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NONPROFIT VERSUS FOR-PROFIT ENTREPRENEURSHIP:

AN INSTITUTIONAL ANALYSIS

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Nonprofit versus For-Profit Entrepreneurship: An Institutional Analysis

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Entrepreneurship is the key driver of a market economy, and economists[1] have emphasized the essential role entrepreneurship plays in the market process. While neoclassical economists have dismissed entrepreneurial activity due to the dominance of general equilibrium analysis, economists outside the mainstream demonstrate how crucial entrepreneurs are to sustaining a dynamic market under appropriate institutional conditions (Blaug, 1998; Casson, 1982; Kirzner, 1973, 1979; Mises, 1949). The entrepreneur's insight establishes what is the driving force for market performance, and this awareness of yet unrealized opportunities is paramount in launching nonprofit ventures as well. The nonmarket economy relies on entrepreneurial activity for its existence, and the theory of entrepreneurial discovery provides a useful foundation to understand how a nonprofit entrepreneur contributes to the nonmarket economic process.

Nonprofit organizations have played an increasing role in the United States' economy during the past century, and their role has broadened substantially since the 1960s (Boris, 1999a; Hall, 1992). Hence, the market and nonmarket economies have flourished in the American capitalist system in ways that parallel each other. This paper looks at the institutional conditions necessary to foster *market* entrepreneurs, and then it applies this to the study of *nonmarket* entrepreneurs in order to understand the conditions that foster nonprofit organization creation and sustainability. The overall purpose of this analysis is to demonstrate that in the market certain institutions are crucial for the development and sustainability of entrepreneurial activity,

[1] Historically those economists reside the Austrian school, while there has been a resurgence of entrepreneurship theory among contemporary economists (Blaug, 1998).

and this institutional framework spills over as a crucial paradigm for nonprofit entrepreneurship. The current climate of American society and philanthropy threatens the once fertile environment for nonmarket entrepreneurs. The intention of this analysis is not to foreshadow a weakening of nonprofit entrepreneurship in the American economy. The problem addressed is that as philanthropy becomes more of an activity of the state, and subsequently more institutionalized, nonmarket entrepreneurs may lose the incentive to create nonprofit organizations. Yet, more importantly, they may create organizations that become institutionalized and essentially agents of the state, and/or these entrepreneurs may create organizations that lack autonomy and the ability to implement a unique mission leading to a disintegration of civil society.

Therefore, the central argument of this paper is that by understanding the essential role of entrepreneurship in a market economy, and the conditions that cultivate entrepreneurial activity, one can understand the nature of nonprofit entrepreneurship. In addition, this leads to an understanding of how nonprofits function in the American system and the nature of philanthropy in sustaining nonprofit ventures. The remainder of this paper is divided into four sections. First, the appropriate method for understanding entrepreneurship in a market economy is analyzed, and the institutional conditions that facilitate this process are explored. Next, a theory of nonprofit entrepreneurship is established based on the Austrian approach to entrepreneurship as discovery. The third section analyzes the institutional mechanisms that provide feedback regarding the success or failure of nonprofit ventures, differentiating them from for-profit mechanisms, while focusing on the gains or distortions that arise based on funding sources and the resulting landscape of philanthropy in America today. Finally, the fourth section contains a brief case analysis of nonprofits in the social service sector. A conclusion follows.

I. Entrepreneurship as Discovery

Conditions Fostering Entrepreneurship

Prior to analyzing what constitutes entrepreneurship, one must look at the environment where entrepreneurship thrives. Institutions are an essential component of the market process and subsequent entrepreneurial activity. Economists define institutions as the rules of the game in society or the "humanly devised constraints that shape human interaction" (North, 1990, p. 3). Institutions allow people to interact and transact in a market because of the establishment of trust and the reduction of uncertainty. These constraints on people's choices can be formal in that they are written down, or they can be informal, tacit rules that cannot be articulated (Harper, 1998). Additionally, David Harper notes in his analysis of North (1981) that the institutional framework of society "comprises constitutional rules, operating rules, and normative behavioral codes" (Harper, 1998, p. 242). Therefore, institutions consist of governing laws, contracts, property rights, and other legal and operational codes that provide predictability.

In terms of a dynamic market process, institutions are essential. As Wolfgang Kasper and Manfred Streit note,

> [H]uman interaction in the economy depends greatly on fairly regular patterns on which people may rely. If these are disturbed by policy interventions, unforeseen side-effects evolve, which makes it impossible to plan precise outcomes. Instead coordination requires general, abstract and adaptive rules of interaction…(Kasper & Streit, 1998, p. 19).

Hence, institutions provide the basis whereby entrepreneurs can operate in an environment that is not completely unknown or random. While it is difficult to maintain that institutions are sufficient for entrepreneurship it can certainly be said that appropriate institutional conditions are necessary for providing the incentive to engage in risk-taking activity (Harper, 1998; Kasper & Streit, 1998). These conditions that foster entrepreneurship, while not limited to the framework comprising classical liberalism, are certainly prominent in a capitalist market structure. As a result, these conditions begin to deteriorate as the state expands its influence.

