

# Philanthropy and Real Utopia

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# Philanthropy and Real Utopia

## EXECUTIVE SUMMARY

People have been giving away their money, property, and time to others for millennia. What's novel about the contemporary practice of philanthropy is the availability of tax incentives to give money away. Such incentives are built into tax systems in nearly all developed and many developing democracies. More generally, laws govern the creation of foundations and nonprofit organizations, and they spell out the rules under which these organizations may operate. Laws set up special tax exemptions for philanthropic and nonprofit organizations, and they frequently permit tax concessions for individual and corporate donations of money and property to qualifying non-governmental organizations. In this sense, philanthropy is not an invention of the state but ought to be viewed today as an artifact of the state; we can be certain that philanthropy would not have the form it currently does in the absence of the various laws that structure it and tax incentives that encourage it. This session specifies and assesses three possible justifications for the existence of tax incentives for charitable giving, identifies a distinctive role for philanthropy in democracies, and argues for a fundamental re-design of the current legal framework governing philanthropy.

The first justification is that the deduction is necessary in order to account for the proper base of taxable income; the deduction, in other words, is no subsidy at all. The second justification is that the deduction efficiently stimulates the production of public goods and services that would otherwise be undersupplied by the state. The third justification links the incentive to the desirable effort to decentralize authority, to some degree, in the production of public goods and, in the process, to support a pluralistic civil society in a flourishing democracy. I defend a version of the third justification and conclude with an overview of public policy changes that flow from this pluralism rationale.

# Philanthropy and Real Utopia<sup>1</sup>

## Introduction

The practice of philanthropy is as old as humanity. People have been giving away their money, property, and time to others for millennia.<sup>2</sup> What's novel about the contemporary practice of philanthropy is the availability of tax incentives to give money away. The charitable contributions deduction in the United States is less than one hundred years old, created by the U.S. Congress in 1917 shortly after the institution of a system of federal income taxation in 1913. Similar incentives built into tax systems exist in most developed and many developing democracies.<sup>3</sup>

More generally, laws govern the creation of foundations and nonprofit organizations, and they spell out the rules under which these organizations may operate. Laws set up special tax exemptions for philanthropic and nonprofit organizations, and they frequently permit tax concessions for individual and corporate donations of money and property to qualifying non-governmental organizations. In this sense, philanthropy is not an invention of the state but ought to be viewed today as an artifact of the state; we can be certain that philanthropy would not have the form it currently does in the absence of the various laws that structure it and tax incentives that encourage it.

Contemporary practice, in which philanthropy is structured by a regulatory framework of incentives, is not the norm but the historical anomaly. Previously, the state protected the liberty of people to make donations of money and property but did not provide incentives for doing so. A natural question arises: why have such incentives and what is their justification in a liberal democracy?

In fact, the historical practice of philanthropy is littered with instances in which the question that presented itself to the state was how vigorously it should *constrain* the liberty of people to give money away. Public influence obtained through private wealth might be injurious to the state for, by example, threatening the authority of the ruling class. In the *Discourses*, Machiavelli tells the following story about ancient Rome: "The city of Rome was afflicted by a famine; and as the public magazines were insufficient to supply the deficiency of food, a citizen named Spurius Melius, who was very rich for those times, resolved to lay in a private stock of grain and feed the people at his own expense. This liberality attracted crowds of people, and so won him the popular favor that the Senate, fearing the evil consequences that might arise from it, and for the purpose of

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<sup>1</sup> This essay draws heavily from "Toward a Political Theory of Philanthropy," in *Giving Well: The Ethics of Philanthropy*, Patricia Illingworth, Thomas Pogge, Leif Wenar, eds. (Oxford University Press, 2010).

<sup>2</sup> For example: Paul Veyne's classic *Bread and Circuses* (New York: Viking Penguin, 1990) discusses the practice of *euergetism* – private liberality for public benefit – in ancient Rome; Maimonides codified eight different levels of charity in the 12<sup>th</sup> Century.

