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**Economic Theories of the Voluntary Sector:
a survey of Government Failure and Market Failure Approaches**

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Abstract: This paper attempts to survey the economic literature on demand-based theories of the voluntary sector, which derive from theory of government failure and the market failure paradigm. We discuss scholarly attempts to define the voluntary sector and establish various criteria which characterise voluntary organisations as well as the ways in which different economists have sought to classify the theories of the voluntary sector. Moreover, we examine theories which invoke government failure to explain the genesis of the voluntary sector and review theories premised on market failure, including asymmetric information models, customer control models, principal-agent problems and private philanthropy, and disadvantaged consumers. The paper ends with some tentative extensions and criticisms of the literature on demand-based theories of the voluntary sector.

Keywords. Voluntary sector; market failure; government failure; voluntary failure.

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ECONOMIC THEORIES OF THE VOLUNTARY SECTOR: A SURVEY OF GOVERNMENT FAILURE AND MARKET FAILURE APPROACHES.

1. Introduction

Social commentators throughout the advanced English-speaking world have become increasingly dismayed at the persistence of deprivation, poverty and unemployment, despite almost a decade of economic prosperity. Recognition that the existing redistributive functions of the contemporary 'welfare state' do not seem to have alleviated the plight of a significant economic and social 'underclass' has led governments of various political persuasions to explore new ways of dealing with this ostensibly intractable problem. Perhaps inspired by the Blair government and Clinton administration's well-documented search for a 'Third Way', conservative politicians have also sought to develop and implement new ways of approaching effective welfare delivery. For example, the Bush administration in the United States has emphasised the importance of religious and other not-for-profit groups in official welfare programs, despite potential constitutional obstacles. Similarly, the Howard government in Australia is also presently experimenting with alternative systems of delivering social services, which include the voluntary sector.

Voluntary organisations, variously described in the English-language literature as charitable, philanthropic, third sector and especially non-profit organisations, in the French tradition as 'économie sociale' and in Germany as 'Gemeinwirtschaft' organisations, constitute a significant proportion of economic activity in advanced democracies, particularly in the delivery of social services. However, the nature of voluntary organisations and the kinds of inputs they employ, which include not only donations of money and time but also other forms of 'helping behaviour' often impossible to measure, have made it difficult to estimate the size of the voluntary sector (Forster *et al*, 2001; Weisbrod and Long, 1977). Indeed, as Smith, Rochester and Hedley (1995, p.2) observe 'voluntary action is notoriously difficult to quantify, definitions of voluntary organisations are contested, and the boundaries of the sector cannot be drawn with confidence'.

Nevertheless, considerable effort has been invested in determining the extent of the voluntary sector. For example, Susan Rose-Ackerman (1996, p.705) reports that, exclusive of the value of volunteer labour, the American voluntary sector has been estimated at \$508.5 billion in 1992. If voluntary labour is added to this estimate, then the voluntary sector accounted for 6.5 per cent of US national income and around 10.6

per cent of national employment in that year. Moreover, the American voluntary sector is growing rapidly through time (Hodgkinson and Weitzman, 1994). In much the same vein, Posnett (1987) reports that in Britain voluntary activity has increased from £7.9 billion in 1980 to some £12.6 billion in 1986. The Australian Industry Commission (1995, Table 1.7, p.25) estimates voluntary sector income at some \$4.8 billion for the 1994 fiscal year. In West Germany, the voluntary sector grew from around 1 per cent of national income in 1960 to about 2 per cent in 1985 (Anheier, 1990, Table 3, p.322). Similar estimates exist for France (Archambault, 1990), Spain (Rovira, 1990) and Japan (Thranhardt, 1990). In sum, despite considerable uncertainties in measurement and significant national differences in size, the voluntary sector appears to be a substantial and growing element in the economic structures of most advanced economies.

This survey of the economic literature focuses exclusively on demand-based theories of the voluntary sector, which derive from government failure and market failure. The paper itself is divided into five main parts. Section 2 discusses scholarly attempts to define the voluntary sector and establish various criteria which characterise voluntary organisations. Section 3 is devoted to the ways in which different economists have sought to classify the various theories of the voluntary sector. In section 4 we examine theories which invoke government failure to explain the genesis of the voluntary sector. Section 5 reviews theories premised on market failure, including asymmetric information models, customer control models, principal-agent problems and private philanthropy, and disadvantaged consumers. The paper ends with some tentative extensions and criticisms of the literature on demand-based theories of the voluntary sector in section 6.

2. The Nature of the Voluntary Sector

Despite the considerable effort that has been expended on developing a satisfactory definition of the voluntary sector, a conceptually sound demarcation has yet to be conceived. Indeed, this may never be achieved. Rose-Ackermann (1996, p.701) has observed that ‘as the study of nonprofits has developed and the data base has grown, analytical efforts that preserve sharp distinctions between the for-profit, nonprofit, and public sectors look increasingly problematic’.

Notwithstanding the difficulties involved in establishing a formal definition of the voluntary sector, numerous scholars have attempted to identify criteria that differentiate between the private, public and voluntary sectors. After a wide-ranging review of the relevant literature, Seibel and Anheier (1990) suggest that ‘three major

sets of criteria have been advanced to distinguish the voluntary sector from the rest of the economy. Firstly, some writers have emphasised the ‘institutional characteristics of organisations’. For example, ‘political scientists have conceptualised the third sector as an intermediary between market and state, and have analysed the way in which third sector organisations act as mediators between the organized economic interests of firms, labour, and the political interests of state agencies and their constituencies’ (p.9). Secondly, a scholarly tradition exists which focuses on ‘the different rationales for social and economic action in the three sectors’ and which typically advances comparative distinctions between sectors along the lines of the assertion that ‘in contrast to for-profit firms, nonprofits tend to be loosely coupled and characterized by multiple goal structures and heterogeneous, often conflicting, constituencies’ (p. 13). Finally, a strand of the literature stresses ‘the institutional functions served by the organisations’. This approach examines ‘which third sector organisations achieve results and supply goods and services that cannot be provided by other sectors, including households’ and thus employs the market failure and government failure paradigms.

