

**Money and Autonomy**  
**Dilemma Faced by the Nonprofit Sector**

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## **Dilemma Faced by the Nonprofit Sector**

### **Abstract**

Nonprofit organizations are also known as "non-governmental organizations" (NGOs). When praising their independence and autonomy, people often forget to ask how nonprofit organizations survive financially and where they get their money. This essay shows that the pervasive myth of nonprofit self-sufficiency has no factual base. In fact, in no country is private charity the dominant source of nonprofit revenue. If private giving is not the major source of nonprofit revenue, what is? Are nonprofit revenue sources the same across countries? How do sources of funding affect nonprofit behavior? These are the questions this article attempts to answer. Its first section tries to explain why it is unlikely for the nonprofit sector to generate an adequate level of resources for itself. The following section identifies three broad patterns of nonprofit finance in the world: the fee-dominant pattern, the government dominant pattern, and the foreign aid dominant pattern. The section III discusses the implications of each pattern for the nonprofit sector's autonomy. The final section is a brief conclusion.

Nonprofit organizations are also known as "non-governmental organizations" (NGOs).<sup>1</sup> When praising their independence and autonomy, people often forget to ask how nonprofit organizations survive financially and where they get their money. The issue of funding, in fact, is no small matter to the nonprofit sector. Insufficient funds might force nonprofit organizations to give up worthy causes half way through; severe shortage of financial support might even drive some of them out of existence altogether. Not only the size of funding matters so does the source of revenue, because the latter has bearing on nonprofit organizations' autonomy. In English, there is a saying: "the one who pays the piper will call the tune." Similarly, an African proverb says: "if you have your hand in another man's pocket, you must move when he moves." Most people would doubt whether nonprofit organizations could maintain their autonomy if they rely mainly on government handouts. By the same token, if nonprofit organizations depend primarily on service charges, people have reason to believe that the behavioral line between for-profit and nonprofit organizations would become blurred. In any event, it seems to be hard for nonprofits to retain a meaningful degree of independence unless they can ensure a vigorous base of philanthropic support, either in the form of private giving or in the form of volunteer labor.

According to conventional wisdom, funding does not constitute a problem for the nonprofit sector. A common belief is that in the West, at least, foundations, corporations and people at large are extremely resourceful and very generous. Charitable contributions from such sources as foundation grants, corporate gifts, and individual giving are so plentiful that they can be used not only to sustain the nonprofit sector within the country, but also to support non-governmental organizations elsewhere in the world. Since private charity alone is sufficient to keep the nonprofit sector functioning, it is not necessary for nonprofits either to seek government support or to engage themselves into commercial activities. Therefore, the nonprofit sector is not in danger of losing its autonomy.

Unfortunately, this pervasive myth of nonprofit self-sufficiency has no factual base. Numerous empirical studies have demonstrated that in no country is private charity the dominant source of nonprofit revenue. A recent seven-country study, for instance, concludes: "Private giving is not only not the major source of nonprofit income in our seven countries. It is not even the second most important."<sup>2</sup> If private giving is not the major source of nonprofit revenue, what is? Are nonprofit revenue sources the same across countries? How do sources of funding affect nonprofit behavior? These are the questions this short article attempts to answer. However, before addressing to these questions, the next section will first try to explain why it is unlikely for the nonprofit sector to generate an adequate level of resources for itself. The following section will go on to identify all major sources of nonprofit revenue and examines the patterns of nonprofit finance across countries. The section III will discuss the implications of each pattern for the nonprofit sector's autonomy. The final section is a brief conclusion.

## Voluntary Failure

Now, everybody knows that both market and state may fail. Market failure refers to its inability to provide collective goods either at all or at the most desirable levels. The existence of market failure is usually used to justify government intervention in resource allocation. While the state is able to offer “public goods” for collective consumption, it may also fail in various forms. One common form of state failure is “inefficiency in the state sector,” which economists have intensively studied.<sup>3</sup> Another form of state failure, however, seems to have only drawn attention from those economists who studies the nonprofit sector. That is, the state tends to provide public goods only at the level that satisfied the median voter, thus leaving some people’s demand for public goods unsatisfied.<sup>4</sup> Where both market and state fail, nonprofit organizations may have a positive role to play. Unlike for-profit organizations, nonprofits can offer public goods. And unlike the state that can only offer standard provision of public goods, private nonprofit organizations are so numerous and so flexible that they can meet the above-mentioned unsatisfied residual demand by providing public goods in amounts supplemental to those provided by government.

In addition to providing collective goods, nonprofit organizations also provide certain types of private goods, especially private goods and services that involve asymmetric distribution between consumers and producers.<sup>5</sup> In order to provide these two types of goods, however, nonprofits have to generate adequate and stable flows of income. This is where voluntary actions will certainly fall far short of the goal. Lester M. Salamon calls this “voluntary failure.”<sup>6</sup> There are two reasons why “voluntary failure” may occur.

First, if what voluntary organizations provide are services that have the character of public goods, they are expected to confront the free-rider problem. “Public goods” are products or services that if supplied to one person can be made available to others at no extra cost. A public good have two characteristics, “non-rival consumption” (that is, one person’s consumption of the good does not reduce its availability to anyone else) and “non-excludability” (that is, if the good is provided at all, the producer is unable to prevent anyone from consuming it). The provision of a public good is a matter of collective choice. Generally, we expect governments to provide public goods through compulsory taxation. An alternative solution is voluntary contribution. The difficulty with this solution is that potential consumers may be inclined to take “free ride.” Since, once produced, everyone can enjoy the good whether or not s/he has paid for it, potential consumers may have incentive to shift the production cost to somebody else. There are, of course, always some people who, for varieties of reasons, do not take free ride.<sup>7</sup> But, unless given discriminating “selective incentives,” most potential consumers of a public good are very likely to act as opportunists. Even those who have altruist utility functions may not be willing to make voluntary contribution either, because, worried about the free-rider problem, they may devote their resource to push for government action. Pervasive free riding thus means that the voluntary solution will end up with a failure. Only when contributions are involuntary, as they are through taxation, are they likely to be

sufficient and consistent. The problem with nonprofit organizations is that they do not have the coercive and compulsive powers of governments and the voluntary solution is the only means available to them. In this sense, philanthropic insufficiency is an inherent shortcoming of the voluntary sector and the sector can never be an “independent sector” in financial terms.

