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Collective Consumption Externalities and Charitable Giving[i]

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Abstract: Charitable giving suffers from market failure, which means government redistribution and other forms of social insurance can be justified. According to market failure theorists, charitable giving for poverty alleviation suffers from a free-rider problem. In a free market, giving will, therefore, be underprovided. Using insights from public choice theory and Austrian economics, our paper finds market failure arguments to be an insufficient justification for government intervention. Private charity and redistribution respects autonomy and is more robust in creating incentives for people to help the poor.

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1 Introduction

In America today, classical liberals and conservatives are alarmed by the runaway level of government involvement in our lives. Interventions affect and complicate nearly every facet of our lives and impose tremendous explicit and implicit costs. The sheer number and complexity of the rules governing our behavior seems to be at an all-time high, and the rapid increase of government interventions in our everyday lives in order to "make them better off" deserves explanation.

Alternative opinions about the overall scale and scope of government intervention depend, of course, on one's more general theoretical understanding of the welfare state. Analysis of the current state of poverty alleviation programs in America cannot be separated from one's general model of the welfare state. We take as our point of departure Thomas Sowell's discussion of the welfare state (2003, B7). According to Sowell, "The welfare state is not really about the welfare of the masses. It is about the egos of the elites." Like Sowell, we think government intervention hampers people's lives and increases in intervention beget more intervention. Our main purpose is to critically examine one argument for government intervention into the market for charitable giving to the poor.

Historically, the economic justification for government involvement in programs for the poor was based on public goods theory. In his classic book, *Capitalism and Freedom*, Milton Friedman (1962, 191) discussed the public goods justification for poverty alleviation when he wrote, "I am distressed by the sight of poverty; I am benefited by its alleviation; but I am benefited equally whether I or someone else pays for its exclusion."

Friedman's claim was picked up by others.[1] Shortly after Friedman, Hochman and Rodgers (1969) claimed that private charity and transfers were underprovided in a free market because of people free-riding on the donations of others. At the core of their argument was the notion that people have interdependent utility functions, i.e., the utility of person A is dependent in part on the utility of person B.

[1] Lee and McKenzie (1990) credit Friedman for being the first to make this connection.

In this paper, we question whether charity will be underprovided in a free market because of free-riding on others donations. We first look at the overall role interdependent utility functions play in a person's decision to give. Most charitable giving seems to occur because of the direct benefits received by the donor. To the extent people do have interdependent utility functions, interdependence does not seem to matter *on the margin* since most attempts to solicit donations do not appeal to the welfare of those helped by the additional donation. Private motivations for giving significantly reduce the argument for government intervention because private charity will reduce or eliminate the gap between the "market failure" level of charity and redistribution and the socially optimal level of charity and redistribution.

Second, *even if* interdependent utility functions exist and free-riding occurs, the resulting outcome is not inefficient because no resources are misallocated. Interdependent utility functions generate pecuniary externalities, which do not misallocate resources. The "ideal" condition, where no free-riding occurs, is analogous to a market environment with no competition. Just as an absence of competition would not be good for competitive markets, an absence of pecuniary externalities in charitable consumption would not be good because much of the innovation in charitable fund-raising flows from the pecuniary externality associated with charitable giving.

An economic analysis of charitable giving yields important insights into the proper role of government towards charity and redistribution from the rich to the poor. The desire to help the worst-off in society is strong and can engender considerable support for the welfare state in its various forms, from transfer programs to a paternalistic regulatory state. We maintain that the best approach to helping people help themselves is through decentralized markets.

The remainder of our paper proceeds as follows. Section 2 discusses market failure theory in the context of helping others in society. Section 3 critically examines the notion that charitable giving suffers from a market failure, while Section 4 concludes with some policy implications of our analysis and some insights from private charity and paternalism.

