

Ács, Zoltán J.; Desai, Sameeksha

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## Democratic capitalism and philanthropy in a global economy

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## **Democratic Capitalism and Philanthropy in a Global Economy**

by

**Zoltan J. Acs  
Sameeksha Desai**

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Carl-Zeiß-Str. 3  
D-07743 Jena  
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Max-Planck-Institute of Economics  
Kahlaische Str. 10  
D-07745 Jena  
[www.econ.mpg.de](http://www.econ.mpg.de)

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# **Democratic Capitalism and Philanthropy in a Global Economy**

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**Zoltan J. Acs**

George Mason University  
and Max Planck Institute of Economics

**Sameeksha Desai**

Max Planck Institute of Economics  
and George Mason University

## **Abstract**

Democratic capitalism has become the popular paradigm in the modern world, and it is spreading further through globalization. It is a model based on growth, expansion and constant innovation. However, it is accompanied by social problems which may worsen despite overall gains in wealth. In this paper, we suggest that democratic capitalist societies may benefit from the application of what has been a primarily American institution: Philanthropy. We present the Entrepreneurship-Philanthropy Cycle, which demonstrates the relationship between wealthy entrepreneurs, philanthropic contributions and economic opportunity. As a nonmarket and nonstate mechanism, philanthropy is unique in its structure and operations, and may offer the ideal approach to solving social problems. We suggest that both the internationalization of American foundations, and the growth of domestic philanthropy, can help developing countries offset social problems.

JEL-classification: O10, P10, I30

Keywords: Philanthropy, entrepreneurship, democratic capitalism, foundation, social problems, India education, social innovation

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## Introduction

The dynamics of the Cold War and decolonization placed political economy at the forefront of intellectual and policy debates in the middle to late 1900s. The virtues of capitalism were the center of debate, which focused on the benefits of capitalist versus socialist systems. As capitalism spread through former socialist and nonmarket economies, it was increasingly identified as a necessary condition and partner to democracy. Democratic capitalism refers to this system, which emerged as the victorious paradigm in the modern world, thereby forcing a shift in the intellectual discourse on political economy. Scholars are now focusing on the positive and negative externalities of democratic capitalism. Simply put, political systems have moved past philosophical questions and onto the optimal implementation, efficiency and where necessary, mitigation, of modern capitalism.

With this in mind, possibly the most significant drawback<sup>1</sup> of the spread of democratic capitalism through the world is its apparent magnifying effect on some social problems, specifically those caused by - and linked to - inequality. Early critics, notably Marx, emphasized the maldistribution of wealth as its major failure. Capitalism enables countries to participate more freely in global markets, both through the added legitimacy of sharing the hegemonic political economy paradigm, and through real changes to legislation that translate to increased economic competition and innovation. Entrepreneurship is a particularly powerful channel for economic development in the economy. However, the central role of competition in capitalist economies creates conditions and outcomes, including market failures and negative externalities, which ultimately prevent all members of the population from accessing the benefits of a stronger economy<sup>2</sup>.

These results, which we broadly label as *social problems*, have been generally accepted as necessary evils of a global system of expanding wealth. They do not make a case against capitalism - still, they need to be solved, as indicated by the pervasive and in some cases, growing inequalities around the world, particularly in new and recent market economies. Despite the rise of per capita income with technology investments and increased exports, the very poor stay poorer or worsen.

Although it seems counterintuitive, the capitalist economy may be the ideal laboratory for solutions to the problems it generates within itself, as it fundamentally embraces the spirit of innovation. Within a democratic capitalist environment comprises a market that creates social problems, its may also comprise nonmarket solutions to alter or equalize them.

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<sup>1</sup> We are deliberate here to avoid the use of the term failure.

<sup>2</sup> We are careful to avoid labeling inequality as market failure. In the traditional sense, market failure is the existence of a non-Pareto efficient outcome – i.e, inefficient allocation of resources. Whether increased inequality qualifies as market failure is an empirical question and cannot be assumed to be Pareto inefficient.

The response to social problems in many countries has been through legislative, regulatory or other government action. This has led to problems of dependence, such as social assistance for the unskilled unemployed in the Scandinavian welfare economies, and to problems of inefficiency, such as in the Indian education system, as we will see later. In many countries in the developing world, state solutions are crippled by poor funding resources for social issues, lack of technical ability to achieve adequate solutions, and in some cases, lack of government legitimacy. Given this, the ideal solutions for social problems must come from *nonmarket and nonstate* sources.