Beyond the free-rider problem, another cause of the “voluntary failure” is the asymmetry in information distribution between potential donors and nonprofit organizations. By definition, donations involve payments for services that are to be delivered to a whole community (i.e. collective goods) or to a third party (as in the case of charities for the relief of the poor or distressed). In either case, the donor is in a poor position to oversee the use made of her/his donation. What is worse, nonprofit organizations often operate behind the screen of secrecy. Many of them are not willing to disclose even very basic financial and programmatic information. Donors thus cannot see for themselves how their donated funds are used in general, not to mention what uses are being made of their individual marginal contributions to the nonprofit organization. Such asymmetrical distribution of information enables some nonprofit managers to abuse the public donations they receive for personal benefits. Recent scandals of high salaries, perks and outright embezzlement in the United States show how easy it is for nonprofit managers to divert some of the residual to themselves and how difficult it is for donors to monitor nonprofit organizations.<sup>8</sup> With weaker legal framework, the monitoring problem is probably much worse in some other countries. Distrust fueled by such instances certainly also limits the nonprofit sector’s ability to generate revenue through voluntary contribution.

Even if in a perfect world where no one is inclined to be a free rider and people fully trust the nonprofit sector, as long as there are economic fluctuations, voluntary failure would persist. This becomes clear when the society experiences an economic downturn. Precisely when voluntary services are most urgently needed, benevolent individuals may find themselves least able to offer help and nonprofit organizations find their revenue base eroding.

Salmon was right when he pointed out that “the voluntary system, despite its advantages in terms of creating a meaningful sense of social obligation and legitimacy, nevertheless has serious drawbacks as generator of a reliable stream of resources to respond adequately to community needs.”<sup>9</sup>

There seems to be two ways to overcome the free rider problem. One way is somehow to make contributions to the nonprofit sector involuntary. In many European welfare states, tax rates are quite high. After using state compulsory power to levy taxes, however, the governments in those countries then heavily subsidize the nonprofit sector. In the Netherlands, for instance, almost all of the staff and program costs of voluntary service agencies are covered by government, through an elaborate subsidy system.<sup>10</sup> In sense, the governments in those countries have collected people’s contribution on the behalf of the nonprofit sector. Correspondingly, in those countries, citizens’ voluntary contributions to the nonprofit sector tend to be small in relative size, because they conclude that they have already made their “contributions” through taxation. Figure 1, which is derived from data on six countries (France, Germany, Hungary, Italy, the United Kingdom, and the United States), shows that there may be a trade-off relationship between tax

burden and private giving.<sup>11</sup> Unfortunately, data on such countries as Canada, Switzerland, Netherlands, Sweden, Norway, Denmark, Austria, and Japan are not available. Otherwise, the trade-off relationship may be more vividly demonstrated.

#### FIGURE 1 ABOUT HERE

An alternative way to overcome the free rider problem is to offer “selective incentives” or positive inducements to those who make donations to nonprofit organizations.<sup>12</sup> Tax incentive for charitable giving is the most common form of “selective incentives” in this area. In some countries, individual charitable contributions are deductible from income before computing tax obligations. In no country, tax incentives for such giving are more generous than those offered in the United States. As a result, Americans seem to be more willing to make contributions to the nonprofit sector than people are elsewhere.<sup>13</sup> It can be hypothesized that the more generous the tax benefits a country offers to those who make private giving, the more contributions its nonprofit sector is likely to get directly from the population.<sup>14</sup>

Tax incentives, in effect, are also a form of state subsidy to the nonprofit sector, because they represent the “foregone” or “potential” tax incomes of the state. Thus, tax subsidy and the above-mentioned direct-grant subsidy are both state subsidies to the nonprofit sector. The only difference is that the former allows individual donors to make allocative decisions, while the latter leaves that power to government bureaucrats. Both solutions have their respective pros and cons. The tax subsidy solution may be able to achieve a higher level of allocative efficiency, but the direct-grant subsidy solution is better at overcoming the free rider problem. Among developed countries, no one adopts only one solution. All of them mix both. However, no matter how well do they combine both solutions, they can never eliminate the free rider problem.

Upon a brief reflection, it should be clear that the tax subsidy solution can be applied only to countries where personal income tax has become an important source of government revenue, and the direct-grant subsidy solution only to countries where the ratio of government revenue to GDP has been relatively high. It implies that poor countries, with few people paying income tax and with low revenue/GDP ratios, may not be in a position to adopt either solution. In other words, it is much more difficult for poor countries to overcome the free rider problem. Even if people in poor countries were altruists, with low levels of income, they probably would have to first pay for necessities like food, housing, and transportation and so on before spending money on philanthropy. Either way, depending mainly on private giving would almost ensure failure there. Although at the low level of development, the demand for collective goods is also relatively low,<sup>15</sup> such demand would certainly exceed the supply of domestic charitable funds. Thus, inflows of external resources become necessary for the nonprofit sector to survive and operate in those countries.

## The Patterns of Nonprofit Finance

Generally speaking, nonprofit organizations draw their incomes from the following four sources:

1. Private charitable contribution, including donations from individuals, foundations, and corporations. This is nonprofit organizations' unique source of revenue, which sets them apart from the public sector and private for-profit institutions. It should be noted that individual giving includes donations of money as well as time. The value of volunteer time should not be underestimated.<sup>16</sup>
2. Government subsidy, including outright grants (i.e. direct government subsidies given to nonprofit organizations in support of their activities and programs), contract (i.e. payments made by public agencies to nonprofit organizations for services they deliver to eligible recipients of certain government programs), and reimbursements (i.e. payments to eligible recipients of government programs who purchase services from nonprofit organizations).<sup>17</sup>
3. Fees and service charges that nonprofit organizations receive from the sale of its own services or of some other products directly to consumers. The services provided by many nonprofits are not public goods but rather private ones (such as the childcare provided by a nonprofit day-care center, the nursing care provided by a nonprofit nursing home, and the entertainment provided by a nonprofit symphony orchestra). In such cases, charging a price for the good or service is conceivable. Even in cases of public goods, whenever exclusion is possible (which makes such public goods "impure" ones), nonprofit organizations may also charge the recipients for the goods or services they deliver. Like for-profits, nonprofits generate some of their funds from the direct sale of services to consumers who want the goods they produce and cannot get access unless they pay the prices.
4. Funds from foreign donors, including grants and contributions from foreign government institutions (e.g. USAID), foreign corporations, international institutions (such as UNESCO, UNICEF, the World Bank), and Western foundations and other nonprofit organizations. These Western nonprofits, in turn, get their money from individual and corporate donors as well as from their governments.

