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## The institutionalist legacy of the *Gemeinwirtschaftslehre*

*Gemeinwirtschaftslehre; institutionalism; instrumental value; price system*

*This paper explores some of the commonalities between the *Gemeinwirtschaftslehre* and the classical institutionalist literature. Both schools are shown to share the acknowledgment of the limited ability of the for-profit sector to achieve a high quality of human life. For this reason, both schools advocate the need for discretionary social control of the economy. These schools' arguments are used to inform several aspects of the modern theoretical understanding of nonprofit organization: its property rights structure, its incentive alignment role, and its conformity with the public interest.*

### I. Introduction

In my previous work, I examined selected implications of the *Gemeinwirtschaftslehre* for the modern economics of the nonprofit sector (Valentinov 2009). My argument was that the *Gemeinwirtschaftslehre* accentuates the important difference in the market failure-addressing mechanisms of nonprofit and for-profit firms. Whereas for-profit firms address market failure by reducing the transaction cost of market exchange, nonprofit firms do so by supplanting the pecuniary entrepreneurial motivation with nonpecuniary one. This argument was helpful in resolving several crucial issues of the modern nonprofit economics literature, such as the (lacking) integration between the market failure and supply-side theories of the nonprofit sector, and the rationale behind the nondistribution constraint.

The present paper argues that the usefulness of the *Gemeinwirtschaftslehre* for the modern nonprofit literature extends far beyond that. Its most important contribution appears to be the conceptual construction of the system of shared societal meaning from which the nonprofit sector derives both its instrumental value and legitimacy. Moreover, this contribution is broadly in line with the institutionalist approach to the nonprofit sector, the term 'institutionalist' being used in reference to the old, or classical American, institutional economics, rather than new institutional economics. The *Gemeinwirtschaftslehre* thus may be viewed as an attempt to apply the insights of classical institutionalists, such as Thorstein Veblen, John Commons, and Clarence Ayres, to explaining the role of the

nonprofit sector in a market economy. The latter statement must be immediately qualified: the proposed view of the *Gemeinwirtschaftslehre* is certainly not supported by its authors explicitly citing and utilizing the works of classical institutionalists. Rather, this view is to be taken as a subjective conjecture intended to explore the logical commonalities of both of these literature strands. Moreover, this conjecture is arguably more than an exercise in what Veblen called ‘idle curiosity’. Instead, it is aimed at demonstrating that the modern new institutional economic theory of nonprofit organization contains a major gap that can be filled by utilizing the conceptual tools of classical institutionalism.

As suggested by the above argument, this gap is related to the missing account of shared societal meaning which underpins the instrumental value and legitimacy of the nonprofit sector. To be sure, this kind of gap presents no surprise, given the methodological individualist outlook of the new institutional economics. Methodological individualists who deny the existence of holistic social entities would not even raise the issue of shared societal meaning. Yet, this issue is of central concern to classical institutionalists who advocate a holistic, evolutionary, processual, and open-ended view of human society (Gruchy 1987; Hodgson 1998).

More specifically, new institutional economists, in line with the principle of methodological individualism, have treated nonprofit organization as a (micro-) contractual arrangement, the key attribute of which is the nondistribution constraint. The scholarly inquiry in this tradition has been basically limited to exploring the determinants of adopting the contractual form of nonprofit organization (Steinberg 2006; Valentinov 2008a). Ultimately, this methodological predisposition is rooted in locating the basic economic problem in the Robbinsian optimal allocation of scarce resource having alternative uses. Classical institutionalists view the basic economic problem differently. To them, it resides in understanding the organization and control of real-world economies (Samuels 1988), and in understanding societal self-provisioning with the material means of life (Gruchy 1987). Accordingly, the approach of classical institutionalism must be concerned with the role of the nonprofit sector in the organization and control of contemporary economies from the holistic societal perspective, and with this sector’s role in societal self-provisioning with the basic means of existence. Addressing these fundamental questions is impossible without referring to a system of shared societal meaning, to the institutionally legitimate conceptions of the ‘material means of life’, and to reasoned assessments of the public interest by rational, purposeful, and habituated individuals.