<sup>3</sup> For an overview of tax incentives for charitable giving across twenty-one countries, see Lester Salamon and Stefan Toepler, eds., *The International Guide to Nonprofit Law* (New York: John Wiley and Sons, 1997).

putting an end to the evil before it should grow too great, created, expressly against Spurius, a Dictator, who had him put to death.”<sup>4</sup>

The question about constraining the liberty of people to give money away remains with us today. We need only consider debates about estate taxation and campaign finance contributions to realize that the state may have good reasons – reasons founded on justice – to limit the liberty of people to give money away.

We might also point to the U.S. Constitution itself for evidence that in some specific circumstances people should not merely *not* receive a tax deduction for a charitable donation but should be entirely forbidden from making the donation. The Appropriations Clause of the Constitution – “no money shall be drawn from the Treasury, but in Consequence of Appropriations made by law”<sup>5</sup> – or the so-called Power of the Purse, can be construed to prohibit private donations to federal agencies. While the clause is invoked to limit what the executive branch can propose and do without Congressional authority, it also appears to limit *any* financing of federal agencies except through Congressional authorization. “As a consequence of the appropriations requirement,” Kate Stith argues, “all ‘production’ of government must be pursuant to legislative authority, even where the additional production is financed with donations and thus appears costless to the Treasury.”<sup>6</sup> To the best of my knowledge, this is indeed our current practice: if a U.S. citizen wishes to make a donation to a federal agency, absent Congressional authorization to do so (as with the Smithsonian Institution or the Library of Congress), her only option is to write a check to the U.S. Treasury.

In the United States and elsewhere there have been, and continue to be, reasons to limit the liberty of people to give money away for charitable purposes. I recount these facts simply to show that current practice in the United States is not the historical norm and to convey how unusual, in some sense, current practice actually is.

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<sup>4</sup> Niccolo Machiavelli, *Discourses* (New York: The Modern Library, 1950), p. 493.

<sup>5</sup> U.S. Constitution, Article I, § 9, Clause 7.

<sup>6</sup> Kate Stith, “Congress’ Power of the Purse”, 97 *Yale Law Journal* 1343 (1988), p. 1357. Stith notes that Congress has passed legislation to permit some federal agencies to receive private donations, among them National Parks, the National Archive, the Library of Congress, and the Smithsonian. Despite the Congressional authorization, Stith believes private funding to be of questionable constitutionality: “Where broad executive discretion is inherent in our constitutional scheme, the most questionable form of spending authority is open-ended authority to receive and spend donations and gifts. As long as the executive agency is prepared to accept the donation, Congress loses effective control over the contours of authorized government activity. Where a donor conditions a gift broadly – for instance, for the defense of the United States – the recipient federal agency is able to direct the supplemental funds to activities that might not have garnered congressional approval. Where the donor specifically conditions the gift – for instance, for defense in the Persian Gulf – the donor may effectively specify the objects of government expenditure. In either event, where Congress cannot significantly circumscribe an agency’s purposes and powers, to allow the agency to spend all contributions would be to permit private power, subject only to executive discretion, to influence the contours of government and government policy” (1384-5).

What rules should govern private charity in a liberal democracy? Consider this simple framework to motivate the question. Assume first that there is a private property regime of some type. Assume second that there is some kind of income tax. Individuals have private property, in particular some income or wealth, and then they have been duly taxed on it. After being taxed, they have money or property which they wish to give away for charitable purposes. What now?

The default position of a liberal democratic state regarding charitable giving, it seems to me, ought to be strict non-intervention: individuals should possess the liberty to give their money or property away to whomever or whatever they please. Restrictions on that liberty, such as with estate taxation or campaign finance restrictions, stand in need of justification; the state bears the burden of showing why such restrictions are necessary or permissible, because consistent with justice. In parallel form, I suggest that incentives for people to exercise their liberty to give their money away also stand in need of justification; the state bears the burden of showing why such incentives are desirable and consistent with justice.

