ALTRUISM AND SOCIAL ENTREPRENEURSHIP

- TOWARDS A THEORY OF NON-MARKET ORGANIZATIONS

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Abstract

Almost all of us sometimes voluntarily give up some scarce resources to make someone else better. Not only the amount of resources used for such purposes, but also other wider concerns (implications for private and government sector) have drawn the attention of economists in recent decades. In this paper I develop a theoretical framework underlying such activities, which can be in short termed as “altruistic”. To do so, I first explain the notion of “altruism”, as can be found in the works of Adam Smith, Gary Becker and Ludwig von Mises. On these grounds, we can say that by voluntary altruistic transactions the utility of both sides of the transaction has been increased. The main differences between the market and non-market sectors are described and the concept of “social entrepreneurship” is developed. The analysis is concluded by application of this theoretical framework to the case of altruism as a “public good”.

Key Words
altruism, economic calculation, entrepreneurship, public goods, non-profit sector, voluntary organizations

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1. Introduction

Philanthropy and other activities based on altruism have played an important role in human society probably from the very beginning. Over the time, they to a large extent disappeared off of the focus of social scientists and are returning back only in recent decades. But this does not mean altruism or voluntary activities would not be important in modern times. Alexis de Tocqueville wrote in 1835:

“Americans of all ages, all conditions, and all dispositions constantly form associations... The Americans make associations to give entertainment, to found seminaries, to build inns, to construct churches, to diffuse books... Wherever at the end of some new undertaking you see the government in France, or a man of rank in England, in the United States, you will be sure to find an association.” (Tocqueville, 1981, p. 403-404)

The existence of such associations was possible from the major part thanks to altruism of those who joined and run them. Today, altruism continues to play an important role in daily life of almost all Americans and ranges from support of arts to giving to local homeless shelter. An average American spends almost three hours a week involved in volunteer activities (not including care for household members). According to a study conducted by Independent Sector (2001) 90 % of American adults give or volunteer. The value of the labor they provide by volunteering has been established in the same survey at $ 240 billion (about 2 % of that year’s GDP). The total value of charitable giving in monetary terms amounted to nearly $ 250 billion in 2004 (another 2 % of GDP) according to Giving USA Foundation. According to the National Center for Charitable Statistics, the voluntary sector employs over 10 million people, or about 7 % of the U.S. workforce.

Though we should take this data with a grain of salt because they are mostly provided by the non-profit organizations themselves and could be to some extent biased, the position of voluntary sector in continental Europe seems to be much

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1 Extensive literature on altruism perceives altruism as a useful evolutionary strategy. For a general treatment of this subject see for example Axelrod and Hamilton (1981).
2 Based on statistics from U.S. Department of Labor (2005). This number includes all activities that can be considered as “altruistic”, but are not related to family members. Decomposition of this total amount is (in hours per week): Volunteering (organizational and civic activities) 1,05; Caring for and helping non-household members 1,89.
3 The Independent Sector research was based on random national digitized dialing telephone survey of 4,216 Americans over 21 years.
4 Some other, perhaps more reliable, sources (such as Putnam, 2000) show that civic engagement of Americans have been falling in most areas since 1960’s. Still, it does not substantially change our conclusion about the difference of this phenomenon between the U.S. and Europe below.
weaker. Although data sources are limited due to great fragmentation of sources among various countries and problems with definition of “non-profit” sector on European-wide basis, the usual estimate of philanthropic giving among Europeans ranges from 0.1 to 1 % of GDP (Greiner, 2006, p. 4). Official resources on civic engagement in the Czech Republic state, that “[n]early half the adult Czech population (47%) are members of citizen-action associations”, including especially sport-related activities (16 %), gardening and cultivation (6 %) and fishing (5 %). The value of labor the Czechs give by their volunteering in the non-profit sector was estimated by the Czech Statistical Office at 3 billion CZK in 2004 (latest available data), which was about 0.1 % of GDP of that year.

Just this brief look suggests that the level and “quality” of participation on voluntary activities as well as its result vary. A better understanding the processes within the “voluntary” sector could lead to more effective use of these resources and provide knowledge necessary to further development of this sector. Contemporary economic policies also have to grapple with complex problems of welfare programs (Murray, 1984) and some suggest that the cooperation between non-profit sector and government could be a possible solution, exploiting advantages of both. But the effects of altruism and community building are much wider. There are for example strong “spill-over” effects of the non-profit sector to the rest of the economy, mainly through social capital formation. As one study of the U.S. voluntary sector (Putnam, 2000) shows, the effect of social capital in enhancing economic productivity can be substantial, depending on the kind of participation. From an even wider and normative perspective, the values connected with and enhanced by the “voluntary” sector are keystones of what is customary to call the Western society. Some, such as Niskanen (1998) points to “the erosion of responsibility ... the erosion of civility ... the socialization of risk ... [and] the erosion of the moral order” (p. 407) as the main factors of disintegration of social order of the Western society today.

The main aim of this paper is to show deeper roots of “social entrepreneurship,” a concept previously outlined by others (Boettke and Rathbone, 2002; Boettke and

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6 Ibid.
7 Czech Statistical Office - Satellite Account for Non-Profit Sector.
8 By “quality” I try to indicate different impact of involvement in various kinds of civic activities. The social consequences will probably be different if one is a member of fishing organization or if one runs an organization helping the poor.
Prychitko, 2004; Frank, 2002) and to extend this framework to areas connected with the non-market sector.

