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CIVIL SOCIETY, SOCIAL ENTREPRENEURSHIP, AND ECONOMIC CALCULATION: TOWARD A POLITICAL ECONOMY OF THE PHILANTHROPIC ENTERPRISE

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The Philanthropic Enterprise

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To this end, we engage scholars and philanthropic practitioners in exploring how voluntary action and philanthropy promote human excellence, prosperity, and social cooperation.

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Our goals include:

- advancing the state of interdisciplinary scholarship and conversation concerning philanthropic and voluntary action;
- exploring promising developments in philanthropic practice;
- articulating a compelling and cohesive rationale for philanthropic and voluntary action; and
- identifying tools and resources that can improve the effectiveness of giving.

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Civil Society, Social Entrepreneurship, and Economic Calculation: Toward a political economy of the philanthropic enterprise

Ted Turner has argued that *Forbes* magazine's list of the wealthiest Americans is ruining the country because the new super-rich are afraid to provide charitable contributions for fear of falling in the ranking. Turner himself has devoted much of his energies in the 1990s to charitable causes, with environmental issues being at the top if his list. Turner has pledged a billion dollars to the United Nations in 1997, perhaps the largest single gift by an individual in history.[1] The basic idea is that the wealthy serve society not by producing wealth, but by using their wealth to support charitable causes. And he personally challenges his fellow wealthy individuals to step up and meet the challenge by giving large portions of their wealth away to help those less fortunate and to tackle the pressing problems of our world. In a recent study, *Bankers Trust* conducted a study of 112 wealthy households to examine the notion of "wealth with responsibility." The idea was to get a measure on how much the wealthy were giving back to society in terms of charitable giving. Ninety percent of respondents stated that they have established an estate plan, which leaves sixteen percent of their assets to charities, forty-seven to their heirs, and thirty-seven percent goes to government in the form of taxation. The *US Trust Survey of Affluent Americans* found similar magnitudes of giving. Those with a net-worth of over $100 million gave away an annual amount of $5.5 million, or fifty-seven percent of their income to charitable causes; those with $5-10 million donated a little over ten percent of their income; and those with $1-5 million donated three and a

[1] All charitable giving by Americans in 1996 was estimated at $120 billion.

half percent. The most significant finding, for the purposes of this paper, is that the *Bankers Trust* study reports that sixty-six percent of the respondents said they would give more if they had better information on the effectiveness of their charitable donations. But measuring the effectiveness of charitable giving is notoriously difficult to appraise. As a result, charitable giving is often more about the giver feeling good, rather than actually doing good.

We challenge Turner's assessment of the situation of charity in America on several points. First, the wealthy in America are extremely generous in their support for charitable causes --- ranging from health and human welfare, to artistic endeavors, to education. Second, we would argue that the creation of wealth through business innovation has tremendous benefits and far exceeds the benefits of individual profit through arbitrage in terms of increasing human standards of living than the charitable activity of the wealthy. Business activity, we contend, can in fact produce generalized benefits that can be realized on a large-scale. To understand the basic thrust of our perspective, just reflect on the benefits realized by the masses of people due to the introduction of mass production techniques which lower the costs of products from automobiles to computer which transformed these products from luxuries consumed only by the wealthy to products consumed throughout society. We are ridiculously better off in terms of convenience, quality of services, and wide availability of products than even our parents let alone are grandparents.[2] And these improvements were not because of the

[2] See "The Greatest Century That Ever Was—25 Miraculous Trends of the Past 100 Years," written by Stephen Moore and Julian L. Simon, and published in the December 15, 1999, issue of Policy Analysis by the Cato Institute. Also see *The Myths of Rich and Poor* by Michael Cox and Richard Alm published in 1999.

charitable contributions of the business elite of our grandparent's era, but because of the profit-seeking activity of individuals.