Harper outlines the core institutional conditions affecting entrepreneurial alertness while providing incentives to exploit profit opportunities. In brief, these primary conditions are: freedom/liberty, the rule of law, the certainty of law, private property, freedom of contract, and freedom of entrepreneurial choice (Harper, 1998). Without these conditions, entrepreneurship will likely fail to flourish and entrepreneurs will lack the incentives to search for profit opportunities. Finally, Harper emphasizes the importance of freedom and he demonstrates that it molds and determines the degree of entrepreneurial alertness in society (Harper, 1998).

Market Entrepreneurship

In order to understand the role of entrepreneurship in the market process it is important to establish the broad differences between Austrian theory and mainstream (or neoclassical) theory in terms of how the market functions. In general, the core of mainstream theory refers to the perfectly competitive model of markets (Kirzner, 1997b). F. A. Hayek provides a summary of the assumptions of this model: 1) A homogenous commodity, 2) Free entry into the market, and 3) Complete knowledge (Hayek, 1948, p. 95). Within this understanding of a perfectly competitive market, neoclassical economists also point to a market in equilibrium. This theory essentially portrays the market as static state without change or improvement.

In addition, neoclassical economists have neglected to emphasize the importance of institutions. They assume institutions are exogenously derived and people adjust perfectly to them; in addition, institutions essentially complicate economic models and are a hindrance to empirical analysis (Kasper & Streit, 1998). Therefore, while constructing a steady state economy, mainstream economists lose sight of institutions, which are paramount to the coordination of a market economy.

Austrians take exception with this understanding of a static omniscient market, where institutions lack importance. The framework that explains markets, as in a state of equilibrium where all necessary knowledge is available to market participants, is highly implausible. The idea of basing an economic theory on such an unrealistic set of assumptions as summarized by Hayek above, lacks real world consideration as noted by economist Israel Kirzner. He states,

> For Austrians it is unacceptable to claim that, at each and every instant, the configuration of production and consumption decisions currently made, is one which could, in light of the relevant costs, not possibly have been improved upon. To claim that, at any given instant, all conceivably relevant available opportunities have been instantaneously grasped, is to fly in the face of what we know about real world economic systems (Kirzner, 1997a, p. 65).

Kirzner is not alone in his objections. The two most notable Austrian economists, Ludwig Von Mises and Hayek, have written extensively about the problems with the neoclassical understanding of the competitive market (see Hayek, 1948; Mises, 1949).

Austrians have developed a more accurate construction of the market process, and the starting point is the entrepreneur (Kirzner, 1997a). In contrast, the concept of an entrepreneur in a neoclassical market is nonexistent. According to Harper, entrepreneurship is defined as "problem-solving activity which involves the exercise of imagination and critical faculties in the context of structurally uncertain and complex problem situations that are conjectured to present profit opportunities" (Harper, 1996, p. 82). This understanding of entrepreneurship is impossible in the neoclassical perfectly competitive market process. Mainstream theory leaves no room for exercising imagination in an uncertain problem situation, for there is no uncertainly and so no genuine problems are faced (Harper, 1996). A search for profit opportunities would not occur where knowledge is complete, and where the cost of discovering a new idea is already known

(Kirzner, 1997b). Therefore, within neoclassical theory, problem solving is a determinate process void of imagination or novelty (Harper, 1996).

The contrasting view of the market held by the Austrians rejects the idea of a competitive process in equilibrium. This would mean a world with no entrepreneurship, while the course of market events are foreordained (Kirzner, 1997b). The market process, according to Austrians, is very different from this picture painted by mainstream economics. The entrepreneur is the driving force of the market process, and he is able to acquire information through market participation (Kirzner, 1973). The entrepreneur is part of a market process where all the knowledge necessary to carry out a new idea is not readily available. As Hayek explains, the acquisition of information is an important part of the market process, for it cannot be assumed that all pertinent knowledge simply exists without having to search for it (Hayek, 1948).

Consequently, an entrepreneur is part of a truly competitive process through which knowledge is discovered and communicated (Kirzner, 1997b). The aforementioned perfectly competitive model is not a competitive process at all, because the competitive process is necessary in order to solve the problem of understanding the wishes and desires of consumers. Hence, the idea that 'perfect competition' reveals this knowledge (wishes and desires of consumers) is stating as given what the competitive process must solve (Hayek, 1948). The specific role of the entrepreneur then is to discover, in a market where uncertainty exists, ways in which to break down the information barriers that hinder consumers from fulfilling their desires.

A Discovery Procedure

To best understand the modern Austrian concept of entrepreneurial discovery, one must examine the foundation of this approach, which is rooted in elements of the writings of Mises and Hayek. From Mises the Austrians learned to understand the market as an entrepreneurial process, and from Hayek they learned the importance of knowledge in enhancing market interaction (Kirzner, 1997a). Kirzner brings together these two aspects of entrepreneurial discovery gleaned from Mises and Hayek by stating,

> Entrepreneurial discovery represents the alert becoming aware of what has been overlooked. The essence of entrepreneurship consists in seeing through the fog created by the uncertainty of the future. When the Misesian human agent acts, he is determining what indeed he 'sees' in the murky future. He is inspired by the prospective pure-profitability of seeing the future more correctly than others do (Kirzner, 1997b, p. 51).