In their appraisal, of the literature, Kendall and Knapp (1995) arrive at somewhat different conclusions. They argue that four basic approaches to the voluntary sector can be identified: namely, the legal approach, the ‘economic/financial’ approach, the functional approach and a ‘structural/operational definition’ approach. The latter approach, which has its origins in the Johns Hopkins Comparative Nonprofit Sector Project, has identified five criteria’ which define voluntary organisations (Salamon and Anheier, 1993). According to this view, a voluntary organisation should be formal, self-governing, independent of government, not profit distributing (and primarily non-business) and voluntary.

Estelle James and Susan Rose-Ackermann (1986, p. 4) have followed a similar path and reached a complementary conclusion. They argue that voluntary organisations ‘combine three important attributes: (1) they are legally and structurally nonprofit; (2) they provide “socially useful” services; and (3) they are philanthropies, deriving a portion of their revenues from (tax-deductible) contributions’. By contrast, Hall (1987, p.3) adopts a functionalist approach: ‘I define a nonprofit organisation as a body of individuals who associate for any of three purposes: (1) to perform public tasks that have been delegated to them by the state; (2) to perform public tasks for which there is a demand that neither the state nor for-profit organisations are willing to fulfil; or (3) to influence the direction of policy in the state, the for-profit sector, or other nonprofit organisations’.

Some writers have argued that attempts at identifying a distinct voluntary sector are essentially futile given the heterogeneous nature of voluntary organisations. For instance, Abzug (1997, p.133) has observed that ‘rather than constituting a distinct sector, nonprofit organisations are hybrid institutions that intermesh resources and rationales from the three actual sectors of state, market, and community/family’. Similarly, Marshall (1996, p.52) approaches the problem from a somewhat different perspective by arguing that ‘to make any progress, however, we shall have to stop talking about the voluntary sector and begin a discussion of the multiplicity of voluntary sectors’. He proposes a fourfold taxonomy comprising a religious sector, a philanthropic sector, a community sector and an informal sector which constitute ‘an amalgam of several sub-sectors, each with a different impetus and character’ (Marshall, 1996, p.58).

3. The Classification of Economic Theories of the Voluntary Sector

The complex and heterogeneous nature of the voluntary sector has greatly complicated the work of theoreticians who seek to model the origins and behaviour of voluntary organisations using the tools of economic analysis. Nevertheless, considerable progress has been made and several plausible theories now exist which shed much light on the voluntary sector. In broad terms, we can distinguish between two genres of theories dealing with voluntary organisations. In the first place, a number of theorists have sought to develop models which can explain why the voluntary sector came into being at all; that is, why do voluntary organisations exist? This category of theorising can be further subdivided into ‘demand’ and ‘supply’ models of the voluntary sector. In essence, demand theories attempt to explain the genesis of voluntary organisations as a response to either market failure, characterized as the inability of a market or system of markets to provide goods and services in an economically optimal manner, or government failure, defined as the inability of public agencies to achieve their intended objectives. Demand models of the voluntary sector form the focus of this paper. By contrast, supply models endeavour to explain voluntary organisations as the outcome of ‘social entrepreneurship’, ‘a variety of explicit and implicit subsidies, including tax exemption from federal, state, and local taxes, special postal rates, financing via tax-exempt bonds, and favourable treatment under the unemployment tax system’ (Hansmann, 1987, p.33), and other factors. Supply theories fall outside the scope of this survey.

The second main theoretical approach to the voluntary sector seeks to explain the behaviour of voluntary organisations. Writers in this tradition attempt to answer questions such as: What motivates entrepreneurs and managers in voluntary organisations? What aims are pursued by these voluntary institutions? Does the behaviour of organisations in the voluntary sector differ systematically from their private sector and public sector counterparts? Literature in this tradition also does not come within the ambit of the present survey.

In many respects the dichotomy between theories focussing on the role of the voluntary sector and theories concerned with the behaviour of organisations in this sector is somewhat artificial. As Henry Hansmann (1987, p.28) has observed 'ultimately, of course, questions of role and questions of behaviour cannot be separated'. Nonetheless, this method of classifying theoretical contributions on the voluntary sector has become a convention in the literature and we follow it as an organizing principle here.

The severe difficulties encountered by economic and social theorists in defining voluntary organisations with any degree of precision are also reflected in problems experienced by writers in classifying the various theories of the voluntary sector. Even linguistic conventions typically employed to describe the voluntary sector often obfuscate its essential character. As Powell and Clemens (1998, p. xvi) have observed '...the terminological tangle that plagues efforts to define and distinguish among charitable activities, the independent sector, the voluntary sector, tax-exempt 501(c) 3 organisations, nongovernmental organisations and the private nonprofit sector' contributes towards these difficulties. The sheer diversity of the voluntary sector, coupled with the fact that variation among voluntary organisations may very well overwhelm differences between this sector and its private and public counterparts (DiMaggio and Anheier, 1990, p.149), further serve to create immense impediments to modelling these organisations in a meaningful way. Moreover, the objectives of theories of the voluntary sector are by no means straightforward. For example, Estelle James and Susan Rose-Ackerman (1986) distinguish between 'normative theories' of the voluntary sector which seek to explain the comparative advantages of voluntary organisations in world stigmatised by market failure and government failure and 'positive theories' which contrast the behaviour of the voluntary sector with the behaviour of the private and public sectors. Similarly, DiMaggio and Anheier (1990) argue that two different kinds of questions need to be addressed: one genre of theories should attempt to explain why voluntary sector organisations exist at all (that is, account for the distribution of social functions between the three main sectors of the

economy) whereas another class of theory must investigate the behavioural dimension of voluntary organisations (that is, are there any systematic differences in conduct between organisations in the three sectors?). Hansman (1987, p.27) proposes much the same dichotomy by emphasizing that whilst one corpus of theory is concerned with the role of voluntary organisations another strand of the literature focuses on the behaviour of the voluntary sector, although he does stress the somewhat ‘artificial’ nature of this division.