In this paper, we take the position that the democratic capitalist system, which encourages entrepreneurship and innovation, is also the perfect environment to nurture equally innovative, *nonmarket* solutions to solve social problems efficiently. We argue that philanthropy, a social innovation born in the United States, has great potential to work in other countries. In the next section, we discuss the unique political economy of the United States, and how entrepreneurship and its resulting creation of wealth has led to a unique mechanism to reconstitute this wealth. We clarify how the relationship between entrepreneurship and philanthropy has been at the core of American economic strength.

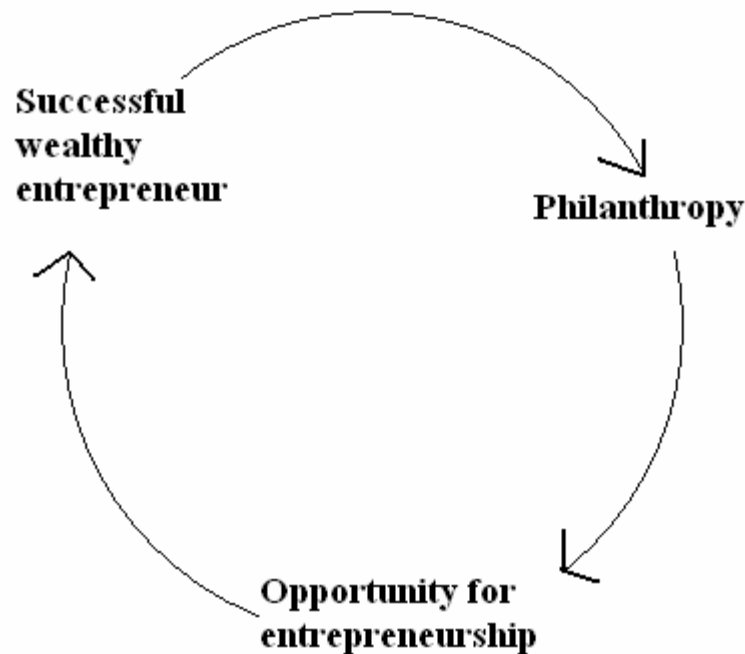
### **Entrepreneurship and Philanthropy in the United States**

The “entrepreneurial spirit” is credited with a great deal of economic success in the United States (Acs et al., 2007), particularly with respect to employment and income generation (Hebert and Link, 1989). As a result, entrepreneurship is promoted through policies (Hart, 2001) at different levels of government. It is not a coincidence, then, that an environment encouraging of entrepreneurship has also witnessed the creation of a major institutional innovation in the nonmarket realm: Philanthropy<sup>3</sup>. Philanthropy is increasingly recognized as a crucial contributor to the stability of American society and culture (Curti, 1957) and to the process of economic development. The relationship between entrepreneurship, the creation of wealth, and philanthropy, the reconstitution of wealth, has given the United States a self-sustaining cycle of growth and support that may explain its long term strength. This relationship differentiates the American political economy from other capitalist countries. Acs et. al. (2007) present a detailed discussion of the roots of philanthropy in the United States and its resulting contributions to American entrepreneurial capitalism. American culture has been glorified and criticized in the same breath for its individualistic focus (Lipset, 1996). Regardless of the degree of centrality of the individual, it has maintained an implicit social contract to return wealth to society (Chernow, 1998). This social contract, shaped within an environment of property rights and individual liberty, has allowed for the development of important institutional innovations, including the foundation (Schramm, 2006). The reconstitution of wealth has served to expand opportunity (Acs and Dana, 2001) by building social institutions that enable future economic growth (Acs et. al., 2007).

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<sup>3</sup> Although multiple definitions of philanthropy exist, we use a broad conceptual derivation from Acs et. al. (2006): *Philanthropy is giving money or equivalent to persons and institutions outside the family, without definite or immediate quid pro quo*. In this paper, we do not discuss the motivation to engage in philanthropy, which has been the subject of interest for economic theorists. The debate on motivation has focused largely on the impetus of self-interest versus altruism. For various perspectives on this debate, see Margolis (1982), Sugden (1982), Smith (1937, 1969), Boulding (1962), Kaufman (1963), Ireland (1969) and Simon (1993).