Nonprofit organizations in all countries rely more or less on the first three sources, but those in developing countries and transition countries also depend on foreign contributions to various degrees. Although nonprofit revenue sources differ greatly from country to country, one thing is nearly universal, that is, in no country is private charity the dominant source of nonprofit finance, which notably contradicts

the widespread conventional impression. According to a 1996 multinational study, within the category of private giving, individual giving is most significant, accounting for 13.9 percent of total nonprofit income in the United States, 6.5 percent in Britain, 3.8 in France, and 2.1 in Germany. It may be surprising to many that foundations are not a major source of nonprofit income. In the United States and Great Britain where foundations are most developed, they provide only 2 percent of total nonprofit income. In other countries, foundations' contributions are almost negligible. The role of corporate giving is somewhat more important, but on average, it accounts for only around 2 percent of total nonprofit income. Adding the three sources together, private giving as a whole only represents 1 percent of nonprofit income in Japan, 4 percent in Germany, 7 percent in France, 12 percent in the United Kingdom, and nearly 19 percent in the United States. While, on average, only 10 percent of total nonprofit income originates from private philanthropic giving in those countries, nearly half (47%) of all nonprofit revenue comes from product sales and service charges, and 43 percent from government.<sup>18</sup> Numerous earlier researches reached essentially the same conclusion.<sup>19</sup> The United Nations' system of National Accounts defines a nonprofit organization as one that receives at least half of its revenue from private giving.<sup>20</sup> Using this definition, we would not be able to find many nonprofit organizations in the world.<sup>21</sup>

If private giving is not the major source of nonprofit income, what is? The answer to this question is "it depends". Three broad patterns can be identified.<sup>22</sup>

#### Fee-Dominant Pattern

In some countries, private fee income surpasses all other sources of nonprofit revenue, constituting the largest share of total support. Examples include Japan, Hungary, Italy, the United States, and Great Britain. The United States is a typical case of this pattern. True, the United States has the highest level of private giving and most developed private foundation sector in the world. But, while private giving is more important in the United States than it does in any other country, it is by no means the major source of nonprofit income. In 1992, total revenues available to the American nonprofit sector were estimated at \$508.5 billion. Private charitable contributions accounted for only 18.4 percent of the sector resources. The most important source of America's nonprofit sector was dues, fees, service charges, and commercial incomes. Included here are college tuition payments, charges for hospital care, income from investments and sales of products, and so on. This source alone accounted for more than half (50.2 percent) of all nonprofit revenues. Government subsidies--the second most important source of income of America's nonprofit sector--accounted for the rest of 31.1 percent of nonprofit income.<sup>23</sup> Since the Reagan era, due to possible cutbacks of government subsidies and stagnant private giving, American nonprofit organizations have been under constant budgetary pressure. To find alternative sources of income, they have moved into the commercial market in a big way. Nonprofit organizations are now doing all kinds of businesses, from YMCA's fitness centers to Museum's gift shops to universities' alliances with big corporations. Scholars now use such phrases as "commercial transformation" to describe the historical change that has happened to the American nonprofit sector in the last two decades of the 20<sup>th</sup> century.<sup>24</sup> From 1977 to 1996, nonprofit



revenue in the United States increased by 96 percent, much faster than the American economy as a whole (62 percent). Revenue from fees and service charges accounted for 55 percent of the growth, while government assistance accounted for another 41 percent. Private saving contributed only 4 percent to the overall growth of nonprofit revenue.<sup>25</sup> If the current trend continues, which is very likely, the already highly commercialized American nonprofit sector would become more commercialized.

#### Government Dominant Pattern

This pattern is very common among European countries, where the largest funding source of the nonprofit sector often is government subsidies and grants. For instance, in large continental countries such as Germany and France, government accounts for 68 percent and 60 percent of total nonprofit income, respectively.<sup>26</sup> In small countries of West and North Europe, government support is even more pronounced. The Netherlands, Sweden, Belgium, and Switzerland are cases in point. In the Netherlands, the government finances nearly 90 percent of nonprofit spending. In Sweden, nonprofit organizations derive more than two thirds of their income from the government.<sup>27</sup> Switzerland is a classic case of decentralization. However, as far as nonprofit finance is concerned, it is very centralized. According to one scholar, “very often Swiss NGOs are financed almost exclusively by government grants.”<sup>28</sup> In many countries, government funding is so important that nonprofit organizations flourish only in those areas where such funding is available.

Many people believe that the relationship between the nonprofit sector and government is one of inherent conflict, in which one’s gain is the other’s loss. If they were right, the government would never lend support to nonprofit organizations. But the public financing of the nonprofit sector is an undeniable fact, which suggests that the government-nonprofit relation could be one of partnership. The partnership often takes the form of public finance/private production: The government relies on nonprofit organizations for the actual delivery of services, while nonprofit organizations rely on the government for financial support. In such a cooperative relationship, each party can use its own strength to counteract the other’s weakness. Government financing helps nonprofit organizations to solve the free rider problem, while private production tends to be more efficient than government production. As a result, rather than having limited the growth of the nonprofit sector, government intervention may actually facilitate its expansion.<sup>29</sup>

