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## Short Circuits and Market Failure: Theories of the Civic Sector

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**ABSTRACT:** This paper reviews three social scientific accounts of the civic sector's role in society: the government failure, contract failure, and voluntary failure theories. All three explain the role of nonprofit organizations as compensating for the market's failure to provide certain collective goods. This approach involves a radical misinterpretation of the underlying principles of civic sector organizations. An account is needed that explains their economy in terms of their normative concerns, rather than explaining normative concerns in terms of their economy. I lay a foundation for such an account by examining (1) the self-understanding among civic sector organizations that they should be "mission-driven," and (2) the implications of this self-understanding for the sector as a "social economy." Whereas "mission-drivenness" calls attention to service-provision, resource-sharing, and open communication as the normative core of civic sector organizations, the notion of a "social economy" suggests a recirculation of money into channels where standard economic logic no longer holds. The key to the civic sector's role lies not in responses to market failure, but in the short-circuiting of a money-driven capitalist economy.

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Three trends will shape the future of education around the world: the revolution in information technologies, the crisis of the welfare state, and the globalization of a consumer capitalist economy. In the face of such powerful developments on a massive scale, philosophy's efforts toward "educating humanity" (1) can seem both presumptuous and quixotic: presumptuous, because much of philosophy has given up global theorizing of sort that could evaluate these trends; quixotic, because the trends will shape the prospects of philosophy itself as a pedagogical practice housed in academic institutions. We philosophers easily appear to tilt with windmills.

Nevertheless, megatrends carry with them potentials for their own resistance or redirection. One such potential deserves special attention from philosophers today, not only because it is so close to philosophy's own self-image but also because it is often overlooked. I refer to the potential of the civic sector, a zone within national and international economies where organizations refuse to do business as usual. Economically, as Rifkin argues, the civic sector may well become an increasingly important location for meaningful activity and paid work as new information technologies eliminate millions of jobs and the welfare state shrinks. Politically, as Habermas argues, "autonomous public spheres," whose economic underpinnings often lie in the civic sector, will remain crucial to the democratic development of solidarity in modern societies. (2)

Unfortunately, standard explanations of the civic sector are inadequate both as normative theories and as sources for public policy. What is needed, and what this paper only too

briefly proposes, is an alternative and critical theory. First I review three social scientific accounts of the civic sector's role in society. Then I use a culture-institutional model to explore normative concerns affecting the politics and economics and future of the civic sector.

## **Failure Theories**

Mainstream economic theories in the United States view the civic sector as responding to unavoidable failure on the part of the for-profit market. The dominant theories restrict themselves to explaining nonprofit organizations, and they do so with a view to questions of public policy. Most economists accept Hansmann's use of the nondistribution constraint to characterize all nonprofit organizations: they are subject, by the laws of the state in which they were formed, to a constraint . . . that prohibits the distribution of residual earnings to individuals who exercise control over the firm, such as officers, directors, or members. (3)

The first general economic theory of the role of nonprofits is the government failure theory proposed by Weisbrod. (4) Weisbrod postulates a three-sector economy (private, public, and voluntary), and he describes voluntary nonprofit organizations as institutional hybrids combining features of both for-profit and governmental institutions. Their primary role is to provide collective consumption goods that government cannot provide and for which the private sector can provide only inadequate substitutes, despite consumer demands for such goods. Collective goods are defined as goods that enter, positively, the utility functions of more than one person simultaneously (Weisbrod 21-22). Nonprofit organizations, then, are extragovernmental providers of collective-consumption goods. These organizations supplement the public provision. . . and provide an alternative to the private-sector provision of the private-good substitutes for collective goods (Weisbrod 30).