The entrepreneurship-philanthropy nexus, as defined by Acs and Phillips (2002) suggests that successful entrepreneurs become philanthropists, directing their wealth at building social institutions that create opportunities, thereby lead to economic growth. They do not address what we know to occur after the creation of opportunity has taken place: Entrepreneurship. We add to their model by “closing” it to create the Entrepreneurship-Philanthropy Cycle, which creates a self-sustaining cycle of wealth creation, social innovation and opportunity:



In our model, the successful wealthy entrepreneur makes a philanthropic investment through a foundation, specifically aimed at alleviating a target social problem. The choice of this problem, i.e., donor intent and the reason for choosing philanthropy in the first place, is a function of personal or experiential forces, perhaps based on the wealthy entrepreneur’s own path to success, but the basic model holds.

The case of John D. Rockefeller, who gave back more than 95 % of his wealth and was one of the greatest philanthropists in world history, demonstrates this cycle<sup>4</sup>. The focus of his own philanthropic activity appears to have been largely on education, but he embraced the idea that philanthropy is a dynamic and responsive mechanism that can tailor solutions to social problems. He said: “The best philanthropy is constantly in search of the finalities – a search for a cause, an attempt to cure evils at their source.” He established the Rockefeller Foundation in 1913 with the very broad mission to promote the well-being of mankind throughout the world.

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<sup>4</sup> See Chernow (1998) for a detailed discussion of the life of John D. Rockefeller. In brief: Rockefeller grew up in Pennsylvania but was born in New York, and was the oldest child among several children, who

While it is unclear exactly what motivated Rockefeller to engage in such generous giving, and with such clear and organized strategy, it is clear that as a wealthy entrepreneur, his philanthropic efforts have created immeasurable opportunity, both in the United States and around the world. In his lifetime, Rockefeller established many important institutions, including Spelman College, University of Chicago, The General Education Board, National Bureau of Economic Research, Brookings Institution and the Rockefeller Foundation. Although the payoffs of his philanthropy cannot possibly be quantified, they certainly include all of the benefits of the University of Chicago, which has generated several Nobel Laureates, who have, in turn, worked on groundbreaking research in medicine and economics at the university<sup>5</sup>. Further, the Rockefeller Foundation funded projects that led to the discovery of a vaccine for Yellow Fever, formulation of penicillin, and created programs in public health and medicine in the developing world (Sachs, 2000).

In our model, we do not attempt any quantification or even delineation of the benefits and types of opportunities that result from philanthropy. However, it is safe to say – at the very least – that entrepreneurship results from opportunity and improved social institutions. This closes the cycle.

#### *A Note on Why Philanthropy is Unique*

We begin with the predominant paradigm of human relationships, typically divided along the lines of some trifecta of State, Market and Society. The idea of a nonmarket, nonstate mechanism naturally falls within the Society arena, but this is often clouded by overlapping, sometimes misnomer terms like civil society, nongovernmental organization, charity, voluntary sector, third sector, etc. These terms blanket all channels for relationships that are not private or public, including intangible concepts like social capital and trust. Therefore, we separate Philanthropy as a distinct and unique term, but as a mechanism that still operates within the Society sector.

The basic unit of analysis for philanthropy is the foundation, for which a clear theoretical framework has still not been established<sup>6</sup> (Schramm, 2006). However, foundations are defined by specific legal status and can be distinguished from associations, companies, etc., in this manner. Foundations are unique because they are funded by endowments<sup>7</sup>, run independently by a board of directors and driven by donor intent (Nielsen, 1996; Schramm, 2006).

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supposedly came from other wives of his father. His father was unable to provide steady support for his family, and disappeared for long periods of time. Rockefeller's mother was religious. Despite his negative home life, relative poverty and lack of education – or because of it – Rockefeller began his first job at Hewitt and Tuttle in Cleveland, on September 26, 1855. He built Standard Oil and became one of the wealthiest men in the world, and retired to spend the rest of his years engaged in philanthropy.

<sup>5</sup> See Schramm (2006) for detailed discussion of this topic.

<sup>6</sup> Perhaps the first reference to philanthropy as a distinct organizational form was by Carnegie (1889), who suggested that keeping ones wealth in a public trust to be administered to social benefit was preferable over bequeathing wealth to heirs.

