

# Non Profit Organizations as Providers of Public Goods

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## ABSTRACT

This paper discusses nonprofit organizations as providers of public goods in the context of market failure theory. The paper defines common terms, elaborates on existing theory regarding non-profits and the market, and ties the argument to the current conversation in Public Administration. The author's argument is that the establishment of non-profit organizations as community solutions to fill the void of market failure is congruent with the communitarian and implicitly Anti Federalist perspective in the Public Administration discourse. Due to urbanization and urban migration related problems, Turkey is facing market failures in the provision of public goods similar to those of the progressive era in the US. As government falls short of providing necessary services, third sector organizations step up to the task. Currently Turkey's third sector is rather loosely structured and needs to be developed to be able to compensate for the shortcomings of the private and public sectors provision of these goods.

**Key Words:** Nonprofit Organizations, Public Goods, Market Failure Theory

**JEL Classification:** L31, H 41

## Kamu Hizmeti Sağlayıcıları Olarak Kar Amacı Gütmeyen Kuruluşlar

### ÖZET

Bu makale kar amacı gütmeyen kuruluşların (KAGK) kamu hizmeti sağlamalarını pazar yetersizliği teorisi (market failure theory) bağlamında ele almaktadır. Ortak kavramlar oluşturulduktan sonra, KAGK ve pazar arasındaki ilişkiyi ele alan teoriler gözden geçirilerek kamu yönetimi literatürüyle ilişkilendirilmiştir. Yazar, KAGK'ların pazar yetersizliği sonucunda, hizmet ihtiyacını gidermek için komüteryen çözümler olarak gelişmelerinin kamu yönetiminde komüteryen (Communitarian) ve Anti Federalist görüşüyle uyduğuna iddia etmektedir. Kentleşme ve kente göç sonucunda Türkiye'de kamu hizmetlerinin yeterli ölçüde sağlanması aksamıştır. Bu ABD'de Progressive dönemde (1890-1920) yaşananlara benzemektedir. Devletin tedarik etmekte yetişemediği hizmetleri doğal bir süreç içinde KAGK'lar üstlenmiştir. Günümüzde Türkiye'nin üçüncü sektörü tam yapılanmamış olup, var olan eksiklikleri telafi edebilmesi için geliştirilmesi gerekmektedir.

**Anahtar Kelimeler:** Kar amacı gütmeyen kuruluşlar, kamu yararı, Pazar yetersizliği teorisi

**JEL Sınıflaması:** L31, H41

### I. Introduction

Nonprofit organizations have traditionally taken on the responsibility of providing basic human services to the disenfranchised and vulnerable segments of society. While initially they may have not been formally structured as formal organizations, the Settlement Houses in the Progressive era became the precursors to human service providing/advocating nonprofits. Settlement houses were established in the Progressive Era to combat poverty related malaise in US metropolitan areas serving largely immigrant communities. They provided

services that were later taken up by government. In this vein they pioneered the first playgrounds, juvenile courts, employment bureaus, special education classes and kindergartens to name some of the initiatives (Stivers, 1995; 2000). Out of this initiative combined with motives of civic participation and active citizenship grew the third sector in the US.

While an institutional third sector in Turkey is yet developing, a culture of providing human services such as health and education can be traced back to the foundations (*vakf*) in the Ottoman Empire. Al (2008) writes that foundations have played a significant role in urban development during the Ottoman era by providing public services that were otherwise undersupplied. Among the many services provided education constituted the most dominant segment. As of 2009, about 4600 foundations and 86,000 associations of diverse purposes are active in Turkey. Out of the 4600 foundations 56.1 % provide human services, 47.5% are education oriented and 21% provide health services (TUSEV). According to İnalçık (2003:149), foundations were urban institutions playing a determining role in city life as many public services were provided by them.

From the light of public administration, nonprofit organizations as community solutions to the problem of market failure are congruent with the communitarian and Anti-Federalist perspective within the public administration discourse. To demonstrate that theory, this paper explores the relationship between the voluntary sector and the provision of public goods. In three parts, the paper will define common terms, elaborate on existing theory regarding non-profits and the market, and tie the argument to the current conversation in Public Administration. To establish a basis for a discussion, a common understanding of terms such as collective or public goods, market failure, and non-profit organizations is required. A theoretical framework will be established using Weisbrod (1975), Kenneth Arrow (1963) Henry Hansman (1987) along with a critical view established by Lester Salamon (1987). Additionally, a brief review of the current literature on the subject will be presented in the context of the contribution from non-profit organizations to collective goods. Finally the connection to Public Administration is made. The Author's argument is that the establishment of Non-profit organizations as community solutions to fill the void of market failure is congruent with the communitarian and implicitly Anti Federalist perspective in the Public Administration discourse. As a final point, the author states the implications of this theory for Turkey.