#### Foreign Aid Dominant Pattern

For two reasons, nonprofit or non-governmental organizations in the third world (Southern NGOs) are unlikely to mobilize enough funds from domestic sources, whether government or private. As pointed out above, free riding tends to be more pervasive in poor countries than in their rich counterparts. It is therefore unrealistic for Southern NGOs to rely mainly on private giving. Meanwhile, the governments of those countries tend to have rather weak extractive and administrative capacity. Since government revenue can hardly sustain its basic functions, it is unlikely to spend much on subsidizing NGOs. Then, one may ask, how can we explain what Salamon calls “associational revolution” in much of the third world?<sup>30</sup> Where do Southern NGOs get their funds? A crucial force helping to foster the growth of Southern NGOs

has been sizable network of nonprofit organizations working in the developing countries (Northern NGOs). Over 4,600 such organizations were in existence as of the early 1980s, including church-related missionary and service agencies, secular nonprofit agencies, foundations, labor and educational groups, and others. In 1990 alone, Northern NGOs provided Southern NGOs with financial aids worth \$7.2 billion, equivalent to 13 percent of official assistance third world countries received from foreign government or to 2.5 percent of total capital inflows for them.<sup>31</sup> It should be noted that these Northern NGOs are often subsidized by their governments. In 1985, for instance, the West German government transferred 7% of its official development assistance through German NGOs.<sup>32</sup> In other words, Western governments often channel money to Southern NGOs through Northern NGOs. Of course, these governments also provide direct grants to Southern NGOs. In the United States, for instance, beginning in the early-1980s, the Congress has pushed to change American foreign aid policies. In 1981, the Congress required 12 percent of financial aids to third world countries to be distributed directly to indigenous Southern NGOs. The ratio was raised to 13.5 percent in 1986.<sup>33</sup> International organizations such as OECD, the World Bank, the United Nations and its agencies have also joined the effort to foster NGOs in the developing world.<sup>34</sup>

As a result of greater funding being made available by Northern NGOs, foreign governments, and international organizations, Southern NGOs have experienced phenomenal expansion in the last two decades. The influx of funds, however, makes those NGOs highly dependent on foreign donors. A study of 62 NGOs in Eastern Africa found that 36 of them received 75 to 100 percent of their funds from foreign sources and 7 between 50 and 75 percent. Only in 18 organizations under study, less than 25 percent of income originated from abroad.<sup>35</sup> The situation elsewhere in the third world was even worse. In India, while NGOs annual income was about \$580 million as of the early 1990s, nearly 90 percent came from abroad, with the rest 10 percent being filled by government subsidies.<sup>36</sup> India's neighbor, Sri Lanka, was no difference. According to James's research, "foreign contributions are by far the largest single source of income, providing 87 percent of total revenues."<sup>37</sup> South Africa's anti-apartheid NGOs were largely a creation made possible by foreign funds.<sup>38</sup>

Western donors have also contributed to the emergence and development of the nonprofit sector in Eastern Europe. The most famous case was probably the Solidarity organization in Poland, which was financed to a large extent by American labor unions and other official and unofficial institutions.<sup>39</sup> In fact, the Solidarity was only one of many Polish non-governmental organizations that drew their income mainly from foreign sources. Without foreign funds, a wide range of nonprofit projects and programs in Poland could never have existed.<sup>40</sup> Poland is not alone in this regard. After the collapse of the Soviet camp in 1989-1990, many Western foundations and NGOs have set up their offices, helped establish local NGOs, and even built up umbrella organizations in Eastern Europe. They brought an unprecedented flow of funds to the region. According to a recent comparative study, "many nonprofit sectors in the East Europe are highly dependent on foreign funding." For example:

In Albania: “Financial and technical assistance from foreign NGOs are mainstays of most Albanian NGOs.”

In Bulgaria: “No reliable statistics are available on the resources of Bulgaria’s civic sector, but most funding comes from foreign sources.”

In Georgia: “In Georgia today, NGOs are heavily reliant on outside funding and grants to sustain their activities.”

In Moldova: “Most NGOs in Moldova currently rely on funding from international aid organizations or foundations established by international organizations such as the Soros Foundation of Moldova.”

In Romania: “International aid makes up 52% of the total financial resources available to Romania’s civic sector.”

In Hungary: “The nonprofit sector probably has a relatively low general level of foreign funding. But even there, the extent of the dependence of some nonprofits’ activities on foreign support is alarming.”<sup>41</sup>

In Russia, the situation is more or less the same.<sup>42</sup>

Although the levels of income are generally higher in these transition countries than in most third world countries, both private giving and government financial support are very limited. Therefore, foreign funding becomes the predominant source of income for the nonprofit sectors in those countries.

### **Implications for Autonomy**

In the last section, we identify three patterns of nonprofit financing: the private fee-dominant pattern, the government-dominant pattern, and the foreign aid-dominant pattern. The first two patterns prevail in developed countries, whereas the last in third world and transition countries. Now the question is whether sources of funding are going to affect nonprofit behavior. If yes, how?

#### Reliance Too Much on Fees and Sales

When nonprofits depend mainly on fees and service charges, it is inevitable that the behavioral line between for-profit and nonprofit organizations will become blurred. This is so because, to maximize fee income, those organizations have to hire managers who have pecuniary instead of nonprofit motives

and values (dedicated volunteers may not necessarily be effective salespersons). To attract such moneymaking-oriented managers, they have to somehow change their traditional compensation practice, which is likely to result in the violation of the nonprofit constraints. Also to maximize fee income, it may be necessary for nonprofits to move into markets that are unrelated to their mission activities but could yield substantial commercial returns. Doing this, however, will encounter fierce competition from for-profit companies that happen to operate in these same markets. In an increasingly competitive environment, nonprofits might have to modify their missions and change their operations further in order to survive financially. As nonprofits behave more and more like for-profit companies, they will be perceived as such, leading to the same distrust that people feel toward for-profits.

Meanwhile, where services are provided only to populations who can afford to pay, nonprofit organizations' service structure and client focus will inevitably change. Once nonprofits become more interested in their own financial survival than in serving the needs of the disadvantaged, they can hardly be called "charitable" any more. In every society, there are people who are too poor to buy services at market prices. When nonprofits operate according to the market principle as for-profit firms do, who will take care of them?