<sup>7</sup> Schramm (2006) notes that foundations are only marginally connected to the market through their endowments.

The foundation plays at least two clear critical roles: First, it provides a channel for wealth reconstitution and second, it acts an institutional entrepreneur (Schramm, 2006). Both functions are equally important and would otherwise remain largely unfulfilled by other organizational forms in the Society sector. The first function – reconstitution of wealth – allows wealth to be used to tackle specific social problems, as defined by the donor. The second function – institutional entrepreneur – is achieved because of the independence of foundation funding, which allows these organizations to innovate and challenge other kinds of social institutions. This means that “foundations break the static equilibrium toward which social institutions gravitate (Schramm, 2006)” while still engaging in own programs. Many foundations are established with fairly “open” missions, such as the Rockefeller Foundation (to promote well-being) that allow for responsiveness to new social problems as the world changes. In short, the foundation is always at the cutting-edge of social innovation.

One important additional function of the foundation is the provision of public goods. Where social problems are the result of a lack of public goods, such as those which provide health, education and personal security, foundations can help stem inequality of availability and access. For example, funding from the Bill and Melinda Gates Foundation in the health sector has contributed to the development of national-level health systems in some countries (Lele et al., 2007).

We must also clarify the distinction between charity and philanthropy. Both activities address Society, and both are aimed at what are ultimately the socially problematic effects of maldistribution of wealth (ie., inequality in terms of income, education, access to housing, healthcare, etc.). The difference lies in the focus of activity. Charity focuses on immediate, symptomatic social problems – for example, feeding large numbers of homeless people, providing shelter to refugees. It is not designed to achieve the actual socioeconomic mobility of people. Philanthropy, as noted by John D. Rockefeller, focuses instead on the root causes of social problems (see Schramm, 2006, for a discussion of how foundations evolved specifically with this purpose) and seeks solutions so they may affect fewer people in future generations. It seeks to create longterm improvement by empowering people, whereas charity tends to be more of “bandaid” and can create dependency. There are certainly differences in scale, but they are largely empirical and based on financial resources. Therefore, we maintain that the important difference between philanthropy and charity is in scope.

### **Globalizing the Model**

#### *Social Problems in Developing Countries: Need for philanthropy*

Prominent philanthropic efforts by “Western” donors have sharpened the focus of aid to developing countries. The focus of these efforts has largely been on creating and bolstering resources in the health and education sectors, which are often neglected by public and domestic market initiatives. Interest in philanthropy and economic development is growing, but very little scholarly work exists on this relationship outside the United States. In this section, we essentially extend the work of Acs et. al. (2007) to an international perspective.



Let us briefly examine the state of the education sector in India, one of the world's fastest growing economies. India has been aggressively promoting entrepreneurship, through its incentives and policy support for investment in high-tech industries and research. A great deal of employment has been generated through foreign direct investment and partnerships with domestic firms, including call centers that service many developed countries. Although government figures report improved education statistics, including literacy across categories, participation in higher education and enrolment, a closer look suggests that this sector, in itself, presents a social problem for the country. Public expenditure on education fell from an already low 3.7 % per cent of GDP in 1991 to 3.3 % of GDP in 2002-2004. In 2006, the poorest 10% of the population held only 3.9 per cent share of income or expenditure (UNDP, 2006). In a country where 98% of rural parents would like to send their children to school (PROBE, 1999), a history of poor government provision of education and exclusionary private schools has led to the growth of "other" educational institutions. Although this initially appears to be a way around the problem of access, the result has been unregistered, unregulated and sometimes unsafe environments that did not necessarily offer more than government-run schools (see PROBE, 1999). As the middle class has gained spending power and the rich have become richer, they have been able to send their children to good private schools. However, the poor and especially the rural poor, do not have market access or public access to proper education facilities, even though some private schools are "aided" or subsidized. That the state of educational facilities in India is poor has been the conclusion of several studies on both the public and private provision of educational services<sup>8</sup>. The state of the education sector in India is clear evidence that in one of the world's most promising emerging economies, there has been a colossal failure on part of both the market (private) and government (public) to provide education. This failure has potentially disastrous consequences not only for future economic growth, but for the future human condition in India.