This returns us to my original question: what is the justification for the current practice in the United States and elsewhere of providing tax incentives for citizens to make charitable contributions? Because the tax incentive constitutes a subsidy – the loss of federal tax revenue – it is no exaggeration to say that the United States and other countries currently subsidize the liberty of people to give money away, foregoing tax revenue for an activity that for millennia has gone unsubsidized by the state. The United States has the most generous subsidy structure. Charitable giving in 2011 was nearly \$300 billion, costing the U.S. Treasury more than \$50 billion in lost tax revenue. Why does the U.S. do this?

The remainder of this essay lays out and assesses three possible justifications for the existence of tax incentives for charitable giving.<sup>7</sup> I focus special attention on the incentive mechanism currently used in the United States and in many other countries: the charitable contributions deduction, a deduction of charitable gifts from a citizen's taxable income.<sup>8</sup> The first justification is that the

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<sup>7</sup> The taxonomy I develop here is neither original nor exhaustive. I have drawn from the literature on the charitable contributions deduction, which is large, unwieldy, and narrow, resting almost entirely within tax law and economics journals. What's remarkable about this literature is how little it engages with normative argumentation about justice. Most theories about the deductions, comments David Pozen, "lack a coherent normative basis" (David Pozen, "Remapping the Charitable Deduction," 39 *Connecticut Law Review* 2 (2006), p. 547). Pozen claims, not implausibly, that no justification is possible for the deduction as it currently exists in the United States.

<sup>8</sup> Most countries use some kind of deduction scheme, including Australia, Germany, Japan, France, India, Spain, South Africa, Egypt, Mexico, The Netherlands, Russia, and Thailand. To the best of my knowledge, only Sweden provides no subsidy structure at all for charitable giving. The mechanism of an income tax deduction for a charitable donation works by creating a subsidy at the rate at which the donor is taxed. So a person who occupies the top tax bracket – currently 35% in the United States – would find that a \$1,000 donation actually "cost" her only \$650. The government effectively pays \$350 of her donation, subtracting this amount from her tax burden. Similar incentives exist for the creation of private and family foundations, and for contributions to community foundations, where donations and bequests to a foundation are deducted

deduction is necessary in order to account for the proper base of taxable income; the deduction, in other words, is no subsidy at all. The second justification is that the deduction efficiently stimulates the production of public goods and services that would otherwise be undersupplied by the state. The third justification links the incentive to the desirable effort to decentralize authority, to some degree, in the production of public goods and, in the process, to support a pluralistic civil society in a flourishing democracy. My references here are chiefly to the practice and regulatory framework of philanthropy in the United States, though I believe my analysis holds more generally for any liberal democracy.

### **Tax Base Rationale**

The first justification rejects entirely the claim that the deduction is a subsidy. The deduction constitutes, instead, the fair or appropriate way to treat the donor; deductibility is *intrinsic* to the tax system. First promulgated by William Andrews, the basic argument is that deducting charitable contributions is necessary in order properly to define an individual's taxable income.<sup>9</sup> If taxable income is construed, as according to the standard Haig-Simons definition, as personal consumption and wealth accumulation, then charitable donations ought not be included in a person's tax base. The reason is that charity cannot be equated with personal consumption since charitable gifts redirect resources from private and preclusive consumption to public and non-preclusive consumption. Andrews concludes that "a deduction should be allowed whenever money is expended for anything other than personal consumption or accumulation."<sup>10</sup> Tax scholar Boris Bittker offers a similar argument, concluding that charitable donations ought not count as consumption because in making a voluntary donation the donor is made worse off (with respect to others at the same income who do not make a donation), relinquishing use of resources that could have been directed to personal benefit.<sup>11</sup>

Unlike subsidy justifications, the tax base justification focuses on the fair treatment of the donor; it does not inquire into the goods produced with the donation or the efficiency with which these goods are produced. There are four obvious criticisms to make of the tax base rationale.

First, and at the level of common sense, if a person has legitimate ownership of resources and can rightfully decide how to dispose of those resources, then whatever a person decides to do with those resources – spend it on luxury goods or give it to charity – is by definition, tautologically, consumption.