In sum, although commercialization may enable nonprofit organizations to overcome income shortfalls, it will exert a subtle yet significant influence on their ways of behavior. With their principal mission altered, nonprofit organizations confront an identity crisis even if they can retain their organizational autonomy. That is why this trend of commercialization has greatly worried those who place high hopes on the nonprofit sector.<sup>43</sup>

#### Reliance Too Much on Government

Salamon rightly identified three potential dangers to the nonprofit sector if it relies too much on government funding: bureaucratization, vendorism, and loss of independence. But he quickly dismissed them, arguing that these dangers did not appear to be as severe as many think.<sup>44</sup> Recent researches on government-nonprofit relations in the United States and elsewhere, however, suggest that these dangers are real.<sup>45</sup>

*Bureaucratization* The procedures for applying for government grants and obtaining government contracts are often extremely complicated, and regulations with regard to the uses of government grants and contracts frequently undergo changes. In order to receive government funds, nonprofit organizations often have to hire professional staff into their organizations. To meet the requirements for proposal writing, to administer new public programs, and to comply with governmental regulations, many nonprofit organizations assign dedicated staff to each government agency that allocates money to secure grant and/or contract, which consumes an excessive amount of staff time.<sup>46</sup> "As a result, many nonprofit organizations developed very complex organizational structures, which largely parallel their public funding streams."<sup>47</sup> Proposal writing, reporting, and financial planning substantially increase the costs of organizational maintenance, thus deflecting key resources from the principal missions of these organizations.

*Vendorism* What also tends to compromise nonprofit organizations' mission is their desperateness for obtaining government funds. When government becomes the main source of income, nonprofit organizations are often forced to pursue available government funding by all means, including changing their basic missions and characters. For instance, Smith and Lipsky find that many American radical organizations born in the 1960s have gradually transformed themselves into "docile, homogenized, public-supported social service bureaucracies—a process driven by years of dependence on government grants."<sup>48</sup>

*Loss of Independence* When an nonprofit organization relies on the government for funding and the government relies on the organization for service delivery, some see a "partnership" that benefits both,<sup>49</sup> while others see a "patron-client relationship". As Frumkin points out, "for there to be a true partnership between government and nonprofits, there must be a relative balance in power between the sectors."<sup>50</sup> Clearly, power distribution between government and nonprofits is by no means even. When nonprofits' income depends mainly on government, it is the latter that decides how to allocate funds, which organizations to support, what services contracted nonprofit organizations should deliver, and the like. If nonprofit organizations have to deliver state-financed services on the terms defined mostly, or even exclusively, by the government, they can hardly be true "partners" with the government. It is more appropriate to call them "agents" of the government. As the patron of nonprofit organizations, the government can lure the latter to concentrate their activities in areas that they would not otherwise. To the extent that government funding can distort their missions, nonprofit organizations' autonomy is no doubt infringed. James was right when he concluded from his comparative study: "government regulations often follow government funding."<sup>51</sup> Indeed, when government funds begin to dominate, it is difficult for nonprofit organizations to safeguard their independence.<sup>52</sup>

#### Reliance Too Much on Foreign Aid

In order to investigate the possible impacts of foreign funds on indigenous NGOs in third world and transition countries, we should first try to understand why foreign donors wish to provide financial support to those groups. According to James, the primary objective of Western governments is to win influence abroad. Therefore, they only have incentive to support those NGOs abroad that they believe as being sympathetic in goals and orientation. As for Northern NGOs, James assumes that their managers "care about control and impact, i.e. discretionary power which they can use to maximize their utility." "It follows that they prefer to work with non-governmental bodies, which they can select and influence, rather than with the governments, whose size, power, and monopoly status make it relatively immune to pressures from nonprofit organizations. Therefore, foreign nonprofits donate to NGOs rather than governments... in order best to control and monitor the use of their funds."<sup>53</sup>

Given their objective function, we should expect to see foreign donors dictating, to a large extent, which local NGOs will dominate the scene. And they would select recipients of their funds not so much according to local needs as according to their own preferences, priorities and concerns that may or may not accord with the priorities of the local society. These conjectures are confirmed by many empirical studies.

For instance, with the explicit objective of promoting civil liberty and civil society worldwide, the US government assistance programs in many countries specifically focused on supporting local “liberal” and “civic” organizations. Organizations not being operating in those areas are normally not eligible for US assistance.<sup>54</sup> American foundations share the same preference. The availability of foreign funds in certain areas tends to induce new organizations to emerge and to lure existing ones to move into these areas to grab the funds. In general, it is those urban NGOs that have the greatest ability to communicate with foreign donors will obtain most generous support. As a result, in many third world countries, there appear to be two types of NGOs: those with substantial foreign funding and those with little or no foreign funding. The groups of the former type are able to survive and flourish, while the groups of the latter often wither away prematurely or remain small.<sup>55</sup> The problem is that those nurtured by foreign money do not necessarily respond to the interests or needs of the local population. In a sense, they are artificial creatures. What is worse, some NGOs may even degenerate into agents of foreign governments.<sup>56</sup>