Social problems in the developing world are deeply entrenched and compounded by lack of knowledge, lack of resources and lack of priority. Many developed countries face the further disadvantage of an unfavorable political economy environment – that is, inadequate market structures are compounded by a weak public sector. In such countries, then, social problems require solutions that transcend and are independent of both market and state mechanisms. Global institutions are weak (Soros, 1998), and global problems are crossing borders and gaining strength. Philanthropy, then, offers the ideal channel for change.

### *Cultural Bias?*

This brings us, naturally, to the question of cultural bias. Is philanthropy yet another Western institution to be unrealistically imposed on the developing world? The roots of philanthropy in the United States are said to lie in its distinct religious history, from which both social contract and social responsibility emerged<sup>9</sup>. Does this, then, pose an insurmountable challenge to replicating the American model of philanthropy in other countries? If we were proposing that this be done exactly and precisely as in the United

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<sup>8</sup> See PROBE (1999), De et. al. (2002) and Aggarwal (2000)

<sup>9</sup> See Acs et. al. (2007) for a detailed discussion of the history and origin of American philanthropy.

States: Yes. But if we were proposing philanthropic activity, tailored to the policy framework and unique social problems from other countries? No. The international development community has learned, painfully, that cutting and pasting what works in one country does not work in others. Rather, we suggest that international, regional and indigenous philanthropy models can be designed based on a successful idea. There is already a rise in internationally-focused philanthropic activity, as indicated by the growing involvement of major US-based foundations in developing countries.

There does not currently exist a robust and effective local philanthropy sector in many developing countries. This does mean that it cannot or should not be built – and it does not mean such a sector will not work. Schramm (2006) notes the foundation was a necessary invention: It was an institutional response in an evolving country seeking better solutions to its problems. The lack of foundations in developing countries is exactly the reason to encourage the growth of such a sector. In addition, the existence of other organizational forms in the Society sector is evidence that people recognize the need to address social problems, and that action is already been taken. The sheer number of nongovernmental organizations and nonprofits in developing countries (though often funded by governments and government aid agencies) indicates the existence of potentially innovative, creative approaches to social problems. However, these agencies suffer from lack of resources, coordination and worse, insecure resources due to sometimes whimsical funding decisions, often determined by changes in leadership. They do not have the mission effectiveness, financial sustainability, independence of donor intent or organizational sustainability that are generalizable for foundations.

As countries are gaining wealth through globalization and the deepening of democratic capitalism, so are their citizens better able to engage in philanthropic giving. In the same manner, as the spirit of entrepreneurship diffuses across countries, so too will an environment more generally nurturing of innovation in other arenas. For this reason, there is every possibility that our model of entrepreneurship and philanthropy, two forces strengthened by democratic capitalism, can create a cycle of social innovation and economic opportunity.

#### *Globalizing philanthropy: Future directions*

We identify two contexts with respect to the idea of “globalizing philanthropy” to developing countries. The first context is that of internationalization, i.e., expanding programs for global focus and international activities of existing (and future) foundations. The second context is that of encouraging domestic philanthropy, i.e., encouraging the establishment of foundations in developing countries with local sources of wealth.

The first context, internationalization, refers primarily to furthering the activities of US-based foundations in other countries. Large foundations are already engaged in the developing world, notably the Soros Foundation (Open Society Institute), Bill and Melinda Gates Foundation, Rockefeller Foundation, Ford Foundation, MacArthur Foundation and Turner Foundation. Most of their efforts have been in the education and health sectors, followed by technical assistance and institutional infrastructure support. They have been involved in their own projects and grantmaking efforts, as well as in institutional innovations that challenge other social organizations. For example, the Bill and Melinda Gates Foundation, in addition to sponsoring its own health initiative across

many developing countries, has also pledged \$ 650 million to the Global Fund to Fight AIDS, Tuberculosis and Malaria. The Fund is perhaps the newest social innovation adaptation, and integrates a range of funding sources in a massive fight against three deadly third world diseases. Through its involvement with The Fund and its own programs, the Bill and Melinda Gates Foundation is achieving both functions of philanthropy discussed in the previous section (Schramm, 2006).