This is not to denigrate the tremendous contribution that philanthropic activity makes to society. Not all activities can be rendered in term of profit and loss statements, and many of these activities are the most precious in our human interactions. Even the most ardent of free market economists, Ludwig von Mises, pointed out the inability of the market economy to value the beauty of a waterfall in making a decision on whether to build a waterworks (1920, 99). Mises, in fact, is explicit on the limits of monetary calculation, and strictly restricts the role of monetary calculation to the sphere of exchange relations and production through a roundabout process. Honor, beauty, happiness all lie outside the strict delineation of exchange relations and thus monetary calculation. But Mises insists that recognizing these limits to monetary calculation do not detract from its significance for everyday economic life. Honor, beauty, happiness are goods of the first order, and thus can be valued directly. Individuals can incorporate these components into their decision even though they lie outside of monetary calculation. As Mises puts it:

> Sensitive people may be pained to have to choose between the ideal and the material. But that is not the fault of a money economy. It is in the nature of things. For even where we can make judgments of value without money computations we cannot avoid this choice. Both isolated man and socialist communities would have to do likewise, and truly sensitive

> natures will never find it painful. Called upon to choose between bread and honour, they will never be at a loss how to act. If honour cannot be eaten, eating can at least be foregone for honour. Only such fear the agony of choice because they secretly know that they could not forgo the material, will regard the necessity of choice as a profanation (1922, 100).

Mises follows this discussion of the limits of monetary calculation with an argument for its importance. Within its appropriate sphere monetary calculation “does all that we are entitled to ask of it.” Without it, we would be lost “amid the bewildering throng of economic possibilities”, and thus “all production by lengthy and roundabout processes of production would be so many steps in the dark” (1922, 101). Mises, in his emphasis on the importance of the mechanisms of profit, loss and prices states “In the absence of profit and loss the entrepreneurs would not know what the most urgent needs of the consumers are. If some entrepreneurs were to guess it, they would lack the means to adjust production accordingly.” (1949, 297).

Mises acknowledged the precise problem we want to confront in this paper, that is philanthropic activities are largely outside the realm of monetary calculation despite the fact that the gifts provided are in monetary sums. Thus, if we follow Mises and insist on limitations of monetary calculation to the arena of exchange relations, we would expect that philanthropic enterprise be limited to activities which can be directly valued, or it will be characterized by endemic waste. Specifically, he notes that “whenever the operation of a system is not directed by the profit motive, it must be directed by bureaucratic rules" and these rules are characterized by "inflexible regulations" (1949, 307). While philanthropic enterprises are subject to all of the above constraints making information difficult to asses with prices absent, and regulations making it difficult for nonprofits to adjust "production" when they have misapprehended local needs and demands; there are striking examples of nonprofits successfully fulfilling local demands through incentive compatible, community based projects in which the nonprofits maintain strict accountability to donors within a limited scope.

We propose to explore the political economy of the philanthropic enterprise and to explore the concept of social entrepreneurship, which has become *en vogue* in recent years. We argue that outside of the context of property, prices and profit and loss, the idea of entrepreneurship as anything more than a wishful conjecture is a misnomer. We challenge the theory that within an market economy, market failure results in either: firms cheating in such a way that they offer for sale high quality goods and deliver low quality goods (Akerlof, 1970); or that the profit motive provides high powered incentives and encourages shirking on quality and as such firms *choose* nonprofit status which softens incentives to assure customers that quality will be higher (Glaeser and Shleifer, 2001). We also argue that in the competition between state and philanthropic provision of goods and services not provided on the market, there are various mechanisms at work, which ensure the dominance of state provision when the activity is pushed beyond very localized provision.[3] We conclude the paper with some suggestions on how the

[3] However, we argue that the effectiveness of state provision cannot be inferred from its survivorship in this competition in the same way that the survivorship of an economic organization can be taken as evidence of certain efficiency properties in that organization. The main reason for this asymmetry in assessment is

philanthropic enterprise can in fact organize its activities to obtain better feedback mechanisms and thus gather better information on the effectiveness of its activities.

CIVIL SOCIETY and SOCIAL ENTREPRENEURSHIP

It has become commonplace in the last decade or so to assert that a vibrant civil society is necessary for the establishment of a working democratic state (Putnam,1993). In most of the literature that has risen around Putnam, civil society is contrasted with the profit motive of the market. The market runs on the principle of everything for sale, while civil society was based on norms and codes of behavior outside of the profit motive. In this literature, criticism is directed at the *laissez-fare* **State vs. Market** dichotomy because it did not seem to recognize the informal norms which underlie democratic life on the one hand, and economic behavior on the other. Instead, we have to see the contrast as between **Society (state and civil society) vs. Market**. The market economy erodes the values, which underlie not only a working democracy, but ironically, the values necessary for the operation of the market economy itself. But, the view that conceives of civil society as the foundation for the effective operation of the state is flawed on several grounds in our opinion. We do not deny that a vibrant democratic society is grounded in a healthy civil society and institutions of self-governance. This is so mainly because it limits government from expanding its scope of activities. Such a limiting constraint on the scope of government is necessary to ensure that government is restricted to those