Doubtless influenced by these complications, various typologies of differing degrees of complexity of theories of voluntary organisations have been developed. For instance, Salamon and Anheier (1998) propose perhaps the most ambitious sixfold taxonomy of theories of the voluntary sector. ‘Market failure/government failure theory’ which attempts to explain the voluntary sector by invoking the shortcomings of markets and states, ‘supply-side theory’ which focuses on the role of ‘social entrepreneurs’ in the creation of voluntary organisations, ‘trust theory’ which stresses ‘contract failure’ and ‘information asymmetries’ confronting consumers, ‘welfare state theory’ which seeks to account for ‘...the expansion of state-provided social welfare services in the first place’ (p.223) and views voluntary organisations as residual provider of social services, ‘interdependence theory’ which replaces the conventional view of the relationship between markets, states and the voluntary sector as ‘fundamentally one of conflict and competition’ with the presumption that there are also ‘important elements of potential interdependence and partnership’ (p.225), and ‘social origins theory’ which attempts to specify the nature of the interrelationships between the three sectors as consisting of four possible models (liberal, social democratic, corporatist and statist).

Similarly, Rose Ackerman (1986) has proposed a comprehensive, if somewhat less elaborate fourfold taxonomy of models of the voluntary sector: namely (1) models which are relatively institution free and concentrate on voluntary provision as a response to government failure; (2) models which see profits as a response to information asymmetries and transaction costs in the private for-profit marketplace; (3) models of entrepreneurs and managers who view the non-profit firm as a way to further their own goals; and (4) models which emphasise the competitive interactions between nonprofit firms producing close substitutes. By contrast, Weisbrod (1987, p.677) adopts a simpler schema and delineates between theories which examine the ‘nature of demand’ and theories which focus on the ‘sources of supply’. He further differentiates demand-side theories into two categories – ‘one emphasizing private market failures, the other emphasizing governmental failures’. Elizabeth Boris (1998,

p.16) has advanced an even more manageable tripartite taxonomy of theoretical approaches to the voluntary sector. She observes that ‘economic theories include the notions of “market failure”, “government failure” and “nonprofit failure”, as ways of explaining the public services delivered by nonprofits, and the partnership of the government with the nonprofit sector in financing a variety of public services’. Ben-Ner and Gui (1993) have developed a somewhat different typology, which distinguishes between three ‘classes of explanation’; an ‘inadequate public provision’ (or government failure approach), a ‘contract failure’ approach stressing market failures when services are difficult to evaluate, and a ‘consumer control’ perspective focussing on the need for donor supervision of voluntary organisations. Along similar lines, Yonder (1986, p.21) has observed that:

Thus, economic theory offers several explanations for why some goods and services are produced by not-for-profit firms. The theory suggests that not-for-profit production may exist as a response to consumers’ need for protection when the good or service cannot be observed or when its quality accurately evaluated, as a response to differential demand for public or quasi-public goods when government has difficulty providing other than standardized output, as a means for government achieving lower-cost production of certain public goods, or a combination of these reasons.

In much the same vein, Ferris (1998, p.140) has suggested an alternative tripartite taxonomy of theories of the voluntary sector which comprises ‘public goods theory’, where voluntary organisations meet demands for collective goods which governments cannot satisfy, ‘trust goods theory’, where consumers are at an ‘informational disadvantage’ in their dealings with producers, and ‘club goods theory’, where voluntary agencies provide goods characterized by both jointness of consumption and congestability to club members.

Finally, Lester Salamon (1987) has proposed a polemical typology which seeks to give his intriguing theory of ‘voluntary failure’ a central role in modelling the voluntary sector. Salamon (1987, p.33) has argued that prior to the development of his theory of ‘third party government and voluntary failure’, two strands of theorising about voluntary organisations could be identified. In the first instance, ‘theories of the welfare state’ exist which seek to ‘...emphasise the monolithic character of the American welfare state and to de-emphasise the continuing role of voluntary groups in public programs’, a view which stresses ‘...the expansion of the state, to convey an impression of governmental dominance of societal problem-solving and service provision, and to leave little conceptual room for a vibrant nonprofit sector’ (p. 34).

Secondly, ‘prevailing theories of the voluntary of the voluntary sector’ can be divided into the ‘market failure/government failure theory’ and ‘the contract failure theory’, neither of which ‘...provides much reason to expect extensive government-nonprofit cooperation’ (p.35). A third genre of theories of the voluntary sector centres on Salamon’s own notion of third party government and voluntary failure. This view ‘would turn the argument round and view *government* as the derivative institution responding to “voluntary failure”, to inherent limitations of the voluntary or nonprofit sector’ and thus conceive of public sector activity as ‘...less a substitute for, than a supplement to, private nonprofit action’ (p. 39) (original emphasis). Voluntary failure itself consists of ‘philanthropic insufficiency’, ‘philanthropic particularism’, ‘philanthropic paternalism’ and ‘philanthropic amateurism’.