Within the *Gemeinwirtschaftslehre*, there are two basic interrelated ideas that are highly suggestive of this system of shared societal meaning. Both ideas are related to the notion of the public interest. One of these is the assertion that the meaningful articulation of the public interest cannot be achieved through the market-mediated aggregation of individual preferences; and the other is that the public interest must be defined formally, rather than substantively, and made dependent on whatever the current politically powerful groups believe the public interest to be. Both ideas are elaborated in Theo Thiemeyer’s (1970) critique of the ‘rationalistic’ conception of the public interest and his support to an alternative, ‘realistic’ conception, primarily in view of some types of individual preferences

being inconsistent with what is believed to correspond to the public interest. Furthermore, both Thiemeyer (1970) and Weisser (1976) argued that the specific contents of the public interest cannot be defined in a value-free way, and that individual valuations are an integral part of the evolving societal discourse about the public interest.

The *Gemeinwirtschaftslehre*'s rejection of the ability of the market to aggregate individual preferences in a normatively meaningful way is paralleled by the essentially similar argument of classical institutionalists. The latter school treats markets as 'instituted processes' subject to the discretionary control of powerful individuals and groups. Even more importantly, it does not share the new institutional economists' faith in the beneficent natural order of social organization embodied in the Pareto-optimal competitive equilibrium (Gruchy 1987). Instead of believing in any ideal consummatory social state, classical institutionalists view society as being engaged in the continuous and open-ended problem-solving process 'that raises the question of how well the economic system provides for the values of individuals and their community' (Gruchy 1987, p. 5). The very open-endedness of this process requires individuals to continuously reassess the performance of their economies in the light of their individual values as well as to reassess these values themselves. This open-ended perspective leads classical institutionalists to advocate the necessity of deliberate discretionary social control of the economy. An obvious form of this discretionary social control is found in the operation of the *Gemeinwirtschaft* or the nonprofit sector.

It must be noted that the incompleteness of the methodological individualist outlook on nonprofit organization has been recognized in the nonprofit literature. Most importantly, Anheier and Salamon (2006, p. 106) contrast the conventional new institutional economics theories of the nonprofit sector with their own "social origins" theory that "emphasizes the embeddedness of the nonprofit sector in the cultural, religious, political, and economic realities of different countries. It thus views decisions about whether to rely on the market, the nonprofit sector, or the state for the provision of key services as not simply open to choice by individual consumers in an open market (...). Rather, it views these choices as heavily constrained by prior patterns of historical development and by the relative power of various social groupings that have significant stakes in the outcomes of these decisions". The social origins theory comes closely to the insight that the rationale for the nonprofit sector is ultimately to be sought in the above-mentioned system of shared societal meaning as reflected in the broad institutional environment. Yet, this theory is centrally concerned with explaining the geographical variation in the characteristics of the nonprofit sector, rather than with revealing the sector's role in the culturally conditioned societal self-provisioning with the material means of life. Effectively revealing this role requires embracing the basic methodological attitude shared by the *Gemeinwirtschaftslehre* and the classical institutionalism, to the effect that the public interest is derived from reasoned and value-laden discourse rather than from market-mediated aggregation of individual preferences, and is implemented through the discretionary institutional choice.

The rest of this paper discusses some of the more specific institutionalist implications of the *Gemeinwirtschaftslehre* that potentially inform the modern literature on nonprofit economics. The next section analyzes the relationship between the price system, embodied in the for-profit sector, and the instrumental theory of value underpinning the ‘realistic’ definition of the public interest. The following section revisits selected issues of the contemporary new institutional economics theory of the nonprofit sector. Concluding remarks follow.

## II. The price system and instrumental value

A key contention of institutionalists is that the price system is only limitedly helpful in furthering social progress. This contention is a value judgment rooted in the instrumental theory of value as the basic normative compass of institutionalism. Being an integral part of the pragmatist philosophy, the instrumental theory of value believes values to originate from the social problem-solving process, rather than from ‘introspective and subjective recesses of the minds of hypothetically rational individuals’ (Gruchy 1987, p. 63). Accordingly, values are held to be historical, socially and culturally conditioned, emergent, and subject to continuous reappraisal. According to Gruchy, ‘what is deemed to be valuable in the valuation process is the item, product, or cultural situation that enables the individual to reduce conflict or tension so that he or she may realize his or her full potential for personal development more effectively and may also contribute more effectively to the enlargement of community welfare’ (ibid., p. 65). One of the latest writers on the topic proposed the following criterion of social value: ‘the continuity and instrumental efficiency of recreating community non-invidiously’ (Tool 2001).