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because of the important distinction between finance through voluntary means and finance through the coercive means of taxation.

activities it can do well and avoids those tasks, which in fact it lacks the knowledge and incentives to accomplish effectively. The attempt to conceptualize the market as contrasted with civil society also commits two errors of commission and one error of omission. First, it underestimates the coercive nature of state action. The state, as Max Weber emphasized, is a geographic monopoly on coercion. The state is a powerful instrument through which some parties can gain by exploiting others. Second, it underestimates the role of civil society as an opposition force of self-governance against the coercive power of the state. It was this aspect of 19th century America that so captured the imagination of Alex de Tocqueville. Tocqueville saw America=s propensity for self-governance as opposed to reliance on the formal structures of state action as a defining characterization of that society. Self-governance was seen as alternative to the state, not as a prerequisite for a working state sector. Third, the contemporary juxtaposition omits a discussion of the importance of the self-enforcing norms and bonds of trust, which are evident in everyday economic life. Formal contracts and various less formal alternative institutional facilitators of voluntary cooperation are at work in the day-to-day operation of a market society. Benson (1990) suggests that in the United States, seventy five percent of commercial disputes are settled privately through arbitration and mediation. Rubin (1997) points out that in developed economies businesses have learned methods of doing substantial amounts of business without relying on contracts and the threat of legal enforcement makes private arrangements easier.

Economic actors must build up a reputation for trustworthiness, craftsmanship, reliability, etc. in order to be successful in the market due to the discipline of repeated dealings. As Hayek (1948, 97) states: “In actual life the fact that our inadequate knowledge of the available commodities or services is made up by our experience with the persons or firms supplying them—that competition is in large measure competition for reputation or good will." It is true, as Adam Smith stressed, that it is due to the power of self-interest that we can expect our dinner from the butcher, the baker and the brewer and not due to their benevolence. But it is also true, that the self-interest of the butcher, the baker and the brewer is best served by their regarding the desires and demands of others who they must deal with in the market. Markets in the absence of a certain background of institutions (formal and informal rules) will not operate effectively to coordinate production and exchange. In short, market activity is embedded within a larger context of rule-governed behavior.

We suggest instead of the distinction that sees the profit motive as contrasted with civil society, that the more appropriate contrast would be the traditional state versus civil society dichotomy, where civil society is divided into non-market and market activity, as can be seen in Figure 1.

Civil Society vs. State

Non-Market | Market | Taxation

The contrast that we postulate is built on the basic recognition of the coercive nature of state action versus the voluntary nature of civil society. In the arena of civil society, whether in the local bridge club or the grocery store, interactions are based on consent; the mutually beneficial interactions whether rendered in profit and loss statements or not. State activity, on the other hand, is built on the foundation of force; the ability of one entity to dictate to another what the terms of interaction are to be as empowered through the power to tax.

Civil society and self-governance in our framework are near synonyms, while state action is by definition is an enforced order. The self-governing properties of a market economy are a function of the institutions of private property, monetary prices, and profit and loss accounting. These institutions provide the incentives to husband resources effectively, the information on the relative scarcities of various goods and services, and the incentives and information necessary for economic actors to innovate and improve in their economic decision-making. Current inefficiencies in economic relations are quickly translated through the informational mechanisms of the price system into profit opportunities for those entrepreneurs who can eliminate those inefficiencies and realize the gains from exchange that were previously going unexploited.

Entrepreneurship within the context of a market economy serves both the function of arbitraging within the existing array of economic decisions to ensure efficiency in exchange and production, and innovating in exchange and production to realize previously unthought economic opportunities. The institutions of property, prices and profit and loss continually work to prod economic actors to adjust and adapt their behavior to realize the mutual gains from exchange until no further gains can be exploited. But what are the analogous institutions in the non-market sector of civil society? The inadequate knowledge of the available commodities and services that Hayek stressed is not only felt by consumers but that same inadequate knowledge of the desires and demands of consumers is faced by entrepreneurs operating within the scope of prices, profit and loss and thus the reality of inadequate knowledge is exacerbated in the arena of nonprofit ventures. Then, by what mechanisms can we ensure that actions undertaken are not merely to feel good, but actually to do good?

