

# Explaining Nonprofit Organisation: the Social Value Approach

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## Introduction

The existence of nonprofit firms in a market economy undoubtedly presents a paradox. The fact that people prefer to join or deal with these firms is evidently indicative of limitations of profit, or more generally, personal economic gain, as a motivating factor of human economic behaviour. Certain needs of society turn out to be of such a nature that self-interested pursuit of profit cannot lead to their appropriate satisfaction. These needs, however, are not self-evident. Their identification and explanation require a theory-building effort, which has been increasingly undertaken in the last few decades by scholars from different social disciplines, most importantly economists, sociologists, and political scientists.

However, the construction of consistent theoretical explanation of the nonprofit sector is complicated by the significant diversity of nonprofit organisations. In the Western economies, nonprofits are most common in such different sectors as health care, education and research, social service, arts and culture, community development, and religion<sup>1</sup>. Nonprofit organisations exhibit diversity also with regard to their structure, in particular, their source of income and the way in which they are controlled, as noted by Hansmann<sup>2</sup>. Specifically, nonprofits may receive their incomes in the form of donations or revenues from sales of goods and services, which gives rise to the distinction between their donative and commercial types; nonprofits may be controlled by their patrons, ie those who provide funding, or by self-perpetuating boards of directors, in which case the distinction is respectively between mutual and entrepreneurial types. In this way, Hansmann<sup>3</sup> arrives at a four-way categorisation of nonprofits: donative mutual, donative entrepreneurial, commercial mutual, commercial entrepreneurial.

Of central interest in this essay are the differences exhibited by nonprofits with respect

to their organisational goals. According to this criterion, nonprofits are classified into:

- 1) public benefit organisations, which provide public benefits from private funds;
- 2) mutual benefit organisations, which provide collective benefits more or less exclusively to its members<sup>4</sup>.

Two remarks should be made regarding this classification. First, it is not intended to serve legalistic purposes, but rather to reflect the actual constellations of interests of organisational members and society at large. Presumably, public- and mutual-benefit nonprofits can be represented by different legal forms in different jurisdictions. To simplify matters, it will not be attempted here to analyse which legal forms in which jurisdiction exhibit public- or mutual-benefit orientation. Second, this classification is based on the understanding that hard-and-fast distinctions between these two types of nonprofits are difficult to draw. Indeed, mutual-benefit nonprofits can serve public purposes by espousing ethical standpoints and other indirect ways. The relevant criterion for this classification, however, can be found in the nature of main activities of nonprofits as stated in their missions. Namely, nonprofits can be attributed to these two groups depending on whether they regard delivery of services to members or pursuance of public interest as their main activity, allowing for the possibility of indirect effects which may blur the boundary between public- and mutual-benefit orientation.

The significant sectoral and structural diversity of the nonprofit sector is probably responsible for the fact that no unified comprehensive theory has been proposed so far that would be equally applicable to all types of nonprofits. Rather, a number of different and complementary theoretical approaches have been developed, which is particularly obvious in the economic literature on nonprofits.

The argument of this essay is that the major existing economic theories of nonprofits, in spite of their important complementarities, still do not offer equally convincing explanations for every possible structural and organisational types of these organisations. Specifically, the least explained type of nonprofits appears to be the public benefit organisation, which most fully corresponds to the commonly held view that nonprofits seek to achieve public and community purposes rather than private ones<sup>5</sup>. In fact, as noted by Douglas, the nonprofits seeking to generate benefits only for their members or patrons are no more serving public purposes than for-profit organisations<sup>6</sup>, although undoubtedly both types of nonprofits represent equally stimulating objects of theoretical enquiry.

This essay will briefly review the major existing economic theories of nonprofit organisation and argue that they are most suitable to those nonprofits which are promoting private rather than public interests. For a better account of the public benefit nonprofits, an alternative theoretical approach will be offered, which relates their existence to the fact that people tend to have social values, ie beliefs that certain types of social relations are preferable to others. This approach will rationalise the nonprofit organisation of public benefit type as a mechanism that people use to realise their social values, ie to change the current social reality in the direction of better correspondence with the values. Therefore this essay will not seek to provide a general theory of nonprofit organisation, but rather a theory of its subclass – nonprofit organisation of public benefit type.

## **The economic theories of nonprofit organisation**

This section will present a brief summary of the major economic explanations of the nonprofit sector and examine the way in which they deal with the public benefit nonprofits. The literature on nonprofits contains a number of well-constructed and comprehensive surveys of economic theories of nonprofits<sup>7</sup>; therefore, in this summary, accent will be made only on those aspects of the theories which are relevant for the distinction between serving private and public interests.

The existing economic theories of nonprofits can be classified into two groups with respect to their identification of the major source of economic problems that nonprofits can more or less effectively deal with: government failure and market failure<sup>8</sup>. The concept of government failure as the motive for the creation of nonprofits is presented in the theory developed by Weisbrod<sup>9</sup>, which is also known as the 'public goods' theory. The general argument of Weisbrod is that government is providing public goods to meet the needs of the median voter. If a fragment of population happens to have a greater need for a certain good than is the case with the median voter, then nonprofit organisation represents a mechanism to satisfy this residual demand by means of private production of public goods by those who need these goods in the greater amount. A number of empirical studies tracing the relative importance of nonprofit organisations in a given sector to the heterogeneity of tastes and demands in the population provide evidence which is in principle supporting the theory<sup>10</sup>.