Therefore, Kirzner encapsulates the concept that the market is not an environment where all participants are aware of all relevant information. But, there exists those that become alert of an opportunity that has been overlooked; an essential feature of the market is the possibility of overlooked opportunities. Additionally, for Hayek the only way the market could reach the state of equilibrium that mainstream economists espouse is through knowledge and learning; specifically, that is through a process where market participants acquire a more informed position concerning the plans of other market participants (Kirzner, 1997a).

Thus, the market established by modern Austrian economists is said to be in disequilibrium, and the role of the entrepreneur is to equilibrate market prices through daring imaginative actions (Kirzner, 1997a; Vaughn, 1994). The entrepreneur in the Austrian market is participating in a competitive environment that is very different from the neoclassical perfectly competitive model. No rivalry exists among market participants in this model, yet for Austrians, the driving force of entrepreneurial discovery is a dynamic competitive environment (Kirzner, 1997a). As Mises describes it, competition is not at all like the neoclassical environment mentioned above, but competition is a situation where people want to surpass each other and find better ways to offer improved and cheaper goods (Mises, 1949, p. 274). This can happen in a dynamic market and where there is opportunity to exploit uncertainties in the future.

This understanding of the market, and the role of discovery according to Mises and Hayek, leads us to the essence of Austrian entrepreneurship. The entrepreneur in this dynamic competitive market is one who makes decisions arising out of "his alertness to hitherto unnoticed opportunities" (Kirzner, 1973). The two critical elements here are decision-making and alertness. Entrepreneurs are perceptive; they see profit opportunities where market participants have desires that are unsatisfied. Additionally, they are able to act upon their alertness. Decision-making is crucial in order for the entrepreneur to take advantage of an opportunity that may only go unnoticed for a short time.

Entrepreneurs engage in profitable ventures by seeking arbitrage opportunities. "Buying cheap and selling dear" is part of the discovery procedure when an entrepreneur notices something in which the market value has gone unrealized (Kirzner, 1997b, p. 34). This arbitrage process is, at its core, the discovery of a profit opportunity "obtainable for nothing at all" (Kirzner, 1973, p. 48). Yet, the entrepreneur can be (and in many cases is) more than simply a discoverer of an arbitrage opportunity. As Harper explains, entrepreneurial activity requires critical imagination and the entrepreneur must "employ active, spontaneous, intuitive and prelogical processes in the discovery and formulation of new problems" (Harper, 1996, p. 88). Harper is emphasizing that alertness by itself is insufficient to account for entrepreneurial activity.

The arbitrage venture explains an aspect of entrepreneurial discovery, but it is too limiting a form of entrepreneurship to exhaust the creativity behind true market innovation. Kirzner himself admits the entrepreneur "is not seizing a 'given' opportunity he is, at that moment, declaring that opportunity to exist" (Kirzner, 1997b, p. 33). While this may include an arbitrage opportunity,[2] an entrepreneur may creatively declare an opportunity to exist that is outside the bounds of simply buying a product and selling it at a higher price.[3] A new technique of production that may lead to an enhanced product encompasses this idea of creativity and discovery (Kirzner, 1997b).

In addition, Harper speaks specifically about entrepreneurship as innovation, and he emphasizes the notion that this takes time (as opposed to pure arbitrage) (Harper, 1996). Also, within entrepreneurial discovery is the understanding of the entrepreneur as a problem solver, who must identify the problem situation (defined by Harper above). Yet, since uncertainty exists, and the innovative entrepreneur knows that his venture is only a 'possible' profit opportunity, the problem-solving situation becomes more difficult (Harper, 1996). Consequently, Harper notes, "structural uncertainty is the most important dimension for characterizing the entrepreneur's problem situation" (Harper, 1996, p. 93). Hence, there is risk associated with engaging in entrepreneurial innovation and problem solving.

Mises emphasizes "the entrepreneur is always a speculator…his success or failure depends on the correctness of his anticipation of uncertain events," and he continues, "the only source from which an entrepreneur's profits stem is his ability to anticipate better than other people the future demand of the consumers" (Mises, 1949, p. 290). Therefore, inherent in the entrepreneurial discovery process is the risk involved in attempting to speculate future trends in the market. The question that arises is to what extent does uncertainty exist? It makes sense that risk-taking is an a priori aspect of entrepreneurial discovery, yet there exists a structure where uncertainty is reduced.

[2] In fact, Harper believes Kirzner's theory of entrepreneurship is simply an arbitrage theory (Harper, 1996, p. 89).
[3] See Kirzner's discussion regarding entrepreneurial competition among producers (Kirzner, 1973, p. 24).