2 Helping Others and Market Failure Theory

The paternalism of contemporary America comes from an obvious and pernicious source: politicians. Politicians – both liberal and conservative – have been promising voters a world of increased health, safety, and wealth, but they never succeed at fulfilling their promises because of the elastic and fleeting nature of the goods they are asked to provide. But, in their attempt to satisfy our every desire, politicians have made good on delivering one thing to voters: a massive increase in the scale and scope of government. In a fundamental sense, Americans are afraid to be free. Politicians are often the "messengers" delivering policies that exploit our fears.[2]

On the opposite side of the political process, voters themselves often contribute to a more expansive state.[3] When it comes to economic policy, the general public exhibits a tremendous amount of ignorance that borders on irrationality (Caplan 2007). Numerous contradictions can be found in the general public's social welfare function. The general public wants higher levels of education and defense spending, but lower taxes. They want higher levels of economic prosperity, but believe in a more progressive system of taxation. Thus, while politicians are often acting as "political entrepreneurs" (Wohlgemuth 2002) interested in discovering new political opportunities, they are at times simply responding and giving voters the policies they want and deserve.

The promises made by paternalistic politicians have led to a large increase in government. In addition to growing in overall size, the government has become increasingly concentrated at the Federal level because more local sources of authority cannot make sense out of all of the contradictory regulations being created by politicians. For those trained in Austrian economics, power becoming increasingly concentrated comes as no surprise. As Mises (1983 [1944]), 3) put it when describing the bureaucrat,

> He has arrogated a good deal of legislative power. Government commissions and bureaus issue decrees and regulations undertaking the management and direction of every aspect of the citizens' lives. Not only do they regulate matters

[2] Buchanan (2005) argues that big government will remain an enduring problem because of man's yearning to escape, evade, and even deny the responsibilities that come with being free.

[3] We thank an anonymous referee for pointing out and encouraging us to discuss the "double-sided dynamic" of the political process.

> which have hitherto been left to the discretion of the individual; they do not shrink from decreeing what is virtually a repeal of duly enacted laws… Every day the bureaucrat assumes more power… There cannot be any doubt that this bureaucratic system is essentially anti-liberal, undemocratic, and un-American …

Over time, piecemeal interventions beget more interventions, and the interventions continue until we have arrived at a totalitarian state.

While man's desire for more regulation has played an important role in the rise of the regulatory state, the market failure literature in economics has also helped to justify and make popular many government proposals. According to market failure theory, people do not care about the spillover benefits/costs of their behavior. Therefore, government must enter markets with externalities to correct for the alleged failures. The remedies to market failure can take many specific forms, but, in general, disincentives are necessary to curb negative externalities and positive incentives are needed to subsidize markets where positive externalities are present.

For advocates of market failure theory, correcting for market failures was a rather straightforward task (Samuelson 1947; 1961). More sophisticated critics of market failure theory recognize the epistemological challenge involved in sorting out the failing and well-functioning markets, estimating the size of the failure, and prescribing corrective remedies (Wagner 1989). Public choice economists also criticized market failure theorists for their naiveté: even if bureaucrats and politicians had the necessary information about external costs, they lack the proper incentives to be correcting for market failures (Shleifer and Vishny 1998).[4]

Over time, policymakers in Washington have ignored the criticisms of market failure theory and latched on to the academic writings of market failure theorists. The new literature on market failure theory helped politicians justify interventions, and it undoubtedly affected the general public's attitude towards government. As Lord Keynes (1936, 383) put it:

> [T]he ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood.

[4] Levy (2002) and Boettke and Leeson (2004) argue for a "robust" approach to political economy that makes "worst case" assumptions where politicians and bureaucrats are said to be both non-benevolent and non-omniscient.

> Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.

Hayek (1960 [1949], 371) concurred with Keynes, when he wrote, "… [intellectuals] have probably never exercised so great an influence as they do today … by shaping public opinion."

For both Keynes and Hayek, the views of the intellectual come to shape the political landscape in an extremely watered down fashion. When policymakers latch onto an academic idea, errors often occur. Many of the ideas selected by policymakers are not the "best" ideas or the "right" ones, but, rather the ideas progressive intellectuals and policymakers stand behind. Market failure theory is one such idea. It is hard to imagine there ever being a time where a majority of economists supported widespread interventions to correct for market failure. Yet, market failure arguments gained traction because they provided intellectual support for a variety of government interventions.

