceed what is available (1992, 161). So far, so good. That's what all economists mean (or should mean) by the term. He questions the role of models wedded exclusively to maximization (1992, 163), and suggests the concept should lose its "privileged position" as a universal approach to social action. We generally agree with him here, too.[17] He slips a bit—as many non-economists do—with his use of the term *surplus*, but our concern is chiefly with his use of the term *production*.

Hearkening back to Adam Smith's *Wealth of Nations*, Lohmann writes,

> 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" (non-revenue) 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 common goods premised on more plausible and relevant assumptions* (1992, 160; our emphasis).

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

Despite our agreement with the central thrust of this critique, we are troubled by Lohmann's 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, have been sources of discussion in the nonprofit literature, including the work of Severyn Bruyn (1991, 322-325), who laments that Smith denigrated the service sector and created a strictly material notion of wealth that he believes haunts us to this day.[18]

Smith, and the early classicals in general, confined "wealth" to material goods production.[19] Smith differentiated material goods from services, and argued, if only as an analytical convenience, that labor used to produce mate-

rial goods was categorically different from labor employed for services. For Smith, labor is *productive* if it increases the output of material goods (wealth); it is *unproductive* if it only provides services.[20] Productive labor is that which creates vendible commodities.

Lohmann supports Smith's distinction because he believes 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, 162). Regrettably, in our opinion, he embraces 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 standard profit-maximization analysis. In other words, it's a fundamentally different category of labor that can't be pigeonholed into the standard maximization model. It is, using Smith's term, *unproductive* labor. For Lohmann, the neoclassical treatment continues to ignore this crucial distinction, which may prove to be a good point at which to begin developing a more coherent theory of production of nonprofit "goods."

The Austrian Contribution

In our view, returning to Smith's distinction between productive and unproductive labor won't help us differentiate the purpose of for-profit firms from nonprofit activity. There is of course a peculiar irony, if we follow Lohmann, that the promotion of the nonprofit sector would imply the exalting of "unproductive" labor, when, in fact, such services can be remarkably productive. But more importantly, we believe that the distinction between "productive" and "unproductive" labor makes absolutely no sense. This is precisely where an Austrian understanding of wealth, production, and ultimately calculation can contribute to the development of an alternative theory of nonprofits such as Lohmann, Salamon, and others seek.

What is wealth?

In its broadest sense, wealth is simply *anything* that a person values. Smith and the classicals developed an economic theory to try to explain material wealth, which led them to make the distinction between labor that

produces material things—vendible commodities—and labor that produces services. By contrast, the subjective theory of value articulated by Austrian economists holds that wealth is whatever a person strives for: it consists not only of material things (from food, water, and shelter to fast cars, video games, and money), but also of nonmaterial goods (such as love, respect, intelligence, historic preservation, beauty, and so forth). As we have stated elsewhere (Heyne, Boettke, and Prychitko 2003, 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?

In simplest terms, production is the creation of wealth, the creation of anything we value. Of course, we typically picture the construction of new buildings, roads, bridges, and the like as productive activities. New things—new human artifacts—have been created. But production is not to be limited to the production of new things. Simple acts of trading already-produced items (as in barter, for example) are productive because they increase 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, 17-20).

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

The restriction of wealth to material things as a result of the differentiation of productive and unproductive labor is simply too limiting. Ludwig von 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, 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, 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 called for a *praxeology* (1981, 180), a general theory of choice that does not succumb to distinguishing choice in a heterogeneous way, and later attempted a full-blown praxeological theory (1966).

What is Calculation?

One of Mises's greatest achievements was in developing a theory of economic calculation. In the Austrian tradition, calculation has a highly refined meaning. It is not merely measurement, as in some input-output flow chart. After all, Soviet planners could measure how much land, labor, fertilizer, tractors, and so on it took to produce a ton of wheat on the collective farms. But they couldn't calculate the added value of that effort to determine whether they had 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, 207). They couldn't determine whether or not their production plans were worth the cost—whether they generated a positive net improvement in wealth. 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 nor related to anything which could be characterized as measurement” (1966, 209). This sounds 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 a yardstick doesn’t.

