

## Chapter 3

# *Public Good Theories of the Nonprofit Sector* Weisbrod Revisited

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### INTRODUCTION

Burton A. Weisbrod's (1975) "Toward a theory of the voluntary nonprofit sector in a three-sector economy" is a cornerstone in the literature on the economics of nonprofit organizations. In the Weisbrod model nonprofit organizations satisfy a demand for public goods, which is left unfilled by government provision. The government satisfies the demand of the median voter and therefore provides a level of the public good less than some citizens'—with a level of demand greater than the median voter's—desire. This unfilled demand for the public good is satisfied by nonprofit organizations. These nonprofit organizations are financed by the donations of citizens who want to increase the output of the public good.

A testament to the strength of the Weisbrod theory of nonprofit organizations is its wide acceptance and recognition within the economics literature. The original paper, Weisbrod (1975), subsequent reprints (1986, 1990), and book (1979) have produced over 100 citations in economics journals according to the Social Science Citation Index. This paper examines how the original theory has been revised, extended, and tested in the economics literature.

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The public goods theory of nonprofit organizations is a natural extension of the theory of club goods (Buchanan, 1965), Coase Theorem (1960), and the theory of collective action (Olson, 1965). In each theory the classic public goods or externality problem is resolved by the collective action of the individuals affected. Buchanan shows that collective action through clubs can be used to provide for the public good and examines the optimality of club membership. The Coase Theorem shows that the problems of markets with externalities not achieving the economically efficient level of output can be resolved through side-payments between the parties affected by or producing the externalities; while the theory of collective action by governments, organizations, and families illustrates the benefits and costs associated with providing for the public good. Likewise, the public good theory of nonprofit organizations provides an economic rationale for the formation of nonprofit organizations to provide for the public good.

Over the past 20 years the public good theory of nonprofit organizations has been revised and extended. Economic theories of altruism parallel and influence the public good theory of nonprofit organizations; while the public good theory has been adapted to include a variety of stakeholders and their demands for a variety of public and private goods from nonprofit organizations.

Donative nonprofits providing public goods depend on the altruism of contributors. Economic theories of altruism examine the impact of changes in government funding for public goods on the level of charitable contributions. The influence of government funding on donations depends on whether altruism is "pure" whereby donors receive benefit only from the increase in the production of a pure public good or whether altruism is modeled as "impure" whereby donors also receive private benefits from their gifts.

The classic public good model of nonprofit organizations considers the organization as producing a single public good in response to the demands of donors. This theory has produced a testable hypothesis that there will be more nonprofit organizations in more heterogeneous communities. Since Weisbrod's original paper, this model has been extended by allowing for the nonprofit organization to produce more than one output and allowing for nonprofit managers, donors, patrons, employees, and volunteers to have different preferences over the production of the public goods. In each case the nonprofit organization provides a public good, which is differentiated from the good provided by the government or a for-profit organization.

This paper also explores the commonalities between the public good theory and the trust theory of nonprofit organizations. The trust theory of nonprofit organizations is modeled by Hansmann (1980). The trust theory models nonprofit organizations as providing goods, which consumers cannot trust for-profit organizations to provide in sufficient quality or quantity because of the information asymmetries between the consumer and producers of the goods. These goods may include day care, education, or health care. Nonprofit

organizations, because of their stated goal not to seek a profit-maximizing goal, are more trusted by consumers to provide these goods. Trust, or the production of information to provide consumers with knowledge of the quality of goods and services, can be modeled as a public good.

## DONATIVE NONPROFITS AND ECONOMIC THEORIES OF ALTRUISM

The public good theory of nonprofit organizations principally describes donative nonprofit organizations. This theory provides a rationale for donors to make contributions in order to support the public good output of a nonprofit organization. Economic theories of altruism model the behavior of donors and therefore the support of donative nonprofits.

It is not necessarily true that theories of altruism describe nonprofit organizations. Typically, economic theories of altruism model donors as receiving some benefit or utility from their donation, without formally modeling the supply of the public good. Altruism can occur in the family, to support government or for-profit organizations, or simple exchanges between neighbors. However, the public good theory of nonprofit organizations requires modeling the donative support of altruistic agents.

An excellent review of the economic literature on altruism can be found in Rose-Ackerman (1996). A review of the experimental evidence can be found in Ledyard (1995); while a survey of the literature on the empirical evidence on crowd-out (the relationship between the financial support for public goods from government sources and its influence on the level of donations received by nonprofit organizations) can be found in Steinberg (1991).

### The Pure Public Good Theory

If nonprofit organizations provide for public goods through donative support, which otherwise would have been provided by the government, the question arises what happens when government provision of the good changes? If donative nonprofit organizations provide pure public goods an increase in government spending will "crowd-out" charitable contributions. The dollar-for-dollar crowd-out of charitable contributions by government spending in the pure public good model is shown in Warr (1982) and Roberts (1984). However, a more comprehensive treatment of this question in Bergstrom, Blume, and Varian (1986) reveals that crowd-out may not be dollar-for-dollar since many donors will simply stop giving in response to an increase in government funding. Since the donor's original contribution may be less than the increase in government funding (i.e., the donor is forced to a corner solution on his budget constraint), crowd-out may be less than dollar-for-dollar.

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