The implicit assumption of the market failure literature is that with enough regulation, all problems can be solved. By constantly passing new laws and massaging our fear to be free, politicians supply the false sense that government is "solving" market failures. Like Demsetz (1969), we think market failure theory suffers from the nirvana fallacy. In its simplest form, the nirvana fallacy is a comparison of real markets with perfect government. When it comes to charity and redistribution, the public good characteristics of charity makes it prone to free-riding behavior. The mere *possibility* of public good characteristics in charity is then taken as sufficient proof of the need for government intervention.

But, government interventions are determined by fallible men and women with their own biases and agendas. A proper stocktaking of the desirability of intervention would: (1) evaluate a market failure argument on its own terms (i.e., is it really a market in the sense of misallocating resources), and (2) compare the robustness of markets and government in addressing the failure in the short and long run. Comparing the robustness of markets over the short and long run is important because government could be more efficient in mitigating the short-run effects of a market failure but crowd out the evolution of decentralized institutional mechanisms, which would be superior in the long run. With an eye towards both market and government failure, we critically evaluate one of the most prominent arguments for government involvement in charity and redistribution

3 Collective Consumption Externalities and Helping the Poor

One of the primary economic arguments for the public provision of charity is that it the supply of charitable activities will be underprovided in a free market because charitable giving has the properties of a collective consumption good. Technically speaking, collective consumption goods are those for which a many people can simultaneously consume the good without reducing the amount available for consumption.[5] National defense is the classical example of a collective consumption good. An increase in a country's population increases the number of people consuming national defense without reducing any other citizen's consumption. The incentive to free ride increases with collective consumption goods, such as national defense, because people can enjoy the benefits of national defense without contributing to it. If we make a few simplifying assumptions about a person's willingness to pay for collective goods, government interventions, such as compulsory taxation, can improve upon the voluntary outcome.

People donate time and money to charitable organizations for many reasons. Some donate for personal edification while others donate because they care about the increased utility of those helped through an organization's programs. When a person's utility depends on the utility of others, they are said to have *interdependent utility functions*. Charitable donations increase the utility of people with interdependent utility functions because when we know the recipients of charity are better off; we are made better off. *If* donors have interdependent utility functions, charitable giving is a collective consumption good where all potential donors benefit when

[5] In his seminal paper that essentially created public goods theory, Samuelson (1954, 387) describes collective consumption goods as those "which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtractions from any other individual's consumption of that good...."

someone gives to charity. If I am a potential donor whose utility depends on the utility of the African poor, my utility increases when The Bill and Melinda Gates Foundation donates $47 million to help treat tropical diseases plaguing Africa's poor (Dugger 2006).

Just as in the case of national defense, people can enjoy the "warm glow" from knowing the poor are being made better off without having to contribute. According to Hochman and Rodgers (1969), some people will free ride on the charitable donations of others, which means the supply of charitable giving in a free market will be underprovided. Maximizing utility, they argue, requires government intervention to ensure the "optimal" level of transfers is made to the poor (Holcombe and Sobel 2000). The possibility of an insufficient supply of giving has led to government programs that aim to increase giving, such as the charitable deduction (Hochman and Rodgers 1977).[6]

There are many problems with this argument. At the most basic level, what if people do not have interdependent utility functions? Or to put it another way, why don't all donors free ride? Many people obtain personal pleasure in giving even though they cannot observer the effect of their actions on the welfare of the recipients (Arrow 1972). While Arrow's formulation of donor motivation is surely not true for all donors (Rose-Ackerman 1982), a considerable amount of donor motivation for giving does not appear to be about the welfare of the recipient. Donors appear to care about the "warm glow" associated with charitable giving, and benefit from the wealth signal they send when they give (Glazer and Konrad 1996).