Weisbrod's theory is challenged with two major objections, one empirical and one conceptual<sup>11</sup>. The empirical one is that the services provided by a growing number of nonprofits do not have the character of public goods but rather represent private goods, in which case a direct competition exists between state, private for-profit, and nonprofit day-care centres, schools, and arts companies. This competition is difficult to reconcile with the public goods theory which presupposes a unique niche for nonprofits.

The conceptual objection is that it is not clear why the demand for public goods in excess of their provision by government should necessarily be satisfied by nonprofit, rather than for-profit firms<sup>12</sup>. To be sure, this criticism is fully aware that markets represent an inefficient mechanism for provision of public goods due to free rider problem. In those cases where this problem hinders the private provision of public goods, this criticism is of course not applicable. However it is also known that human nature is not so selfish and self-centered as assumed in the rational models of economic behaviour. It is a matter of fact that sometimes people do want to contribute to the provision of public goods. The question is: when they want it, why should they choose to patronise nonprofit rather than for-profit firms to execute the

delivery of the needed public goods? For example, the public goods theory cannot answer why the charitable delivery of food to poor countries is often organised by nonprofit rather than for-profit firms<sup>13</sup>.

These two objections are effectively eliminated in the contract failure theory developed by Hansmann<sup>14</sup>, however at the cost of using a different explanatory approach which does not extend to the issues of the relationship between state and nonprofits. Contract failure is defined by Hansmann as the inability of consumers “to police producers by ordinary contractual devices” and represents a particular kind of market failure<sup>15</sup>. Specifically, contract failure occurs when consumers cannot determine the quantity and/or quality of goods and services that are provided to them, as is the case eg with medical care or day care for small children. In this situation, for-profit firms would have an incentive to downgrade quality/quantity characteristics of the products they offer at each given price, and appropriate the resulting profits. The advantage of nonprofit firms in dealing with such products lies in the fact that no profits can be appropriated by members or patrons, which explains that nonprofit firms should not have any similar incentives to cheat consumers. In this sense, nonprofit firms are more trustworthy than for-profit ones.

Whereas the contract failure theory evidently has a most direct bearing on commercial nonprofits, ie those which generate their income by selling goods and services, it also has a certain appeal as an explanation for donative nonprofits, ie those which receive a major part of their income in the form of donations<sup>16</sup>. It is certainly true that donations to any organisations make little sense unless the donor has a guarantee that the contributed funds will be used only for the purpose established by him. If the for-profit firm would receive a donation, it would have an incentive to appropriate it as profit, whereas the nonprofit firm would be legally obliged to use all funds for the purposes of the organisational activity. When applied to issues of donations and philanthropy, the contract failure theory views nonprofits as a response to the principal-agent problem, where principal is represented by the donor, and agent – respectively by the entity entrusted to administer the donated funds<sup>17</sup>.

The contract failure theory does provide a number of ingenious explanations for the

existence of donative financing. For example, in the high-culture live performing arts, donative financing can be rationalised as a form of voluntary price discrimination, which is made necessary by the unusual cost and demand structure of this industry: significant fixed costs, low marginal costs, and highly variable utility of the arts products across consumers<sup>18</sup>. In these conditions, no single ticket price exists which would allow the arts organisations to cover their total costs. Whereas standard price discrimination is infeasible due to potential transferability of tickets, voluntary price discrimination has turned out to be possible: consumers are encouraged to donate to arts organisations to better reflect the individual utility that they derive from the performances<sup>19</sup>. Donations to higher educational organisations are rationalised as voluntary repayments under an implicit loan system that has arisen to compensate for the absence of efficient loan markets<sup>20</sup>.

Another type of market failure that the nonprofit firm theoretically can correct relates to the inability of markets to ensure sufficiently strong consumer control over the activities of firms. The stronger consumer control may be necessary to guarantee that products offered by firms are of sufficiently high quality<sup>21</sup> or to avoid potential exploitation of customers in the case of exclusive social clubs<sup>22</sup>. These roles of nonprofits resemble the economic functions of co-operatives<sup>23</sup>, whereby the co-operative form is preferred in those cases where the strongest objective is to minimise prices paid by consumers, and mutual nonprofit form – respectively in those cases where maintenance of high quality is the major priority<sup>24</sup>. This consumer control theory, however, has limited empirical support<sup>25</sup> and provides no explanation for the existence of public benefit nonprofits.

The contract failure theory of nonprofit organisations has also been challenged with a number of criticisms. Although the theory has been indirectly confirmed by a number of empirical studies<sup>26</sup>, it does not take account of the fact that managers of nonprofit firms can find other ways to dishonestly appropriate earnings besides distributing them as profits. Moreover, consumers often do not really know (and care) if the firm they are dealing with is nonprofit or for-profit<sup>27</sup>. And, most importantly for the theme of this essay, the contract failure theory does not explain why individuals may

want to make donations, but only suggests that if they want to do it, they are likely to donate to nonprofit rather than for-profit firms<sup>28</sup>.

It can be summarised therefore that the market failure theories seek to rationalise nonprofit organisation as a mechanism to protect private economic interests, and therefore cannot offer much to explain why private funds can be consciously allocated to promote public interests, ie to bring benefits to individuals who have no personal connection with donors. In these theories, nonprofit organisation is represented either as a contractual device mainly intended to overcome the problems of asymmetric information and principal-agent relationships (the contract failure framework) or as a mechanism of mutual self-help on the part of consumers seeking to avoid various forms of exploitation by business firms (consumer control framework). The major question that seems to be unanswered by contract failure explanations of donating behaviour is: why do people not free ride when they have an opportunity to do so? Why do they donate if they know that their contribution might be insignificant, or might not be really discernible for other people<sup>29</sup>, and that there would be no sanctions in case of donating nothing?