Michael Spicer argues that there is no exact definition for the term collective goods, but a "key characteristic" seems to be that "individuals in a group have little incentive to contribute to the provision of such goods because once the goods are made available to some individuals they cannot be withheld from others" (Spicer, 1985:518). Since individuals are interest seeking, some will avoid contributing, leading to the "free rider" problem. John Head describes public goods based on Paul Samuelson's theory of public expenditure. He states that the consumption of a collective good by one person will not reduce its (the collective good's) availability to another individual's consumption (Head, 1974 in

Baker & Elliot 1990:178). Head cites two main characteristics of which the first, jointness, is similar to Spicer's argument. It refers to the understanding that once a collective good is provided no one can be excluded from its usage. In a less extreme sense it means that once it is made available, more than one person can use it without adding a marginal cost to its production, however to a certain limit (Head, 1974: 180). The second characteristic is that collective goods lead to external economies or diseconomies. This concept states that the consumption or production of one good will affect the consumption or production of another good (Head, 1974: 181). The market then fails to provide the optimal amount of the good because the value people put on certain goods are not revealed. This brings us back to the free rider problem. Rational individuals will not disclose their preferences because otherwise they might have to pay for them. They will tend to understate their willingness to pay for a public good, say national defense, hoping others will state higher amounts and take on the burden.

Burton Weisbrod states that, "undersatisfied demand for collective type goods is a governmental "failure" analogous to private market failures" (Weisbrod, 1988: 26). With this statement he introduces the non-profit sector as a potential corrective measure for market failure. The non-profit sector is often referred to as the third sector. It is a major and integral part of a functioning market economy (Young & Hammack, 1993: 399). Steven Ott describes the non-profit sector as a "particularly unique product of the democratic capitalistic governments that have evolved in the United States" (Ott, 2001: 2). He depicts it as a "means for reacting to marketplace failures by filling economic voids with volunteer time and charitable contributions" and also, the non profit sector is "filling voids left by government agencies that cannot or will not adequately serve citizens in need" (Ott, 2001: 2). Furthermore, Ott claims that the roots of voluntarism in America can be seen in the colonial era, when survival was dependent on the voluntary associations neighbors formed for mutual assistance.

Three basic characteristics formally describe non-profit organizations: first, no individual or group is allowed to benefit from the profit (non-distribution constraint); second, non-profits are exempt on taxes from corporate income; and third some non-profits may enjoy tax privileges such as subsidies, or deductibility of donations to the organization (Weisbrod, 1988: 14). Even though there are nonprofit organizations that provide a return for their members, for example Trade Commissions, these are not the subject of this paper. For the sake of this argument the author will focus on organizations that adhere to the non-distribution constraint.

In a societal context, non-profit organizations have taken on a crucial role in the development of a civil society. A strong third sector is considered to be "central to prosperous and successful democracies" because they help "to build the networks of trust and reciprocity, [and] the social capital, that allows democratic societies to function effectively" (Putnam 1993; Walzer 1991 as cited in Boris, 1999). Couto (1999) summarized the relationship between nonprofit sector and democracy when he noted that the third sector is innovative, provides

services and develops policy, supports minority and local interests and beyond all, furthers active citizenship. In a more action oriented definition, Hall notes that nonprofit organizations perform public tasks that have been delegated to them by the state and that have not been provided by the public and private sector and at the same time influence the direction of policy in the state, the for profit sector, or other nonprofit organizations (Hall, 1987 : 3).

## II. Theoretical Framework

The grounding for this discussion has been taken from Burton A. Weisbrod's seminal (Young, 2001; Te'ni & Young, 2003) and original (Hochman, 1980) theory on the voluntary non-profit sector as provider of public goods (Weisbrod in Phelps, 1975). His theory suggests that market failure occurs due to non-optimal provision of public goods. Some goods are under, others are oversupplied, leaving citizens unsatisfied. Though some undersupplied common goods could be substituted from the private sector this would not be an optimal solution. Consider a lighthouse for example; it could be substituted with shipboard radars or a stand by fire department with sprinklers or a police department with private security, handguns or watchdogs. However these examples display, according to Weisbrod, that these are poor as well as expensive substitutes leaving the consumer again in non-optimal situations. This rationale leads Weisbrod to the assumption that "a class of voluntary organizations will come into existence as *extra-governmental providers of collective consumption goods*" as they will "supplement the *public* provision (which can be zero) and provide an alternative to the *private*-sector provision of private –good substitutes for collective goods" (Weisbrod, 1975: 181-182). In the original formulation of his theory Weisbrod states that these voluntary associations will be financially burdened because not everybody will want to financially contribute to the common good, resulting in the free rider problem. But ultimately the existence of nonprofit organizations will result in higher provisions of public services, leading to Pareto superior allocation (Weisbrod 1986 as cited in Preston, 1988).