Entrepreneurship is fundamentally an act of dissent. The entrepreneur sees the situation differently than his contemporaries and engages in an action, which is directed at changing the situation in direct opposition to how his contemporaries are currently viewing the scene. If everyone saw it the way the entrepreneur saw it, then there would be no entrepreneurial profits to be gathered – a profit opportunity known to all is realized by none. This grasping of the situation differently is the essence of entrepreneurship whether it is in the activity of buying low and selling high (arbitrage) or building a better mouse trap (innovation). Another way to put it, is that entrepreneurship is a bold and wishful conjecture made by an economic actor. Within the context of the market economy these wishful conjectures are the prime mover of progress, but precisely because we have clear mechanisms for sorting among these conjectures. Not all wishful conjectures are correct. Most, in fact, go by the wayside and are revealed as little more than wishes through the operation of the price system. In the process entrepreneurs are redirected in their activity either to make conjectures that are more in line with the underlying tastes and preferences of their fellow citizens or to lose the monetary resources which enable them to finance their wishful conjectures. Nobody's financial pockets are unlimited. In short, what spurs entrepreneurship is the lure of profit, and what disciplines entrepreneurs is the penalty of loss. The property rights structure provides the incentives and establishes the issue of the residual claimant, and the price system provides economic actors with the information to act on the bases of those incentives to utilize resources effectively.

Our question is how much confidence can we have that the wishful conjectures of some actors will be sorted in a manner which ties them to the demands and desires of others on the one hand and the underlying technological possibilities and resource availability on the other outside the context of price system? To answer this question, just think about the disciplinary devices that emerge when faced with problems of principal and agency. When ownership is separated from control, the principals (owners) can be exploited by the agents (those entrusted to manage the assets) unless these agents are monitored effectively. The principals, however, by the nature of the problem we are setting up cannot directly monitor the activities of the agents. In the context of a market economy, various impersonal market mechanisms emerge to provide a corporate governance structure and effectively monitor that behavior of agents. There is both the market for corporate control through takeovers and mergers, and the market for managerial labor. The evolution of the modern corporation provided a means for financing expansion in business while not incurring all the risk. By selling shares in its business entity, an enterprise could raise needed financial capital. Once this was done, however, a chasm was introduced between the owners (shareholders) and the managers --- between principals and agents. The share price of a firm is a reflection of the expected future profitability of the firm. If the firms assets are not highly valued and its expected future earnings are low, its share price will fall and in the limit the firm will be driven out of existence. If, on the other hand, the firms assets are highly valued, but its current earning do not match that expectation, the share price will fall, but others will have an incentive to buy up those shares at the lower price and reorganize the firm to realize the potential earnings of those assets. Managers who do not realize the potential of the firms assets will be displaced through the process of mergers and acquisitions in the market for corporate control. In addition, there is a vibrant market for managerial labor, and individuals compete vigorously to establish that they can in fact realize the full potential of a firms assets, and in fact, improve the value of those assets with their organizational and team leadership skills. The impersonal forces in a market economy, found in this example in the markets for corporate control and for managerial labor, discipline the behavior of agents so it aligns with the interests of the principals. This is accomplished by the institutional functions of property, prices and profit and loss.

But can we say anything in alternative contexts? First, lets consider the state sector and in particular because it is considered responsive let us consider the effectiveness of democracy in assuring that agents act in the interest of the principals. In this example the agents are elected officials, and the principals are the voting public. Is the vote mechanism as effective in disciplining the behavior of the agents in relation to the demands of the principals, as what we argued was the case in the market setting? Are argument is no. The voting mechanism is governed by the logic of concentrated benefits and dispersed costs. The interaction in democratic politics is one characterized by rationally ignorant voters, specially interested votes, and vote seeking politicians. The bias of this interaction is for the politician to concentrate benefits on the well-organized and well-informed special interest voters and to disperse the costs on the unorganized and ill-informed mass of voters. This is why good economics is not necessarily good politics, and thus policies can be chosen which are counter-productive from the perspective of overall economic growth. It is this basic examination of the logic of democratic discipline that underlies the argument for government failure theory, which is juxtaposed with market failure theory, in modern political economy. The state cannot be viewed as a better provider of a service even in the face of a market failure simply by hypothesis.