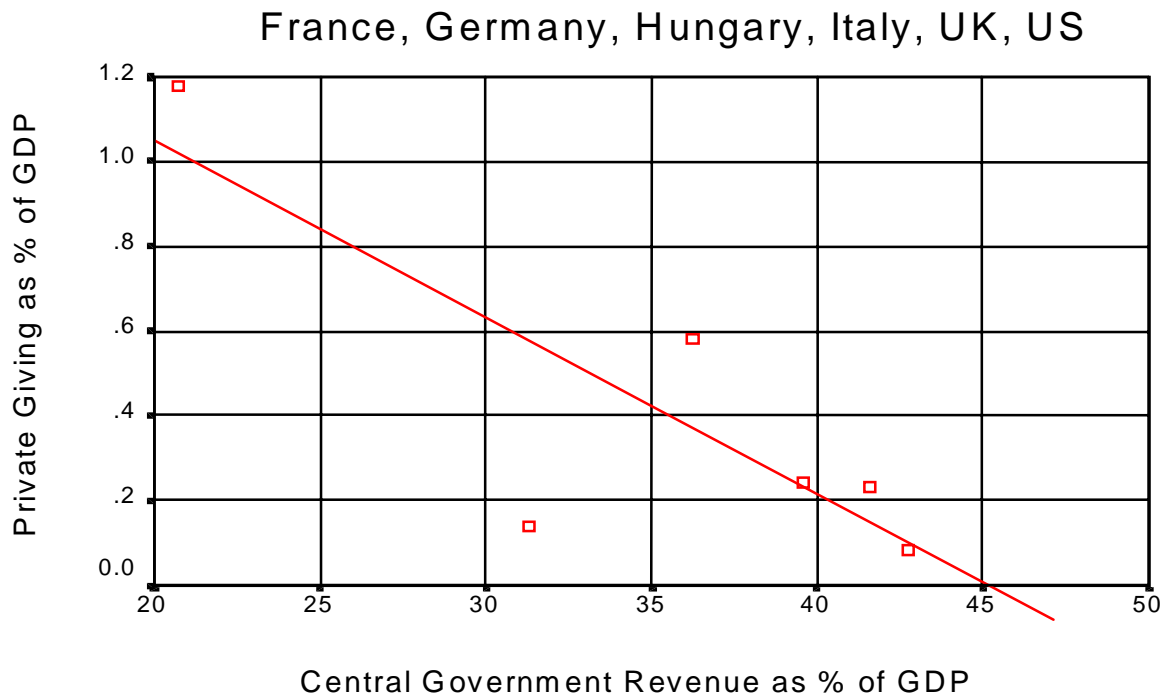
For those organizations that are not rooted in the local society, it is a great challenge to raise local support and become financially independent from foreign donors. Therefore, they are extremely vulnerable to the oscillation of foreign funds. Unfortunately, foreign funds tend to have an oscillating character. Thus, reductions in foreign funds could destroy or at least paralyze them.<sup>57</sup>

### **Conclusion**

For the nonprofit sector, individual giving of money and time is probably the best source of support, because such support normally comes with little or no strings attached. When a nonprofit organization can enlist support from a large number of individual donors, a single donor is not in a position to threaten its independence. Contributions from large foundations and corporations are different. Such income often comes with some kinds of strings.<sup>58</sup> However, comparing to funds from commercial activities, governments, and foreign donors, private philanthropic support (including giving by foundations and corporations) appears to be much less threatening to the sector’s independence. Unfortunately, we can hardly find any country in today’s world where private giving is the major source of nonprofit revenue. This study shows that the nonprofit sector in almost every country relies mainly on either commercial earnings, or government handouts, or foreign contributions. Thus, the nonprofit sector faces a dilemma. On the one hand, private giving is good for maintaining independence, but relying on it alone would not allow the sector to survive. On the other hand, it is easier to obtain funds through commercial activities, or from government or foreign donors, but to get such incomes, nonprofit organizations often have to alter their missions and characters. Given their revenue structure, we may conclude that the nonprofit sector in no country is fully independence. And as long as they are not able to become financially independent, it is unlikely that they will be able to set their agenda free of external influence. To ensure a reasonable degree of autonomy, the nonprofit sector has to build up a solid base of private philanthropic support. However, it is unrealistic to expect that private giving will constitute a major source of nonprofit income. Thus, the only

feasible solution to the dilemma discussed here is to avoid relying too much on any single source of revenue, whether it is from commercial activities, government, or foreign donors.

**Figure 1: Tax Burden and Private Giving**





## ENDNOTES

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<sup>1</sup> Typically, NGOs refer only to organizations directly engaging themselves in the promotion of political and social development. Lester M. Salamon and Helmut K. Anheier argue that focusing on NGOs alone may ignore the presence of large number of voluntary organizations of other types, which also contribute to the formation of "social capital" and the socioeconomic and political development. See their "The Third World's Third Sector in Comparative Perspective," a working paper of the Johns Hopkins Comparative Nonprofit Sector Project, 1997. The term "nonprofit organization" (NPO) appears to be more inclusive. Therefore, I choose to use this term in this article, which includes non-governmental organizations.

<sup>2</sup> Lester M. Salamon and Helmut K. Anheier, The Emerging Nonprofit Sector: An Overview (Manchester: Manchester University Press, 1996), pp. 62-63.

<sup>3</sup> Martin Janicke, State Failure (University Park, PA: The Pennsylvania State University Press, 1990), pp. 31-40.

<sup>4</sup> Burton Weisbrod, "Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy," in Edmund S. Phelps, ed., Altruism, Morality, and Economic Theory (New York: Russell Sage, 1974).

<sup>5</sup> Henry Hansmann advanced this theme in his 1980 article "The Role of Nonprofit Enterprise," Yale Law Journal, Vol. 89 (1980), pp. 835-901. Hansmann argued that nonprofits typically arise where ordinary contractual mechanisms do not provide consumers with adequate means to police producers. His theory has been termed the "contract failure" theory since then.

<sup>6</sup> Lester M. Salamon, "Partners in Public Service: The Scope and Theory of Government-Nonprofit Relations, in W. W. Powell, ed., The Nonprofit Sector: A Research Handbook (New Haven: Yale University Press, 1987), p. 111.

<sup>7</sup> See Susan Rose-Ackerman, "Altruism, Ideological Entrepreneurs and the Nonprofit Firm," Voluntas, Vol. 8, No. 2 (1997), pp. 120-134.

<sup>8</sup> For recent instances of nonprofit scandals, see John Hawks, For A Good Cause: How Charitable Institutions Become Powerful Economic Bullies (Secaucus, NJ: A Birch Lane Press Book, 1997)

<sup>9</sup> Salamon, "Partners in Public Service," p. 111.

<sup>10</sup> Herman J. Aquina, "A Partnership Between Government and Voluntary Organizations: Changing Relationships in Dutch Society," in Benjamin Gidron, Ralph M. Kramer, and Lester M. Salamon, eds., Government and the Third Sector: Emerging Relationships in Welfare States (San Francisco: Jossey-Bass Publishers, 1992), pp. 57-74; Ralph M. Kramer, "The Use of Government Funds by Voluntary Social Service Agencies in Four Welfare States," in Estelle James, ed., The Nonprofit Sector in International Perspective: Studies in Comparative Culture and Policy (New York: Oxford University Press, 1989), pp. 217-244.