In stark contrast to these mainstream efforts aimed at developing a satisfactory taxonomic system for classifying theories of the voluntary sector, Henry Hansmann (1996) has pioneered a general theory of enterprise ownership which seeks to explain the different forms of ownership in a modern advanced capitalist economy by focussing on their comparative advantages. Drawing on ‘New Institutional Economics’ (NIE), Hansmann (1996, p.287) bases his theory on the proposition that ‘the relative efficiency of alternative forms of ownership in any given industry is determined by the costs of market contracting and the costs of ownership that confront the industry’s consumers and suppliers’. Voluntary organisations, or ‘firms without owners’, thus ‘...typically arise where there is at least one class of patrons for whom both the costs of contracting and the costs of ownership are quite high, with the result that there is no class of individuals to whom ownership of the firm can be assigned without severe inefficiencies’ (p.228). Given these characteristics of voluntary organisations, as the “asymptotic extreme in the separation of ownership from control’ (p.7), they fall at one end of a continuum of different models of ownership. Accordingly, theories which seek to explain the nature of voluntary organisations must be situated in a more general theory of ownership.

Notwithstanding the virtues of Hansmann’s (1996) generic theory of ownership and the elaborate taxonomies of Salamon and Anheier (1998) and Rose-Ackerman (1986), for our present purposes we will follow the more sedate typology developed by Weisbrod (1987) which distinguishes between demand theories and supply theories, with the former category sub-divided into market failure and government failure arguments.

4. Demand Theories Based on Government Failure

The first serious attempt at developing a theory to explain the existence of the voluntary sector began with Weisbrod (1975). Weisbrod (1977, p.52) explicitly set out to model 'the provision (financing) of public-type, collective-consumption goods by nongovernmental enterprises' by focussing on 'certain constraints on governments' or government failure. The analysis itself begins by examining the standard public finance approach to the provision of public goods which derives a market demand curve by the vertical aggregation of individual demand curves on the assumption of full preference revelation with an absence of free-riding and a tax price rule that the costs of provision are borne equally by all citizens. Where a Lindahl tax system is impossible to implement and the magnitude of actual provision of the public good is decided through the political process, the result is that only the median voter's equilibrium outcome will be achieved insofar as the tax price will equate with this person's marginal benefit or demand schedule. Because preference intensities for the collective good in question will vary between different consumers, this necessarily means the median voter outcome will deliver a volume of output '...that exceeds what some voters demand and falls short of what others demand' (p.54).

Dissatisfied consumers face four 'adjustment possibilities'. Firstly, they can migrate to governmental jurisdictions which provide their optimal desired volume of the collective good in question, a proposition which has real-world relevance in the local government sphere (Tiebout, 1956). Alternatively, voters can decide to form 'lower level governments' populated by consumers with similar preferences that provide optimal levels of the public good. Thirdly, unhappy consumers can purchase substitute, but not necessarily the same, commodities in private markets. Thus, for example, inadequate police services can be augmented by burglar alarms, locks and other security devices obtained through private markets. Finally, when the substitute goods offered by markets do not fully meet unsatisfied demand for the collective good, consumers can resort to voluntary organisations.

The voluntary sector is thus conceptualised as a response to incipient government failure and the subsequent inability of markets to make good the shortcomings of the state provision of public goods. Weisbrod (1977, p.30) argues that '...a class of voluntary organisations will come into existence as extra governmental providers of collective-consumption goods' and serve to 'supplement the public provision (which can be zero) and provide an alternative to private-sector provision of the private-sector provision of the private-good substitutes for collective goods'. Moreover, since the origins of the voluntary sector are ascribed to unmet demand for public goods, it

follows that the size of the voluntary sector should be proportional to the heterogeneity of the demands of the population in question. If the initial assumption that voters differ in demanding different quantities of the public good is dropped in favour of diverse tastes regarding quality of the collective good, then Weisbrod's theory still holds that *mutatis mutandis* the publicly-provided range of goods will be insufficiently augmented by the private sector hence giving rise to voluntary sector provision. Put differently, 'either excess demand or differentiated demand will increase the size of the nonprofit sector' (Chaves, 1998, p.54) (original emphasis).

Despite its ingenuity, Weisbrod's (1975) model has been subject to various criticisms. The static nature of the theory has been attacked on grounds that it does not recognize that the interactions of the public, private and voluntary sectors represent a system of simultaneous determination of collective goods and services. For example, Weiss (1986) has demonstrated that once additional collective goods are produced by the voluntary sector voters may seek less government production which may, in turn, reduce total output of the good. Similarly, it is not clear why the private and voluntary sectors respond to government provision shortcomings and not vice versa (Roberts (1984). Secondly, although the Weisbrod hypothesis can explain why the private production of collective goods occurs, it cannot support the proposition that this production will be conducted on not-for-profit lines. Some additional comparative advantage argument is thus necessary to account for the introduction of the voluntary sector (James and Rose-Ackerman, 1986). As Hansmann (1987, p.29) asks: 'What is it about nonprofit firms that permits them to serve as private suppliers of public goods when proprietary firms cannot or will not?'

5. Demand Theories Based on Market Failure

Theories of the voluntary sector, which have their origins in market failure, can be traced back to the literature on health economics with Kenneth Arrow (1963) suggesting that information asymmetries between patients and health professionals about the quality of health care may explain the prominence of non-profit hospitals in the American health system. Similarly, Nelson and Krashinsky (1973) and Nelson (1977) hypothesised that, given the difficulties of evaluating the quality of child day care centre service, parents overwhelmingly patronised non-profit organisations whom they felt they could trust rather than private firms which could take advantage of service ambiguities by providing inferior child care.