This weakness of the contract failure theory is not, however, characteristic for Weisbrod's public goods theory. As indicated by Hansmann<sup>30</sup>, the public goods theory provides a good explanation of the existence of eg some donative nonprofits that collect private donations to finance medical research, such as the American Heart Association, the National Cancer Society, and the March of Dimes). The major aspect of the public goods theory-based explanation is that there are people who demand certain products in excess of their amount provided by government; as a consequence, they are willing to provide their own funds to support the private production of these products.

As has been already mentioned, this explanation appears incomplete since it does not make clear why individuals would like to provide funds to a nonprofit organisation rather than to contract with a for-profit firm to ensure the execution of the same type of research. Whereas the contract failure theory seems to provide a satisfactory answer to this criticism, it leaves unanswered yet another possible question. Specifically, if some individuals need

a certain service in excess of the level provided by the government, and if for-profit firms are not willing or able to produce it, why should these individuals establish a public benefit nonprofit rather than a cooperative or a mutual self-help association in order to organise the provision of this service to themselves? Such a mutual self-help entity would certainly represent a nonprofit firm, and this would be in full congruence with the Weisbrod's theory.

Indeed, the fact that some individuals demand certain public goods and that this demand is not satisfied by government absolutely does not necessitate the creation of a public benefit nonprofit organisation. If I need a certain service, why should I pay to allow others to enjoy it if I need it myself in the first place? Rather, I should be thinking how to finance my own access to it. If the public good which I need is at least to some extent excludable, then it is worthwhile for me and other individuals with same demand to establish a club in the sense of Buchanan<sup>31</sup>. Moreover, it seems not impossible that even though certain individuals might not have own demand for a certain service, but would still contribute to its provision. Such facts would be clearly unthinkable in Weisbrod's framework.

The upshot of this discussion is that the public goods theory of nonprofit organisation, although both logically and evidently empirically correct, explains the existence of mutual benefit nonprofits but not of those with public benefit orientation. One outlined difficulty with this theory is that public goods are not necessarily inter-related with public benefit, since they can be enjoyed also privately. The other difficulty is that the extent of individual demand for a product is also not necessarily correlated with voluntary contributions of respective individuals. The consumer control theory also concentrates on mutual benefit rather than public benefit nonprofits, and the contract failure theory sees the meaning of nonprofit organisation in protecting private economic interests of consumers but again not in promoting the public interest. Therefore, the question why some nonprofits do directly serve public purposes is largely unanswered by the major economic theories of nonprofit organisation. In the following sections, an alternative theoretical framework will be offered, which will allow to resolve the above mentioned conceptual problems in explaining the nature of nonprofit organisation of the public benefit type.

## The key role of social values

### Social values as the foundation for public benefit nonprofits

The major element of an explanatory framework for public benefit nonprofit organisation offered in this essay is that this type of organisation exists because it enables the realisation of social values held by people. Social values are understood here as enduring beliefs that a specific end-state of existence is socially preferable to an opposite or converse end-state<sup>32</sup>. Since people have these beliefs, they are motivated to practically realise them, ie to change the existing social reality in the direction of its better conformance with what is seen as preferable. A possible mechanism for changing the existing social reality presents itself in the form of supporting a nonprofit organisation which has a mission to promote the respective values. Arguably, such mission-oriented nonprofits are the most appropriate organisations to pursue public purposes with private funds; consequently, the existence of and pursuit of social values by individuals represents the major factor necessitating the operation of nonprofit organisations of the public-benefit type.

Whereas values do actually represent a type of beliefs, they differ from other beliefs in their capacity to ensure self-realisation or self-enforcement. The existence of a certain belief in itself does not lead to the idea that its contents ought to be somehow implemented in the reality, which is true for beliefs of a descriptive or reflective character. These beliefs represent human attempts to better understand the reality, whereas values as normatively oriented beliefs represent attempts to create a mental picture of a better reality which ought to be implemented. It is important to emphasise that this better reality, although it may be unachievable in its complete form, can be feasibly realised in a number of partial forms. In this way, in contrast to other types of beliefs, values possess a certain self-realisation potential, due to their special effects on motivation of human behaviour. The key argument here is that private support to nonprofit organisations of public benefit type is motivated by values shared by groups of individuals.

The role of values in shaping economic behaviour represents a controversial issue in economic theory. In positivist neoclassical economics values have naturally been an alien

issue since economics was increasingly seen as a science of prediction and testing whereas value statements are inherently not amenable to falsification<sup>33</sup>. With the advent of institutionalism, however, it became clear that it is only under idealised conditions of perfect availability of information and full rationality that self-interest can lead to the promotion of public benefit, as is suggested by the Smithian idea of invisible hand<sup>34</sup>. In the real world, economic agents are confronted with possibilities also of such non-productive behaviour as stealing, shirking, cheating, which promote self-interest but not the public one. Values play a crucial role here since they determine whether economic agents will prefer honest or dishonest ways of doing business. In this sense, the stock of values determines the cost of operating the economy<sup>35</sup>, and consequently sets limits to the maximum level of economic welfare that can be realised in the society.

This recognition of the important role of values and culture in general in determining economic performance undoubtedly represents a major step toward a more realistic understanding of economic reality. However it is quite possible that the economic significance of values is more diverse than suggested by the above mentioned view that the function of values is reduction of transaction costs. In order to better understand the effects of values on the existence of nonprofit organisations, it is important to take account of the differences between different types of values, since different values, as will be shown below, have different economic implications.