Uncertainty within the entrepreneurial decision-making framework is bounded. As Harper notes, “if it were not, and market events were purely random, all entrepreneurial choice would be purposeless and ineffectual” (Harper, 1996, p. 101). Within the market, an order exists formulated by rules, norms, and institutions. Additionally, Hayek emphasizes this role of rules by explaining how society benefits from (tacit) knowledge not easily expressed, and he states the cultural environment “into which man is born consists of a complex of practices or rules of conduct” and these rules prevail because they “made a group of men successful” (Hayek, 1974, p. 17). We learn from others’ experiences and the rules of society, which limits the uncertainty of our entrepreneurial actions.

As noted above, the existence of institutions bounds the uncertainty faced by the entrepreneur. Institutions “establish a stable structure to human interaction,” and they evolve, a fact that alters the options available to the entrepreneur (North, 1990, p. 6). Therefore, the uncertainty faced by human actors, by being bounded, enables the entrepreneur “to act creatively and make meaningful choices” in a world that is not completely arbitrary at one extreme or completely deterministic at the other (Harper, 1996, p. 101). Consequently, the strategies employed by the entrepreneur can be creative and innovative, but they are bounded by what is known through rules, norms, and institutions.

A final important understanding regarding the nature of the entrepreneur is his relationship to capital. The entrepreneur is the creative actor who notices an opportunity and acts creatively within the market. Hence, the entrepreneur does not own any capital (Mises, 1949, p. 253). This point is important when understanding entrepreneurial profit, obtainable from nothing at all, yet an entrepreneur can be a capitalist as well (Kirzner, 1973). That is to say, an entrepreneur may also finance his venture, but the act of entrepreneurial discovery is carried out by someone who possesses the cognitive ability to perceive an opportunity. Hence, entrepreneurship does not necessitate the endowment of substantial resources (or any resources).

In terms of entrepreneurial profit, it is the case that within the market profit is understood by the measurement of monetary gains by the entrepreneur. Yet, in the context of the next section of this paper, it is important to look at profit in a broader context. As Mises aptly states,

> Profit…is the gain derived from action; it is the increase in satisfaction (decrease in uneasiness) brought about; it is the difference between the higher value attached to the result attained and the lower value attached to the sacrifices made for its attainment; it is, in other words, yield minus costs (Mises, 1949, p. 289).

Therefore, in applying the Austrian approach of entrepreneurial discovery to the nonprofit entrepreneur, one can look at profit in terms of this broader perspective laid out by Mises. Profit among human actors within the context we now turn, sometimes varies from the traditional notion of which economists often speak.

II. Nonprofit Entrepreneurship

The Nonmarket Economy

Before turning to the specific case for the nonprofit entrepreneur, an analysis of the nonmarket economy is important. The nonprofit economy consists of several different types of nonprofits embedded in various economic sectors. Nonprofits exist in healthcare, education, arts and culture, and the social service sectors to name a few. This begs the question as to why non-government and nonprofit organizations exist? Burton Weisbrod is acknowledged for initiating the work in understanding why nonprofit enterprises form (Weisbrod, 1975). While the scope of this paper is to consider the case for nonprofit entrepreneurship (and not to exhaust the research catalyzed by Weisbrod's 1975 paper), it is important to establish a general purpose for this economic choice. Within the nonprofit literature, market failure, government failure, contract failure, and public goods theory are key reasons why entrepreneurs establish organizations in the nonmarket economy (Hansmann, 1987; Salamon, 1995; Weisbrod, 1988). In addition, other political theories are posited to explain why nonprofits provide goods and services that the public sector might otherwise provide i.e., why government-nonprofit partnerships arise; and, this research is typically focused toward the provision of public goods and the free-rider problem (Douglas, 1987; Gassler, 1990). Yet, Austrian theory questions these notions of coordination problems within the market and voluntary sectors as the reason for government or nonprofit provision of "public" goods.[4]

Therefore, prior to establishing a case for the nonprofit entrepreneur, while at the same time adding to the explanation of a nonmarket economy, an alternative theory is reviewed. Andrei Shleifer makes the case that nonprofit organizations fulfill a role in a limited government context where neither the state nor the private market has the proper incentive to efficiently produce. In four situations, according to Shleifer, the market and government are inferior to a nonprofit economic setting: 1) opportunities for cost reductions lead to non-contractible deterioration of quality, 2) innovation is unimportant, 3) competition is weak and consumer choice is not effective, and 4) reputational mechanisms are weak (Shleifer, 1998). In these four cases, Shleifer is making the point that the market economy has an alternative to government, which is the establishment of nonprofit firms. He states, "entrepreneurial non-for-profit private firms can be more efficient than either government or the for-profit private suppliers…where soft incentives are desirable, and competitive and reputational mechanisms do not soften the incentives of private suppliers" (Shleifer, 1998, p. 140). Whether justifiable or not, schools, hospitals, day-care centers and other firms raise concerns about private provision.

[4] See Boettke and Prychitko (presented at this symposium) for a critique of market failure theory applied to government-nonprofit partnerships.