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from estate and gift taxation. In permitting these tax incentives, federal and state treasuries forego tax revenue. Had there been no tax deduction on the \$1000 contribution, the state would have collected \$350 in tax revenue.

<sup>9</sup> Williams Andrews, "Personal Deductions in an Ideal Income Tax," 86 *Harvard Law Review* 309 (1972)

<sup>10</sup> *Ibid.*, p. 325.

<sup>11</sup> Boris Bittker, "Charitable Contributions: Tax Deductions or Matching Grants?" 28 *Tax Law Review* 37 (1972).

Some people have a taste for spending, others for donating; each brings apparent satisfaction to the respective person.

Second, there are obvious benefits that some, perhaps many or even all, donors receive in making a charitable contribution. Economist James Andreoni has attempted to model and measure the motivation of receiving a “warm glow” or psychological benefit in behaving altruistically.<sup>12</sup> In making a charitable contribution, the donor experiences pleasure in giving and receives in return for the gift a “warm glow”, consuming the benefit of altruism. A warm glow might be non-preclusive in that purchasing joy through a charitable contribution does not diminish the ability of others to do the same. But a warm glow is undeniably private rather than public. Altruism might also be construed as a scarce resource, anyway. Other economists have demonstrated how much charitable giving, especially to elite institutions such as universities, hospitals, and cultural organizations, is motivated by status-signaling.<sup>13</sup> Here the motivation to give is not altruistic but self-interested; to maintain position or move up the social hierarchy. Regardless of motive – altruistic or self-interested – there are returns to the donor that make it impossible to describe donors as engaging in behavior that is public and non-preclusive or that necessarily makes them worse off. We need not be incorrigible cynics to believe that donors are purchasing something for themselves when they make a charitable contribution.

Third, Andrews’s theory has perverse implications about the permissible recipients of charity according to current law in the United States and elsewhere. If for Andrews anything which is not personal consumption or accumulation should be deductible from the donor’s tax base, then a billionaire businessman’s donation of a million dollars to Wal-Mart, a for-profit company, to encourage its efforts in union-busting, ought to be deductible. (Assume the businessman holds no stock in Wal-Mart.) Similarly, a donation to a foreign country or foreign charity where the donor has no connection and is motivated simply, say, to alleviate poverty, ought to be deductible. But U.S. tax law – like the tax regimes of most of other countries -- excludes donations of both kinds. In the United States, to qualify for a deduction, charitable donations must be directed to a qualifying so-called 501(c)(3) nonprofit organization that is registered by the Internal Revenue Service.

Finally, and moving from theoretical conceptualization to empirical fact, even the briefest reflection on philanthropy in the real world reveals how donors quite frequently purchase with their charitable dollars rival and excludable goods for which they are among the primary consumers. Contributions to one’s religious organization are an obvious example; churches provide club goods rather than public goods, or to put it differently, they are more like mutual benefit

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<sup>12</sup> James Andreoni, "Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving," *Economic Journal*, v.100, June 1990, pp. 464-477.

<sup>13</sup> Amihai Glazer and Kai Conrad, "A Signaling Explanation for Charity," *American Economic Review* 86 (1996), pp. 1019-1028; William Harbaugh, "Prestige Motive for Making Charitable Transfers," *American Economic Review* 88 (1998), pp. 277-282.

rather than public benefit organizations.<sup>14</sup> Charitable gifts to arts organizations for which one receives in return premium seats, special access, private tours, and so on are another example. Charitable gifts to one's child's public school may also deliver improved educational opportunities or outcomes for one's child, not to mention boosting the value of one's house due to the fact that public school quality and real estate values are correlated.<sup>15</sup>

On top of these criticisms can be added still another that is more fundamental. I refer to the argument expounded by Thomas Nagel and Liam Murphy that the choice of a tax base cannot be assessed in the absence of the larger normative consideration of what constitutes social and economic justice.<sup>16</sup> The definition of taxable income is strictly instrumental on their view, the tax system just a mechanism for pursuing larger social aims. "Since justice in taxation is not a matter of a fair distribution of tax burdens measured against a pretax baseline, it cannot be important in itself what pretax characteristics of taxpayers determine tax shares".<sup>17</sup> As a result, there is for Nagel and Murphy no such thing as intrinsic fairness of the tax system or tax base but only taxation that is an instrument in realizing or pursuing the aims of a larger theory of social and economic justice.