In his 1988 expansion of the theory he addresses the free rider problem and suggests solutions by explaining how individuals can be convinced to reveal their true preferences. Weisbrod states that "nonprofits have two principal instruments for encouraging consumers to reveal their demands. One is a stick: societal pressure; the other is a carrot: subsidies. Individual pursuit of self interest has to be harnessed if collective goals are to be achieved" (Weisbrod, 1988:28). This harnessing often occurs during our socialization into our community. Social institutions often work as harmonizing agents between the individual's self interest and the pursuit of a common good. For example, individuals learn early in their lives that littering is a bad thing as it ultimately leads to pollution. Or, in Canada a certain hour of volunteerism is a requirement to graduate from high school (Handy & Srinivasam, 2004). For many religions giving to charity constitutes a requirement. Whatever the specific motivation may be they constitute a societal pressure for charitable giving. Charitable giving to further common goods such as welfare, health, education and research are "encouraged

through a variety of subsidies to both nonprofit organization and their financial supporters” (Weisbrod, 1988: 28). These subsidies in return contribute to the solution of the free rider problem through increasing the organization’s revenues, because charitable giving is tax deductible and reduces the after tax cost of the contribution to the donor, stimulating further giving. Through the subsidies the non-profit organization receives, the donor gets more output for his or her donated dollar. These two aspects stimulate the individual to reveal to some extent, their willingness to pay for a certain common good (Weisbrod, 1988:29).

Kenneth Arrow was one of the earlier economists to explain the rise or survival of the non-profit sector. He wrote about market failure in the context of welfare economics of medical care (Arrow, 1963). Though not comprehensively formulated into a theory, he argued that “when the market fails to achieve an optimal state, society will, to some extent at least, recognize the gap, and nonmarket social institutions will arise attempting to bridge it” (Arrow, 1963 : 947). He claims that “the doctrine that society will seek to achieve optimality by nonmarket means is not novel” (Arrow, 1963: 947), and that the particular choice of voluntary institutions rather than for-profit organizations can be explained with the issue of trust. In his discussion of the dilemma that is faced in a patient/doctor or consumer/provider relationship that is tainted by financial considerations, Arrow concludes that the departure of the profit motive increases the trust within those relationships. He states that “departure from the profit motive is strikingly manifest by the overwhelming predominance of nonprofit over proprietary hospitals” and “the simplest explanation is that public and private subsidies decrease the cost to the patient in nonprofit hospitals” (Arrow, 1963: 950). Another explanation might be that “the association of profit making with the supply of medical services arouses suspicion and antagonism on part of the patients and referring physicians, so they prefer non-profit institutions” (Arrow, 1963:950). Furthermore, Arrow argues “product uncertainty” exists. What he means is that there is an “information inequality between the two parties” and their relationship is “colored “by the fact that both are aware of that (Arrow, 1963: 951). What Arrow is referring to is information asymmetry, which constitutes the base for Henry Hansmann’s theory of contract failure.

Contract failure theory is based on information asymmetry. As Kenneth Arrow noted, information asymmetry occurs when the supplier of the good has more information about the good than the consumer, such as the health care provider and the patient (Arrow, 1963: 947). Hansmann developed the thought and concluded that “nonprofits of all kind typically arise in situations in which, owing either to the circumstances under which a service is purchased or consumed or to the nature of the service itself, consumers feel unable to evaluate accurately the quantity or quality a firm produces for them” (Hansmann in Powell, 1987: 29; Young in Ott, 2001). Young (2001) states three specific reasons for information asymmetry. First, certain goods may be too complex for the lay person to judge, such as higher education or medical care as previously explained by Arrow; second, the consumer might not be competent to judge the quality of

the product, such as the child evaluating day care services or mentally ill judging the services provided for them; and third the consumer might not be the person who purchased the services and might not be able to transmit information about the service to the buyer. Using day care as an example, since the parents do not consume the service themselves they cannot judge the exact quality of the care provided.