The major challenge for internationalization is the current policy context in the United States. As noted by Schramm (2006), vested interests, political interests and increased legal and regulatory complexities are threatening the foundation in the United States. Such problems erode independence, particularly when policy begins to treat foundations as a quasi-government service providers, contractors, etc. This is indeed a very real danger in the United States, where the federal contracting model encourages outsourcing of government functions across industries and purposes. Social services at the state and county level are already being carried out by nonprofits and nongovernmental organizations, and it is critically important to prevent this from happening with foundations. At their very core, foundations are driven by donor intent, and operate successfully because they are nonmarket and nonstate in nature; to tamper with this would surely sacrifice their effectiveness.

The second context, encouraging domestic philanthropy, is more complicated because it requires several things, some of which imply a paradigmatic shift in the responsibility of people to Society. It means that people must first buy into the idea of solving social problems, which requires vision and perhaps a specific personal configuration based on wealth and culture. Once people recognize that social problems should be addressed, they must then believe that it is, in fact, possible to solve them. The next step is the biggest challenge: Why philanthropy, over other organizational forms in Society including traditional charities and other local mechanisms? This is not to say that because developing countries are poor, their populations are not engaged in any kind of social development at all. First, only a small handful of wealthy individuals are needed to create foundations with endowments, and such individuals exist across societies, regardless of per capita income. Unlike charities, which are more likely to be supported by large numbers of people giving modest donations, foundations come into existence because of one individual and a large endowment. Second, all societies appear to have developed coping mechanisms of some kind to address social problems like hunger, poverty, illiteracy, inequality<sup>10</sup>.

We do not intend to discount these efforts – certainly immediate and short-term community support is necessary – we merely suggest that the foundation model may be effectively able to *solve* some of these social problems. We consider various forms of charity useful and important from a humanitarian perspective, but long term mobility and improvement come from addressing the underlying causes of social problems. Ideally,

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<sup>10</sup> For example, the idea of *Seva* (community service) in the Sikh religion means that Gurdwaras host free kitchens for the hungry in the community. The idea of fairness encourages Jews to engage in *Tzedakah* – giving to the community poor. Observant Muslims with adequate financial means are expected donate a portion of their income to community charity. Aside from religious mechanisms to address social problems, there are countless regional and local civil society organizations engaged in community service and community development activities.

treating existing problems and attempting to resolve them should occur simultaneously. Despite evolving as a uniquely American institution, the foundation can be adapted for other political economy contexts because it is contextually responsive. The nature of political economy constraints on institutional activities in developing countries can undermine efforts by actors within states or markets. The foundation is not dependent upon government legitimacy or market profile, both of which can be unreliable in developing countries<sup>11</sup>. In fact, country-centered assistance is not enough to fix development problems (Lele et al., 2007) – one important possible factor is because government structures often lack legitimacy and the trust of citizens.

## Conclusion

There is already a growing trend for private donors and philanthropies to become involved in developing countries<sup>12</sup>. It is premature to offer policy insight at this point, or advice on how to make this series of changes occur in developing countries. The purpose of this paper has been to highlight the function of philanthropy in solving social problems, and suggest a framework to understand how this occurs. We present the two contexts to introduce possible directions for philanthropy in the globalizing world, both as a new theme for scholarly research and as suggestion for policy research.

Visionaries even before Carnegie – who wrote of the “responsibility of wealth” – were concerned with how to gain and then appropriately use their wealth (Wren, 1986). It appears many more people will be faced with this question as the overall wealth of the world grows with the spread of democratic capitalism. This political economy paradigm does not appear to be slowing down. In addition to participating in international export markets, developing countries interested in loans and development grants face regulatory pressures to open their markets, privatize industries, and standardize along a long list of favored practices by international organization. This means that entrepreneurship and the growth of small and medium enterprises around the world is likely to escalate, leading further to the creation of jobs and wealth. As the world gets richer, its people become better able to take care of those that globalization neglects. Democratic capitalism, as it moves people and capital, also moves ideas. By moving the philanthropy model across countries, it may be better able to sustain its own growth, by taking care of those it has overlooked.

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<sup>11</sup> For this reason, foundations offer additional promise in developing countries marked by failing markets and failing governments. For example, the Soros Foundation / Open Society Institute has been working in areas of instability or former conflict across Eastern Europe, the Middle East and Africa.

<sup>12</sup> See Lele et al., 2007, for discussion of private initiatives in health, including the Vaccine Fund of the Gates Foundation, President Clinton’s Global Development initiative, etc.

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