Their argument is built on the claim that private property is a convention of the legal system. Property rights are not pre-institutional or pre-political but rather a consequence of a set of laws that form a part of a broader theory of justice. Consequently, pre-tax income does not count automatically as a person's own money, and without the notion of a pre-tax baseline of income there can be nothing intrinsic about the selection of a fair tax base.<sup>18</sup> It is nonsense, then, to argue that charitable contributions ought to be deducted from one's taxable income because such deductions logically belong to the identification of the appropriate tax base.

I accept the Nagel and Murphy thesis but will not attempt to defend it here except to note that, whatever its merits, it locates the argument on the

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<sup>14</sup> Some people mistakenly believe that gifts to religious organizations do in fact provide public goods because many congregations are thought to provide extensive social services. The best available evidence about the use of donations to churches does not bear this out. Sociologist Robert Wuthnow, who writes admiringly of faith-based social service providers, observes that "the amount spent on local service activities is a relatively small proportion of total giving, probably on the order of 5 percent" (Robert Wuthnow, *Saving America? Faith-Based Social Services and the Future of Civil Society* (Princeton: Princeton University Press, 2004), p. 49).

<sup>15</sup> For the deeply inequitable consequences of private giving to public schools, see the data in my "A Failure of Philanthropy: American Charity Shortchanges the Poor, and Public Policy is Partly to Blame," *Stanford Social Innovation Review* (Winter 2005) pp. 24-33.

<sup>16</sup> Thomas Nagel and Liam Murphy, *The Myth of Ownership: Taxes and Justice* (Oxford: Oxford University Press, 2002).

<sup>17</sup> *Ibid.*, p. 98.

<sup>18</sup> "Since there are no property rights independent of the tax system, taxes cannot violate those rights. There is no prima facie objection to overcome, and the tax structure, which forms part of the definition of property rights, along with laws governing contract, gift, inheritance, and so forth, must be evaluated by reference to its effectiveness in promoting legitimate societal goals, including those of distributive justice" (*Ibid.*, pp. 58-9).

appropriate intellectual terrain: argument about social and economic justice. No one deserves a tax break for a charitable contribution simply in virtue of some account of a person's tax base. Tax incentives for giving, if they are to be justified, find their justification in a larger account of social justice for which the tax system is just an instrument.

### **Subsidy Rationale**

The more typical defense of the charitable contributions deduction – and one that does, even if sometimes only implicitly, take into account a broader theory of social and economic justice – is that the state accomplishes something of important social value by providing subsidies for people to be charitable. The state provides incentives for charity because it is believed that the incentives stimulate the production of something of greater social value than what the state could have produced on its own, had it not offered the incentives.

The subsidy therefore counts as a tax expenditure, the fiscal equivalent of a direct spending program.<sup>19</sup> When the state allows citizens to deduct their charitable contributions from their taxable income, the state foregoes tax revenue, which is to say that all taxpayers are affected. They are affected in (at least) two important ways. First, they stand to lose some portion of the benefit they receive from direct governmental expenditures. If every citizen gains some fraction of the total revenue of the federal budget, the loss of billions of dollars in tax revenue through the deduction lowers every citizen's fractional benefit. Second, citizens lose in democratic accountability, for the foregone funds are not accountable, or even traceable, in the way that direct government expenditures are. To give an obvious example: citizens can unelect their representatives if they are dissatisfied with the spending programs of the state; the Gates Foundation also has a domestic and global spending program, partly supported through tax subsidies, but its directors and trustees cannot be unelected.

Thus the success of the subsidy rationale depends on whether the benefits brought about by the subsidy exceed the costs of the lost tax revenue. Consistent with the Nagel and Murphy thesis, the subsidy is but a mechanism for realizing larger social aims. If these aims are realized, then the subsidy may be defensible.