This paper is divided into four sections. First, relevant terms are defined and today’s state of discussion on altruism introduced. Next, the concept of “social entrepreneurship” is described in depth, followed by the application of this approach to the concept of public goods – one of the most prominent reasons given for government interventions in the non-profit sector. The final section provides conclusions.

2. Debate on altruism

2.1 Theoretical foundations

First, the main terms used through this paper should be clarified. People usually use the words philanthropy, altruism and charity interchangeably, but each holds a unique meaning.

The distinction between the terms philanthropy and charity has been sufficiently for our needs clarified by Ostrower (1995). Philanthropy is usually used in a narrower sense, meaning “private giving for public purpose” (p. 4) – especially large scale and on the part of the elites. It is an “integral and defining element of elite culture” (p. 6). It usually includes establishing a foundation for providing resources to institutions serving the general public, such as universities, religious institutions, hospitals, museums, parks, research institutes or social service institutions.

By charity we also mean private giving, but in the form of help to individual persons, often those facing dire circumstances. This giving can be channeled through an intermediary organization, collecting individual contributions and providing them to the needy.

Both of these terms have in common the essence of altruism. Altruism is the broadest of these terms. At a general level it covers any kind of “other-regarding impulses” (Sisson, 1910, p. 158). It is also used as a technical term in biology (“biological altruism”) as “a group phenomenon in which some genes or individuals, which must be presumed to be selfish, benefit others at costs to themselves” (Darlington, 1978, p. 385) or in economics as “the case where the level of consumption of one individual enters the utility function of the other” (Roberts, 1984, p. 134, similar definition is used by Becker, 1981, as discussed below). However, these notions of altruism do not reveal the motives that drive one’s actions. Therefore some
authors distinguish between “pure” and “impure altruism” (see for example Andreoni, 1989 and 1990; Monroe, 1994), the later meaning behavior motivated by various kinds of self-oriented motives (e.g. a “warm-glow”, obeying social rules, etc.), or they limit the use of the term altruism only to the cases of “pure altruism”, i.e. behavior without any kind of utility or benefit brought to the actor.

The distinction between “pure” and “impure” altruism is particularly important to further our exposition and it is necessary to discuss it in greater depth. We can trace the distinction back to the beginning of economics as a science — back to Adam Smith and the interpretation of his writings that keep puzzling social scientists for centuries. This puzzle is sometimes called Das Adam Smith Problem and in short it represents the seeming difference between Smith’s observations of human nature in his two main works — The Wealth of Nations (1981 [1776]), where man is viewed as guided only by his self-interest, and The Theory of Moral Sentiments (1982 [1759]), where Smith, according to some interpretations, introduces also “higher” virtues, such as benevolence or altruism. The key question is than: Are these two works in contradiction?

There is an extensive literature, which attempts to solve this problem. Although Hutchison (1976, p. 482) asserts that this problem “is today mostly regarded as exaggerated or even imaginary”, some others still try to resurrect it. For example Kolm (2000, p. 8) asserts that Smith purposefully published these two books in two volumes, because he wanted to stress “the fact that a person can behave selfishly towards some people, notably in markets, while so acting for altruistic reasons toward others individuals (or for any other non selfish purposes)”. An opposite explanation is suggested perhaps in the best way by Coase (1976) who emphasizes Smith’s concept of the “impartial spectator”: “It is not the love of mankind which makes the ‘man of humanity’ willing to make this sacrifice, but because he sees himself through the eyes of an impartial spectator” (p. 6) and

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9 But the roots are much deeper, stemming (in our cultural environment) probably from Christianity and especially Catholicism. Even the Bible in some respects builds on self-interest of those who believe (“These [who do not give] will go away into eternal punishment, but the righteous into eternal life.” Matthew 25:46), but the later development of Catholic mysticism promotes the idea of motivation solely based on love to God (perhaps most clearly expressed by Saint Teresa of Avila: “If I love You, Lord, it is not just because of heaven, which You have promised; if I fear to offend You, it is not because hell threatens me. What draws me to You, O Lord, is Yourself alone.” – quotation from FeastOfSaints.com).

10 For a similar view see also Werhane (1989).
“[i]t will be observed that Adam Smith’s account of the development of our moral sentiments is essentially self-centered. We care for the others because, by sympathetic response, we feel as they feel, because we enjoy the sharing of sympathy, because we wish to appear admirable in our own eyes; and we conform to the rules of conduct accepted in society largely because we wish to be admired by others.” (ibid., p. 8)

According to Macfie’s (1959, p. 223) interpretation of Smith’s writings, “Wealth of Nations is simply a special case – the economic case – of the philosophy implicit in the Moral Sentiments”. Macfie also looks for the source of confusion. He sees it in a different interpretation of self-love (self-interest):

“Briefly, self-love war regarded by all the eighteenth-century thinkers as at least on basic, final, and abiding motive in individual action... They regarded proper self-love as obligatory and admirable; we tend to equate it with selfishness... But probably we are the hypocrites here, the eighteenth century the realists.” (ibid., p. 227)