It seems only rational that a for-profit firm would want take advantage of this situation and provide less of the good than they actually have to and that was paid for. "A nonprofit firm in contrast" Hansmann argues," offers consumers the advantage that, owing to the non-distribution constraint, those who control the organization are constraint in their ability to benefit personally from providing low quality services and thus have less incentive to take advantage of their customers" (Hansmann, 1987:29). Nonprofits will step in as a corrective measure for contract failure when the value put on the protection from being exploited exceeds the inefficiencies that might accompany nonprofit organizations. Another correcting measure might be the notion of trustworthiness. The assumption is that leaders of nonprofit organizations did not get into their position to increase their own monetary profit; profit oriented people would not be attracted to the nonprofit sector to begin with. Therefore consumers are provided with a sense of trust that can help overcoming contract failure (Young, 2001: 194; Hansman cited in Young, 2001). Another stream of thought coming out of Hansmann's theory suggests, the corrective effect is due to structural aspects rather than the non-distribution constraint. The fact that managers agree to a fixed income and devote all other resources to the service, compared to the profit firm that will only contract on the basis of producing a given output at a given price, makes the nonprofit seem more trustworthy. Even though the output of the nonprofit organization is more difficult to measure, their expenditures as well as salaries can be monitored and regulated (Easley & O'Hara, 1983, cited in Young, 2001). Yet another strand of contract failure theory focuses on the governance of nonprofit organizations. It depicts the organization as kind of a cooperative where production and consumption of a service are incorporated. This way the consumer will be an insider in the organization and will be able to overcome the information asymmetry (Ben-Ner, 1986, cited in Young, 2001).

A legitimate question for this theory asks how for-profits still exist in the environment of information asymmetry. One answer to this question could be that some consumers are confident, seek information and choose the most efficient service provided for their need, and they might end up with a for profit firm. However consumers who are less competent or do not have the time and resources to investigate the most efficient solution might settle for trust and prefer the non-profit (Young, 2001: 196).

Weisbrod and Hansmann's approaches to the rise of nonprofit organization as providers of common goods in response to market failures has been greatly criticized by Lester Salamon. Salamon argues that government and nonprofit sector partnerships are not new, quite the contrary, they are rooted

deeply in American history. For example in Colonial Massachusetts “ the commonwealth government not only enacted a special tax for support of Harvard College but also paid part of the salary of the president until 1781” (Salamon in Powell 1987: 100). A similar relationship was established between Connecticut and Yale University as well as various institutions in the health care field. He states that the emergence of the nonprofit sector was a result of the efforts to keep public and private sectors apart. Previously charitable organizations were part of the public sector, blurring sometimes the boundaries between public and private. “If the concept of the nonprofit sector thus had its origins in a broader effort to distinguish the private sector from government” (Salomon, 1995: 38-39), Salamon argues, theories about the welfare state and the voluntary sector, where he implies Weisbrod and Hansmann’s theories, are responsible for the elaboration of this division and the neglect of government –nonprofit relationships.

Salamon specifically criticizes Weisbrod’s theory that nonprofits will step in as substitutes to fill the void of government provisions. He states that “because the nonprofit sector is viewed as a substitute for government providing goods and services that the full political community has not endorsed, government support to nonprofit organizations has no theoretical rationale. To the contrary, under this theory, to the extent that nonprofits deliver services that the government underwrites, they violate their theoretical *raison d’etre*, which is to supply goods the government is not providing” (Salamon, 1987: 109). This argument can be countered on the grounds that government has no clear understanding of citizen’s preferences to begin with due to the fact that individual refrain from revealing their true preferences to become a free rider. Policy is shaped according to the information from the median voter. This information is not reflected in the preferences of marginalized citizens, such as minorities. Since these marginalized groups pay taxes, they too are entitled to benefit from public goods. It is only rational that government becomes aware of its limitations and contracts these services out to non-profit organizations. Salamon puts the theory of third party government forth, which argues that government is efficient as the financial provider, since it has the power to tax and can overcome the free rider problem, and non-profit organizations are efficient service providers due to their decentralized administration. If government were to provide all these services by itself it would grow dramatically.

Salamon continues his critique with Hansmann’s contract failure theory. He states that government agencies oversee and regulate service providers so they will not take advantage of the information asymmetry that exists between provider and consumer of a service. Furthermore he argues that “since government agencies might be expected to have even less reason to betray than nonprofits, this theory might lead one to expect more reliance on government agencies than on nonprofit ones” (Salamon, 1987:109). This view however entails a great trust in the government, which is contrary to the traditional American perception and attitude towards government control. Americans have historically displayed distrust and caution towards a growing and controlling centralized

government. The overriding theme of the Federalist-Antifederalist debate was distrust in the centralized government due to its regulatory power.

