

## **Economic theory and its capacity to comprehensively explain the presence of non-profit organisations in society**

Jennifer Finn

*Junior Sophister*

finnjn@tcd.ie

*Although the non-profit sector may seem like an area which defies analysis by the field of economics, as Jennifer Finn seeks to demonstrate there are in reality a wide range of insights which economic theory can offer to explain why a multi-billion dollar 'third sector' has sprung-up and flourished in today's global economy. Indeed, as Finn argues, it is the economic importance of these entities which justifies their study by this discipline.*

### **Introduction: the nature of the third sector and its modes of finance**

*"Nonprofit institutions are legal or social entities created for the purpose of producing goods and services whose status does not permit them to be a source of income, profit, or other financial gain for the units that establish, control or finance them. In practice their productive activities are bound to generate either surpluses or deficits but any surpluses they happen to make cannot be appropriated by other institutional units - United Nations, 1993: paragraph 4.54."*

(Anheier, 2005: 46)

The non-profit sector, sometimes referred to as the third sector (Anheier, 2005:4), consists of non-profit, voluntary and private organisations. It is composed of a rich variety of entities ranging from museums such as the Getty Museum in Los Angeles, to human rights organisations like Amnesty International, to medical bodies such as Médecins Sans Frontières and even universities like Yale and Stanford. The non-profit sector is a major economic force which accounts for "7.1 per cent of total employment in the US[A]" with education representing its most significant aspect (Anheier, 2005: 65). The third sector is dominant from an economic perspective in the fields such as health, education and social services (Anheier, 2005: 68).

Non-profit organizations are financed by public sector payments such as grants, private donations from corporations and ‘program fees’ such as investment income (Anheier, 2005: 69). Many of these bodies are staffed by volunteer labour, for example, Oxfam charity shops, and even when their staff are remunerated, the wages are typically lower than those in the public and for-profit sectors. Indeed these entities are “barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors or trustees” (Hansmann, 1980: 838). Therefore, stakeholders in a non-profit organisation such as volunteers, employees and directors on the board do not receive any dividends. Furthermore, volunteers receive no monetary benefit, but are instead motivated by non-economic concerns. Non-profit organisations rely on their volunteers as well as donations, without which they could not operate.

Although, these characteristics of the third sector (non-economic motivations such as altruism, reliance on non-wage labour and donations) appear to exclude it from analysis by economic theory, it must be noted these entities now form a multi-billion dollar industry, which wields considerable influence in the global economy (Salamon, 1996). Though at first, second and third glance, the use of economic theory to explain their existence seems beyond its scope, their importance in the economy justifies such an analysis. This article aims to analyse the various economic theories, which go a long way to comprehensively explaining their presence.

### **Public goods theory: filling the gap left by the market**

A public good is characterised by non-excludability and non-rivalry; as such it is unlikely to be provided by the market. Quasi-public goods are more excludable and rivalrous but are still likely to be provided in insufficient quantities (Weimer & Vining, 1989). Weisbrod (1978) developed the public goods theory of the non-profit sector, which argues that the third sector’s existence is predicated on a need to satisfy a heterogeneous demand for public goods, which goes unmet by the market. The author develops the concepts of demand heterogeneity and the median voter. Demand heterogeneity refers to the demand for public and quasi-public goods, as well as how this demand is dispersed across the population. While the median voter refers to the segment of the population where most demand exists. This theory works best in relation to near-public goods and non-profit organisations that are funded by donations, for example, the services of the Irish Cancer Society. Weisbrod (1978) makes the assumption that altruism exists and is an important factor in explaining charitable donations. However, it fails to recognise the prevalence of impure altruism in society. The theory of impure altruism is an example of a ‘warm glow’ theory (Anheier & Ben-Ner, 2003: 57). It posits that

donors may gain benefits from the act of giving such as social status, relief of guilt or a warm glow from making the donation itself. Thus impure altruists give for selfish reasons.

Despite this limitation, the strength of this theory is that it can be used to explain the importance and necessity of donor support in non-profit organisations. Public good theory perceives the rise of non-profit organisations as a response to the “governmental undersupply of public and quasi-public goods” (Anheier, 2005: 123). The Irish Blood Transfusion Service, for example, relies on blood donors. The government could not supply this so the non-profit sector steps in to meet demand. Weisbrod’s (1978) public good theory has been praised for its “wide acceptance of and recognition within the economics literature” (Kingma, 2003: 53) as well as its ability to explain institutional choice in the context of public-fund shortages. The weakness of this theory is that it assumes an inherent conflict between the government and the third sector. Also, more research is required for policymakers to develop tax and subsidy policies.