In other words, an accurate reading of Smith can help us solve the problem of the two “kinds” of altruism. Authors using the term “pure altruism” simply assume there is some “virtue” of altruism given to some men who follow it regardless of their own interest. It is significant that they do not give any examples of behavior motivated by this “virtue”. Not even the smallest impact on the utility of the actor is allowed (otherwise this distinction would not make any sense and altruism would be “impure”).11 This brings into question the motivations of economic actors – how can we, as economists, say anything about the motivations of economic actors, while we keep economics value free, without injecting any of our own value judgments into it?12

The interpretation of altruism as self-interested behavior prevails among economists today, but still has not been accepted by part of other social scientists (see for example Monroe et al, 1990), perhaps because they do not stress value-neutrality of their respective sciences as much as most economists do. The approach of neoclassical economics toward altruism has been formulated by Gary Becker and

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11 Even if we “conceptualize[d] types of [self-interested and altruistic] behavior on a continuum” as Monroe (1994, p. 863) does, we implicitly assume the existence of “pure” altruism, because we would have to include it on one end of this continuum.

12 Questions concerning value neutrality of economics go beyond the framework of this paper. I assume economics should be a value free science, based on David Hume’s statement that from an “is” no “ought” correctly and logically follows. The terms “altruism” or “self-interest” are used in this paper in
perceives “effective altruism” as interconnected utility functions of two or more individuals: “Altruistic means that h’s [first person’s] utility function depends positively on the well-being of [second person] w, and ‘effectively’ means that h’s behaviour is changed by his altruism.” (Becker, 1981, p. 1)

A similar, but more general notion of altruism can be found in the writings of Ludwig von Mises. People act (even in altruistic way) because they consider the state of affairs they are in as less satisfactory. By acting they want to improve this state. After achieving his or her goal, the actor is “happier” than before, i.e. they receive “psychic profit”\textsuperscript{13} from this action.

If action is primarily directed toward the improvement of other people’s conditions and is therefore commonly called altruistic, the uneasiness the actor wants to remove is his own present dissatisfaction with the expected state of other people’s affairs in various periods of the future. \textit{In taking care of other people he aims at alleviating his own dissatisfaction.} (Mises, 1996 [1949], p. 499, emphasis added)

\textbf{2.2 Practical applications}

This notion of self-interested altruism is sometimes refused on the basis that the exchange-like nature of altruism would require a real (that is material) transaction to take place (see Kolm’s arguments below). This view omits the fact that people are sometimes willing to act only to achieve immaterial benefits. At the most general level, we can illustrate this problem if we look at altruism from the perspective of social capital accumulation.

The term “social capital” is described by Coleman (1988) as investments done by individuals into their social relations, either at work, in family or local community, that allow them to reap certain benefits. Social capital increases individual’s productivity, as well as physical capital and human capital do. It is obvious that good relations with other people (“informal connections”) allow people to achieve goals that would be harder or impossible to achieve otherwise. Sufficient accumulation of social capital helps to decrease transaction costs and can have direct benefits for the

\textsuperscript{13} We use the term “psychic profit” in the sense used by Mises as a pure description of the motive for individual action, without any need to search for psychological foundation of what causes peoples’ happiness, thus leaving this task to psychology or ethics. For more see Mises (1996 [1949]).
“social investor”. In this sense, we can view altruistic activities as an investment into relations with other people (or into the actor’s reputation, that is reflected in such relations – see the definition of philanthropy above).

This helps us to solve some questions in the area of altruism, for example the one given by Kolm (2000, p. 16). He considers strange the fact that people in some cases prefer non-personal market exchange to personal relations based on reciprocity and altruism. His argument, built on a well-known passage from the Wealth of Nations about self-interested baker, goes as follows: If the baker gives me bread as a gift, that is without wanting anything in return (instead of selling it to me for money), and I give him voluntarily the product of my labor as a gift in reciprocity, we would have the same final allocation of resources as after a normal market exchange based on self-interest, plus a “gratifying social relation” between me and the baker. The “sum” of the game in the case of this transfer based on reciprocity and altruism would than be higher than the one gained through regular market transaction. “Why is [than] gift-giving relatively so scarce as a mode of transfer in modern economies?”, asks Kolm (ibid.).

The problem with his argument is that investment in social capital is costly and people invest in social capital only where it brings them some benefit that is not possible to achieve in any other less resource-consuming way. In his example, there are no “direct” or “visible” costs for each party. But in spite of this they do exist and are represented by uncertainty whether the other party gives anything in return. In this sense, gifts are very uncertain investment (not talking about the barter nature of such relations, due to which it can be hard to convert inappropriate gifts into some valuable use for the receiver, as opposed to money - the universal medium of exchange). Therefore, exchange based on gifts has higher transaction costs. Social capital (as any other kind of capital) is a scarce resource and there is no reason to invest in our relations with the baker if we can achieve the same aim (get a loaf of bread) without doing it. The case would be different if we aim at something else, for example if there is a shortage on the market with regulated prices and we would not be able to get the bread without starting some informal relation with the baker. This

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14 On the economic importance of informal social institutions see also North (1990). Peters and Stringham (2006) show an interesting application of the concept of social capital – they argue that an investment in social capital through spending on social drinking can increase one’s earnings, because social drinkers usually belong to larger social networks (i.e. have accumulated larger social capital).

15 “It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest.” Smith (1981, Book 1, Chapter 2, P. I.2.2)
also explains why most relations inside the family are based on some kind of altruistic behavior, or in other words why an individual invests in social capital between his/her spouse or children and him-/herself.\textsuperscript{16} The aims the family was established for (such as provision of love or mutual care) cannot be provided on the market and cannot be based on monetary relations. We shall turn to this observation of non-marketability of certain “goods” and the appropriateness of “altruistic enterprise” later in Chapter 3.