### **III. Placing the Discussion into the Public Administration Context**

Nonprofit organizations as community solutions to the problem of market failure are congruent with the communitarian and Anti-Federalist perspective within American Public Administration. Richard Green (Green in Shafritz, 1998) argues that during the ratification process of the constitution, Anti-Federalists echoed their concerns, that the liberal aspects of the constitution would transform society into a corrupted group of self-interested individuals. With this argument they brought out the communitarian aspect of the debate. Communitarian thought has been interpreted in various ways, however some general points are that the individual is not considered to be “fundamentally estranged and isolated”, and that individuals “shape their lives through complex relationships” (Green, 1998: 435). People give meaning to their lives and find their place in society through those relationships. Furthermore a communitarians reject the idea that that a community is an “aggregation of strangers” and also emphasize “aspiration and public responsibility over liberal’s manipulation of contending selfish interests and protection of rights” (Green, 1998: 436).

Among the various aspects of communitarianism, Fowler states that the image of a “community as roots” (Fowler 1991, cited in Green: 437) concentrates on private and institutional institutions such as the family, neighborhood, church, school and voluntary associations. This view of voluntary associations as builders of community and civil society as well as a corrective measures to the shortcomings of public goods, has its roots in the settlement houses of the progressive era (Stivers, 2000) This shows that the discussion of voluntary association as providers of public goods has its place in American Public Administration and is reflected in contemporary works of Terry Cooper, John Rohr, Camilla Stivers and many more (Green, 1998: 438).

### **IV. What about Turkey?**

Turkey has inherited a long tradition of providing public goods through foundations from the Ottoman Era. However while population is steadily increasing the number of foundations has barely changed over the last decade. The number of associations may have grown over the last decade from 61,000 to approximately 88,000, however their effectiveness is questionable and as research by the Turkish Third Sector Foundation (TUSEV) has revealed, only 9.7% of the population is member of any association. While the same research indicates that only 7.1% of the population regularly volunteers that may not be correct as informal, grassroot, neighborhood activities may not be captured by this statistic. However this research shows that the third sector in Turkey is yet at a developmental stage.

Urbanization is rapidly increasing in Turkey. While in the Ottoman Era it was a task of the foundations to segue individuals to urban life, this is now left unattended to leading to variety of problems. Es and Ateş (2004) classify problems related to urbanization and migration to urban areas as economic and



social in nature, where the first emphasizes unemployment, sectorial and regional imbalances, infrastructural problems and housing deficiencies. The latter points out problems in terms of environmental damage, social stratification and the polarization of classes, cultural adjustment problems as well as inequalities related to income and scattered housing (Es & Ateş, 2004: 218-219). None of these problems are unique to Turkey and have been experienced in some way during the urbanization process in other parts of the world. In the example of Settlement houses in the Progressive era social and economic conditions were somewhat comparable for urban migrants. In that case the shortcomings of public services or government failure, was compensated by emerging voluntary associations or later called nonprofit organizations.

Urban areas in Turkey are experiencing similar pains. Es and Ateş suggest urban planning related precautions to relief these malaise. Nevertheless government provision grassroot social services are rather difficult and will probably never be sufficient. For the previously stated reasons it will be of little interest for the private sector to venture in this area. Therefore it will be task of the third sector to step up and compensate the failure of market and government provision.

### **Conclusions**

This article has shown an economic theory of the emergence of the nonprofit sector starting with Kenneth Arrow's observations in welfare economics of medical care. His argument was that market failure will lead non-market institutions to fill the void. As an explanation to why that void could not be efficiently filled with profit making institutions he proposes in the event of an information asymmetry individuals tend to trust a non profit rather than for-profit organization. This argument was picked up and formulated into a comprehensive theory by Burton Weibrod and later expanded by Henry Hansmann, who elaborated on the contract failure that results from information asymmetry. As a counter argument Lester Salamon's critique was presented. The discussion is concluded with the placement of this argument into the Public Administration context. Finally, Turkey's third sector is discussed briefly in this perspective.

As summary we can say that the nonprofit sector, now holding almost 15% of America's wealth, has a significant place in the market economy. It is an advocate and supporter of civil society, as well as a significant provider of public goods. Voluntary associations have grown beyond national borders and have become important actors in the international arena for the provision of common goods. The relief efforts after the recent Tsunami disaster are only one example of the key roles charitable organizations play in this century.

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