Other economists have criticized the government failure theory for failing to explain (1) the role of those nonprofits, such as nursing homes, whose services are not public goods, (2) what permits nonprofits to serve as private suppliers of public goods when proprietary firms cannot or will not (Hansmann 29), and (3) why donations are made to nonprofit organizations. (5) These limitations are addressed by contract failure theories, the most influential of which has come from Henry Hansmann. Hansmann argues that the expectation of contract failure is the most important factor making certain tasks more suitable to nonprofit than to for-profit organizations. (6) When people find it difficult to measure the quantity or quality of contracted goods or services and to enforce future contracts, they turn to nonprofit organizations, expecting that, because of the nondistribution constraint, nonprofit organizations will not sacrifice quality for private profit, whereas for-profit firms have both incentive and opportunity to exploit the customers' ignorance and weakness. Theoretically, then, if not historically, nonprofits arise in response to contract failures in the for-profit sector, provided the value of the customers' expected protection outweighs the economic disadvantages of the nonprofit form.

Although this approach fills some of the explanatory gaps in government failure theories, it has its own limitations. Estelle James identifies two. (7) First, contract failure theories overestimate the trustworthiness of nonprofit organizations and overlook the incentives they have to downgrade the quality of services and to divert donations from intended purposes. Second, empirical research in various countries shows that many nonprofit organizations are founded by ideological groups for the purpose of promoting faith or gaining adherents. In many cases it is not the expectation of contract failure but rather the stance of commitment that explains the choice of the nonprofit rather than the for-profit form of organization.

These two objections indicate a need to supplement economic theories with political and sociological perspectives. Because theories of government failure and contract failure ignore factors that cannot be captured in narrow rational-choice models of utility and consumer preference, they misinterpret the political and cultural fabric of nonprofit organizations. As a

result, the societal significance of the civic sector is underestimated, and the scope of interdependence between government and nonprofit organizations is overlooked.

Such interdependence has been championed by the political scientist Lester M. Salamon, who propounds a voluntary failure theory. Salamon sees a direct correlation between the nonprofit sector's dramatic growth and the welfare states rapid expansion in the U.S. between 1950 and 1980s. (8) Salamon demonstrates that the federal government has fostered a growing network of alliances among public, for-profit, and nonprofit bodies. Theories of government failure and contract failure cannot do justice to the sizable role of nonprofit organizations in the implementation of government programs because such theories regard the third sector as substituting for the state in the provision of collective goods. These theories suggest that the existing government-nonprofit partnership should not exist (Salamon 36). The facts of the matter are quite different, however.

Salamon's alternative theory hinges on the notion of voluntary failure. Its core intuition is this: Government is not the typical response to the for-profit markets failure to provide collective goods, and nonprofits are not derivative institutions filling in for government failure. Instead, nonprofit organizations are the primary response mechanism for market failure, and government is a derivative institution responding to the inherent limitations of the voluntary or nonprofit sector. Government programs arise in response to voluntary failure. Because of higher transaction costs (9) when government responds, the nonprofit sector "will typically provide the first line of response to perceived market failures" (Salamon 44). Their respective strengths and weaknesses makes collaboration perfectly sensible (Salamon 48-49).

Although the voluntary failure theory accords greater societal significance to the civic sector than do the economic theories of Weisbrod and Hansmann, Salamon shares their fundamental assumption that the role of nonprofit organizations is to compensate for market failure. Salamon simply switches the positions of government and the civic sector: he changes the order, from contract failure > government response and failure > voluntary response, to contract failure > voluntary response and failure > government response. Indeed, the fatal flaw in all three failure theories of the civic sector is that they assume the factual and normative primacy of a capitalist market economy. This leads them to treat nonprofit organizations as derivative institutions whose economic role is to compensate for failures by for-profit firms. Not only does this approach involve a radical misinterpretation of the underlying principles of the civic sector, but also it ignores the ways in which the economic role of nonprofit organizations changes. An account of civic sector organizations is needed that explains their economy in terms of their normative concerns, rather than one which explains their normative concerns in terms of their (misunderstood) economy. I wish to lay foundations for such an account by examining (1) the self-understanding among civic sector organizations that they should be mission-driven and (2) the implications of this self-understanding for the economy of the sector as a whole.