As an illustration of this exchange-like nature of altruism we turn to concrete empirical research conducted in the sphere of donors’ motivations, where facts confirming these statements can be found. Even if the use of these findings as an exact proof of motivations of actions is limited,\textsuperscript{17} they can give us a clue what the donors at the time of the research thought about their altruistic engagement. For example, Ostrower (1995) interviewed a representative sample of 99 donors from the New York City. The main reasons given by them for their philanthropy included, but were not limited to “obligation”, the “responsibility that goes with success”, “giving back” and “feeling of guilt if not giving” (ibid., p. 12). Also the paths leading people to philanthropy have much to say about the nature of their involvement – the most frequently mentioned were family (parents), marriage (to a wealthy man), business associates, religion or generally membership in or the use of services offered by “non-profit” organizations, and personal tragedy (ibid., p. 17). It is not hard to imagine ways in which these motives can contribute to an increase in donor’s “psychic profit” (for example by accumulation of the donor’s social capital, fulfilling religious obligations or – in the last case on the list – as a form of therapy). Hitchcock’s (2005) historical study presents another example, wherein he examined begging on the streets of London at the end of the eighteenth century. First, he refuses Smith’s idea of self-interested altruism and insists that

\begin{quote}
“the continuing success of beggars in maintaining a place on the streets, and in the hearts of almsholders, reflects the extent to which
\end{quote}

\textsuperscript{16} Becker (1981, p. 10) offers similar explanation, though he does not talk about social capital directly and he limits his observations only to a family. The notion of social capital is extendable to any kind of social relations.

\textsuperscript{17} Consistently with previous statements, the information about motivation of action is accessible only to the particular acting person weighing his or her benefits and costs, as perceived by him/her at the very moment of decision. Interviews and questionnaires are distant in time from the actual decision and economists have no tool for intertemporal comparison of utility. Such methods can also suffer from bias of what the respondents think they are expected to answer, which is not possible to avoid and must be taken into account when interpreting results of such surveys.
the self-conscious adoption of Adam Smith’s political economy remained a thin patina on the surface of English society well into the nineteenth century ... [e]ach farthing was a stone thrown at Adam Smith.” (ibid., p. 483 and 497)

But elsewhere he describes petty services that the beggars provided (ballad selling, prostitution, charring, shoe blacking) and says that they “made foggy and indistinct the boundary between begging and service” (ibid., p. 490). The problem with this conclusion is that there is no such a boundary, because value of a “service” is subjective. The beggars provide “service” even by receiving a quarter without giving anything material or visible back. By providing petty service, the beggars increase their competitiveness and therefore chance to get the alms, because they obviously lack some of the attributes for being successful without it.

3. Social entrepreneurship

Describing altruism as essentially self-interested has allowed economists to apply tools of economic analysis into unexplored areas of human behavior. Though the foundations of this analysis are mainly thanks to Becker’s contribution well developed, there still remain some questions to be answered. This chapter deals with the position of entrepreneurs within the non-profit or altruistic framework.

3.1 The typology of voluntary organizations

Mainstream literature describes two possible modes of goods or services provision. An entrepreneur has a choice between a for-profit or non-for-profit status. Glaeser and Shleifer (1998, p. 3), citing Hansmann (1996), assert that “the critical characteristic of a nonprofit firm is that it is barred from distributing any profits it earns to persons who exercise control over the firm”. This allows the owners of a non-for-profit (NFP) organization to distribute the gains from its operation only in an indirect way (in general as some perquisites for the entrepreneur and the employees), making the NFP status less desirable (as compared to for-profit firms). On the other hand, there are also some advantages in the NFP status. Glaeser and Shleifer see

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18 As follows from above, if this was not the case, the donor would not behave in this way. See also Boettke and Prychitko (2004) who link this artificial distinguishing to no less erroneous differentiation between “material” and “immaterial” in the labor theory of value.

19 For a thorough analysis of this exchange-like nature of begging see for example Geremek (1999) or (more generally) Becker (1998). On institutional analysis of various self-enforcing rules within the framework of altruism see Chalupniček (2006a), or more generally Šíma (2004).

them mainly in the signaling potential to customers indicating higher quality of services provided by the NFP organizations where there is a “non-verifiable component of consumer quality” in the product.\(^{21}\) In their model (with slight modifications) they also include organizations operating on donation basis, i.e. altruistic entrepreneurs, but they treat them in no different way from other NFP organizations. I believe this approach is too crude and a further demarcation of the differences within the NFP organizations would bring us a deeper insight into the problems connected with altruistic activities in the economy.

First, we should distinguish between NFP organizations that could operate under the for-profit regime, i.e. there is no problem with them charging a full market price for their service (I will call them non-for-profit firms), and other organizations. In some areas (such as hospitals, culture, etc.) there are non-for-profit and for-profit firms operating together, each attracting different kind of customers (consistently with Glaeser and Shleifer). Such NFP firms are not dependent on donations, but they in fact do not even need them. But there are certain NFP organizations that cannot do without altruistic donors, that is are fully dependent on sources of income other than from their customers (take a charity serving the poor as an example). I will label them as “non-market organizations” (NMOs).\(^{22}\)

I use the term “non-market”, because such organizations do not enter the market with the services they produce – the charity provides food but due to its special mission it does not charge any price (as opposed to for example a restaurant), but relies on voluntary donations from altruistic individuals instead. If we take another example, a hospital, we can imagine a for-profit hospital (operating as a regular firm), non-for-profit hospital (charging the same price as the previous one, but investing profits back into the hospital itself instead of distributing them to the

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\(^{21}\) Omitting the tax-related issues that may present another incentive for the NFP status of an organization.