This language can be confusing to non-economists, so we shall forgo any 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 be determined only by market prices. Mises insists that “money prices are the only vehicle of economic calculation” (1966, 201; also see 208-209, 229).

Exactly what is calculated?

Mises further insists that “Monetary calculation is not the calculation, and certainly not the measurement, of value” (1981, 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?

Hence, the dependence of calculation upon market-generated prices does not necessarily handicap not-for-profit firms. Recall our distinction between nonprofit organizations and not-for-profit firms. Not-for-profit firms 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 (a “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. Perhaps this is why Lohmann places them outside the realm he calls the commons. The donors 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 for framing their grant-making choices.[21]

Most noncommercial voluntary organizations, however, do not calculate.

And *here's* what Lohmann is really trying to point out. Voluntary nonprofit 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 engage in unilateral transfers, providing a scarce service to others without the exchange of money (or any other commodity, for that matter) in return (Boulding 1981, ch. 1). They do have access to market processes (and, of course, political processes). Being "in" the commons does not imply they are divorced from other social institutions and processes. Yet, although nonprofits can undertake *measurement*s, and, if encouraged, a rational assessment of their outcomes (using both quantitative and qualitative means), 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 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 there remains a troublesome aspect of these kinds of nonprofits in the very fact that calculation does not and cannot exist. The absence of such calculation implies that entrepreneurs who create and executives who manage nonprofit firms may indeed be handicapped in their ability to demonstrate the efficiency or inefficiency of their activities. 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 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 have "solved the calculation problem" in the nonprofit sector. This also implies that the search for a calculation of "social wealth," "social return on investment," or even a standard measurement, is problematic.[22]

Does this problem imply that the largest set of nonprofit firms are prone to coordination failure?

Salamon, of course, has his own answer to this question, related to his use of the voluntary failure concept. As we have declared above, however, we believe that applying notions of failure, which are by definition linked to concepts of economic efficiency, creates a problematic and misleading approach to a theory of nonprofit activity.

We recognize that 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, 234). This avoidance of reductionism is what Lohmann really has in mind, and justifiably so. Mises argues that economics is the subset of praxeology that deals with calculative action (1966, 199), but he affirms that not all human action is "economic" and calculative (1966, 231). When we consider the nonprofit sector, 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, 3). But economic calculation is not *synonymous* with rational human action. It is one terribly important *kind* of rational action that evolves with commercial society, but it would be a great mistake to claim that only calculative action engenders rational, coordinating properties.

The following statements by Mises (1966, 214-15), which we shall quote at length, should help clarify what's at stake in our exploration of the non-profit sector (we interject in brackets where we deem it helpful):

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

Mises's acknowledgement that calculation is not required to make a rational decision to spare the town landmark hits the heart of the issue. Nonprofits are not isolated islands of human activity within the voluntary sector—the commons. 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, and they can and do participate in the knowledge-disseminating features of the market process. Although they cannot calculate the value added of their efforts, they can determine whether their specific goals and efforts are worthwhile. Nonprofits have to persuade prospective donors that their effort is worthwhile, of course. Rather than persuade them with the lure or calculated signal of monetary profit, however, they must turn to noncalculative but measurable or assessable means. The lack of economic calculation does not in itself create any impediment to coordination. Likewise, there can be no theoretically sustainable notion of "voluntary failure" such as that proposed by Salamon. The objection might be made, however, that application of a subjective theory of value as proposed here cannot help produce overall efficient allocation of philanthropic resources (or of tax-generated resources for welfare). Here, more broad accomplishment of plan fulfillment must suffice in the necessary absence of some more comprehensive yet undefinable and unattainable standard of social optimality. Even against the Pareto standard, there is little justification for criticizing nonprofit firms as failing in terms of efficiency.

We suggest that the managers of nonprofits, "social entrepreneurs," and their donors are able to make rational decisions about 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).[23] We would add that they would have a greater incentive than government officials to assess effectiveness, because unlike Mises's councilmen 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, where many nonprofits often bypass the responsibility of persuasion and voluntary exchange and instead seek support from

the state (not unlike many private business enterprises). In this regard, to accept Salamon's advocacy of third-party government, which in effect seeks to legitimate nonprofit firms as arms of state action, would further weaken the effectiveness of nonprofit organizations by encouraging them to engage more in political rent-seeking than in marketplace persuasion.