The sociological literature draws a major distinction between instrumental and terminal values, the former of which refer to beliefs regarding the desirable modes of conduct, and the latter – respectively desirable end-states of existence<sup>36</sup>. The transaction cost reducing role of values, as discussed eg by Ben-Ner and Putterman<sup>37</sup>, arguably refers to the instrumental values, or, more precisely, to their subclass which may be termed ‘moral values’. If economic agents would have more moral values, there would be less opportunism, and less productive resources would have to be directed to its prevention. The terminal values however do not necessarily perform this transaction cost economising function. Rather, they determine the types of political and economic institutions that exist in a given society.

Although the effects of both instrumental and terminal values on economic behaviour represent much too a complex issue which is beyond the scope of this essay, here it can be specified that whereas instrumental values determine how organisations in a given society operate, terminal values determine what kinds of organisations are there. Rokeach<sup>38</sup> suggests that institutions are generally assigned the task of the maintenance and enhancement of certain subsets of human values and of their transmission from generation to generation; as examples he mentions religious, educational, political, economic, and legal institutions. Although it would be surely an exaggeration to state that the enhancement of human values represents the only function of such a diverse set of institutions, it can be reasonably argued that such values are more important for some of these institutions than for others. For example, terminal values are definitely more important for public-benefit nonprofits than for business firms, or even for mutual-benefit nonprofits.

Of course, terminal and instrumental values are closely interrelated, and the boundaries between them may be no less blurred than the boundaries between public- and mutual-benefit nonprofits. This is demonstrated by possible overlaps and intersections in the activity areas of public-benefit nonprofits, mutual nonprofits, and for-profit firms. Indeed, in some cases for-profit firms donate to nonprofits; in others, non-profit and for-profit firms stand in a competitive relationship (which means that they offer similar products); still in others, they form partnerships and alliances<sup>39</sup>, not to mention the sometimes uneasy distinction public and mutual interest orientation of nonprofits themselves. All this suggests that the social values which play a decisive role for organisations often do not represent the only values that these organisations have.

The sociological literature suggests that terminal values may be further subdivided into personal (self-centered and intrapersonal) and social (society-centered and interpersonal) ones<sup>40</sup>. Evidently only social values may motivate the delivery of private voluntary contributions to promote public purposes and in this sense are relevant for public benefit nonprofit organisation. On the contrary, the pursuit of personal values can be realised not only by mutual-benefit nonprofits, but also by for-profit firms, which might offer good

opportunities to reach preferred end-states of personal existence.

### **Distinguishing between economic and sociological interpretations of value**

In discussing the significance of values for nonprofit organisation, and more general institutional and organisational arrangements of society, it is important to draw a terminological distinction between economic and sociological understanding of the concept. Whereas sociologists understand the values as beliefs about preferability of certain modes of conduct or end-states of existence, the values that economists are concerned with are the subjective values people attribute to the sources of their satisfactions and dissatisfactions<sup>41</sup>. The argument offered here that nonprofit organisation emerges as an attempt to realise certain social terminal values is naturally based on their sociological interpretation. Assuming that the economic relations represents just one fragment of the all-embracing social reality, the economic meaning of the concept of value can be considered to represent a particular case of the sociological meaning, since individual satisfaction provides the basis for individual preferences of some products over others.

With this distinction in mind, the argument offered here can be integrated into a more general theory: values of whatever type motivate human behaviour; the type of values determines the type of mechanism that people will choose to realise them. In the case of economic subclass of values, this mechanism is represented by market<sup>42</sup>; in the case of terminal social values – by civil society organisations, ie nonprofits, and specifically by those which use private funds for the promotion of public purposes. There are of course a potentially large number of other types of values in the sociological understanding of the term (ie personal values as opposed to social ones; moral values; competence values; institutional values, etc<sup>43</sup>). Other values will respectively require other mechanisms of realisation, the clarification of which certainly represents a stimulating area of social research.

It should be mentioned that market in a general sense does not represent an absolutely efficient mechanism of realisation even of economic values due to a number of reasons: markets are sometimes only imperfectly competitive; consumers' valuation of their own

satisfaction is sometimes unreliable, as is the case with public and merit goods; production or consumption of some goods may generate favourable or unfavourable side effects which do not go through the market but which nevertheless ought to be taken into account<sup>44</sup>. Some of these reasons represent a rationale for governmental interference; some others, eg related to the problem of public goods, have been used in constructing economic explanations of nonprofit organisation (in Weisbrod's framework). But these explanations, as we have seen, are applicable to mutual-benefit nonprofits rather than to those of public-benefit type.

### **Public benefit nonprofits and altruism**

The studies of nonprofit organisation, particularly those dealing with donations, have traditionally been confronted with the limitations of the rational choice model of economic behaviour. Rational behaviour motivated by self-interest is indeed incompatible with selfless charitable giving in the true sense of the term. Moreover, even in the case of mutual-benefit organisations, where all financial contributions are used to promote the interests of the members themselves, rational self-interested behaviour would result in free riding and consequently decreasing ability to reach common objectives with the increasing organisational size, as demonstrated by Olson<sup>45</sup>. Therefore, economists ever more feel the need to sacrifice the formal elegance of models explaining seemingly altruistic behaviour in terms of self-interest in order to obtain a more realistic and more complex view of human nature. This is done by admitting that self-interest does not represent the only motivation of human behaviour, though in many cases it may be the major one.

Public benefit nonprofits are evidently more dependent on altruistic behaviour than mutual benefit ones, since they use their financial resources to promote the interests of individuals other than donors. This is why it is important to examine the possible motivations of individuals to donate to public benefit nonprofits. Rose-Ackermann<sup>46</sup> suggests that

Some giving is the result of feelings of commitment; some results from sympathy; some arises from belief in the moral value of reciprocity; some is motivated by private

benefits to the donor such as prestige, pride, and attendance at elite parties.