<sup>11</sup> Data on the central government revenue are from World Bank, World Development Indicator, 1999 (Washington, D.C.: World Bank, 1999), pp. 234-236. The data on private giving are derived from Salamon and Anheier, The Emerging Nonprofit Sector, pp. 81-114.

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<sup>12</sup> For a discussion of the role of “selective incentive” in stimulating collective action, see Mancur Olson, The Logic of Collective Action: Public Goods and the Theory of Group (Cambridge: Harvard University Press, 1973), p. 51.

<sup>13</sup> In the US, private giving was 1.7 percent of personal income in 1991 and 1993. In Canada and the UK, it was less than 1 percent. Excluding giving to religion, US residents gave 0.57 percent of personal income in the late 1980s compared with 0.13 percent in France, and 0.18 percent in Germany in 1991-92. General government revenue as a percentage of GDP was 31.6 percent in the US in 1988, and 39.6 percent in Canada, 39.7 percent in the UK, 46.5 percent in France and 44.6 percent in Germany in 1989. See Rose-Ackerman, “Altruism, Ideological Entrepreneurs and the Nonprofit Firm,” p. 131.

<sup>14</sup> It has been observed that the countries with the lowest levels of private giving also have the least generous tax incentives for such giving. The relative high level of private giving in the United States may be attributable to generous tax deductibility as well as a relatively simple self-certification method. In Britain, however, the tax benefits flowing from contributions accrue to the charity rather than the individual contributor. What is more, the British tax system requires people to commit themselves to making charitable contributions for three consecutive years. Both lower people’s incentive to give. Elsewhere, the incentive for charitable contributions is even less supportive. In Italy, individual contributions to nonprofit organization are normally not deductible. Consequently, private giving constitutes a negligible share of nonprofit income. The same is true in Japan. See Salamon and Anheier, The Emerging Nonprofit Sector, pp. 123-126. Even with the context of a single country, we can see the effect of tax incentive. In the United States, for instance, philanthropic giving increased sharply between 1930 and 1932 (from 1.27% of personal income to 1.50%), increased again between 1938 and 1940 (from 1.47% to 1.61%), and then increased steadily from 1944 to 1954 (from 1.56% to 2.15%). There is very little change from 1956 to 1982, though there is a slight upward drift from 1956 to 1970 (from 1.82% to 1.96%) and a slight downward drift from 1970 to 1980 (from 1.96% to 1.88%). According to Jencks, these apparent trends in philanthropic giving mostly mirror changes in the tax code. He points out: “The Hoover administration lowered filing requirements in 1932, increasing middle-income families’ incentive to give, and estimated giving rose, too. The Roosevelt administration lowered filing requirements repeatedly from 1940 and 1942, again increasing the incentive to give, and estimated giving rose again. It is true that the Roosevelt administration also introduced the standard deduction in 1944, which eliminated most taxpayers’ incentive to give, and that estimated giving did not fall as a result. But the percentage of itemizers rose steadily from 1948 to 1970, and estimated giving did the same, until 1962. Congress repeatedly increased the standard deduction from 1970 to 1977, lowering middle-income families’ incentive to give, and estimated giving fell. If we discount 1940-44 on the grounds that the tax code changed so rapidly that giving did not have time to adjust fully to the new incentives, then it seems that tax changes largely explain trends in giving.” Christopher Jencks, “Who Gives to What,” in Powell, ed., The Nonprofit Sector, p. 332.

<sup>15</sup> Burton A. Weisbrod, The Voluntary Nonprofit Sector: An Economic Analysis (Lexington, MA: Lexington Books, 1977), pp. 69-70.

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<sup>16</sup> According to a survey done in 1989, 98 million Americans volunteered an average of 4 hours per week to various charitable and other organizations. The volunteer labor available to these organizations translates into the equivalent of almost three million full-time employees. If these organizations had to hire such employees, the cost would be nearly \$52 billion. Therefore, it is possible to consider this volunteer time as contributing another \$52 billion to the revenues of the nonprofit sector. See Lester M. Salamon, America's Nonprofit Sector: A Primer (New York: The Foundation Center, 1992), pp. 27-28.

<sup>17</sup> Here, it is important to distinguish financing from delivery. Governments often finance the production of quasi-public goods such as education and health care, but to delegate at least part of the delivery to the private sector. Sometimes, only nonprofit organizations are eligible for such subsidies and grants.

<sup>18</sup> Salamon and Anheier, The Emerging Nonprofit Sector, pp. 62-65.

<sup>19</sup> For example, see Estelle James, "The Nonprofit Sector in Comparative Perspective," in Powell, ed., The Nonprofit Sector, pp. 397-415; chapters in Salamon, eds., Government and the Third Sector; James, ed., The Nonprofit Sector in International Perspective; and Helmut K. Anheier and Wolfgang Seibel, eds., The Third Sector: Comparative Studies of Nonprofit Organizations (Berlin: Walter de Gruyter, 1990).

<sup>20</sup> See Salamon and Anheier, The Emerging Nonprofit Sector, p. 62.

<sup>21</sup> It is interesting to note that in some countries, such as Sweden, large donations are actually discouraged, because they imply "a trade-off of pecuniary wealth for status and control that are frowned upon by the Social Democratic ethos." See Estelle James, "The Private Provision of Public Services: A Comparison of Sweden and Holland," in James, ed., The Nonprofit Sector in International Perspective, p. 54.

<sup>22</sup> Among the following three patterns, the first two are identified by Salamon and Anheier in their The Emerging Nonprofit Sector, pp. 65-68.

<sup>23</sup> The value of voluntary labor is not counted here. If the value of voluntary labor is included, then the share of private donation in the total rose to 33 percent. See Rose-Ackerman, "Altruism, Ideological Entrepreneurs and the Nonprofit Firm," pp. 130-131.

<sup>24</sup> See Burton A. Weisbrod, ed., To Profit or Not to Profit: The Commercial Transformation of the Nonprofit Sector (New York: Cambridge University Press, 1998.).

<sup>25</sup> Lester M. Salamon, "The Nonprofit Sector at a Crossroads: The Case of America," Voluntas, Vol. 10, No. 1 (1999), pp. 9-12.

<sup>26</sup> Salamon and Anheier, The Emerging Nonprofit Sector, pp. 67-68.