\(^{22}\) I take these categories as ideal types. In reality, of course, the situation would be more complicated. For example, some NFP firms would be mainly financed from user fees, but would also accept some donations, and similarly some NMOs would charge low fees to their users (or would limit use of their services in some other way). Our analysis of NMOs applies to NFP firms to the extent they are dependent on contributions from the donors, i.e. to the extent they rely on altruism. Our idealized division serves analytical purposes. I also use the term NMO solely for voluntary organizations, not for state organizations, which are also non-market (but involuntary) from their nature. Similarly, when I speak about non-market sector, I mean voluntary non-market sector, not the state sector. The idea of involuntary nature of the state is, in short, based on solely power of state to use violence, or, as Max Weber puts it, “politics operates with very special means, namely, power backed up by violence” (Weber, 1946 [1918], p. 118). In contemporary economics, this idea is pursued by members of Chicago School, Public Choice School and Austrian School. For brief surveys of this development see Boettke
owners), or charitable hospital (as an example of a NMO, serving the poor and not charging them any price at all). The mechanism of functioning of a NMO is therefore different from the case of for-profit or non-for-profit firms.

To sum up, I list the main differences of all three kinds of organizations in the following table.

<table>
<thead>
<tr>
<th>Voluntary</th>
<th>For-Profit Firms</th>
<th>Non-for-Profit Organizations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distribution of Profits to Owners</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Possibility of Charging Market Prices</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

Based on Boettke and Rathbone (2002); Boettke and Prychitko (2004) and Glaeser and Shleifer (1998)

### 3.2 The problem of economic calculation

Market firms, i.e. for-profit and non-for-profit firms, “charge a price for their service ... and ... can therefore calculate the expected and realized monetary ‘profit’ or ‘residual’ of their collective efforts” (Boettke and Prychitko, 2004, p. 35). On the contrary, NMOs, as we have seen, cannot charge the full price because it would hamper the very reason for their existence.

In the case of market firms, the economic calculation,23 “simple and indispensable for production decisions ... [because] it provides the basis for discrimination between viable and non-viable production projects” (Lewin, 1998, p. 2), is possible.24 Profit (in monetary terms) is simply the difference between costs and revenues. Prices of inputs, i.e. costs, “can be seen to represent the market value of opportunities foregone as a result of purchasing the input in question” (ibid., p. 3) and revenues are “proceeds from the sale of the relevant outputs” (ibid., p. 1). This may seem clear, but there is even in the case of market firms necessarily also an

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23 The term economic (also monetary) calculation is here given the meaning ascribed to it by Mises (1990 [1920]). As summarized by Salerno in postscript to 1990 edition of Mises’s Economic Calculation in the Socialist Commonwealth (p. 35), “monetary calculation is the indispensable mental tool for choosing the optimum among the vast array of intricately-related production plans that are available for employing the factors of production within the framework of the social division of labor. Without recourse to calculating and comparing the benefits and costs of production using the structure of monetary prices determined at each moment on the market, the human mind is only capable of surveying, evaluating, and directing production processes whose scope is drastically restricted to the compass of the primitive household economy.”

24 For perhaps the clearest explication of the theory of firm in this Misesian-Coasean tradition see Rothbard (2004 [1962]).
element of arbitrariness. Because “in a world of genuine uncertainty ... it is impossible to objectively measure the precise contribution of any member of the team” (ibid., p. 3) to the final output, the entrepreneur must use his or her judgment to find out what this contribution was. Lewin offers here a solution to the so called “imputation problem” based on entrepreneurial judgment. Entrepreneurs have to arbitrarily appraise the value of resources owned by the firm. They have to establish “transfer price” (Klein, 1996, p. 14) for these factors, using their judgment and external information available from outside of the firm.25 As was already said, this arbitrariness applies only for factors of production owned by the firm, because market provides “objective” information for factors bought from the outside the firm (their prices “arise from an ongoing process of competitive bidding of entrepreneurs” [Klein, 1996, p. 11]) and especially for the short term. In the long term

> “all capital assets must be used up or completely replaced, [and therefore] profit appears less arbitrary... the profit calculations that emerge provide a widely accepted (peaceful) way of adjudicating between viable and non viable projects. This is reinforced in the long term by the presence or absence of cash flow.” (Lewin, 1998, p. 4, emphasis in original)

In the in long term, all entrepreneurs operating on the market and lacking correct judgment in finding the right transfer prices will be eliminated. Since “[s]uch estimated transfer prices contain less information than actual market prices” (Klein, 1999, p. 27), “all else equal, firms able to use market-based transfer prices should outperform, in the long run, firms using administered or negotiated transfer prices” (Klein, 1996, p. 17). Fama wrote in his 1980 article that “the firm is disciplined by competition from other firms, which forces the evolution of devices for efficiently monitoring the performance of entire team and of its individual members” (p. 288). It is in the interest of the market firm26 to make the appraisal of “transfer prices” as close as possible to the “real” or “objective” market prices (or use some of well-established methods),27 otherwise the firm will head towards calculation chaos. The essential role of this judgment in the conduct of a firm leads Lewin to conclude that it

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25 Sometimes they even establish an intra-firm market with the possibility to outsource the suppliers of various departments of the firm and to a great extent eliminate this arbitrariness (they set the transfer prices close to the market level). This forces all parts of the company to be at least as good as the best market players (taking into account their advantage from being a part of the same firm).