The subsidy rationale has been invoked in several U.S. Supreme Court decisions, lending the rationale some additional weight. "Both tax exemptions and tax deductibility are a form of subsidy that is administered through the tax system," noted the Court in 1983 in *Regan v. Taxation with Representation*.<sup>20</sup> The deduction has, moreover, been included in the annual federal tax expenditure budget issued by the U.S. Government.

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<sup>19</sup> On the concept of a tax expenditure, see Stanley Surrey and Paul McDaniel, *Tax Expenditures* (Cambridge: Harvard University Press, 1985).

<sup>20</sup> *Regan v. Taxation with Representation*, 461 U.S. 540 (1983), p. 544.

What's obvious about the subsidy rationale is that it shifts attention from the fair treatment of the donor to the recipient of the donation and the good that is done with the gift. Even so, the particular vehicle used in the United States to provide the subsidy – a deduction from taxable income – is vulnerable to powerful criticisms that keep a focus on fair treatment of the donor. First, the deduction is available only to itemizing taxpayers, a group which constitutes roughly thirty percent of all tax returns. The other seventy percent of taxpayers, though they may make substantial charitable contributions (as an absolute sum or percentage of income), are excluded because they take the standard deduction. Thus the subsidy is capricious, for its availability depends on a characteristic, one's status as an itemizer, that has nothing whatsoever to do with the value of giving. If the subsidy is justified because it produces some social good, then why should two donors who make identical donations to identical organizations, ostensibly producing the identical social good, be treated differently by the tax code?

Second, in a system of progressive taxation the deduction is tied by definition to marginal tax brackets. The richer you are, the less a charitable contribution actually costs you. The deduction functions as an increasingly greater subsidy and incentive with every higher step in the income tax bracket. Those at the highest tax bracket (35% in the U.S. in 2008) receive the largest deduction, those in the lowest tax bracket (10%) receive the lowest deduction. Scholars have dubbed this the “upside-down effect”, the result of which is that, for charitable deductions, “the opportunity cost of virtue falls as one moves up the income scale.”<sup>21</sup>

But these concerns do not constitute criticism of the Nagel-Murphy thesis, for these are not criticisms of the subsidy rationale per se. They are criticisms of the mechanism, currently in use in the United States and in many other countries, to deliver the subsidy, the tax deduction. Reform of the subsidy mechanism could eliminate or mitigate the problems. For example, the deduction could be extended to all taxpayers regardless of itemizer status; or the deduction could be eliminated in favor of a partial or total tax credit; or the incentive could come, as in the United Kingdom, in the form of so-called “gift aid”, where the states matches some portion of an individual's charitable donation to an eligible organization; and so on.

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<sup>21</sup> Richard A. Musgrave and Peggy Musgrave, *Public Finance in Theory and Practice*, 4<sup>th</sup> edition (New York: McGraw Hill, 1984), p. 348. The progressivity of an income tax code translates, perversely, into a regressive system of tax deductions: the wealthiest garner the largest tax advantages. Compounding this oddity is a variant of the objection offered above. Identical donations to identical recipients are treated differently by the state depending on the donor's income; a \$500 donation by the person in the 35% bracket costs the person less than the same donation by the person in the 10% bracket. Since the same social good is ostensibly produced in both cases, the differential treatment appears totally arbitrary. The upside-down phenomenon is not specific to the tax deduction for charitable donations, of course. Deductions in general massively favor the wealthy. In 1999, 50% of all tax deductions were claimed by the wealthiest decile of earners in the United States.

How then might we assess the subsidy rationale as a whole? One obvious way to evaluate the subsidy rationale, rather than just the subsidy mechanism currently in use, is to look to the social good the subsidy produces and the efficiency with which it is produced.