Theories of the voluntary sector based on market failure take as their point of departure the 'stylised fact' that voluntary organisations are subject to a

‘nonredistributive constraint’ which implies that these organisations surrender ‘the right to accumulate a monetary residual which can then be distributed to its owners for personal consumption ... instead, all not-for-profit organisations’ resources must be used internally’ (James, 1982, p.1). Estelle James (1990, p.22) spells out the analytical significance of the nonredistributive constraint as follows:

The basic idea is that if managers cannot benefit financially by receiving profits, they will be less likely to cheat consumers; therefore nonprofits are more trustworthy. For similar reasons, potential donors (of money or of volunteer labour) are more willing to donate to nonprofit organisations because nonprofits are more to use donations for intended purposes. Thus, nonprofits develop where trustworthiness is important, because many small customers or donors do not have adequate information about the product.

James and Rose-Ackerman (1986) identify three kinds of theories of voluntary organisation which fall within the market failure genre: namely, asymmetric information models, principal-agent or ‘customer control’ models and principal-agent or ‘private philanthropy’ models. We adopt this taxonomy in the discussion that follows but also extend it to include ‘disadvantaged consumers’.

Asymmetric Information Models

The first comprehensive theory of the voluntary sector based on market failure induced by asymmetric information was developed by Hansmann (1980; 1986). In his ‘contract failure’ theory, Hansmann (1987, p. 29) argued that ‘nonprofits of all types typically arise in situations in which, owing either to the circumstances under which a service is purchased or consumer to the nature of the service itself, consumers feel unable to evaluate accurately the quantity or quality of the service a firm produces for them’. Under these conditions, ‘a for-profit firm has both the incentive and the opportunity to take advantage of customers by providing less service to them than was promised’, whereas, given its nondistribution constraint, managers of a voluntary organisation ‘are constrained in their ability to benefit personally from providing low-quality services and thus have less incentive to take advantage of their customers’ (p. 29). Put differently, voluntary organisations originate in circumstances where ‘ordinary contractual mechanisms’ do not give consumers sufficient protection from unscrupulous producers and thus make ‘contract failure’ possible.

The Hansmann model assumes an information asymmetry in favour of producers, which induces consumers to deal with voluntary organisations on grounds of their greater ‘trustworthiness’. By contrast, Easley and O’Hara (1983; 1986) examine the

case where inputs are observable but output and 'managerial effort' are not perceptible. Under these conditions, private sector managers will produce neither output nor expend managerial effort and simply expropriate monies paid by consumers. What are necessary are incentive-compatible contracts that seek to entice managers to behave in organisationally desirable ways. In voluntary organisations managers are paid a fixed remuneration, and if they are forthcoming with managerial effort, then contract failure can be avoided.

Both the Hansmann (1980) and Easley and O'Hara (1983) models predict that the voluntary sector should predominate in industries in which the quality of output is difficult to evaluate. Although in intuitive terms this seems plausible, not all commentators are satisfied. For instance, James and Rose-Ackerman (1986, p.22/23) observe that 'it is not clear on a priori grounds that the quality (or other output characteristics) of nonprofit services is more difficult to evaluate than the quality of, say, used cars, which are sold exclusively by profit-maximizers, or that nonprofits are uniformly 'trusted' more than for-profits'.

Customer Control Models

Where output quality is difficult or even impossible to ascertain due to information asymmetries between sellers' and buyers' customer control of firms, often termed consumer cooperatives or consumer mutuals, is one way of addressing this problem. This appears to be especially relevant to situations where consumers place great emphasis on the need to ensure the maintenance good quality rather more mundane monetary objectives. Ben-Ner (1986) has developed an interesting model to try to explain the genesis of consumer cooperatives. In essence, Ben-Ner (1986) argues that in normal market circumstances consumers and producers bear an antagonistic relationship to each other since they pursue conflicting objectives. This conflict of interest '...induces firms and consumers to exploit special advantages or information they hold in order to enhance their welfare (profits or consumer surplus, respectively) at the expense of the other party' (p. 94). However, if the consumers and the business in question are integrated into a single organisation, then conflictual relations between them will vanish, all gains from trade will be internalised, and 'the incentives to withhold information and exploit special advantages disappear' (p. 94). Moreover, 'the integrating party obtains information that cannot be transmitted on the anonymous market and requires the organisation to maximize joint surplus (profits plus consumer surplus)' (p.94). Since private sector firms cannot initiate integration with their customers, and consumers can only achieve integration, the increase in joint

surplus due to integration will accrue exclusively to customers. The nature of customer control can take the form of demand revelation, determination of the integrated organisation's goals, and monitoring of organisational behaviour.

Ben-Ner (1986) demonstrates that backward integration by consumers will enhance consumer welfare under three scenarios: when private firms are better informed than consumers on product characteristics; when private firms systematically provide incorrect quality and other product characteristics; and when private firms use quantity rationing to exclude consumers of excludable public goods. In all of these cases, the net gain to consumers will exceed the benefit of trading with a private sector company.

Various problems have been identified with the Ben-Ner (1986) approach. For example, Rose-Ackerman (1986) notes that the model itself is based on a monopolistic market structure and it is not clear if the same results would flow from a competitive market. Similarly, Hansmann (1987, p.34) observes that 'Ben-Ner does not distinguish between nonprofit organisations and consumer cooperatives, but rather suggests that his theory explains the appearance of both types of firms... these two organisational forms generally seem to occupy distinct economic niches, and thus we need a theory of role that distinguishes them'.

Principal-Agent Problems and Private Philanthropy

Theories, which focus on philanthropic donations as a primary explanation for the existence of voluntary organisations, bear a striking resemblance to models based on asymmetric information. Thus, just as the consumer under informational uncertainty seeks a voluntary organisation run by management subject to a rigid nonredistribution constraint to avoid exploitation, so too donors as principals search for agents as managers who are bound to observe the nonredistribution restriction as a safeguard against abuse.