The Bigger Picture: Governance and the Nonprofit Sector

With Lohmann, we believe that the nonprofit sector is viable and, we should add, productive. But we think Lohmann's appeal to the distinction between productive and unproductive labor as a central theoretical premise should be jettisoned in favor of the Austrian distinction between calculative and noncalculative rationality. This leads us back to 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

A promising 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 considers so anomalous in standard economics. As we argued above, this distinction 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 simultaneously empower the protective and productive state while constraining the redistributive state through constitutional construction. The problem, of course, is whether such a balancing act can indeed ever 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 taxation power to benefit some at the expense of others.

Kenneth Boulding (1969, 482) recognized that "the private grants econo-

my may be justified primarily in terms of it being a check or countervailing power to the public grants economy." Salamon fails to appreciate Buchanan's concerns and Boulding's insight—in part, we believe, because his new "paradigm" doesn't take sufficient account of the unintended consequences of human action.

In a genuinely free society, the voluntary sector should play a critical role in reinforcing the constitutional constraints that limit government to those activities, and only those activities, to which it has a reasonable claim to engage and use its coercive power of taxation and monopoly provision. Granted, this is not the intended 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 can—as an unintended consequence—function to reinforce constitutional constraints on the state simply by providing goods and services without state involvement or intervention. And it is this unplanned, though fertile, feature of the voluntary sector in a free society that is ignored by standard analysis, and by Salamon's approach, despite the fact that it was observed by Alexis de Tocqueville prior to the growth of the modern welfare state.

Many people misunderstand the argument made by economists such as Buchanan, Friedman, and Hayek concerning the role of government. Such "libertarian" economists are typically less concerned with the scale of government than the scope of government. Of course, the absolute size of government can be a concern, given fiscal realities, but the primary concern of these economists is the activities government attempts to tackle. There are activities in which government should not be involved 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 of news services, but the majority have not objected to government financing and provision of educational services (a consent now being reexamined by a burgeoning school choice movement). 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, moreover, ceases to serve this function—and loses the capacity to do so—when organizations within it partner with the coercive powers of the state. At that point, neither government nor market shortcomings can be overcome by this "third sector" because, instead, nonprofit organizations are transformed into rent-seeking entities dependent on tax finance rather than the voluntary contributions of individual donors. As client-partners of the state, many contemporary not-for-profit and nonprofit organizations provide goods and services, but no longer sustain the necessary feedback and disciplinary mechanisms to ensure that good intentions are channeled in directions that generate desired results. In the absence of both calculation and other measures of program effectiveness, modern nonprofits rely increasingly on political effectiveness, which inherently weakens their independent character. This shortchanges society of the valuable information and learning that should arise from independent nonprofit institutions.

Institutions and information

Hayek's work encourages readers to consider the capacity of people to learn 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. In social interactions, of course, human intentions do not automatically equal the realized results; thus, in economic analysis, a results orientation must trump considerations of intent and moral intuition. Actors must be disciplined to align their behavior with desired outcomes, and they must be continually informed about how best to do so. In a for-profit setting, actors receive signals through the price system, helping them align their incentives and actions appropriately. In the political setting of democratic politics, political actors are disciplined—in theory, at least—through the vote mechanism. In an independent 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 striving to explain the coordinating properties of the sector.[24]

Like the nonprofit sector, politics does not work as smoothly as theory might predict. The vote mechanism is not as effective at disciplining politicians as we might like, 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 the gap left by government and the market. But again, the voluntary sector can only serve this role if it abstains from or is denied the use of tax-derived resources.

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 the community environment; health, education, and work opportunities; and even the basic codes of conduct we rely on in our daily intercourse. Ironically, Cornuelle contends that as the voluntary sector gained the power to accomplish more things thanks 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 the finance and provision of those services done by the government, but also to challenge its monopoly on their provision.[25]

It may indeed be true 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 for coupling government finance and provision, let alone for giving the government 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, 56). As such, even when it has been established that the government should finance and produce a particular good or service, the claim of the state to be a monopoly provider—or the sole source of financial underwriting for such services—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, 59).