Does the non-profit sector avoid the pitfalls of the state sector? The non-market component of civil society certainly avoids the pitfall of coercion, but it does not have recourse to the institutions of property, prices and profit and loss to the same extent as the market component does. Instead, the non-market sector relies on face-to-face interaction and the disciplinary devices most appropriate for that sort of interaction, namely reputation. The idea of social entrepreneurship has become a hot topic in the last decade, as the subject of the non-market component of civil society has become increasingly discussed. In this context, the idea simply means innovation in the philanthropic sector to fill in the gaps left by both the market sector and the state sector. How can the philanthropic enterprise succeed in helping the needy, or increasing human welfare, where the state bureaucracy and the vagaries of the market have failed? New initiative is required and these new ideas of community activism are termed "social entrepreneurship." We applaud these efforts and nothing that we say should be construed as anti-community activism. Instead, we value these community based voluntary initiatives. Our concern goes to the disciplining of the conjectures of social entrepreneurs. How does the social entrepreneur <u>know</u> if they are doing the right thing in their choice of project A, or project B? How does he calculate the use of scare time and financial resources? We contend that he can do this only by limiting those initiatives to those, which can be directly monitored and disciplined on the basis of face-to-face mechanisms of self-governance. The social entrepreneur does not have recourse the anonymous mechanisms of self-governance that exist in a market economy.

The example of micro-finance might provide a clear illustration. In the standard story, members of a society who are denied access to normal financial markets can be aided through micro-lending program to start small businesses that improve their lot in life. These micro-lending programs are run as follows. Since the individuals in question do not have access to traditional forms of collateral to put up against the loans, the loan agreement is organized as follows. In order to get a loan, the individual must put up their reputation as collateral – say 5 non-family members of the community must vouch for them and being willing to pay their debt if they default. Small loans are made on the basis of this, and business are started which otherwise would not have been started and the individuals achieve a level of personal material comfort which otherwise would have alluded them. This is an example market mechanism of self-governance based in part of the norms of face-to-face interaction.

We suggest that social entrepreneurship is most effective when modeled along these lines. In making grants to educational institutions, health care facilities, or artistic endeavors, if the granting foundation has personal knowledge of the grantee and can monitor closely to make sure that the agent (recipient) is acting in the interest of the principal (giver) then the entrepreneurial innovation is more likely to be truly effective in accomplishing its goal, as opposed to merely being advertised as being effective because they have more lines of business. Since the reputational capital of the recipient is what is being held as collateral, the recipient has a strong incentive to accomplish the task for which he has received the grant. In fact, we would argue that given the necessity of reputation as the main self-governing mechanism (if our goal is effectiveness) that social entrepreneurship is really a function of betting on people, not on projects. Grant giving organizations should identify people they trust and these people must put their reputation on the line each time. Projects can be attractive, but unless the feedback loops are well established even the most promising project can be poorly executed.

Competition between the Independent Sector and the State Sector

A case study in the provision of student loans lends credit to the notion that philanthropic entrepreneurs or social entrepreneurs can fail in the face of competition from the government, which provides student loans via coercive taxation of the citizenry. Richard Cornuelle and colleagues created the United Student Aids Fund, Inc. in an attempt to compete with federally subsidized student loans. The first task of these entrepreneurs was to identify who needed loans and how much they needed. They assessed that there was a demand for student loans that existed among college students. The costs of college were increasing and the biggest need was among low-income families attempting to send their children to college who were high risk and had no collateral. Cornuelle and associates attempted to identify the neediest students and enable them to get student loans. The problem faced by these entrepreneurs was twofold. The social entrepreneurs have to acquire capital from private organizations and must convince the donors that the money is necessary and will be directed to the goal of putting the neediest students through college. What makes this problem especially difficult is that United Student Aids Fund, Inc. was attempting to privately provide a service that the government was already in the business of providing. This makes the problem of convincing private donors to donate money all the more difficult. Thus the notion of reputational collateral is the method by which the social entrepreneur must attain capital. The social entrepreneur must convince the private donors that the government provided service has failed to meet the needs of low-income students to attain loans and additionally that the money donated to the United Student Aid Fund, Inc.

would better enable the needy students to attain student loans and that the students would complete their education. Yet, the nature of any nonprofit is that it operates under the structure of a bureaucracy and as such is subject to “soft budget constraints” (Kornai, 1980). The private donors must be convinced that their money is necessary even though the government already provides such a service but also must be convinced that the money will not be misused in the traditional bureaucratic fashion but that it is making society better off or is reaching the neediest students in a manner that was previously lacking.