In his model, Hansmann (1980) argues that donors are analogous to private sector consumers except that they purchase services either for delivery to third parties or contribute in an indiscernible incremental way to an aggregate of collective consumption services. In both cases, the buyer is in a weak position to ascertain whether the contracted service has actually been delivered as promised. Accordingly, an incentive exists for donors to patronize voluntary organisations to avoid, or at least minimize, potential contract failure. For example, Hansmann (1987) cites voluntary international aid agencies which provide food and other emergency supplies to impoverished people in third world countries. He argues that, although private firms

could undertake the same service, donors have ‘little or no ability to determine whether the firm performs the service at all, much less whether the firm performs it well’, and thus prefer voluntary organisations since “a proprietary firm might well succumb to the temptation to provide less or worse service than was promised’ (p. 30). Much the same argument applies to public goods. For instance, person who contributes to an existing agency, like a public radio station, cannot be sure whether their marginal contribution actually improved the transmitted service or was simply appropriated by management and therefore seek the additional assurance offered by nonredistributive voluntary organisations rather than profit-maximizing firms.

Hansmann (1987, p. 30) argues that the contract failure theory of private philanthropy should be viewed as ‘complementary’ to Weisbrod’s (1975) model outlined above since ‘even if individuals are prepared to overcome their incentive to free ride and will donate toward financing some public good, they will have an incentive to contribute to a nonprofit rather than a for-profit because of the monitoring problems’ involved. By contrast, consumer control models, like Ben-Ner’s (1986) theory, which attempt to explain mutual voluntary organisations such as exclusive social clubs, do not rest on contract failure since patrons are capable of evaluating the services they receive. In these cases, ‘the nonprofit form is evidently adopted simply as a means of establishing patron control over the enterprise’ which seems to serve ‘the purpose of preventing monopolistic exploitation of the patrons by the owner of the firm’ (p. 33). Nevertheless, the observed pattern of donations in western countries demonstrates that many voluntary organisations even in the ‘pure’ charitable industries survive without philanthropic contributions (James and Rose-Ackerman, 1986). After reviewing the evidence, James and Rose-Ackerman (1986, p. 26) conclude that ‘while a substantial tendency to free-ride remains, some of it has been overcome, and donations will be found where large groups in society desire goods characterized by external benefits or decreasing costs or where income redistribution is the objective’. Although these factors represent classical arguments for government intervention, ‘it should be recalled that that voluntary ‘nonprofit’ social mechanisms existed long before strong governments did – and some of these mechanisms still survive’ (p.26).

Disadvantaged Consumers

In contrast to standard neoclassical assumptions about the utility maximising characteristics of consumers of public goods, in their theory of the comparative advantage of the voluntary sector, Billis and Glennerster (1998) approach the demand

for human services by emphasising the 'disadvantaged' nature of recipients of human services. Four kinds of disadvantage are identified. Firstly, some people are 'financially disadvantaged' and thus unable to participate in the normal market exchanges necessary to sustain a viable way of life. In the second place, individuals may suffer 'personal disadvantage', like mental illness, retardation and extreme age, which renders them unable to exercise rational preferences even if they possess the requisite financial resources. 'Societally disadvantaged' people include ethnic minorities, drug addicts, homosexuals, single mothers and other groups which are 'stigmatised' and excluded from the broader community despite generally being able to function well. Finally, Billis and Glennester (1998, p.88) identify 'community disadvantaged' citizens as people who live in ghettos where 'market, political and civil structures have broken down' to such an extent that they cannot participate in normal life.

Given the fourfold taxonomy of disadvantage amongst recipients of social services, the question arises as to the comparative advantages of government agencies, private firms and voluntary organisations in delivering these services to variously disadvantaged citizens. Billis and Glennerster (1998) suggest two methods of approaching this problem. In the first instance, it may be 'fruitful' to examine 'the structural features of "typical" agencies in each sector which might cause them to align with particular categories of disadvantage' (p. 88). Alternatively, and more promisingly, combinations of disadvantage can be correlated with specific sector responses. In other words, we need to consider under what conditions of disadvantage we can expect the emergence of government failure, market failure and voluntary failure.

If we examine each form of disadvantage in turn, then this can assist in highlighting potential structural comparative advantages possessed by the three means of delivering human services. Financial disadvantage by itself represents the clearest case. Billis and Glennerster (1998, p.88/89) unequivocally state that '...the state in most instances can, if the need is deemed justified, provide the cash and thus remove the disadvantage': neither the private sector nor voluntary agencies is deemed to enjoy any comparative advantage. While at first sight this argument may seem convincing, upon further reflection it seems unnecessarily restrictive since it considers only the effectiveness of outcomes and not their efficiency in terms of resources. Monetary transfers to financially disadvantaged persons in the form of unemployment benefits and other social security payments are typically legislatively determined, easily calculated and readily monitored. Accordingly, if we distinguish between public

provision and public production, then it is difficult to see why government funded welfare payments could not be delivered by private sector firms. After all, transfer payments consisting of public funds delivered by private firms can be safely monitored with minimal principal agent problems given the straightforward nature of the transaction. Moreover, there is ample evidence that the private sector can perform this task at lower unit costs than the public sector, especially with powerful public sector trade unions raising costs and reducing labour productivity. It would thus seem that, contrary to Billis and Glennerster (1998), the private sector might enjoy the greatest comparative advantage in this sphere of disadvantage. The complexities and ambiguities associated with voluntary organisations, especially their loose hierarchical structures, would seem to make them prone to voluntary failure under these circumstances.