Competition, whether in the for-profit market setting or among 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 coordinate their plans further. We suggest, with Hayek, that monopoly privilege and the coercive power to tax in order 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. Markets free of excessive government resources and intervention and an independent voluntary sector are better vehicles for promoting learning and social coordination.

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 and social 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" (Hayek, 1979, 53).

We suggest, then, that the sort of "third party government" advocated by Salamon would distort the incentives for nonprofit innovation and weaken the ability of philanthropists and social entrepreneurs to fill in the gaps that might be left by for-profit firms before government bureaucracies expand to fill the supposed vacuum. A persistent lack of conceptual clarity cascades into a theoretical confusion over the nature of this sector, a confusion that might also color the way Salamon and others read the empirical data. Ultimately, government-nonprofit partnership will not invigorate the voluntary sector but instead will enervate it. Lohmann's approach provides a glimpse of the direction we might head, and we believe that further exploration of the field from an Austrian perspective will advance our understanding of the complex, fertile role of the voluntary sector in promoting human excellence, by offering the information necessary for both individual plan fulfillment and social cooperation.

NOTES

[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 theory of government-nonprofit partnership, one which continues to influence his most recent work.

[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.

[3] Recently, the methodology behind Salamon's empirical research has been strongly challenged by Smith (2000, 42-49).

[4] 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, 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.

[5] Salamon seems unaware of Boulding's work (1981), which is not founded on the market failure/government failure analysis. Boulding was a former professor of ours in the 1980s, and his work, particularly on knowledge transmission processes, fits nicely in the Austrian tradition.

[6] In a recent paper, Glaeser and Shleifer (1998) explore the question of when entrepreneurs may decide to enter the market 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-inter-

ested entrepreneur will opt to enter as a not-for-profit entity.

[7] 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, if one is 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 on coercion. Finally, his term "third-party government" has nothing to do with political parties. It is, rather, merely 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, 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.

[8] 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 costs $3.00. At this point, there is no longer room for mutually beneficial trade. Other things being constant, any given consumer would value *one more* loaf of bread less than $3.00; and any given baker could produce *one more* loaf of bread only at a cost higher than $3.00, so all bargaining possibilities have been fully exhausted.

[9] 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.

[10] See Boulding's "The Economics of Knowledge and the Knowledge of Economics" in Boulding (1966) and Hayek's "Economics and Knowledge" and "The Use of Knowledge in Society," in Hayek (1948, 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, 323-43) and Wagner (1996).

[11] 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, 48). It is completely unclear precisely what "optimal" or "adequate" means in his new paradigm.

[12] Salamon regrets that, during the Reagan years, this structure began 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, 121-22).

[13] Buchanan's point became conventional textbook material on the theory of public goods, available long before Salamon embarked upon a new paradigm. Thus Jack Hirshleifer (1980, 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).

[14] "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, 17-18). "Commons are not places any more than are markets or states" (1992, 62).

[15] 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, which together 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 (Lohmann (1991, 34). Lohmann's "commons" is that sector composed exclusively of nonprofit associations.

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

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

[18] "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, 324). "The issue, finally, as more and more social scientists are coming to realize, is finding a way to measure social wealth" (1991, 325). We shall suggest that such a measure will be impossible.

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

[20] 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, 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, 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."

[21] 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.

[22] Mises (1981, 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."

[23] We use the term "entrepreneur" only in the popular sense of being bold and venturesome here. If our argument is correct, nonprofit managers and foundation leaders *can't* undertake entrepreneurship in the strictly economic sense of profit-seeking. We wish to suggest only briefly here that they function instead like middlemen in the strict sense. They are "go-betweens," specialists who have a comparative advantage in reducing the transaction costs among donors and recipients, and it is this middleman function that helps coordinate the commons. This is a topic worthy of further research, which

one of the authors hopes to undertake in a separate paper.

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

[25] As Hayek 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, 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.

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