United Student Aids Fund, Inc. coordinated banks, colleges, students and contributors and the loans were made through the banks. For every dollar that was deposited into the bank the bank agreed to lend $12.50 at a nonprofit rate. The money was to be held in a security fund. Students could borrow up to $1000 per year for undergraduate and $2000 per year for graduate students with a maximum of $4000 to be borrowed which was to be repaid starting four months after the student graduated with three years total to repay the loan. Cornuelle observed that while his program was achieving success the government program was expanding at a rapid pace.

One of the biggest problems he found was in attempting to persuade private companies and individuals to donate when they already observe the government providing this service. Cornuelle states “ …fundraising was difficult. The program was untested. Worst of all, donors felt the government had already preempted the field. It was a hard sale all around.”

The second problem is giving the money to the students who not only need the money the most but that desire the assistance thus the social entrepreneur must engage in not only establishing his own reputational collateral in an effort to acquire capital from private donors but must identify and acquire reputational collateral from the students who are receiving the assistance. This all occurs in the philanthropic arena under which there is no price mechanism because the market has been unable to facilitate exchange in the face of government provision of such services and thus assessing willingness to pay through the price mechanism is not possible. Market prices convey information among buyers and sellers. Without the price mechanism there are proxies for the exchange of information and the determination of willingness to pay. It then becomes the task of United Student Aids Fund, Inc. to assess which students want to go to college and which among them are most likely to finish. This is the only way to ensure future private donations. The government program need not prove the value added in the final product. The government coercively taxes its citizens in an effort to fund the student loan project so the costs to each individual taxpayer are small and the benefits to society are vaguely measurable at best. What is the value added to any one individual of one more person attaining a college education? Infinitesimal, yet in the aggregate political agents assure citizens that society is better off when more of its citizens have college educations. Thus, the government in the provision of such services is not subject to the same rigorous tests of value added as social entrepreneurs are.

This is exemplified in the manner in which the government distributes student loans as compared to the manner in which United Student Aids Fund, Inc. distributes loans and the conditions under which they were repaid. Currently the federal government appropriates funds each year to be dispersed by the Student Loan Marketing Association which is a government sponsored enterprise created by a 1972 federal charter. There is no minimum amount and the only qualifications to students are that they be enrolled full or part time, be a U.S. citizen or eligible resident non-citizen and have a satisfactory credit history. The only limit on the loan is that the student can borrow up to the total cost of education less any other grants the student may receive. The federal program has much higher amounts of money that they allow students to borrow each year and students do not have to repay until a year after they graduate and they have ten years to repay the loan. Students pay no interest on the portion of their loan that is subsidized and on the unsubsidized portion they pay no interest while they are in school and there is a cap on the federal interest rate of 9.0%. At the time that the program was in place students paid 3% interest on the government loans. To default or get a forbearance in the federal program is also much easier and often if the student is studying for certain government sanctioned professions as much as half of the loan will be forgiven.

The social entrepreneur then must assess a willingness to pay criterion for the students who have no ability to pay. Thus the standards for providing services by social entrepreneurs are rigorous because capital to fund the project is scarce compared to the governments ability to sequester capital and redristribute it at will and thus the social entrepreneur must not only establish his own reputational collateral in attempting to acquire capital but must acquire reputational collateral from the students as a proxy for the willingness to pay.

To establish this reputational collateral among the students the United Student Aid Funds, Inc. required specific levels of academic achievement from the students receiving loans. Ultimately United Student Aid Fund was better able to provide student loans to the most needy students with the lowest default percentages. They did this through setting up the strict requirements of academic achievement and repayment methods and the interest rate.