### **Mission-Driven Organizations**

Many civic sector organizations self-consciously seek to be mission-driven. The fact that this phrase has become commonplace reflects a heightened awareness of factors that could divert such organizations from their primary purposes, whether through adopting pervasive bottom-line strategies imported from the money-driven for-profit sector, or through embracing a bureaucratic logic that resembles power-driven approaches in government. Philosophically, to be mission-driven implies three things: (1) providing services is central to the life of the organization; (2) the organizations resources are to be shared rather than hoarded; (3) its communicative capacities do not become mere means for the organizations self-preservation. Let me comment briefly on each.

Service provision: There is a strong cultural expectation, rooted in the history of the civic sector, that the *raison d'être* of such organizations is to provide socially significant services of

collective benefit. The nondistribution constraint is a legal codification of the civic sectors self-understanding, and it provides some recourse in situations where nonprofit organizations flagrantly abuse the public trust. The normative primacy of service-provision implies both that the mission for which the organization exists ought never to become a means to some other end and that the strategies and policies adopted by the organization ought to further that mission. Hence, to justify its existence in public, a civic sector organization must be able to point to its mission. Similarly, internal decisions and actions must be capable of justification with reference to the organizations mission. Any attempt to avoid such justification, or to pursue approaches that most staff and board members can see to be at odds with the mission, weakens the organization and undermines the credibility of the persons responsible.

Resource sharing: If, following Habermas, we consider solidarity to be the primary resource for social integration circulating in civil society, the civic sector can be regarded as the way this resource gets institutionalized where civil society meets the economic system. Whereas the economic system (capitalism) allows the integrating resource of money to flow toward the private profit of those who control the market, the civic sector brings a different principle to bear, namely the solidaristic imperative to share resources without assurance of private gain.

In that sense nonprofits and other civic sector organizations should not be viewed as responses to market failures, as if such organizations would not be necessary were the capitalist economy less flawed. Rather, they are responses to a different set of needs from those which the capitalist economy satisfies in the first instance: not the needs of self-preservation or personal gratification or private wealth, but the need to care for others, to participate in a common project, and to give away what has been received. So too, government programs supporting the arts, health care, social welfare, etc. should not be regarded as responses to voluntary failure. Considered normatively, government programs are not substitutes for inadequate generosity any more than they are guarantees of private profit for the captains of capitalism. Rather, such programs should secure a measure of public justice, particularly for the marginalized or oppressed.

Of course the sharing of resources can be interpreted as a mere means to utilitarian ends: corporate image, individual fame, member privileges, etc. What this fails to explain, however, is why people bother with civic sector organizations when there are simpler ways to acquire the utilities in question. They do so because many people genuinely subscribe to the principle of sharing resources, out of a commitment, however vague, to solidarity with people beyond ones own narrow circle of acquaintances. Support for civic sector organizations arises from convictions about the importance of their substantive purposes and confidence about their ability to achieve these purposes. Supporters of such organizations in the arts, education, social services believe not only that the organizations are doing worthwhile work but also that the sharing enacted by organizations of this type is socially significant.

Open communication: For a civic sector organization to be mission-driven also means that its communicative capacities do not become mere survival mechanisms. (10) Because civic sector organizations arise from intersubjective efforts structured around shared commitments, they require committed cooperation from members, staff, and supporters if they are to achieve their missions. Committed cooperation cannot be sustained in the absence of open communication. Internally, open communication requires that everyone within the organization whose participation could be affected by a decision or policy or strategy has adequate opportunity to know about its formation, to discuss its implications, and to challenge its rationale. Although consensus need not always be achieved, governance and administration must continually orient themselves to the actual understandings and commitments of the organizations members toward its mission. Externally, open communication requires that the organization deliver its services and share its resources in ways that encourage evaluation and public accountability. The normal mode of communication should not be damage control or image building or self-promotion. Clients,

supporters, and the public should have ready access to information about the organizations internal operations; they should be able to count on legitimate concerns receiving a proper response; and the organization should encourage them to assure themselves that the organization is pursuing its stated mission. (11)