In contrast to financial disadvantage, which is relatively easily remedied, personal disadvantage represents a much more thorny problem. People in this category generally require others, like parents, relatives or guardians, to act on their behalf. But many personally disadvantaged individuals may not have anyone to represent them or available act in their interests. Given its profit motive, the private sector would seem unsuitable since it would confront strong moral hazards and thus market failure may be expected to exhibit itself. Similarly, public sector delivery agencies are ‘...likely to receive weak messages from politicians defining their goals and standards’ and accordingly ‘normal practice will therefore be to leave it to the ‘professionals’ to act as interpreter and guardian of the personally disadvantaged person’ (Billis and Glennerster, 1998, p. 89). Past experience in many developed countries has indicated that under these circumstances government failure in the tragic form of sexual and other abuse often occurs. In comparison, voluntary organisations seem to possess definite advantages deriving from stakeholder ambiguity. By ambiguity in this sense, Billis and Glennerster mean the ‘overlapping roles’ characteristic of many voluntary organisations, where often no clear-cut distinctions can be drawn between ‘employer and employee, employee and non-employee, provider and recipient, chairperson and director, director and subordinate’ (p. 91). The ‘informality of an ambiguous and relatively small voluntary organisation’, together with highly committed staff, might thus well be best suited to the complexities of assisting personally disadvantaged clients.

Similar arguments appear to hold force in the case of societally disadvantaged people, although to a lesser degree. Alcoholics, drug addicts, Aids sufferers and other stigmatised people are not always blessed with much public sympathy and cannot

always expect sympathetic treatment from electorally sensitive vote maximising politicians. This renders assistance by public agencies problematic and government failure highly likely. On the other hand, if societally disadvantaged persons are not financially disadvantaged, then often private sector firms, such as detoxification clinics and hospices, can deal with the problem. But voluntary agencies would seem to have a comparative advantage where financial disability is combined with societal disability. This is readily evident in contemporary many contemporary advanced societies, where, for example, organisations like the Salvation Army and the Wesley Mission routinely care for socially disadvantaged people.

Community disadvantage, characterised by the absence of the usual institutions of civil society, seems to be the form of disadvantage least amenable to successful intervention from any of the three possible avenues of human service delivery. Public agency responses to community disadvantage are typically “short term” and beset by government failure, often consisting simply of emergency relief and riot suppression. Moreover, disadvantaged communities are not normally endowed with a viable market economy and accordingly face endemic market failure. Thus, ‘self-help and community mobilisation, despite resource constraints, appear to be one of the few ingredients of a possible upwards cycle’ (Billis and Glennerster, 1998, p. 93) in which voluntary organisations may act as a vital catalyst.

6. Concluding Remarks

We conclude this survey of demand-based theories of the voluntary sector by offering some tentative extensions and criticisms of the literature in its present form. The discussion focuses firstly on demand theories derived from government failure and then goes on to consider models of the voluntary sector drawn from the market failure paradigm.

Weisbrod (1975; 1977) bases his model of the voluntary sector on the proposition that voluntary agencies provide goods and services which are not supplied by the public sector to a sufficient degree (that is, the problem of excess demand) or to a sufficient kind (that is, the problem of differentiated demand). If we focus initially on the question of excess demand, then the kind of government failure concerned can clarify the type of voluntary sector involvement that may be forthcoming. For instance, health services with universal coverage, like the British National Health Service, are often characterised by patient queuing problems due to ongoing excess demand and a chronic lack of funds from the national exchequer, which could represent a case of legislative failure. Alternatively, a shortage of social work services for incapacitated

people could originate from too few social workers ‘on the beat’ rather than too few social workers *per se*, which could be described as bureaucratic failure. Similarly, a well-endowed urban human service contrasted with a poorly-resourced rural service may be ascribed to rentseeking by powerful urban interest groups. In each of these examples, the nature of the voluntary sector response could vary substantially. For instance, in some cases voluntary organisations could augment public under-provision by direct production of services. The Salvation Army, the Wesley Mission and other church-based charitable organisations often perform this function in the human services area to reinforce government agencies where the latter are unable to cope with the demands placed on them. By contrast, voluntary organisations sometimes specialize as lobby groups which seek to pressure governments into providing greater social security and other transfer payments to indigent groups in society. For example, the Australian Council of Social Service acts as a peak body for welfare recipients by attempting influence the Commonwealth government through its rentseeking activities.

Similar arguments can be constructed when we focus on the voluntary sector responding to government failure manifest as a Weisbrod’s (1975) problem of insufficiently differentiated demand. For instance, primary and secondary public education in contemporary developed western societies is universally available to all children, often as a statutory right. But many parents are not happy with the standard of this education, its secular emphasis, the kind of discipline imposed by teachers, and many other factors. Accordingly, even though in quantitative terms children must be offered publicly provided school places, in qualitative terms this may leave many families unhappy with the outcome. The voluntary sector has responded to this form of government failure in various ways. For example, exclusive and expensive private school systems have sprung up which offer ‘superior’ educational services to pupils. Similarly, various religious orders have created schools which provide ‘faith-based’ education, often heavily subsidised by other sources, including public funding, like the church school systems in Australia. Moreover, numerous private voluntary institutes offer vocational educational services to youths not interested in general academic education. In some cases, these kinds of voluntary sector responses can be ascribed to legislative failure, such as the failure of public representatives to fund religious education, whereas in other cases the response can be interpreted as an attempt to overcome bureaucratic failure, where educational standards may be low or classroom discipline poor.