The point of Shleifer's work is to weaken the case for government provision because the nonmarket economy arose to provide where the private market lacked the incentive to do so to the satisfaction of consumers. While this understanding of the nonmarket economy does not run completely counter to some of the previous literature, it does highlight some of the shortcomings of theories based on a strict neoclassical framework that lead to this idea of market failure. For example, Weisbrod and others contend that nonprofits form due to the nature of public goods and the free-rider problem (Weisbrod, 1975), yet nonprofit entrepreneurs are not mainly concerned with free-rider problems because governments and private firms could organize just as easily (Gassler, 1990). For the nonprofit entrepreneur there are certain limiting measures of success to venturing into the nonmarket economy, which are discussed below, but these limitations are not substantial enough to necessitate government involvement. While Weisbrod and Salamon claim this to be market failure, the nonmarket economy is "market-driven" in a fundamental sense and government is not a necessary component, in economic terms, of the nonprofit economy.

A key component of the nonmarket economy, which stems from an economic framework grounded in the understanding of institutions, is the conditions that foster for-profit market-driven entrepreneurship also help create nonprofit entrepreneurship. Fundamentally, the substantial size of the nonprofit sector in America is the result of several factors: increased efficiency in nonprofit provision of services and the lack of trust in government; market wealth generation and the availability of seed capital for nonprofit entrepreneurs; and possibly most important, the institutional conditions that substantiate the capitalist system. Again, while it is popular to legitimate the independent sector by employing "failure" theories, where the government allows the market to function and key institutions to flourish, the nonprofit sector will follow.

The Nonprofit Entrepreneur

The nonprofit entrepreneur derived from the Austrian perspective is the actor who discovers an opportunity and initiates a new venture, which is embedded in the nonmarket economy. The term nonprofit is a loaded concept when seeking to understand entrepreneurship as a discovery procedure. Nonprofit organizations are simply set up where they cannot distribute any net earnings (pure profits) to individuals who exercise control over the organization (Hansmann, 1980). Therefore, nonprofits may earn profits, but the entrepreneur does not realize these monetary profits in the same way as a for-profit entrepreneur (due to the non-distribution constraint), and as a result must operate under a different incentive structure than for-profit entrepreneurs.

Essentially, the concept of the nonprofit entrepreneur is someone who first notices an opportunity as in the Austrian construct, and, as Kirzner states regarding entrepreneurs, is someone who has the freedom to enter the market where they see fit (Kirzner, 1997a). This nonprofit entrepreneur chooses to enter the nonprofit sector as their base of operations (Young, 1986). Why would an entrepreneur choose to enter into a nonmarket economy? What incentives are there for the entrepreneur who sees a hitherto unrealized opportunity to venture into a market where profits cannot be distributed to the owners of the organization? These are the essential questions in understanding nonprofit entrepreneurship. On the surface, it seems odd for an entrepreneur to start a new venture where success or failure is not subject to the ultimate institutional market mechanism: profit.

Two potential reasons have been posed as to why a rational actor would start a nonprofit firm rather than a for-profit firm, yet neither has complete explanatory power. First, according to Glaeser and Shleifer, due to the non-distribution constraint the incentive to earn profits is weakened, and this "commitment to weaker incentives is valuable in markets where entrepreneurs might be able to take advantage of their customers, employees, or donors, since it reduces their interest in profiting from such opportunities" (Glaeser & Shleifer, 2001, p. 100). This protection offered by nonprofit firms provides the entrepreneur a competitive advantage in the market, which is necessary due to competition, not only from other nonprofits, but also from for-profit firms and government (Steinberg, 1987). The second reason posited for starting a nonprofit firm, according to Bilodeau and Slivinski, is that "in situations in which the entrepreneur would herself contribute toward the public good's provision and in which the firm would also receive voluntary contributions from others, it will be in the entrepreneur's own interest to found a nonprofit" because the non-distribution constraint would illicit greater contributions from others (Bilodeau & Slivinski, 1998, p. 554).

The latter case described above is oversimplified, and the entrepreneurial decision is based on model specifications that are unrealistic (e.g., there are no nonpecuniary rewards to nonprofit entrepreneurship, no tax advantages to nonprofits, etc.) (Bilodeau & Slivinski, 1998). The former case, described by Glaeser and Shleifer, is realistic for a certain set of nonprofit organizations, yet the model, albeit intentionally, leaves out a certain class of nonprofit entrepreneurs that do not require the softening of profit maximization in order to avoid shirking on quality (Glaeser & Shleifer, 2001) (for example, nonprofit altruists or ideologues).