Supposing that the goods produced by charitable recipients were of social value, we might ask, for instance, whether the subsidy is so-called “treasury efficient”. Does the subsidy shake off more in donations than it costs in federal tax revenue? If so, the subsidy is treasury efficient. Economists will then argue about the optimal rate of the subsidy, or how to stimulate the most giving for the least cost to the treasury. Empirical analyses of the tax deduction in the United States show that the deduction is indeed treasury efficient, though significantly less so than initially was thought.<sup>22</sup>

While treasury efficiency assures us that the subsidy is not a mere reward for charitable giving that would occur even in the absence of the subsidy – a loss of federal revenue to produce something that would occur anyway – its success depends very much on the initial supposition that the goods produced by charitable recipients are of broad social value.

When we inquire into the social good produced by charitable donations, rather than focusing squarely on questions of treasury efficiency, three problems present themselves, at least in the U.S. context.

First, United States law permits a truly kaleidoscopic landscape of public charities to receive tax-deductible charitable contributions.<sup>23</sup> Some and perhaps many of the social goods produced by charities will be of no value whatsoever to certain citizens. Because churches are eligible to give tax deductions to donors (e.g., congregants) for contributions, atheists are vicarious donors to churches

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<sup>22</sup> Newer studies that take long term effects into account generally find lower price elasticities than earlier studies, ranging from -0.47 to -1.26 rather than -1.09 to -2.54. The decision to make a charitable donation is not made solely with reference to the availability of a deduction in any given year; people are likely to look to the year ahead and behind in deciding how much to give. Because previous studies focused on short term effects of changes in tax incentives, they often exaggerated the impact of incentives. When tax benefits for charitable contributions decreased one year, short term studies would document a significant decrease in giving for that year. But these studies would miss the longer term reactions of donors, who would eventually increase their giving again once they became accustomed to the changes in tax incentives. Another development in recent studies is the use panel studies as opposed to cross-sectional or time series samples. The panel data uses information from the same group of individuals at successive points in time. See, for instance, Gerald Auten, Charles Clotfelter, and Holger Sieg, “Charitable Giving, Income, and Taxes: An Analysis of Panel Data,” *American Economic Review* 92 (2002), pp. 371-82. The overall picture is that incentives are significantly less important than was initially thought. In explaining why people make charitable contributions, Evelyn Brody concludes, “Apparently tax considerations are not paramount. After all, philanthropy long preceded the enactment of the federal income tax, and no income-tax subsidy is available to the 70% of individual taxpayers who claim the standard deduction” (Brody, “Charities in Tax Reform: Threats to Subsidies Overt and Covert,” 66 *Tennessee Law Review* 687 (1999)), p. 714.

<sup>23</sup> U.S. law permits tax-deductible donations to organizations “operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals” (Internal Revenue Code Section 501(c)(3)). In 2008, not including churches or religious groups, these numbered in excess of 1.1 million organizations.

through the tax subsidy. By contrast, Catholics are vicarious donors to Planned Parenthood and its support for abortion rights. Such examples are easily multiplied. The basic point is that the subsidy cannot be justified as a Pareto improvement, where some benefit and no one is made worse off.<sup>24</sup> At best, the subsidy is a Kaldor-Hicks improvement, where the gains for those who consume the particular social good produced by charity offset the losses to those with no interest in that social good.

But relying on a Kaldor-Hicks improvement as the standard for justifying the subsidy rationale raises a second set of problems. For obvious reasons, the beneficiaries of a deduction are highly skewed toward upper income earners. Wealthier individuals donate more as an absolute amount (but not as a percentage of income) and receive a larger subsidy for giving (the upside-down effect) and claim, as a result, a staggeringly large share of the deduction. (Those making \$200,000 and above received 30% of all deductions for charitable contributions; those making \$75,000 and above claim >65% of all deductions.)<sup>25</sup> The result is a plutocratic bias in the subsidy, where the favored beneficiaries of the wealthy receive the lion's share of the subsidy.