When we look at the way in which charities solicit donations, they are clearly not appealing to donors' altruistic motives. Development officials do not rely primarily on stories regarding the charity's work to raise money. While the charitable works are always part of the marketing campaign, the actions of development officials point towards donors being motivated by the approbation flowing from giving or the signaling value of a donation. One manifestation of the signaling motivation is in "naming rights," where a new facility or program is named after a donor. Or charities provide different "tiers" of giving, with the choicest of status gifts being given to the high-

[6] Gergen (1988) provides an excellent discussion of arguments for and against the charitable deduction, including that of Hochman and Rodgers (1977).

est donors (e.g., "gold circle members receive regular updates from the president *and* monthly donor receptions").

The warm glow is also a powerful motivator. Donors not only want to see the poor better off, but they want to feel good about having been part of the effort. Andreoni (1990) quotes the Red Cross using the slogan "Feel good about yourself – Give blood!" Donors appear to be motivated by many reminders of their charitable deeds, either for internal reasons or because of external approbation of their efforts. Spreading charitable giving around instead of focusing on the one cause a person feels "best" about is more evidence against the altruistic giving explanation.[7] McGranahan (2000) examines seventeenth-century English wills and finds more bequests left to the poor when the deceased had fewer immediate family and friends. Even in death, people appear to be more concerned with how they are perceived by others.

In economic models where preferences are modeled as being purely altruistic, public giving reduces private giving dollar-for-dollar: if all you care about is the welfare of the recipient, government financed transfers will cause you to reduce your voluntary donation by the amount of the forced transfer. Yet field tests fail to find considerable "crowding out" of private charitable donations (Clotfelter 1985; Kingma 1989; Ribar and Wilhelm 2002).[8] The fact that there is not complete crowding out suggests that donations to private charities are often motivated by factors other than the welfare of the recipient.[9] If for example, you also care about the warm glow you receive from donating to help the poor, you are not going to stop doing so because the government is now taxing you to provide charity.[10]

We are not making a normative claim about people's motivations for giving.

[7] This argument is made by Landsburg (1997), who argues that if our motivations were purely altruistic, we would give all charitable donations to the charity we think does the greatest good. Giving to ten different charities is evidence, Landsburg argues, that people care about their own sense of self-satisfaction.

[8] At best, the evidence on crowding out is mixed. Some recent papers by Andreoni and Payne (2003) and Gruber and Hungerman (2005), for example, show strong evidence of some crowding-out.

[9] As pointed out by an anonymous referee, the sphere of charitable giving is wide and motivations for giving vary considerably across individuals and organizations. Crowding out could be high in certain contexts such as religious giving where fundraising efforts are based on observable need. This, for example, could explain the high-levels of crowding out found by Gruber and Hungerman (2005) in Depression-era churches in response to the New Deal.

[10] It should be clarified, however, that the low level of crowding out does not mean that government charitable activity is not harmless. There is the not so insignificant matter of the administrative and

Rather, we are arguing against the idea that people are primarily motivated by altruistic concerns. We do not believe giving for purely altruistic reasons has any moral superiority over other kinds of giving. Adam Smith (1759 [1790], section III.I.6) said it best in *The Theory of Moral Sentiments* when he wrote,

> To be amiable and to be meritorious; that is, to deserve love and to deserve reward, are the great characters of virtue; and to be odious and punishable, of vice. But all these characters have an immediate reference to the sentiments of others. Virtue is not said to be amiable, or to be meritorious, because it is the object of its own love, or of its own gratitude; but because it excites those sentiments in other men.

Giving in order to be perceived in a favorable light by others is not lacking in virtue, and in fact is far more virtuous than any other alternative.

Compared to private charity and redistribution, transfers to the poor done through democratic means are almost certainly less virtuous. The replacing of voluntary transactions with a compulsory democratic one transforms helping the poor from a virtuous activity into an obligatory one. The self-reinforcing cycle where people give because they seek the approbation of their fellow citizens is instead replaced by representative democracy, where resources are often transferred to the middle class in the name of helping the poor. While giving for purely altruistic reasons might be nice to contemplate, we do not live in such a world and charities must appeal to self-interest as well as altruism in order to get donations. If it were possible to compare the transfers to the poor under a completely private system of charity versus a more public system, a completely private system would be superior because of closer link between donation and outcome. Even if many United Way fundraisers are organized by real estate agents and owners of car dealerships because it is good for business (Hartford 2006), a less than ideal arrangement is superior to a world where people have no incentive to become involved in private charity at all.[11]

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deadweight losses associated with raising tax revenue for alleviating poverty. In addition, government solutions typically prevent the institutional experimentation that might lead to institutional innovations (such as mutual aid societies) that found voluntary solutions to the problems associated with poverty alleviation.