Needless to say, the instrumental theory of value is highly at variance with the orthodox utility theory of value underpinning both neoclassical and new institutional economics. The utility theory locates the source of value in individual subjective utility and accordingly believes competitive equilibrium to engender the quasi-Hegelian consummatory state of social utility maximization. In contrast, the instrumental theory of value contains two non-utilitarian postulates that are crucial for understanding the rationale of the nonprofit sector: 1) human values are rooted in society rather in individual introspection; and 2) human values are continually reassessed in the course of the ongoing social problem-solving. Indeed, the decision to create a nonprofit firm reflects a proactive attitude that is difficult to reconcile with the hedonistic view of economic actors as passively responding to the external stimuli of pleasure and pain. Furthermore, certain needs must be deemed as sufficiently important to warrant the creation of a nonprofit firm, while the utilitarian view of needs (or wants) as primary exogenous data precludes their critical scrutiny. Finally, nonprofit firms’ missions (that reflect the above needs) are obviously conditioned by the institutional, social, and cultural environment of particular societies, and arise from specific problems of these societies, rather than from ahistorical subjective introspection.

While the price system is the ultimate locus of value for the orthodox utility theory, its place is much more qualified in the instrumental theory embraced by institutionalism. While recognizing the price system's role in the coordination of economic decisions, institutional economists believe that the price system is limited in its ability to ensure high quality of human life. As Clarence Ayres argued, prices quantify vice as readily as virtue, and quantify mistaken decisions as readily as wise decisions. Furthermore, the price system is essentially circumscribed by the current income distribution and therefore legitimizes this distribution without clear ethical justification (Ayres 1978, p. 227). According to Kenneth Galbraith, in a differentiated society, the price system presents a mechanism whereby large capitalists dominate and extract resources from other society members. Given that the price system is only of limited use in realizing instrumental values, society needs alternative institutions of self-provisioning with material means of life. These are nonmarket institutions that may take the form of the *Gemeinwirtschaft* or the nonprofit sector.

This is a very important point. The meaning of the *Gemeinwirtschaft* and the nonprofit sector is not in helping the price system to work more smoothly through the partial correction of market failures (as assumed by modern nonprofit economics). Rather, this meaning is in transcending the price system itself because this system fails to realize instrumental value (which is in turn being continuously redefined through the ongoing societal discourse). Both the *Gemeinwirtschaftslehre* and institutionalism agree with the new institutional economics perspective that the Smithian 'invisible hand' does not work in the real world and thus needs to be supplemented by nonmarket institutions. Yet, the deeper reasons for this belief are fundamentally different. While the new institutional economics believes the 'invisible hand' to work if undisturbed by market failures, the *Gemeinwirtschaftslehre* and institutionalism deny its very existence. There is no 'invisible hand' or any other scheme of beneficent natural order; there only is the ongoing evolutionary process of societal self-provisioning with material means of life. Both market and nonmarket institutions are discretionary institutional forms of this self-provisioning that are being continuously reassessed as to their ability to solve existential social problems.

The institutional economics emphasis on societal self-provisioning transcends the individualist outlook of the Smithian theory of the social division of labor that differentiates between exchange and self-provisioning as alternative mechanisms of gratification of human needs (Locay 1990). Seen holistically, both of these mechanisms present different forms of societal self-provisioning, with the former mechanism being its indirect form, and the latter one – the direct form. The indirect nature of the market exchange as a form of societal self-provisioning follows from its reliance on individual motivation being essentially egoistic and thus unrelated to the basic societal purpose of achieving a high quality of community life. Nonmarket institutions, such as the *Gemeinwirtschaft* and the nonprofit sector, involve the substitution of the indirect societal self-provisioning for the direct one. As I have argued elsewhere, a general explanation for the necessity of this substitution may be found in the Veblenian notion of the pecuniary-industrial dichotomy,

i.e., the failure of the pecuniary motivation to realize instrumental value (Valentinov 2008). Thus, in contrast to for-profit firms, nonprofit organization is essentially constituted not by networks of contractual exchange relationships, but by collective self-provisioning aimed at overcoming the failure of contractual exchange to meet specific human needs (Valentinov 2008).

### III. Implications for modern nonprofit economics

This section draws out implications of the above argument for several aspects of the theoretical understanding of nonprofit organization: its property rights structure, its incentive alignment role, and its conformity with the public interest. Each of these aspects is seen differently depending whether one takes the individualist market-centred perspective of modern nonprofit economics or the holistic evolutionary perspective of classical institutionalism and the *Gemeinwirtschaftslehre*.