## **Social Economy**

The normative perspectives implied by mission-drivenness suggest that civic sector organizations are not designed to do business as usual. Given the bias in capitalist societies and among many economists that pursuit of private profit is the only way to do business, such normative perspectives can seem hopelessly idealistic or old-fashioned. Every attempt to counter that bias by demonstrating the success of nonprofit organizations simply confirms the bias, so long as the criteria of success come from the for-profit sector.

A more fruitful approach is to explore the implications of mission-drivenness for civic sector economics. Here the concept of a social economy (Thierry Jeantet) becomes crucial. According to Jeremy Rifkin, what is most significant about the third sector is what defies standard economic measurements: Community service is a revolutionary alternative to traditional forms of labor. Unlike slavery, serfdom, and wage labor, it is neither coerced nor reduced to a fiduciary relationship. [I]t is more akin to the ancient economics of gift giving. Whereas market exchange is always material and financial and the social consequences are less important than the economic gains and losses, community service is primarily a social exchange, although often with economic consequences to both the beneficiary and the benefactor (Rifkin 242).

For Rifkin, this implies that two levels of transformation, both structural and ideological, will occur when the social economy comes to play a greater role in society. Structurally, the civic sector will provide work and basic services no longer available from the first and second sectors. Ideologically, the civic sector will offer ingredients for a compelling vision of life to replace the productivism and consumerism long fostered by capitalism. The social economy can offer an alternative vision steeped in the ethos of personal transformation, community restoration, and environmental consciousness. If this vision were to gain widespread currency, it would lay the intellectual foundation for the post-market era (Rifkin 246-47).

Because the social economy defies conventional wisdom, however, it is easy for advocates to slide between the languages of economics and ethics. The very term social economy suggests an economy governed by ethical principles and pervaded by an ethos of care and participation and generosity. This is clearly Rifkins understanding. He believes that third sector organizations around the world share a biospheric perspective embracing democratic participation at the local level, the re-establishment of community, service to fellow human beings, and stewardship of the earths common biosphere. The social economy is the last best hope for re-establishing an alternative institutional framework for a civilization in transition (Rifkin 285-92).

But what can all of this mean for economic theory, which assiduously avoids ethical perspectives other than utilitarianism? Perhaps one clue can be found in the recirculation of money. Earlier I suggested that solidarity is the primary resource circulating in the civic sector.

Because of this, it would be a mistake to reduce the sector-defining imperative of sharing resources to a mere mandate to recirculate money. Yet the recirculation of money might offer some clues into the peculiar economy of the civic sector.

As the abstract medium of exchange in a capitalist economy, money is a universal measure of relative value. The exchange-value of capitalist commodities can be reduced to quantities of monetary value. When money circulates in the civic sector, however, its capacities for

measurement shift. There money is not so much an abstract medium and universal measure as it is an economic means to non-economic ends. Although it is possible to put a price tag on civic sector goods and services, there is always something slightly odd about doing so, since the primary value attached to them by creators and participants alike is not an exchange value, but rather the value of health or education or cultural expression and the like. Moreover, much of the labor behind these goods and services is not commodified in the same way as wage labor. It is not undertaken simply as a way to earn a living. It is, some people say, a labor of love, done for its own sake or for the sake of some social purpose, and not simply for monetary reward.