Donations to public benefits nonprofits may be explained in various degrees by all of these reasons. The important point however is that although self-interest might play an important role in some cases (eg when donor seeks to gain prestige by donating), the pursuit of social values as motivation for donating represents an essentially selfless behaviour.

Specifically, the pursuit of social values can be described in terms of two major motives of selfless behaviour – love and duty, or sympathy and commitment<sup>47</sup>. Of these two, the most appropriate seems to be duty in the sense of commitment to certain views about better organisation of society. For example, some people might prefer to live in a physically healthier society or a society which takes good care of disadvantaged individuals; others might prefer a society which is more open and conducive to certain types of arts; still others want their society to place greater emphasis on religious values; still others have a preference for society which promotes particular types of education and research. All of these social values are based on commitment to abstract views about the ways in which the existing social reality can improved.

Love or sympathy may also to some extent explain giving behaviour: if an individual has a personal sympathy for other individuals, the help to whom is set as the mission of a given nonprofit, he is likely to donate to that nonprofit. It should be noted however that personal sympathy represents only a limited explanation for donating to nonprofits, since if its emotional background is strong and the group of beneficiaries is well specified, then nonprofit organisation becomes in fact unnecessary. In this case, the donor can support the target individuals directly, ie without the nonprofit firm. An exaggerated example is that parents do not need to donate to nonprofits in order to help their children because it is easier for them to do that directly. Moreover, the values which are pursued in these cases are more likely to be of personal than of social type. The pursuit of social values in the pure case presupposes that donors are not personally acquainted with beneficiaries; therefore duty or commitments to principles and ideas represents the major altruistic motive relevant for the pursuit of social values.

### **The nature of economic coordination in nonprofit organisation**

As noted by Salamon, Sokowski, and List<sup>48</sup>, the nonprofit sector is important not only in social and political terms, but it also represents a significant economic force. In the thirty five countries covered by the John Hopkins Comparative Nonprofit Sector Project described by the above mentioned authors, as of the late 1990s the nonprofit sector had aggregate expenditures of US\$1.3 trillion, with religious congregations included. This represents 5.1 per cent of the combined gross domestic product of these countries. The nonprofit sector in these countries is also a major employer, with a total workforce of 39.5 million full-time equivalent workers, including religious congregations<sup>49</sup>. The huge amount of resources coordinated by the nonprofit firms stimulates an inquiry into the nature of economic coordination within nonprofits, and its relationship to mechanisms of economic coordination used outside the nonprofit sector, ie by profit-oriented firms.

As has been convincingly demonstrated by Williamson<sup>50</sup>, the major economic institutions of capitalism are represented by markets and hierarchies. Economic actors will choose to organise their transactions across markets or within hierarchies depending on the relative values of transaction costs of market or hierarchical coordination. Markets and hierarchies however represent not only distinct institutional arrangements but also mechanisms of economic coordination. Coordination in markets is achieved through prices; in hierarchies – respectively through authority relation<sup>51</sup>.

In this context, the paradox of nonprofit organisation lies in the fact that their activities seem to be coordinated neither through prices nor through administrative instructions. This is suggested by the two fundamental characteristics of the giving behaviour:

- 1) it is voluntary, ie undertaken not in response to any hierarchical instructions; and
- 2) it is selfless or altruistic, and in this sense any changes in market prices must be irrelevant for it.

Rather, according to the approach suggested here, social values represent the major principle which coordinates allocation of private resources to achieve public objectives. It can

be therefore generalised that whereas coordination in markets and hierarchies is achieved through respectively through prices and authority relation, in the case of nonprofit organisation the coordination role is performed by social values.

It has been suggested earlier that economic coordination in co-operative organisations also cannot be described in terms of prices and authority relation, since members of co-operatives are not buying anything from each other and are working together voluntarily rather than in response to administrative instructions. Rather, it has been argued that internal coordination and resource allocation in co-operatives is determined social capital, which stands in the same role for cooperatives, as prices – for markets and authority relation – for hierarchies, respectively<sup>52</sup>. In this connection, it can be noted that the pursuit of social values as the motivational mechanism explaining the existence of public benefit nonprofits undoubtedly has something to do with the stock of social capital present in a society, as social capital and civil society are seen as essentially interdependent phenomena<sup>53</sup>.

However there are some evident differences in the types of social capital as coordination principle in public benefit nonprofits and co-operatives. Specifically, the social capital required by cooperative members mainly refers to trust and ease of communication between them. As shown by Bonus<sup>54</sup>, trust among members allows them to internalise transactions involving transaction-specific resources and in this way avoid expropriation of respective quasi-rents by outside opportunists. In this sense, cooperatives require personal social capital, ie social capital linked to the relations among individuals well acquainted with each other. In contrast, social values motivate individuals to help other individuals with whom they have no personal connection; therefore social capital required by public-benefit nonprofits is of impersonal type. Mutual-benefit nonprofits in this sense evidently stand closer to co-operatives than to public-benefit nonprofits.

### **Why not markets and governments?**

The proposed argumentation that the existence of public-benefit nonprofit organisation can be traced back to individual



motivations to pursue certain social values evokes a natural question: why cannot these social values be realised by markets and governments as the major alternatives of the nonprofit sector? Why does the public benefit nonprofit organisation represent the best mechanism to realise them? Or does it at all?