Nonprofit entrepreneurs are in many ways Austrian entrepreneurs. They notice a gap in the market where the wishes and desires of consumers are not yet realized, and they attempt to fulfill these desires or, as Kirzner alluded to, they attempt to bridge the gap between customers and providers (Kirzner, 1973). A nonprofit entrepreneur typifies the creative/innovative actor necessary to engage in a new potentially unique venture. Additionally, the nonprofit entrepreneur, such as an artist, derives satisfaction (profit) from the creative act (Young, 1986, and in so doing may decide to engage market participants without requiring compensation from those same participants. In this sense, the nonprofit entrepreneur is much more than an actor engaging in arbitrage, but is a market participant whose motive is of a different nature. Also, the nonprofit entrepreneur, like the Austrian entrepreneur, is "profit" motivated in the Misesian sense quoted above. Profit is gain derived from action and it consists of nonpecuniary elements.

At this point it is important to distinguish between two types of nonprofit organizations, which reflect differing incentives for nonprofit entrepreneurship. First, there are those firms that are established by entrepreneurs who choose to locate in the nonmarket economy, yet they act like for-profit firms. Nonprofit hospitals, for example, act like for-profit hospitals aside from the distribution of profits. The second type of nonprofit, for the purposes of this analysis, are those organizations where a significant portion of their operating resources are not provided by patrons. These organizations are typically art/cultural, research, human service or ideological in nature and mission.[5] The first type of organizations (hospitals, universities, etc.) fit closely into the category described by Shleifer above. These nonprofit entrepreneurs choose the nonmarket economy due to "soft incentives" including reputational considerations, and they would maintain this organizational form even in the absence of tax advantages (Glaeser & Shleifer, 2001; Shleifer, 1998).

In the latter type of organizations, the nonprofit entrepreneur is motivated not by monetary profit (as understood in the for-profit context), but is interested in profit as the increase in satisfaction described by Mises. The motive may be altruistic, or it may be simply the desire to disseminate ideas or values through research (e.g., an organization such as the Brookings Institution). In addition, many of these entrepreneurs are ideologues (Rose-Ackerman, 1996),

[5] For a more detailed breakdown of nonprofit organizational types see (Weisbrod, 1988).

who create organizations embedded in the nonmarket sector based on passion or mission that may be immune to market mechanisms or that may be better suited apart from market mechanisms. Or, more precisely, these entrepreneurs establish an organization responding to the collective passions of individuals who, due to transactions costs, do not realize the provision of their desired good in the market. This form of entrepreneurship is practiced by entrepreneurs who anticipate the desires of market participants, or who correctly declare an opportunity that others had not thought of.

In sum, the nonprofit entrepreneur acts in many ways within the Austrian construct of entrepreneurial discovery. The nonprofit entrepreneur is a creative actor who seeks to provide market participants with a desire yet unfulfilled, and their motivation is profit in the broad sense Mises spoke about. Nonprofit entrepreneurs are part of a larger market process, but they typically locate their activity outside the traditional boundaries subject to monetary profit-motivated endeavors.

III. Philanthropy and The Independent Sector

Nonprofit entrepreneurs establish nonprofit organizations using capital from varying sources in ways much different than their for-profit counterparts. Additionally, the source(s) of funds available for these entrepreneurs' impacts, in significant ways, the resulting organization in its initial form and as it evolves. Therefore, nonprofit entrepreneurs seek resources for their ventures from private philanthropists or private foundations in order to establish their organizations. Venture philanthropy is developing into a promising means of coordinating donors in a manner similar to methods of capital generation for market driven entrepreneurs. In addition to foundations and private donors, the state has become a substantial funder of nonprofit organizations in order to create government-nonprofit collaborations for the provision of "public" goods (Lipsky & Smith, 1989-1990). A negative result of government funding is the nonprofit entrepreneur, especially in the social service sector, can be (and has been) restrained in their mission (which can be another factor in efficiency considerations) by taking government funds. Nonprofits have formed due to government funding, which is given as a catalyst for the provision of social services (Lipsky & Smith, 1989-1990; Rose-Ackerman, 1996).

Nonprofit entrepreneurs, as their Austrian market-based counterparts, must work within the norms and institutional framework of society. Yet, as institutions evolve to reduce uncertainty by providing a structure to market and nonmarket activities (North, 1990), it is evident that there are some institutional structures available to for-profit entrepreneurs that are not available to their nonprofit counterparts. Since there are a wide variety of nonprofit organizations each with potentially varying "profit" motivations, a nonprofit entrepreneur may experience a difficult time grasping the proper institutional structure necessary to acquire relevant knowledge. The potential outcome of this environment is greater uncertainty faced by the nonprofit entrepreneur and, as a result, greater risk in such a venture and possibly decreased efficiency. Due to the lack of success measures available to nonprofits they often find themselves seeking public funds to survive.

One measure of success, reputation, is an important mechanism that helps hold nonprofits accountable (Boettke & Rathbone, 2001; Shleifer, 1998). Nonprofits must be extremely diligent in maintaining a positive perception as to the use of funds and profits. If abuse of funds is exposed, the reputation, and therefore the existence, of a nonprofit will be in serious jeopardy. Hence, while nonprofits are not exposed to the same efficiency criteria as for-profit firms, the reputational mechanism can be a powerful indicator (and motivator) of efficiency. The next section discusses the current landscape of philanthropy in America and how various funding sources affect success mechanisms employed by nonprofits. While nonprofit entrepreneurs cannot look to profit and price for feedback, there are additional indications of success that are partially lost due to how philanthropy has evolved throughout the 20th century (Ealy, 2001).