[11] Lee and McKenzie (1990) show that once private benefits from charitable giving are taken into account, the public good argument for redistribution is hard to justify.

Even if people gave out of entirely altruistic reasons and had interdependent utility functions, however, government intervention is not warranted because there is no misallocation of resources.[12] The collective consumption externality pointed out by Hochman and Rodgers (1969) is a pecuniary externality, which does not lead to market failure (Holcombe and Sobel 2000). In fact, pecuniary externalities are necessary for competitive markets. To understand why pecuniary externalities do not lead to economic inefficiency, it is important to better understand the distinction between pecuniary and technological externalities.

Nearly every activity in markets generates effects on third parties. There are two types of third-party effects (also called externalities): technological externalities and pecuniary externalities. Technological externalities are externalities that directly affect the production of the individual or firm. For example, suppose a factory moves next door to a dry cleaning establishment and begins emitting pollution. The emissions make it impossible for the dry cleaner to launder clothing while the factory is operating. As a result of the externality, the profits of the dry cleaner owner fall.

Pecuniary externalities, on the other hand, are third-party effects transmitted through prices. Instead of a factory moving next door to a town's only dry cleaner, let us suppose that another dry cleaning establishment quickly engaged the incumbent dry cleaner in a price war. As competition occurs, the profits of the incumbent dry cleaner fall by the same amount as in the factory example. Clearly both pecuniary externalities and technological externalities lead to welfare losses for the dry cleaner.

The policy implications for different types of externalities vary. For example, technological externalities can lead to market failure because resources are misallocated. When factory owners do not take the effect of their pollution into account, there may be too much pollution. In the pecuniary externality case where a new dry cleaner comes in next door, however, no resources were being misallocated and no inefficiency resulted. In fact, the truth is exactly the opposite. Pecuniary externalities are necessary for the efficient operation of markets as they are the byproduct of competition.

[12] Reece (1979) finds, using the Bureau of Labor Statistics Consumer Expenditure survey, that people *do not* have interdependent utility functions. His evidence is that there is no relationship between charitable giving and the consumption level of potential recipients of said charity.

Holcombe and Sobel (2000) take the distinction between technological and pecuniary externalities from the production literature and extend it to the consumption literature. In their analysis, consumption externalities, such as the case of interdependent utility functions identified by Hochman and Rodgers (1969), are pecuniary externalities because they do not directly affect household production. Individuals maximize their utility by allocating household resources to various activities based on the shadow prices of those activities (Becker 1981). Given a fixed set of inputs, free-riding does not influence a household's level of charitable giving. Instead, utility falls because the actions of others lower the return associated with a particular set of inputs. Just as intervention is not required because competition among dry cleaners reduces economic profits, neither is intervention required when the actions of others reduce the utility a person receives from charity. Contrary to Hochman and Rodgers, Holcombe and Sobel (2000) conclude that the Pareto-optimal public policy is to have no government intervention.

To further illustrate this concept, imagine a world with two income groups – rich and poor – both groups having interdependent utility functions *a la* Hochman and Rodgers (1969). In this world, every rich person free-rides off the charitable giving of other rich people and the level of charitable giving is zero. In such a world, the utility of both the rich and the poor would be reduced because of the free riding. From the perspective of Hochman and Rogers, government transfers from the rich to the poor can make both parties better off.

This perspective, however, overlooks the distinction between technological and pecuniary externalities. Placing it in the Holcombe and Sobel (2000) framework, the larger charitable donation has merely changed the "price" of charitable giving, not the amount of charitable activities that a household can undertake given the resources at their disposal.[13] A household charitable donation of $1000 produces $1000 of charity regardless of whether other individuals decide to donate or not.[14] The actions of

[13] On the recipient side, recipients of charity have lower utility because they have less money (because of reduced transfers), but their household production function is not affected at all by the interdependent utility function. For any given set of household inputs they can produce the same level of outputs.