The second potentially fruitful method of evaluating theories of the voluntary sector derived from government failure resides identifying characteristics common to both public agencies and voluntary organisations. Wolf's (1989) taxonomy of non-market failure is particularly insightful in this regard. For instance, Wolf identifies the lack of a linkage between revenue and costs which derives from the fact that typically the revenues of public agencies come from tax revenues collected by the exchequer whereas expenditures are incurred to run programs which do not raise funds. The resultant inefficiencies in the form of 'redundant and rising costs' can obviously also characterize voluntary organisations which also often have no direct connection between their income and expenditure. Similarly, Wolf's 'internalities and private goals' type of non-market failure may well present itself in the guise of Salamon's (1987, p.41) 'philanthropic paternalism' which describes the way in which affluent philanthropic donors may impose their own preferences on the operations of voluntary organisations. Moreover, Wolf's taxonomic category 'non-market inequities' can also manifest itself in the voluntary milieu in the form of Salamon's (1987, p.40) 'philanthropic particularism' which focuses on the way in which the voluntary sector tends to assist members of specific ethnic and religious groups, such as needy Catholics and Jews in the New York non-profit system, to the exclusion of other deprived groups.

Some theorists have adopted a converse line of reasoning and argued that public agencies and voluntary organisations have weaknesses or 'failures' which do not correspond at all closely. Indeed, they contend that the strengths and weaknesses of the public and voluntary sectors augment rather than amplify each other. For example, in one of the rare attempts at analysing the potential failures associated with voluntary organisations, Salamon (1987, p.42) argues that 'significantly, however, the voluntary sector's weaknesses correspond well with the government's strengths, and vice versa' since 'government is in a position to generate a more reliable stream of resources, to set priorities on the basis of a democratic political process instead of the wishes of the wealthy, to offset part of the paternalism of the charitable system by making access to care a right instead of a privilege, and to improve the quality of care by instituting quality-control standards'. Furthermore, the voluntary sector possess a clear comparative advantage in 'personalizing' the provision of human services, operating on a much smaller scale, and adopting flexible operating procedures devoid of 'red tape'.

Turning our attention to demand theories based on market failure, at least three observations can be made. Firstly, none of the theories of the voluntary sector based

on market failure differentiate explicitly between the ‘narrow’ efficiency-only model of market failure and its more extended ‘efficiency and equity’ counterpart (Wolf, 1989). For instance, Hansmann’s (1980) ‘contract failure’ model, with its emphasis on ‘trustworthiness’ appears at first sight to rely on narrowly-defined market failure arising from asymmetric information between producers and consumers. But to the extent that voluntary organisations replace profit-driven private sector firms to prevent ‘exploitation’ on equity grounds seems to indicate that a broader conception of market failure is involved. Gui (1993, p. 67) cites the example of frail elderly persons in nursing home care – a quintessential instance of potential contract failure – who are ‘exposed to both moral hazard (the organisation opportunistically supplies lower quality than agreed), and adverse selection (low quality organisations might drive high quality competitors out of the market)’. These unfortunate people can suffer two kinds of damage: that is, ‘they may engage in transactions that they would refuse if better informed’ and ‘they may refuse mutually advantageous transactions because they do not trust the organisation’. In other words, to the extent that the source of asymmetric information resides the limited judgemental capacities of the aged patients rather than the intrinsic difficulties inherent in evaluating the quality of the service, contract failure in this case rests on equity rather than exclusively efficiency considerations. Indeed, government intervention in the elderly care market is often justified on anti-age discrimination grounds as well as ‘quality of care’ arguments.

Similar arguments can be brought to bear on customer control models, like Ben-Ner (1986), and agency theories, such as Hansmann’s (1980) ‘nonredistributive constraint’ approach. However, it would appear disabled customer models, along the lines of Billis and Glennerster (1998), are rather less prone to this criticism. Although Billis and Glennerster (1998) do not draw any distinction between the narrow and broad definitions of market failure in their seminal paper, the weight they place on specifying the nature of customer disadvantage suggests that they have in mind explicit considerations of equity.

While theoretical disregard of the distinction between equity and efficiency considerations in the market failure paradigm is unlikely to have any deleterious impact on actual voluntary organisations that have evolved spontaneously to meet perceived societal needs, it may nevertheless create other problems. For example, if theorists do not spell out in a rigorous fashion the essence of the market failure to which the voluntary sector is purportedly responding, then they cannot differentiate between attempts at achieving allocative efficiency and efforts aimed at ameliorating

equity issues. This obviously impairs both the analytical coherence and explanatory power of theories of the voluntary sector reliant on market failure. Similarly, the policy prescriptions which may flow from these models and may mean government intervention, and which do not distinguish between economic efficiency objectives and equity goals, can hardly be expected to enjoy the confidence of policy makers.

Secondly, in practice it is generally exceedingly difficult to determine the marginal social costs and marginal social benefits of any particular economic activity, and accordingly problematic to ascertain whether or not market failure is indeed present. It follows that the existence of voluntary organisations in a specific sector does not necessarily imply that market failure is the reason for their operation. After all, in many real-world industries private firms coexist with voluntary organisations for long periods of time. This argument echoes the earlier criticism of James and Rose-Ackerman (1986) of asymmetric information models that rest on market failure induced by uncertainty over product quality. If pronounced market failure is present due to asymmetric information, then how should we account for the continued survival of private firms in the sector?

Finally, given these difficulties and the nirvana critique of the market failure advanced by Demsetz (1969), theories of the voluntary sector premised on market failure seem to fit well into a comparative institutions approach. Thus in any evaluation of actual institutional arrangements in a particular industry should focus on how the comparative advantages of various organisational structures, like private firms and voluntary agencies, enable them to coexist together. This kind of approach would distinguish between shades or intensities of market failure in a specific industry and co-locate private firms and voluntary organisations as service providers. For example, in the frail aged care accommodation market failure problems associated with quality determination may exist alongside ability-to-pay difficulties experienced by poor patients, with accredited private nursing homes overcoming the informational asymmetry problem and voluntary agencies dealing with financial inability.

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