#### 1. The property rights structure of nonprofit organization

New institutional economists have long argued that only the regime of fully delineated private property rights can provide sufficient motivation for individual agents to take full account of the wealth effects of their actions. This implies, in particular, that only privately owned resources will tend to be allocated to their highest value uses and that the extent of specification (delineation) of private property rights will be directly proportional with the efficiency of resource allocation (Furubotn/Pejovich 1972). Consequently, new institutional economists pointed out that the attenuation of property rights precludes efficient allocation of resources. A major example of this attenuation is the nondistribution constraint of nonprofit organization (i.e., prohibition to appropriate any residual earnings). New institutional economists believe that the nondistribution constraint prevents nonprofit managers from bearing the full range of wealth consequences of their actions, since these managers are not under profit maximization pressure and thus engage in extensive on-the-job consumption (Furubotn/Pejovich 1972, Alchian/Demsetz 1972). This argument has been qualified by the trustworthiness theory developed by Henry Hansmann (1980). According to him, the nondistribution constraint makes nonprofit firms more trustworthy than for-profit firms, with two transaction cost-economizing effects. First, the nondistribution constraint facilitates donative financing by assuring donors that the donated funds will not be appropriated as profits, and, second, it serves as a signal to consumers that the firms' owners have no incentives to cheat them by 'cutting corners' on quality or providing unnecessary services (Valentinov 2008a). Yet, the trustworthiness theory has to grapple with serious criticisms. For one, it assumes that the nondistribution constraint is perfectly enforced (Ortmann/ Schlesinger 2003). Moreover, Malani and Posner (2007) have shown that eliminating the profit incentive to shirk on quality does not eliminate other incentives to do so, because the nonprofit organizational

form, by itself, simply replaces one non-verifiable condition (quality of the product or service) with another (altruism of the entrepreneur).

On the whole, the trustworthiness theory may have a good point, but it is hardly sufficient to account for the multifaceted role of the nonprofit sector in modern societies. As mentioned above, this role is related to this sector's ability to realize instrumental value that is only imperfectly transmitted through the price system. At the same time, the issue of property rights has been of central concern to classical institutionalism that combines the considerations of property rights and instrumental value in a unified theoretical framework. This combination is well exemplified by the position of Clarence Ayres, a classic institutionalist author. Ayres (1978) argued that the societal evolution, proceeding along the 'technological continuum', has to withstand the resistance of backward-looking institutions (ceremonies), with the institution of private property being a prime example of these. Social progress is enabled by the continuous abolition of ceremonies, and specifically by the successive elimination of various attributes of the institution of private property. From this perspective, the nondistribution constraint involves the elimination of the profit motive that presents a ceremonial constraint on the realization of instrumental value. Put differently, the adoption of the nondistribution constraint may be seen as an attempt to abolish those backward-looking institutions which stand in the way of achieving a high quality of community life.

## **2. The incentive alignment problem of nonprofit organization**

The new institutional economics explains the existence of the for-profit firm in terms of its ability to facilitate information flows and to align incentives of economic actors (Valentinov 2008b). In the context of the for-profit sector, incentive alignment essentially means constraining the scope of opportunistic behavior. The above-mentioned trustworthiness theory of Henry Hansmann (1980) applies the same incentive alignment logic to the nonprofit sector. It argues that the nondistribution constraint aligns the incentives between nonprofit managers and consumers in such a way as to dampen the incentives of the former to take opportunistic advantage of the latter. Yet, in line with the cited criticisms of the trustworthiness theory, it is questionable whether the minimization of opportunism may be regarded as the key incentive alignment problem of nonprofit organization. Most importantly, the opportunism-centred view of the incentive alignment problem is hard to reconcile with the broader societal meaning of the nonprofit sector related to its ability to realize instrumental value.

In my previous work, I proposed that the incentive alignment role of nonprofit organization is more appropriately seen in cultivating intrinsic motivation of its key stakeholders rather than in combating their opportunism (Valentinov 2008c). Intrinsic motivation may be regarded as the expression of societal meaning and instrumental value at the level of individual behavior. Moreover, the proposed view of the incentive alignment problem suggests an explanation of the basic governance features of nonprofit organization, such as the nondistribution constraint and the self-governing character. Both of these features

tend to switch off, respectively, monetary and administrative incentives which are known to adversely affect intrinsic motivation (through the so-called ‘crowding-out effect’). The nondistribution constraint may thus be explained not only as the opportunism-reducing device, as the trustworthiness theory would imply, but also as a device for maintaining intrinsic motivation.