Hence when money circulates in the civic sector, it often flows into channels for which standard economic logic no longer holds. The closed circuit of money/commodity/money crosses the open circuit of gift/receipt/social purpose, and often becomes short-circuited. Short-circuiting can also happen in the other direction, however. It is possible for gifts to become merely abstract media divorced from any social purpose. It is possible for gifts to be received as if they were mere commodities. It is even possible that apparent social purposes become no more than a form of economic currency. To the extent that a social economy depends on the operations of a market economy, these things happen more often than panegyrics to the civic sector would lead one to expect. Yet there is an inherent limit to how often and to what extent this reverse short-circuiting can occur, so long as the social economy remains tied to organizations that do not wish to do business as usual. A critical measure of the legitimacy and viability of proposals for societal transformation today is the extent to which they allow genuine alternatives to flourish outside the systemic logics of money and power. By upholding and testing this critical measure, philosophy can continue to play its part in the education of humanity.

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## Notes

(1) This paper is intended for presentation at the Twentieth World Congress of Philosophy, whose theme is Paideia: Philosophy Educating Humanity. I wish to acknowledge research support from the National Endowment for the Humanities.

(2) There is no adequate label for the complex area I have in mind. All the common labels--voluntary, philanthropic, independent, nonprofit, and third sector--have limitations. This paper uses the terms civic sector and third sector as synonyms, equivalent to civil sector in Jeremy Rifkin, *The End of Work: The Decline of the Global Labor Force and the Dawn of the Post-Market Era* (New York: G. P. Putnam's Sons, 1995). Concerning autonomous public spheres see Jürgen Habermas, *Between Facts and Norms: Contributions to a Discourse Theory of Law and Democracy*, trans. William Rehg (Cambridge, Mass.: MIT Press, 1996).

(3) Henry Hansmann, *Economic Theories of Nonprofit Organization*, in *The Nonprofit Sector: A Research Handbook*, ed. Walter W. Powell (New Haven: Yale UP, 1987), p. 28.

(4) Burton A. Weisbrods initial statement occurred in 1975 as *Toward a Theory of the Voluntary Non-Profit Sector in a Three-Sector Economy*. It appears in revised form in *The Economics of Nonprofit Institutions: Studies in Structure and Policy*, edited by Susan Rose-Ackerman (New York: Oxford UP, 1986), pp. 21-44.

(5) Susan Rose-Ackerman, *Introduction*, in *The Economics of Nonprofit Institutions*, p. 5. The question about donations is troublesome for rational choice theories because of the free-rider problem: unless strong incentive or coercive force prevails, many people will not pay for collective goods from which they derive no exclusive benefit--they'll take a free ride and let others pay.

(6) "The Role of Nonprofit Enterprise," *Yale Law Journal* 89 (1980): 835-901. I cite the

revised version in *The Economics of Nonprofit Institutions*, pp. 57-84.

(7) Sharon Oster and Estelle James, Comments, in *The Economics of Nonprofit Institutions*, pp. 152-58; James comments occur on pp. 154-58. See also Estelle James, *The Nonprofit Sector in Comparative Perspective*, in *The Nonprofit Sector*, pp. 397-415.

(8) Lester M. Salamon, *Partners in Public Service: Government-Nonprofit Relations in the Modern Welfare State* (Baltimore: Johns Hopkins UP, 1995). Prior to becoming director of the Nonprofit Sector Project at the Urban Institute, Salamon served as deputy associate director of the U.S. Office of Management and Budget during the Carter Administration.

(9) Transaction costs are ones assigned to factors that are required to bring about an economic exchange but are not themselves the product or service being exchanged. Such costs can occur in production itself, between producers and consumers, or among consumers.

(10) Jon Van Tils *Mapping the Third Sector: Voluntarism in a Changing Social Economy* (Washington, D.C.: Foundation Center, 1988) hints at this, but a communitarian emphasis on building habits of the heart keeps Van Til from pursuing the normative implications of voluntarism for the communication that should characterize such organizations and their relations to the public.

(11) Civic sector organizations are under tremendous pressure to bend their communicative capacities for the sake of sales, advertising, marketing, and public relations strategies whose primary objective is the promotion and preservation of the organization itself. While such strategies are necessary, openness suffers when communication subserves these strategies rather than these strategies themselves submitting to tests for open communication.

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