Nonprofit Funding and the Current Scope of Philanthropy

The sources of funding accessible to nonprofits have evolved, while the institutional climate where these entrepreneurs reside has progressed as well. The for-profit entrepreneurs and capitalists that helped shape American industry in the late 19th and early 20th centuries established foundations with the wealth they amassed, which eventually became a key source of funding for nonprofits (Acs & Phillips, 2002). Yet, Cornuelle observes that throughout the 20th century, philanthropy in American has undergone a shift characterized by three trends: centralization, monopolization, and professionalization (Ealy, 2001). Foundations have evolved in this fashion with large general-purpose foundations such as those started by Rockefeller, Carnegie, and Sage dominating the philanthropic landscape. Hence, in the early part of the 20th century, foundations transcended the way nonprofit entrepreneurs established and maintained their organizations (Smith, 1999).

A substantial shift in funding nonprofits took place in the mid-20th century as the nonprofit sector began to grow more and more dependent on public funds. “Philanthropy” increasingly became a redistributive tool of government as the public sector sought to deal with social ills, and as a result private donations have become a smaller proportion of nonprofit revenues from 26 percent in 1977 to 19 percent in 1996 (Boris, 1999b). In addition, almost one-third of total revenue for nonprofits in 1997 was through government contracts and grants (*The New Nonprofit Almanac & Desk Reference*, 2002).

The result of this evolution in funding nonprofit entrepreneurs and sustaining their organizations is demonstrated in the centralization and monopolization of philanthropy. This shift has important impacts for nonprofits and the institutional structure surrounding the independent sector. Government-nonprofit relationships, as well as the pervasiveness of large national foundations, has changed the nature of nonprofits in five primary ways: the institutionalization of nonprofit organizations, mission drift and lost autonomy, lack of entrepreneurial alertness and uniqueness, lost efficiency measures, and the challenge of accountability with public funds.

Sociologists Walter Powell and Paul DiMaggio have written extensively on organizational institutionalism, and while they claim points of divergence with institutional economists, there are some important parallels evidenced in the nonprofit sector (DiMaggio & Powell, 1991a). As noted above, institutional economists stress how institutions shape the activity of individual entrepreneurs, yet the resulting organizations, established by these entrepreneurs, are increasingly molded by the environmental factors that they face. These external factors begin to mold nonprofit organizations into bureaucratic institutions. Hence, sociologists demonstrate how organizations (nonprofits) become institutionalized as their funding stream is increasingly dominated by the state and other large organizations (Meyer & Rowan, 1991). These large foundations, which have come to characterize the managerial philanthropy philosophy, have a similar impact on nonprofit[6] organizations as government funding (Ealy, 2001).

The result of this institutionalization is a dramatic change in the character and scope of the organizations within the nonprofit sector. As nonprofits seek funds tied with substantial

[6] Victoria Alexander demonstrates the impact of government and large funders on art museums as they shape exhibitions and formats in 15 large American museums (Alexander, 1996).

external control and uniformity of purpose, due to the equity agenda attached with public funds, these organizations begin to conform to each other through, in DiMaggio and Powell words, coercive isomorphism (DiMaggio & Powell, 1991b). The second factor naturally follows, nonprofits then lose their autonomy and their mission becomes driven by the funder. In a study by Kirsten Gronbjerg of community organizations in Chicago she found, "The external control and lack of discretion that characterize government grants and contracts limit the range of internal management decisions that recipient organizations can make," and she also found agency autonomy was threatened leading to increased bureaucratization (Frumkin, 2000; Gronbjerg, 1993). Consequently, the resulting complex organizational forms that characterize the independent sector are the outcome of public and large institutional (foundation) funding.

The third detriment to the current scope of philanthropy and the increased role of state funding is its impact on nonprofit entrepreneurial alertness. As nonprofits become institutionalized, and individual philanthropy declines, the ability and incentive for an entrepreneur to search for and establish a unique organization diminishes as well. This is especially the case when these entrepreneurs seek funds that are only awarded for highly targeted purposes. Government funds and gifts from large national foundations tend to direct the nonprofit sector skewing taxpayer and donor intent. The resulting bureaucratized environment changes the incentives for entrepreneurial alertness, while destroying the catalyst for innovation within the independent sector. In response, a transformational philanthropy is being advocated that emphasizes discovery among nonprofit entrepreneurs, while it seeks to empower grassroots individuals to find and direct solutions to societal problems (Ealy, 2001).

The fourth outcome of the current trends shaping philanthropy in America today is the loss of efficiency measures available to nonprofit entrepreneurs and the organizations they establish. When the state, and to some extent large national foundations, provide funds to nonprofits donor intent is often lost. Donor intent is a proxy for whether nonprofits are fulfilling the mission funders intend, and the philanthropy today often relies on internal measures of success as opposed to measures determined by donors or independent agencies (Ealy, 2001).