26 If we suppose that the aim of the owner of the firm is to achieve prosperous future.

is the main task of firms to provide conventions for such judgments (Lewin, 1998, p. 4).

But to what extent is the theory calculation extendable to the non-market sector? The NMOs do not sell their products in the way market firms do. Therefore, they are not able to engage in economic calculation as the market firms and calculate their profits and they from this perspective lack a measure of success of their undertaking – they are the “non-profit” organizations in the pure sense of this word. But because of this it would seem they are doomed to fail and have to face large inefficiencies.  

Let us illustrate this again on an example of a NMO providing money to charitable purposes. This NMO certainly does not calculate in relation with the way it expends money. It does give the money to various causes and it is hard for the NMO to value the use of such money per se. The managers of the NMO might stand in front of a decision: Would it be better (more “socially desirable”) to give the money to the poor directly, or to build and run a charitable hospital? Because they lack profit-driven incentives, it is hard for them to solve this task. If we imagine just this part of the decisive process, it is impossible for the NMO to decide which from the list of possible causes is worth supporting on “objective” bases, i.e. what would bring the highest benefit to the rest of the society. On the market it would be informed via the price system, but in this case it can see only the expenses.

But there is also another part of the decisive process – the source of money, that is the donors.  

Here the limits of calculation do no apply, because the donors can directly assign some monetary value to their utility. As was noted earlier in chapter 2, private charities (or other kinds of NMOs) provide altruistic donors with services that increase their “happiness” or “psychic profit”. Donors adjust donations precisely in this way – they weigh the benefit resulting from donating versus the benefit following from the best alternative use of their money (or voluntary labor or any other kind of scarce resource they provide). The donors value directly the utility they receive from their donation. In this sense, the NMOs create a “quasi-market” with services they provide – they supply certain service to the donors and let them pay a certain price for it. This motivates the managers to be responsive to the donors’ demand and

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28 By “efficient” I mean the allocation of resources corresponding to demonstrated preferences of customers, that is of those who pay.

29 We suppose that the NMO has to ask the donors for money. Our analysis is limited concerning for example large foundations endowed by a bequest from a rich person.
provide mechanism for meeting the needs of the contributing public. In short, it forces them to behave as “social entrepreneurs”.

### 3.3 Social entrepreneurship

To understand the term “social entrepreneurship” (i.e. entrepreneurial activity in the non-market sector), it will be useful to review its underlying notion of entrepreneurship itself.

Activities in the market sector are driven by the force of entrepreneurial activity. The term “entrepreneurship” is associated with Israel Kirzner, who builds on Mises’ concept of acting human together with Hayek’s theory of information and competition as discovery process. In this view, market is a never-ending process of changes, generating unlimited number of possibilities to achieve pure profit. According to Kirzner (1997a, 1997b, 1982) there are three basic elements of entrepreneurial process in the economy: (a) the role of entrepreneur, (b) the role of discovery, and (c) “rivalrous” competition.

In the neoclassical concept, the entrepreneur is treated as a maximizing agent within a framework “made up of a given objective function, a given set of resource constraints, and a given set of technologically or economically feasible ways of transforming resources into desired objectives” (Kirzner, 1997a, p. 62). This corresponds with the neoclassical view of a firm, in which the firm is considered to be a black-box, represented by a production function. This model is “really a theory about a plant or production process, not about a firm” (Klein, 1996, p. 5, emphasis in original). There are no possibilities for pure profit, no space for entrepreneurial activity and no space for unique entrepreneurs. On the contrary, in the Kirznerian (or generally Austrian) approach,

> “the role of entrepreneur is fundamental. Whereas each neoclassical decision maker operates in a world of given price and output data, the Austrian entrepreneur operates to change price/output data. In this way ... the entrepreneurial role drives the ever-changing process of the market.” (Kirzner, 1997a, p. 62, emphasis in original)

The entrepreneur takes up the advantages provided by changes in the market and is able to achieve “pure profit”. This profit is his reward for undertaking risky opportunities in the environment of uncertainty.
As was stressed before, the entrepreneur is not limited by neoclassical framework of given resources; therefore his activity does not consist only in shifting already existing resources from one use to another. He has the ability to enhance these limits, to overcome “sheer ignorance”.³⁰

But entrepreneurial opportunities and the existence of entrepreneurs are not enough to ensure the working of the market mechanism. They have to be able to meet each other – entrepreneurs must have the freedom to enter any market in which they see opportunities for profit. Any kind of artificial barriers restraining entrepreneurs from entering the market they wish to enter hampers entrepreneurial activity.

If we apply this concept of entrepreneurship to the non-market sector, we get what is called “social entrepreneurship”. From a Coasean perspective, we can view social entrepreneurs as entities decreasing transaction costs of transfer of resources from those who are willing to give to those who are (according to those who give) worth to receive.