### 3. The public interest orientation of the nonprofit sector

Both the *Gemeinwirtschaftslehre* and the classical institutionalism share the conception of the public interest as determined in the process of the ongoing societal discourse that precludes the use of any fixed and once-and-for-all substantive criteria. The nonprofit sector has been traditionally presumed to act in the public interest. Indeed, it is on this basis that the nonprofit sector has enjoyed favourable taxation in many countries. However, the flexible nature of the public interest complicates controlling the actual conformity of this sector’s activities with the public interest. Whereas nonprofit organizations are increasingly required to demonstrate their commitment to the public interest through the use of effective accountability mechanisms, nonprofit accountability remains a highly contested issue.

As I argue elsewhere, the continuing challenge of nonprofit accountability can be explained by the coexistence of two alternative ways to define the public interest, aggregative and processual (Valentinov forthcoming). The former definition takes the public interest to be the majoritarian aggregate of individual preferences; the latter takes it to be the product of a particular procedurally legitimate process. The main thrust of the current literature on nonprofit accountability seems to be concerned with emphasizing the insufficiency of accountability based on the substantively understood public interest. At the same time, it is obvious that the positions of both the *Gemeinwirtschaftslehre* and the classical institutionalism embrace the processual definition of the public interest. Accordingly, both of these schools suggest that the answers to the key accountability issues “for what?” and “to whom?” are to be looked for in the processes, rather than substantive results, of the nonprofit sector’s activities (Stone/Ostrower 2007, p. 423).

There are two specific implications that follow from the proposed processual approach to nonprofit accountability. First, nonprofit organizations are often minority-serving and thus should not be criticized for pursuing particularistic missions (i.e., missions seen as unimportant from the perspective of the substantive public interest). The public interest legitimacy of nonprofit missions merely requires these to be legal and responsive to the stakeholders. Second, in developing accountability mechanisms, nonprofit managers need to emphasize processual aspects, such as contributions to democracy building, civic participation, and social capital. It is arguably this need that underlies the recent call for ‘broadened accountability’ in the nonprofit sector (Valentinov forthcoming).



## IV. Concluding remarks

This paper has argued that the *Gemeinwirtschaftslehre* is in fundamental agreement with several key ideas of the classical institutionalist literature, despite the lack of explicit interaction between these two schools. Their common heritage converges on acknowledging the limitations of pecuniary social organization in realizing instrumental value. These limitations dictate the need for discretionary social control of the economy. The public interest as the criterion of this discretionary control is derived not from market aggregation of individual preferences, but from the ongoing societal discourse involving individual valuations.

Yet, as the practical experience has shown, bringing the public interest thus derived to bear on the actual operation of the *Gemeinwirtschaft* has been a serious challenge. Moreover, as evidenced by the current debates on nonprofit accountability, it remains a challenge for the modern nonprofit sector as well. Arguably, meeting this challenge calls for envisioning the community as a whole, rather than the formal government, as the effective locus of the public interest formation. Both the *Gemeinwirtschaft* and the nonprofit sector must be seen as instrumental with respect to the public interest, in line with the *Gemeinwirtschaftslehre*'s 'instrumental thesis'. However, it is crucial to apply the 'instrumental thesis' to the formal structures of government at the same time. In the institutionalist tradition, the government itself must be seen as instrumental for the 'non-invidious recreation of the community' (Tool 2001, p. 300). Only in this case can the actual operation of nonmarket institutions be genuinely participative and hence 'incentive-compatible' in the sense of new institutional economics.

The proposed argument suggests two major directions of further research. One of these is concerned with exploring the way in which the specific drawbacks of pecuniary social organization give rise to specific nonmarket institutions. One recent example of this research direction may be found in the 'rurality' theory of the nonprofit sector (Valentinov 2009a). This theory holds that the special features of rural areas engender special limitations of pecuniary social organization in achieving a high quality of rural life and thus call for rural nonprofit organizations. The second research direction is concerned with examining the way nonmarket institutions enable genuine participation of individuals in the community life. The viability and, indeed, the very justification of nonmarket institutions hinge on their ability to ensure a fuller participation than is possible within the for-profit sector. Both of these research directions emphasize the unique role of nonmarket institutions, such as the *Gemeinwirtschaft* and the nonprofit sector, in achieving a high quality of human life in modern societies.

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