A final detriment evidenced as a result of philanthropy today, especially in terms of government funding, is the issue of accountability. The primary issue necessitating accountability in terms of nonprofits delivering social services is equity. Traditionally, nonprofits and government have not viewed equity in the same manner. As Lipsky and Smith note,

> [G]overnment is overwhelmingly driven by concerns of equity…nonprofit agencies are less concerned than government in serving all clients within a specific target group. Instead, nonprofits focus on serving clients compatible with the agency's mission…Nonprofit agencies consequently invite criticism from government officials that service is being provided inefficiently or inequitably (Lipsky & Smith, 1989-1990, p. 632-632).

Therefore, in the social service sector nonprofits are more inclined to service some individuals and not others, and they often strive to meet the needs of those they have the greatest likelihood of helping (Lipsky & Smith, 1989-1990). Government defines its mission with a much broader scope than these nonprofits typically do.

In sum, nonprofit entrepreneurs are being negatively impacted by the nature of funding that controls the independent sector. The aforementioned five factors, which reflect the outlook of nonprofits in America, all point to a negative trend that is shaping this crucial component of civil society. By intention, civil society is meant to remain beyond and distinct from the state (Bruyn, 2000), yet as government-nonprofit relationships continue to increase (especially in terms of funding) a weakening of civil society occurs. The Charitable Choice legislation signed into law by President Bill Clinton, and President George W. Bush's Faith-Based Initiatives executive order expanding Charitable Choice, are two recent examples of the pervasive expansion of government, and the subsequent institutional change, within the nonprofit sector.

IV. Nonprofits in the Social Service Sector[7]

In this section, a brief look at two nonprofit social service organizations and their funding procedures is analyzed. The first is a community development nonprofit in Washington, DC and the other is a similar organization in Pittsburgh, PA. Each of these organizations attempt to enhance poor urban communities through housing restoration and other community education programs, and each has annual revenues of approximately $1.3 Million. The nonprofit located in Washington receives at least half of its funding from government grants, while the organization in Pittsburgh receives no money from the government.

The differences between these organizations reflect the trends highlighted above. The nonprofit in Washington, while maintaining some autonomy, acts as an agent of the state as it seeks funding based on what type of grants are currently being offered by the government. This is not to say that it changes its mission on a whim and simply follows the money, yet there is certainly a bureaucratization that has occurred as this nonprofit is continually forced to meet the accountability standards imposed on it. With government funding, there are multiple stakeholders involved (citizens, elected officials, federal agencies), which substantially increases the burden placed on a nonprofit to demonstrate it is using funds properly (or as the government intends for them to be used). In addition, for the organization in Washington, measures of success are often guided by bureaucratic response.

The second nonprofit, located in Pittsburgh, has similar struggles as the Washington one yet to a lesser degree. They receive about one-third of their revenue from foundations, all of

[7] The information from this section was obtained through phone interviews with development directors from each of the organizations analyzed.

which are local. The primary difference between these nonprofits is that the Pittsburgh organization shields itself from the bureaucracy of government funds, and they also are able to fulfill, to a much greater degree, donor intent. They have an established relationship with several small foundations, which allows money and mission to closely ally. The area where this Pittsburgh nonprofit finds itself trapped, within the current context of philanthropy, is based on the agenda set by large local foundations (funded with old industrial money) that often impacts the agenda of smaller foundations throughout the area. Therefore, two or three large foundations can set the tone for funding throughout a local community.[8]

This analysis of funding sources for two community development nonprofits sheds a little light on the challenges faced within American philanthropy today. While certainly not representative of all nonprofits, these two organizations do show the affects of increased government-nonprofit relationships and the affects of organizationally (managerially) directed philanthropy. A more detailed case study comparing nonprofits across sectors and regions is needed to understand the nature and pervasiveness of these trends in philanthropy.

Conclusion

Institutions are an essential component in fostering both for-profit and nonprofit entrepreneurship. As institutions begin to break down, resulting in the loss of liberty and the restriction of individual freedom, entrepreneurs are hindered in their incentive to seek “profit” opportunities in market and nonmarket contexts. Additionally, on the organizational level as government and large national foundations increasingly fund nonprofit entrepreneurs and the ventures they form, they will become progressively less autonomous and more bureaucratized.

[8] Whether this is a positive outcome of a large local foundation (that almost exclusively gives to the local area) is debatable in that they are much more entrenched in the area and in touch with local donors’ desires.

Further research is needed on the scale of nonprofits changing into government agency-like organizations. This is a substantial concern especially in the social service sector because the very attributes that lead to successful delivery of human services via nonprofits (community-based knowledge, flexibility, organizational culture, mission) are in jeopardy once government and large institutional funding, and subsequent restrictions, plays a significant role. Additionally, more research is crucial in terms of understanding how nonprofits are encouraged toward efficiency or succumb to failure. Harnessing the incentives that lead to efficient nonprofits is an important step for a more developed theory on the failure of these organizations to serve their intended, donor initiated, purpose.

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