### **Entrepreneurship and stakeholder theory: innovation and conflict in the third sector**

By contrast, entrepreneurship theory argues that non-profit organisations are “the result of a specific form of entrepreneurial behaviour” (Badelt, 1997: 63). It offers behavioural explanations for the existence of non-profit organisations in society. The entrepreneurial element of non-profit organisations can be seen in the innovative character of these organisations. Growth of the third sector is attributable to the “presence of considerable entrepreneurial effort” (Badelt, 1997: 170). Entrepreneurship theory has a predictive power. An entrepreneur is required to build a new enterprise, whether it is a public, private or non-profit enterprise. Schumpeter (1936) thus conceptualises the entrepreneur as a ‘change agent’:

“The Schumpeterian entrepreneur is also innovative by employing new means of production, especially new factor combinations”

(Badelt, 1997: 169)

Establishing any organisations involves an element of risk. Entrepreneurs in the third sector bear the same risk as those in the public or private sectors. The strength of this theory is that it explains the pre-eminence of non-profit organisations in health and education. The venture of taking a risk and setting up a non-profit

organisation in society is known as ‘social entrepreneurship’<sup>1</sup>. It emerges from this theory that social entrepreneurship is an organisational behaviour rather than an individual behaviour. Entrepreneurship theory brings out the air of professionalism in the third sector. However, the weakness of the theory is that it does not consider non-value-based non-profit organisations, such as those concerned with environmental security.

Stakeholder theory by contrast, emphasises conflict between stakeholders’ diverging interests. All economic interactions involve at least two parties and a clear conflict of interest (Krashinsky, 2003: 127). In economic theory, the individual is rational and utility-maximising, whilst utilising the profit-metric. Stakeholders can also be bound by the commonality of unforced participation in a common cause. Stakeholder theory argues that stakeholders deliver the service without having a goal of profit. The heterogeneity hypothesis highlights the need for “social cohesion” amongst stakeholders (Anheier & Ben-Ner, 2003: 58). This theory takes a simplistic tripartite view of the interaction of stakeholders with the non-profit organisation and the recipient of the service. It also develops the concept of patron control, whereby consumers seek control of the organisation so as to avoid the exploitation of other stakeholders through the monopolistic power of an independent owner. However, this analysis is limited by its narrow focus on the experience of stakeholders.

### **Interdependence, trust and organisational theory: different facets of the third sector**

Salamon’s (1996) interdependence theory argues that “government support of the third sector is extensive” (Anheier, 2005: 130). This theorist criticises other economic theories for neglecting to describe the “symbiotic relationship between the non-profit sector and the government” (Anheier, 2005: 130). Interdependence theory, sometimes referred to as voluntary failure theory, argues that voluntary action arises out of people’s sense of social obligations and their natural tendencies for collective action. Voluntary failure leads to the need for government action in the form of support for and collaboration with non-profit organisations. This complementary relationship between the third sector and the public sector has a functional basis in society (Anheier, 2005). Interdependence theory is effective in acknowledging the need for government support. It portrays the economic efficiency created in society through the interdependence of government and non-profit.

---

<sup>1</sup> The phrase was initially used in 1972 to describe the social reformer Robert Owen (Banks, 1972).

“Government and the nonprofit sector complement each other and compensate each other’s strengths and weaknesses”

(Anheier, 2005: 131)

Voluntary failures allow non-profit organisations to develop “synergistic relations with the public sector over time” (Anheier, 2005: 133). The strength of interdependence theory is that it takes transaction costs into account, and considers the outcome of lower transaction costs on the provision of public and quasi-public goods to society from organisations in the third sector. It also explains the pattern of public-private partnerships within society. The weakness of interdependence theory is that it takes the development of synergies for granted. It is not clear when these symbiotic relationships will develop. It also treats value-based and non-value-based behaviour as equivalent.

Social origins theory (Salamon & Anheier, 1998) attempts to put interdependence theory in context by moving away from placing too much emphasis on microeconomic models and by considering the size and structure of the organisation. It offers an improvement on economic approaches to the third sector by addressing some of its limitations and considering state society relations.

Trust theory by contrast focuses on the way non-profit organisations are viewed as more trustworthy from the consumers’ perspective. There is, in the consumers’ view, little information asymmetry, which would increase the likelihood of profit accumulation. Consumers trust non-profit organisations to provide the service in a straightforward and honest manner, without the incentive of profits. This can increase the likelihood of profiteering. The strength of this theory is that it takes a supply-side perspective. It also focuses on the nature of the good or service. The weakness of this theory is that it is weakly enforced and neglects the concept of government regulation.

Finally, organisational theory considers isomorphism which is the process through which all organisations with the same institutional expectations and constraints tend to become homogenous over time. It also considers economies of scale and of scope. This is an interesting economic theory in that it looks at the organisational structure and the task environment of the non-profit organisation.