Because we live in the world of scarcity, NMOs have to face competition. Not only from the side of other NMOs fulfilling the same or similar task and targeted at donors’ resources, but also from any other possible use of such resources. This “rivalrous” competition is, in the Kirznerian sense, the main driving force in non-market sector course forward.³¹

4. Public good

The similarity between market and non-market sector raises a question of “non-market failures” as analogous to “market failures”. It would be unsound to deny there can also be problems with functioning of NMOs. Since people are erring beings, every human activity is prone to mistakes. But it is in the interest of all individuals participating in activities of NMOs (especially social entrepreneurs and donors) to make “mutual adjustment of individual plans [which] is brought about by a process that we have learned to call negative feedback” (Hayek, 2002, p. 15). Nobody else has stronger incentives and better know-how to do this instead of them.

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³⁰ This term shouldn’t be confused with the neoclassical notion of “perfect information”. “Sheer ignorance” represents also facts that are not known or obvious (for example entirely new use of existing resources, or even discovery of new resources).

³¹ Some authors (see for example Philipson and Posner, 2006) argue that there is need for state antitrust policy in the non-for-profit and non-market sector as much as in the market sector. The problem of this conclusion is it is based on neoclassical notion of perfect competition and the model presented is too static. See Armentano (1996).
Voluntary altruistic activities are usually considered as an example of a “public good”. Probably the best formulation of this was given by Milton Friedman:

“It can be argued, that private charity is insufficient because the benefits from it accrue to people other than those who make the gifts... To put it differently, we might all of us be willing to contribute to the relief of poverty, provided everyone else did.” (Friedman, 1962, p. 191, emphasis in original)

There are two distinct, though connected, problems. First, altruistic activities tend to produce good in the given community, that benefits someone else (say, the poor) than is the one who pays (the donors). In other words, there is a double principal-agent problem in the relation between the donor, the social entrepreneur and the receiver. Second, since this good not only benefits the receiver (the poor) and the donor (“psychic profit” resulting from altruistic behavior), but creates some external benefits for others (for example lowering crime rate in the given area or eliminating beggars in the streets). Such external benefits are usually non-rivalrous and non-excludable. Friedman argues that these two tendencies cause the problem of “free riders” – of people, who did not pay, but enjoy the benefits. Therefore, the consumers have no incentives to show their true preferences for the good and the level of contributions (and resulting “public good”) is lower than it otherwise would be.

To solve the problem of the “public good” nature of charitable activities, we can also use the concept of altruism outlined above.32 The transaction between a NMO and the donor is similar to any other exchange. The donor gives up scarce resources and receives a service. The fact that others benefit from his action should increase his utility through the interconnectedness of their utility functions (and therefore also increases the amount of resources he is willing to sacrifice). As Rose-Ackerman paraphrases Kenneth Arrow (1974):

“the benefits that a person obtains from the act of giving to a worthy cause even if he or she cannot measure the direct consequences of this act in higher service levels. Taken in its extreme form, this explanation converts charitable giving into a private good and avoids all free rider problems.” (Rose-Ackerman, 1982, p. 194)

32 We are not dealing with other, more general problems of externalities, such as their presence in almost any kind of market transaction (Block, 1983) and the meaningfulness of the concept of “public good” itself (presenting almost unlimited opportunity for smuggling value judgments into economics and resting on methodologically spurious interpersonal comparison of utility, see Rothbard, 1956).
We can elaborate further on this solution using the concept of entrepreneurial activity. The entrepreneurs himself should be in most cases interested in attracting the largest possible amount of resources. Therefore, entrepreneurs look for ways to “internalize” these “external” benefits from their activities. The higher degree of internalization they achieve, the better for them, because the donors will be willing to sacrifice higher amounts of resources for their cause. The entrepreneurial element will lead these organizations (in the same way it does in the market sector) to discover the best ways of providing feedback to their donors and to internalize these externalities. It is a part of know-how of each NMO to cultivate its relations with donors and look for the best ways of providing information to them about goals that have been achieved with use of their resources. The ways may vary; they can take place in quantitative form (number of attendants of free classes at charitable education institution) or qualitative form (thank-you letter or personal evaluation of each participant) or any thinkable combination. Entrepreneurs can for example conduct activities primarily in the donors’ community, where they can get the most from the social capital they accumulate (internalization of externalities within local communities). Or they can use various forms of “differentiating between people who do not want the good (given its price) and people who do and [the social entrepreneurs] would than require contribution from the latter group only” (Schmidtz, 1991, p. 88). They can for example require that the donors sign “assurance contracts” (term used by Schmidtz) – donors will have to pay their contribution only in case the fundraisers collect enough money from other donors to undertake given project. Donors are hence assured that their money will not be wasted on some less expensive, but also less preferred projects. All these activities contain an element of entrepreneurial discovery. Good ways tend to be imitated, bad ways tend to be eliminated.