[14] To make a clearer analogy to household production, a household purchasing $1000 of food receives $1000 worth of groceries. The utility derived from that bundle of goods depends on the relative prices of different food stuffs in the household's consumption bundle. An increase in the relative price of

others might affect the utility *received* from giving, but from the standpoint of public policy that change in utility is the result of a change in the relative price of giving and thus is not Pareto-relevant.

This should not be taken to imply that pecuniary consumption externalities do not have real effects; they certainly do. Just as pecuniary externalities can reduce a firm's profits they can also reduce a household's utility. From the standpoint of public policy, however, these harms are not policy relevant. In fact, they are necessary for the efficient operation of markets because it is pecuniary externalities that cause firms and, we would argue, households to engage in entrepreneurship that that is the wellspring of progress.

Just as the dynamic nature of the market process causes firms to come up with new products and new ways of doing things, pecuniary externalities cause individuals concerned for the poor to be "social entrepreneurs." If pecuniary consumption externalities reduce charitable donations, then those wanting to help the poor have to take advantage of other facets of individuals' utility functions, such as the warm glow received from giving. Making high levels of donations status goods, for example, links donors' interests in being seen as someone who can afford to give a lot with the interests of the poor. The bundling of desired goods (such as public recognition or exclusive access to social networks) with donations is another such innovation. In finding new ways to align the self-interest of potential donors with the interests of the poor, development officials help to expand the level of charitable giving in an economy through experimentation. While government officials can raise taxes or reallocate funds to the poor, they do not have the same ability to innovate and find solutions to the free-rider problem. Moreover, taking and redistributing does not create a "culture of giving" where others give out of a desire for approbation (and might, in fact, crowd out future giving).

groceries, to the extent it lowers household utility is not Pareto relevant because no resource misallocation has occurred.

4 Conclusion

This paper has examined a particular economic justification often given for government involvement in helping the poor. The lack of charitable giving may not be a market failure at all. In addition, it is unclear that interdependent utility functions are as rampant as some theorists suggest. Moreover, even if the collective consumption characteristics of charity did lead to a reduction in charitable giving because of interdependent utility functions, the undersupply of charitable giving would not be economically inefficient in the sense of misallocating resources. More importantly, private charity and redistribution are more "robust" in the sense of finding ways to align the incentives of potential donors and the poor. In doing so, free markets help to foster sympathy for the less well-off and a culture of approbation for those who help them. Government intervention, on the other hand, transforms a private, voluntary transaction into a public obligation. This places a strong presumption in favor of laissez-faire.

Ultimately, the difference between those who want government involved in charity and redistribution and those opposed comes down to a belief in the individual's ability to help himself and his fellow man. Just because some people are different than others is not, *ipso facto*, an argument for paternalism, but, rather, an argument for leaving people alone. Efforts to force people to contribute to anti-poverty programs takes away from the richness and general culture of society and inhibits trial, error, and learning.

Those in favor of government involvement in poverty alleviation are guilty of making the perfect the enemy of the good. This attitude regards almost all government intervention as desirable and sees many areas where more government involvement could improve market outcomes. But, it suffers from the same problem that all arguments for big government encounter: it assumes other people – the experts – are outside and above the economic order. The experts are said to be better at deciding for everyone what's best. By trying to make their values (or, to be more precise, the values of the "rational actor") the values everyone should live by, they are failing to recognize the beauty of millions of people pursuing their own interests according to their own values.

Government as a corrective to market failures is an inferior solution to alleviating poverty problems when compared to the private sector. The crowding out of a whole range of private charitable organizations – most of which were quite effective at dealing with "free riders" and deviant behavior – is one of the greatest, and largely unaddressed, costs of big government. In the absence of government, we do not and cannot know what specific mechanisms might arise to deal with the "free rider," but we do have some historical experiences where mutual aid arrangements worked quite well (Beito 2000; Chalupníček and Dvořák 2007; Friedman 1962, 190-91).

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