Before these questions will be answered here, it is important to point out that the proposed approach by no means rules out the possibility that markets and governments have something to do with social values. As was discussed above, the efficiency of markets depends on the extent to which market agents adhere to moral values such as honesty. In addition, McCloskey<sup>55</sup> correctly indicated that markets promote a number of moral values such as prudence, being entrepreneurial, thriftiness, modesty<sup>56</sup>. Moreover, production of regular consumer products having the character of private goods may be associated with such social values as economic efficiency and satisfaction of consumer demands. These values however are fully compatible with the pursuit of self-interest given that entrepreneurs observe a number of moral values, as discussed above. It is clear however that consumer satisfaction and efficiency of business firms represent only a small fraction of social values important for society. When certain goods and services are associated with values other than these then for-profit firms will not be so appropriate for their provision as public-benefit nonprofits. The government may assume responsibility for performing socially useful tasks which are highly valued by citizens.

Therefore, in order to provide adequate answers to the posed questions, it is important to remember the specific type of human values which explain the existence of public-benefit nonprofits: social rather than personal, terminal rather than instrumental, and requiring altruism rather than self-interest. In other words, the argument that public-benefit nonprofits represent the best mechanism for realising social terminal values does not exclude that human values of other types (not social and/or not terminal) may be effectively promoted by markets and/or governments. With account of this provision, the posed questions can be reformulated in a more specific way: what are the disadvantages of markets and governments in coordinating resources for the pursuit of social terminal values?

The two major disadvantages of markets include:

- 1) individually preferred end-states of social existence are unrelated to specific instances of organisational performance which constitutes a constant survival test in the marketplace; and
- 2) managerial behaviour motivated by economic objectives is not necessarily compatible with behaviour aimed to realise these individually preferred end-states of social existence.

The first disadvantage essentially means that if a for-profit firm would be entrusted with the mission to pursue a certain social value, then the degree to which this social value can be realised by this firm would depend on its ability to survive, ie to make profits or at least, to cover costs. Whereas profitability in itself would have nothing to do with the contents of the social value it seeks to achieve, it would represent a serious constraint on the possibility of realisation of this value. Namely, the possibility of value realisation becomes dependent on whether the firm performs well in comparison to its competitors; competition and market dynamics generate a number of risks which endanger the value realisation process. In contrast, survival of nonprofit firm is less dependent on whether it performs well in comparison to competitors (although of course it has to compete and should be able to cover costs). In this context, the meaning of private donations and governmental subsidies precisely lies in the attempt to 'switch off' the constraints and risk factors related to the necessity to ensure the economic survival of organisations seeking to realise the social values, whereas the use of donations and subsidies in for-profit firms is complicated by the possibility of their appropriation as profits.

In some cases, it is explicitly evident that goods or services associated with certain social values cannot be economically viable, which provides an additional reason to transfer their production into the sphere of responsibility of nonprofits. Weisbrod<sup>57</sup> argued that:

private enterprise, driven by profit seeking, cannot be relied on to undertake activities, such as pollution control and consumer

health and safety protection, that would be unprofitable even if consumers valued them highly.

The social value approach proposed here does not assume that goods or services associated with social values are always unprofitable (although sometimes they may be so); some live arts performances or educational programmes may be profitable. However, what people want to achieve with entrusting these social value-laden outputs to nonprofits rather than for-profit firms is not to allow the production of these outputs to depend upon profitability which is unrelated to the contents of the social value in question.

The second, and related, disadvantage of for-profit firms in seeking to realise social terminal values is that managerial behaviour oriented to achieve economic objectives, related to profits, organisational size, etc is different from behaviour seeking to use all available resources to promote certain abstract ideas. This is an even more important disadvantage than the first one, since it a priori guarantees that scarce resources will be used for purposes other than the realisation of social values; whereas the first disadvantage did not presuppose guarantees that the social value-laden goods and services should be economically unviable. Knowing that resources cannot be used efficiently (with respect to social value realisation) by for-profit firms, potential donors would want to establish a nonprofit firm and make donations to it. This argument is supported by a number of studies conducted by James<sup>58</sup> who found that nonprofit firms often represent ideological organisations seeking to pursue abstract ideas rather than to make profits.

The major disadvantages of governments in pursuing social terminal values include:

- 1) governmental agencies are constrained by strict rules and regulations that do not apply to non-governmental organisations; and
- 2) realisation of social values by government requires these values to be sufficiently broadly shared by citizens.

The fact that governmental agencies are limited in their freedom of choice of strategies to achieve their objectives may even motivate them to delegate a number of tasks to nonprofit

firms because the latter can perform the required activities more efficiently<sup>59</sup>. Moreover, the extent of governmental provision of social value-laden activities is determined according to the same logic as the extent of governmental provision of public goods in Weisbrod's theory. Specifically, if population is heterogeneous and particular social values are supported by some groups of population and opposed by others, the total governmental provision of social value-laden activities in question can fall short of the level that would be satisfying to the group which supported the respective values. Nonprofit firms do not have this limitation. Indeed, they are free to support any activity which is not prohibited by law; consequently, they can deliver the required social value-laden activities up to the point at which the demand for them is fully satisfied.

There is still another disadvantage of markets and governments commonly shared by both of them – crowding out of private initiatives to contribute funds to realise social values. Government can crowd out these initiatives in two ways:

- 1) increase of public funding for certain goods and services may cause reduction of private contributions<sup>60</sup>; and
- 2) bureaucratic organisation characteristic for governmental agencies may also lead to dissipation of the values held by individuals employed by these agencies.

For-profit firms pursuing a certain ideological mission (if they do) always run the risk of commercialisation, ie of change in their organisational mission and goals in the direction of greater emphasis on economic objectives. Introduction of profit motives into the motivational systems of individuals seeking to realise social values is likely to lead to compromising these values.