This is also applicable to the second problem mentioned above – the principal-agent relations in the chain of resource transfer in non-market sector. It is certainly true that it is more difficult to interest managers of a NMO on its performance, since there is no direct monetary measure of their success and other motivations applicable to, for example, joint stock companies (such as share motivation programs) do not
hold in this case. Therefore, as some argue, it is not sure that the NMO will support
the causes the donors see as the most pressing. Fama (1980) suggests one solution –
most of the managers will have to enter the market for managerial labor at certain
point. It is in their interest to run the NMO in the way it will induce other foundations
to bid for their labor on this market. Shared ideology can also played its role,
especially in case of religious or other ideology-based NMOs, targeting both the
donors and the NMOs’ staff towards the same objectives. There are also some
measures that can substitute the profit or other standard indicators of managerial
success, as we have seen above. Another solution can be based on market signaling by
a NMO, such as its name (“brand”), period of being “in the business”, names of its
trustees or donors, participation of the NMO in some quality-certification network,
publishing annual report with an auditor’s statement or allowing donors to become
NMO’s board members and thus being able to monitor the use of money, etc. All
these signals helps differentiate the product of the NMO and are an important
indicator for those who give, because they help to assure them that their money will
be spent well.34

There are also other implications of our framework of social entrepreneurship.
For example, in the traditional view, the NMOs fulfill the definition of “bureaus” as
given by William Niskanen. In order to be labeled as “bureau”, the institution’s
income must come from other source than sale of output for unit prices (Niskanen,
1994, p. 15). I argue that the greater is the “dependence” of a NMO on giving of
private individuals, the greater is the difference between such NMO and a bureau.
Because contributions for NMOs are voluntary (contrary to government agencies
based on coercive taxes), donors are usually not bound to fund one particular
institution, but can turn to others in case they fulfill their demand in a better way. As
a result, voluntary NMOs will tend to get rid of excessive bureaucracy. This incentive
to limit the extent of administrative apparatus will of course be lower in case of looser
ties between efficiency of a given NMO and the contribution it receives. This is for
example the case when a NMO is funded solely or mostly by big foundations or even
by the government. For example Frank (2002, p. 22) names five ways in which

33 In this sense, our analysis is an extension of stream of literature seeing entrepreneurial activity as a
solution of the “public good problem” – see Buchanan and Faith (1981), Coase (1974) or Foldvary
(1994).
34 For more on market signaling see Klein (1998) or Chalupniček (2006b).
“government-nonprofit relationship, as well as the pervasiveness of large national foundations, has changed the nature of nonprofits... 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.”

We could certainly develop this topic much further. The concept of social entrepreneurship gives also solid grounds to explain various cases of crowding-out effects between government and private (voluntary) sector, as described for example by Andreoni and Payne (2003) or Gruber and Hungerman (2005). The crowding-out effect in this respect is similar to the one that appears on financial markets. It has the same cause which could be described as government dumping, that is using monopoly state power to eliminate private market subject competing with the government for scarce resources, for example by using tax money to subsidy charitable or similar activities (such as social insurance or health care).

5. Conclusion

The main aim of this paper was to illustrate the role of non-market sector in the sphere of human activities. The gap between non-market and market sector is not as wide as it might seem. There are several theoretical reasons why we should consider the non-market sector to be closer to market sector than to the state sector. In fact, our conclusions are not supported only by theory. Also the development in non-market sector gives us evidence that this theoretical approach is promising.

There has been movement within the non-market sector called “new philanthropy”. This movement is characterized by “decentralization, individualism and freedom, and democracy. Its premise is that new analyses of complex, self-ordering systems suggest that self-governance through more democratic, less hierarchical structures is a necessary and potentially effective component of positive social change” (Shockley, 2002, p. 5). New donors usually come from the most progressive industries (such as IT sector) and can be described as follows: „New donors ... are (1) relatively newly wealthy, because of business activity, investments,

35 See also the quotation from de Tocqueville at the beginning of this paper.
36 On a thorough illustration of this crowding-out in the sector of mutual-aid societies in the 19th and 20th century in the U.S. see Beito (2000). For the tools used by FDR’s administration to implement compulsory government social insurance in the 1930s see Attarian (2001) and for crowding-out between state and private schools in low-income countries see Tooley et al. (2005). For the effects of “privatizing” religion in Connecticut and Massachusetts in 19th century, see Olds (1994).
or inheritance; and (2) already motivated to become philanthropists“ (Sagawa, 2001, p. 2). “New donors” bring their entrepreneurial spirit with them and with success spread it in the non-market sector, either by redesigning of a previously existing NMO or creating a new one. They usually use their skills (in the area of corporate or asset management or other fields of their specialization) by direct engagement with given NMO and can execute effective control over its results. Donors also require greater extent of “internalization” of benefits of their philanthropic activity, for example by “investing” into communities in their neighborhood. New methods discovered by them are later used also by “old philanthropy” organizations, in very similar way new innovations diffuse in market sector. Sagawa surveys studies about “new philanthropy” movement and comes to conclusion, that “new donors” prefer organizations that

“can demonstrate results through evaluations; maximize the share of funds going to program rather than administration; offer specific goals and clear strategies to achieve them; and can find productive roles for donors seeking involvement particularly those that use their business skills” (ibid., p. 2).

Shockley (2002, p. 29) further notes that in the area of “new philanthropy” NMOs such as “museums and all other types of nonprofit arts organizations are conceived of as productive systems”.

Finally, Weaver-Smith (2002) gives some practical examples of NMO that fit this concept of “new philanthropy”. As she says, share of such organizations is so far negligible, but rapidly growing. According to Sagawa (2002), their expansion can be effectively blocked by “old”, established NMO. Business-like drive of “new philanthropists” is often seen as undesirable, because it forces them to change their traditional and rooted practices. But parallels from the market sector, such as extensive boom of new technology industries, provide base for an expectation that this might change soon.
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