<sup>27</sup> Estelle James, "The Nonprofit Sector in Comparative Perspective," in Powell, ed., The Nonprofit Sector, p. 407. Also see Estelle James, "The Private Provision of Public Services: A Comparison of Sweden and Holland," in James, ed., The Nonprofit Sector in International Perspective, pp. 31-60.

<sup>28</sup> Antonin Wagner, "The Interrelationship Between the Public and Voluntary Sectors in Switzerland: Unmixing the Mixed-Up Economy," in Gidron, Kramer, and Salamon, eds., Government and the Third Sector, p. 115.

<sup>29</sup> Lester M. Salamon, Partners in Public Service: Government-Nonprofit Relations in the Modern Welfare State (Baltimore: The Johns Hopkins University Press, 1995).

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- <sup>30</sup> Lester M. Salamon, "The Rise of the Nonprofit Sector," Foreign Affairs, Vol. 73, No. 4 (July/August 1994), pp. 109-122.
- <sup>31</sup> UNDP, Human Development Report 1993, p. 92.
- <sup>32</sup> Estelle James, "The Nonprofit Sector in Developing Countries: The Case of Sri Lanka," in James, ed., The Nonprofit Sector in International Perspective, pp. 298-303.
- <sup>33</sup> OECD, Development Co-operation 1988. Paris: OECD, 1988, p. 84.
- <sup>34</sup> Salamon, Partners in Public Service, pp. 252-53.
- <sup>35</sup> Zei Gariyo, "NGOs and Development in East Africa: A View from Below," in Edwards and Hulme, eds. Non-governmental Organizations Performance and Accountability, pp. 133-34.
- <sup>36</sup> John Farrington and David J. Lewis, eds. Non-Governmental Organizations and the State in Asia, 1993, p. 93.
- <sup>37</sup> James, "The Nonprofit Sector in Developing Countries," p. 299.
- <sup>38</sup> Adam Habib and Rupert Taylor, "South Africa: Anti-Apartheid NGOs in Transition," Voluntas, Vol. 10, No. 1 (1999), pp. 73-82.
- <sup>39</sup> Salamon, Partners in Public Service, pp. 252-53.
- <sup>40</sup> Joanna Regulska, "NGOs and Their Vulnerabilities During the Time of Transition: The Case of Poland," Voluntas, Vol. 10, No. 1 (1999), pp. 61-71.
- <sup>41</sup> Eva Kuli, "Different Eastern European Countries at Different Crossroads," Voluntas, Vo. 10, No. 1 (1999), pp. 51-59.
- <sup>42</sup> James Richter, "Foreign Assistance and Social Movement Organizations in Russia: Creating Civil Society?" a paper presented at the Annual Meeting of the American Political Science Association, Atlanta, Georgia, September 2-6, 1999.
- <sup>43</sup> Salamon, "The Nonprofit Sector at a Crossroads: The Case of America," pp. 5-23.
- <sup>44</sup> Salamon, "Partners in Public Service," pp. 114-116.
- <sup>45</sup> For a summary of researches on American nonprofit sector, see Peter Frumkin, "Rethinking Public-Nonprofit Relations: Toward a Neo-Institutional Theory of Public Management," PONPO working paper, No. 248 (April 1998), Yale University.
- <sup>46</sup> Kramer, "The Use of Government Funds by Voluntary Social Service Agencies in Four Welfare States," pp. 226-227.
- <sup>47</sup> Frumkin, "Rethinking Public-Nonprofit Relations," p. 10.
- <sup>48</sup> Cited from Frumkin, "Rethinking Public-Nonprofit Relations," pp. 10-11.
- <sup>49</sup> Salamon, Partners in Public Service.
- <sup>50</sup> Frumkin, "Rethinking Public-Nonprofit Relations," p. 11.
- <sup>51</sup> Estelle James, "Why do different countries use a different public-private mix in education," Journal of Human Resources, 28 [1993], 571-92
- <sup>52</sup> Of course, the degree of governmental control may be a function of the method of financing. Some modes of funding may give government more measures of control than others do. For instance, contracts

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for purchase of services tend to be more restrictive than unconditional grants. See Kramer, “The Use of Government Funds by Voluntary Social Service Agencies in Four Welfare States,” pp. 231-233. In the UK, a shift from outright grant aid to purchase-of-service contracting has given rise to complaints that government is undermining the sector’s advocacy function. See Salamon and Anheier, The Emerging Nonprofit Sector, pp. 121-123.

<sup>53</sup> James, “The Nonprofit Sector in Developing Countries,” pp. 301-303.

<sup>54</sup> This is true in South Africa, Poland, and Romania. See Habib and Taylor, “South Africa;” Regulska, “NGOs and Their Vulnerabilities During the Time of Transition;” Daniel Saulean and Carmen Epure, “Defining the Nonprofit Sector: Romania,” Working Papers of the Johns Hopkins Comparative Nonprofit Sector Project, 1998.

<sup>55</sup> James, “The Nonprofit Sector in Developing Countries,” p. 299.

<sup>56</sup> South African President Nelson Mandela, a champion of non-governmental movement, recently accused some NGOs of following the agendas of foreign governments. See Habib and Taylor, “South Africa,” p. 80.

<sup>57</sup> For instance, the influx of funds—especially from Scandinavian countries, the European Union, and US foundations—encouraged anti-apartheid NGOs during the 1980s. After the landmark 1994 election, however, the foreign donor community has begun to channel funding directly to the government, which resulted in a several financial crisis for most NGOs, except those “liberal” NGOs that continued to receive money from American official and non-official institutions. See Habib and Taylor, “South Africa.”

<sup>58</sup> In his 1987 article, Salamon gave the following examples: “Until recently, little private support was available for inner-city minority organizations, particularly those with an advocacy mission. In recent years, many local United Way and corporate donors have insisted that agencies raise more of their funds from fees and charges and make other management changes, such as merging with other organizations. In addition, many foundations have standing policies against ongoing institutional support, which makes it necessary for nonprofit organizations to generate successive “novel” or “experimental” programs to attract foundation support.” See Salamon, “Partners in Public Service,” p. 114.