### **Economic analysis of the third sector: the strength of the economic perspective**

“The studies by economists have refined models of giving by exploring the modifications of or additions to the neoclassical

assumptions needed in order to better capture the facts of individual charitable donations.”

(Halfpenny: 1999: 202)

Halfpenny (1999) carried out economic analysis of charitable giving. He explored why people give their own money in order to make others better off - the ‘paradox of giving’. Through neoclassical economic analysis, the author acknowledges the exchange through which “donors advance their own well-being through their giving” (Halfpenny, 1999: 200).

“Economic theory remains objective, looking at factors that influence decisions rather than imposing one’s values on the quality of another’s choice”.

(Hughes, 2006: 431)

The discipline of economics regards the firm as a profit-maximising entity. Economics draws on mathematical and statistical methodology. It offers regression analysis to academics. Regression analysis measures the size and significance of causal relationships. The results can be used as empirical evidence to support findings. Gains from economic analysis have been conceptual and analytical in the study of the motivations of charitable giving. Economic analysis has the capacity to take tax into consideration and how its incidence affects the generosity of donors. And although organisations in the third sector do not aim to maximise profit, they exist in the same economic conditions as for-profit organisations. They are no less vulnerable to these harsh economic conditions than their for-profit counterparts.

## **Conclusion**

As we have seen, the discipline of economics has paved the way to understanding the third sector by offering evidence-based explanations for its existence in society. The field’s strength lies in its capacity to create explanations for the existence of non-profit organisations in society by taking the profit metric into consideration in ways that the disciplines of sociology and political science fail to do. Interdependence theory probably offers the most valuable insight into the third sector by offering a plausible explanation for its existence. Evidence of the mutually beneficial relationship between the state and the third sector is observed through state funding for non-profit organisations. This relationship can compensate for voluntary failure. Whereas other economic theories fail to distinguish between microeconomics and macroeconomics, interdependence theory focuses on the micro

level of the firm itself whilst also taking into consideration, the macro level of the government.

While the combination of these theories forms a comprehensive explanation for the presence of non-profit organisations in society, there is a real lack of empirical studies into the third sector, which ultimately takes away from the rich theoretical tapestry. It must be stressed that the simplifying assumptions and contradictory conclusions which are contained in the above theories could be ameliorated by using a multi-disciplinary approach to the third sector.

## Bibliography

Anheier, H., 2005. *Nonprofit Organizations: Theory, management, policy*. London: Routledge.

Anheier, H. & Ben-Ner, A., 2003. *The Study of the Nonprofit Enterprise: Theories and Approaches*. New York: Kluwer Academic/ Plenum Publishers.

Badelt, C., 1997. Entrepreneurship Theories of the Non-profit Sector. *Voluntas: International Journal of Voluntary and Nonprofit Organizations*. 8(2):162-178.

Banks, J., 1972. *The Sociology of Social Movements*. London: MacMillan.

Halfpenny, P. 1999. Economic and Sociological Theories of Individual Charitable Giving: Complementary or Contradictory? *Voluntas: International Journal of Voluntary and Nonprofit Organizations*. 10(3):197-213.

Hansmann, H. B., 1980. The Role of Nonprofit Enterprise. *The Yale Law Journal*, 89(5):835-898.

Hughes, P., 2006. The Economics of Nonprofit Organizations, *Nonprofit Management and Leadership*, 16(4): 429-449.

Kingma, B. R., 2003. Public Goods Theories of the Nonprofit Sector: Weisbrod Revisited. In H. Anheier and A. Ben-Ner, (eds.), *The Study of the Nonprofit Enterprise: Theories and Approaches*. New York: Kluwer Academic/ Plenum Publishers.

Krashinsky, M., 2003. Stakeholder Theories of the Nonprofit Sector: One Cut at the Economic Literature. In H. Anheier and A. Ben-Ner (eds.) *The Study of the Nonprofit Enterprise: Theories and Approaches*. New York: Kluwer Academic/ Plenum Publishers.

Salamon, L. 1996. *The emerging nonprofit sector: an overview*. Manchester University Press: Manchester.

Salamon, L. & Anheier H., 1998. Social Origins of Civil Society: Explaining the Nonprofit Sector Cross-Nationally. *Voluntas: International Journal of Voluntary and Nonprofit Organizations*. 9(3):213-248.

Weimer, D. & Vining, A., 1989. *Policy Analysis: Concepts and Practice*. Pearson: Prentice Hall.

Weisbrod, B. A., 1978. *The voluntary nonprofit sector: an economic analysis*. Lexington, MA: Heath