It should be emphasised however that the above mentioned disadvantages do not give rise to any hard and fast separation between the responsibilities of markets, governments, and public benefit nonprofits. This is so primarily due to the fact that social values represent a continuous rather than discrete variable which, moreover, may exhibit significant dynamics over time. Therefore it is also important to identify possible complementarities between the pursuit of social values and the operation of both governments and markets.

In the case of government, the public provision of social value-laden outputs can be compatible with the spirit of these values in those cases when they are widely or universally shared. The widely shared values may relate for example to basic health care services, basic educational programmes, or national defence. Since the values are so much accepted and viewed as vital, members of society may prefer not to rely on voluntary contributions to minimise the risk of not getting the sufficient amount of funds due to potential free rider problem as well as any other reasons. When the state evokes the coercive power of law to obtain the required funds by means of taxation<sup>61</sup>, the adequate supply of the valued output becomes certain. Although the governmental provision of social value-laden outputs is associated with a number of above mentioned disadvantages, it may be preferred by society if certainty of supplying these outputs is more important. In this sense, the social value approach suggests that social value-laden goods and services, depending on the degree of social acceptance of the values in question, may be performed by both governments and public-benefit nonprofits.

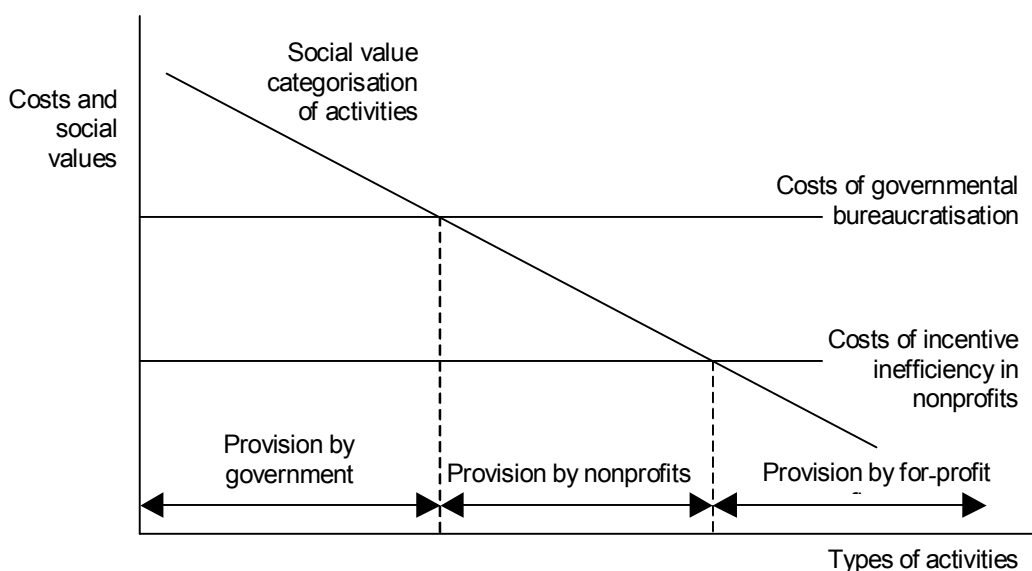
The argument that the differences in the degree of acceptance of certain social values may determine whether the respective activities are undertaken by public benefit nonprofits or governmental agencies can also be applied to identification of complementarities between public-benefit nonprofits and markets. As has

been already mentioned, some of regular consumer products related eg to literature, arts, education, etc may have relevance to certain social values. However private gains might represent an overriding motive for their consumption, whereby the degree to which private gains are more important than social gains reflects the preference for for-profit rather than nonprofit form of provision of these products. Based on this complementarity between responsibilities of governmental agencies and public benefit nonprofit firms, the general logic of organisation of economic activities with respect to their association with social values can be demonstrated graphically (Fig. 1).

The horizontal axis represents a listing of economic activities that are relevant for a given society; this listing is organised in the descending order of importance and acceptance of social values associated with these activities (with social values promoted by markets not included) and represented by the downward sloped line denoted as 'social value categorisation of activities'. In the Figure, the term 'incentive inefficiency in nonprofits' refers to the fact that

nonprofit managers have little incentive to manage their firms efficiently because no one has a claim to the residual earnings<sup>62</sup>,

which is aggravated by the absence of markets for corporate control<sup>63</sup>. The introduction of the



**Fig1. The social value approach to explaining public benefit nonprofit organisation: a graphical illustration**

costs of incentive inefficiency explains the fact that when adherence to certain social values do not represent the major motivation for supply of certain goods and services, for-profit firms will be preferred to nonprofits.

Finally it should be mentioned that that Fig. 1 refers only to public benefit type of nonprofits and is therefore not relevant for other nonprofits discussed in the theories of eg Weisbrod<sup>64</sup> and Hansmann<sup>65</sup>. It can be assumed that nonprofits explained by contract failure can be located in the area of 'provision by for-profit firms' if they have no significant association with any social values. Nonprofits explained by excess demand for public goods are likely to be located in the area of 'provision by nonprofits', since many public goods are associated with certain social values, although this is not necessarily always so.

## Conclusions

In his article on 'pragmatic view on values' in economics, Klamer<sup>66</sup> arrived at a conclusion that in order to realise their social values, individuals need a sphere that does not suffer from the rigor and discipline of both markets and governments. This essay has sought to demonstrate that at least a part of this 'third' sphere which is most appropriate for the pursuit of social values is represented by public-benefit nonprofit organisation.