The implications of this case study and the problem of attempting to determine and assess proxies for market prices is that social entrepreneurs face the challenge of acquiring capital through reputational collateral which requires face-to-face knowledge of the donors and of the needs and desires of the communities it strives to help. The social entrepreneur cannot use market prices to convey information regarding willingness to pay and thus has high search costs for acquiring information regarding what the needs of the community are. The government in providing student loans at below market costs obfuscates the price signal and does not concern itself with assessing willingness to pay among the community so the government does not face the same search costs as the social entrepreneur does. Thus the government elicits students to attain low-interest loans with little cost for poor academic performance and little cost for default and thus those who would not have desired a college education are encouraged to do so in the face of very low costs. The phenomena of dispersed and tacit knowledge in society (Hayek, 1948, 77-78) can make search costs high yet the government is not confined by such costs. The coercive nature of government allows it to relax standards of assessing who needs the loans the most and gives loans to almost anyone hence there is no monitoring mechanism because the costs of doing so would be exorbitant. The independent sector faces much higher search costs but often more correctly identifies the needs of the community it strives to serve due to local, community based initiatives which require strict donor accountability and thus fewer loans are distributed but the loans that are are given to the students who are most likely to want the assistance and who are better off for the assistance.

This problem of overcoming the dispersed knowledge makes social entrepreneurship a local phenomenon. To accurately assess the needs of the community, to acquire and attain reputational collateral are the primary goals of the social entrepreneur. This can only be achieved on the local level. The Habitat for Humanity project which provides housing for those who live in substandard housing and cannot obtain a mortgage require the individuals they attempt to help by requiring a huge amount of reputational collateral. According the Millard Fuller the founder of Habitat for Humanity every Habitat affiliate has a “family selection committee” and the committee is comprised of local residents and the people desiring a house must fill out an application. They must invest what Fuller calls “sweat equity”. The family must help build the house and once they move in they are required to pay the money back. If the people cannot make the payments due to irresponsibility Habitat will take the house back (Philanthropy Roundtable, 2001). Thus there is an end product and a monitoring mechanism. This is only possible on the local level and it is an effort to help the people that want the help the most by making them pay for the assistance in non-monetary forms.

Enterprise Mentors International, a nonprofit organization run by Menlo Smith, is aimed at providing low-interest loans and advice to poor entrepreneurs in the Third World. Smith states that the main objective is to identify on a local level which of the poor entrepreneurs are promising. Smith says that they don’t need a sterling credit rating but that they must demonstrate “the three M’s: morality, mentality, and motivation”(Philanthropy Roundtable, 2000). This is an attempt to establish reputational collateral in the burgeoning entrepreneurs and give them the help they need. This effort to establish reputation occurs in the absence of prices and thus the absence of feedback mechanisms. To be effective the social entrepreneur can only operate on a local level because acquiring the disbursed knowledge and understanding the needs of the community is infinitely costly at the federal level and thus the government when providing any type of welfare assistance generalizes the requirements for distribution and lacks effective feedback mechanisms and thus may endanger the people it attempts to serve by eliminating market exchange and crowding out social entrepreneurs.

Conclusion

The non-profit sector plays a vital role in a society of free and responsible individuals. Without the activities of churches, community groups, etc., which provides not just support for those in need, but also a sense of community and identity to us all, the lifeblood of a society, will be depleted. But it is our contention that nothing kills community quite like the coercive powers of the state. The state has grown in size and scope with the consequence of distorting and in many instances displacing the self-governing properties of civil society. The problem that was often not recognized in an examination of civil society was that market forces work in anonymous situations, whereas non-market self-governance is based on face-to-face relations. Both are essential for a vibrant civil society --- face-to-face and anonymous relationships --- but they mean different limitations. Market forces tend to disturb us when applied to areas of life typically thought of as requiring face-to-face transactions. But we should be just as concerned when the self-governing norms of fact-to-face society are pushed into situations, which require the self-governing institutions of anonymous interaction.

Our argument is that non-market activity, such as the philanthropic enterprise, are most effective when limited to local action where the "reputational collateral" of the recipient of the grant is clearly on the line and the services can be directly monitored and valued. When pushed beyond this local level, the philanthropic sector either gets crowded out by state activity or co-opted by state activity. The state cannot manage it affairs any better than the non-market sector when pushed beyond a certain level of complexity, but through the power to tax it avoids to a considerable extent the financial constraint which impacts more harshly activities which cannot rely on tax financing. State and non-market activity geared toward helping those in need and providing a sense of community and identity when pushed beyond that face-to-face level are characterized by waste and ineffectiveness. Effective large-scale projects must be coordinated through various impersonal forces as provided through the monetary price system; effective small-scale projects can be coordinated through the face-to-face forces of reputation and community membership. A vibrant civil society will limit state intrusion as much as possible and instead rely on the self-governance of both the non-market and market variety and most importantly understand the proper delineation of them.

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