Specifically, the essay argued that the major existing economic theories of nonprofits explain them in terms of their capacity to protect and promote private economic interests but not the public ones, thereby leaving unclear why some nonprofits do directly serve public purposes. According to the approach offered in the essay, nonprofits of public-benefit type exist because they represent a mechanism of realising certain social values by individuals who adhere to them. In this way, the social value approach has also pointed toward a need to deepen the understanding of social values in economic theory: whereas the economic significance of some values lies in reducing the cost of operating the economy<sup>67</sup>, the role of other social values lies in determining the types of organisations that exist in society,

specifically in determining the relative importance of the nonprofit sector with regard to market and government sectors. It has been also argued that by attracting a significant amount of resources under discretion of public-benefit nonprofits, social values also perform the function of the principle of economic coordination in these organisations, similar to the role of price in markets and authority relation in hierarchies.

The importance of public-benefit nonprofit organisation in realisation of social values is also explained by respective limitations of the market and government sectors. Markets are disadvantaged here because the contents of social values and the degree of their acceptance in society are unrelated to economic performance of organisations which seek to promote these values if this performance is determined solely by market forces; unexpected variations in performance consequently represent a risk factor which can to some extent be avoided by public-benefit nonprofits. Markets also presuppose specific patterns of managerial behaviour which are not necessarily consistent with the pursuit of social values. Governments are bound by strict rules which may increase the costs of activities aimed at realisation of social values; in addition, performance of these activities by governmental agencies requires a broad consensus about their importance in a given society. Both markets and governments, if entrusted with the performance of social value-related activities, may crowd out private voluntary initiatives.

The approach presented in the essay suggests a number of questions for further research. It would be interesting to explore the implications of the approach for interaction between the three sectors – markets, governments, nonprofits, specifically explain why in some cases this interaction brings synergies while in others – crowding-out effects. Another fruitful direction of research lies in verification of the major hypothesis proposed here that the existence of social values gives rise to the existence of public benefit nonprofits by interpreting empirical relationships between specific values and specific nonprofits.

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## Notes

- 1 James and Rose-Ackermann (1985, p5)
- 2 Hansmann (1980)
- 3 Ibid
- 4 See eg Douglas (1987, p51). To these two types, Douglas adds a third one: political action organisations, which aim not to provide benefits themselves but to persuade government to do so. However, in the context of this discussion, political action organisations can be considered to represent a subclass of mutual benefit organisations since they seek benefits only for their members.
- 5 Salamon, Sokolowski, List (2003, p1)
- 6 Douglas (1987, p51)
- 7 See eg Rose-Ackermann (1985); Hansmann (1987)
- 8 Badelt (1990)
- 9 Weisbrod (1977, 1988)
- 10 See eg Lee and Weisbrod (1977); Feigenbaum (1980); James and Benjamin (1984)
- 11 Hansmann (1987, p29)
- 12 Ibid
- 13 See Hansmann (1980, p835)
- 14 Hansmann (1980, 1987); see also Nelson and Krashinsky (1973), Nelson (1977)
- 15 Hansmann (1980, p845)
- 16 Hansmann (1987, p30)
- 17 Ibid
- 18 Hansmann (1981b)
- 19 Ibid
- 20 Hansmann (1980; 1987)
- 21 See Ben-Ner (1986)
- 22 Hansmann (1980, 1987)
- 23 Hansmann (1987, p33)
- 24 James and Rose-Ackermann (1985, p15)
- 25 Hansmann (1987, p34)
- 26 See eg Hansmann (1981a)
- 27 See eg Permut (1981)
- 28 Hansmann (1987, p37)
- 29 Cf the argument of Olson (2002, p64)
- 30 Hansmann (1987, p29)
- 31 Buchanan (1965)
- 32 Rokeach (1973, p5). This definition represents a particular case of the more general definition of values offered in the cited book.
- 33 Ben-Ner and Putterman (1998, p3)
- 34 Ibid, p8
- 35 Ibid, p6
- 36 Rokeach (1973, p7)
- 37 Ben-Ner and Putterman (1998)
- 38 Rokeach (1973, p25)
- 39 See eg Weisbrod (1998)
- 40 Rokeach (1973, p7)
- 41 Scitovsky (1993, p93)
- 42 As indicated by Scitovsky (1993, p93), the interest of economists in the public's subjective value judgements is explained by their concern with "the economy's ability to allocate resources, coordinate production, and distribute products, so that the public should be provided with the goods and services they want, in the quantities they want them, and in a way that creates the greatest benefit at the least cost as those benefits and costs are evaluated by people who experience them".
- 43 See eg Rokeach (1973)
- 44 Scitovsky (1993, p95-96)
- 45 Olson (2002)
- 46 Rose-Ackermann (1996, p714)
- 47 It should be mentioned however that different views exist on whether love and duty represent truly selfless motives. See review in Mansbridge (1998).
- 48 Salamon, Sokowski, List (2003, p13)
- 49 Ibid
- 50 Williamson (1985)
- 51 Valentinov (2004)
- 52 Ibid

- 53 See eg Fukuyama (2000)
- 54 Bonus (1986, p335)
- 55 McCloskey (1996)
- 56 Quoted in Klamer (2003, p196)
- 57 Weisbrod (1988, p5)
- 58 James (1982, 1984, 1986)
- 59 Douglas (1987)
- 60 Weiss (1986); Steinberg (1993)
- 61 Douglas (1987, p44)
- 62 Rose-Ackerman (1996, p717)
- 63 Ibid
- 64 Weisbrod (1977)
- 65 Hansmann (1980)
- 66 Klamer (2003, p209)
- 67 Ben-Ner and Putterman (1998, p6)