The plutocratic bias is troubling, for systematic over-attention to the interests and preferences of the wealthy against the interests and preferences of the middle-class and poor seems a strange, indeed unjust, basis for social policy. But the trouble might be undercut if the product of charitable giving were pure public goods, in the economic sense, namely goods that are non-excludable and nonrivalous. If wealthy people donate to create goods that no one can be prevented from enjoying and that one person's consumption does not reduce the amount available to others, then the plutocratic bias nevertheless redounds to the advantage of all citizens. But the vast majority of public charities do not produce pure public goods. Hospitals and universities, for instance, together account for more than half of the revenue of all nonprofits organizations in the United States. Both hospitals and universities can easily exclude persons who cannot pay for their services.

Leaving aside the strict conditions of pure public goods, the concern about plutocratic bias might be mitigated if the favored beneficiaries of the charitable givers, and the wealthy especially, were charities engaged in social welfare or services for the poor. At the very least, then, the effect of charitable giving would be to some degree redistributive. Unfortunately this is not the case, at least in the United States. And this is the third problem with the subsidy rationale. More than half of all individual giving in the United States goes to religion, and none of this money goes to the faith-based charities associated with religious groups. Those off-shoots of religious organizations have been counted in the relevant category of public/social benefit organizations, which receive less than 6% of all

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<sup>24</sup> This is Mark Gergen's argument in "The Case for a Charitable Contributions Deduction," 74 *Virginia Law Review* 1393 (1988), p. 56.

<sup>25</sup> Calculations from IRS data.

charitable giving.<sup>26</sup> If we focus squarely on the favored beneficiaries of the wealthy, we see that cultural organizations, hospitals, and universities are the usual recipients. Sometimes these gifts have redistributive benefits (e.g., scholarships for the poor); sometimes not. The best economic analysis of the redistributive nature of the charitable sector concludes, optimistically I think, that “no overarching conclusions about distributional impact can be made” and that while “in no subsector is there evidence that benefits are dramatically skewed away from the poor and toward the affluent” there is also evidence “that relatively few nonprofit institutions serve the poor as a primary clientele.”<sup>27</sup>

<SEE GRAPHS 1 and 2 and 3>

One final point. Suppose now that charitable donations were redistributive in the sense that gifts from the relatively wealthy flowed to the relatively poor. Granting this, we may nevertheless not yet conclude that nonprofit organizations and foundations are in fact redistributive all things considered, because we must still account for the tax concessions to philanthropy and the counterfactual scenario in which the money flowing into nonprofit organizations and foundations would have been taxed and become public revenue. The relevant question is not merely, “Is philanthropy redistributive?” but rather, “Do philanthropic dollars flow more sharply downward than government spending does?” In order for the return, so to speak, on the public’s investment in philanthropy to be worthwhile, philanthropy must do better than the state would do had it taxed the philanthropic assets.

Answering this counterfactual question is difficult. We are forced to speculate about how the state might spend the tax revenue it could have collected if it hadn’t extended the tax concessions to philanthropists for their gifts.<sup>28</sup> I will not make any such speculation here. Instead, I wish to note that anyone who seeks to ground the special tax treatment of philanthropy in the United States on the sector’s redistributive outcomes must confront at least three reasons to be suspicious that any such redistribution actually occurs. There is the first and obvious difficulty that a motley assortment of nonprofit groups all qualify for 501(c)(3) status, puppet theaters and soup kitchens alike. There is the second difficulty that religious groups dominate as the beneficiaries of individual charitable dollars. And there is the third difficulty that the burden on the sector’s advocate is to show not merely that philanthropy is redistributive but that it is more redistributive in its actions than would be the government. In short, we

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<sup>26</sup> Giving USA publishes an annual databook on charitable giving, from which I have drawn these figures. Recall here that donations to religion (i.e., to one’s own congregation) do not fund more than trivial amounts of service provision; these donations predominantly fund operating expenses of the congregation (e.g., utilities, salaries, facilities, etc.). See footnote 13.

<sup>27</sup> Charles Clotfelter, ed., *Who Benefits From the Nonprofit Sector?* (Chicago: University of Chicago Press, 1992), p. 22.

<sup>28</sup> Western European governments have been historically more redistributive than the United States. The counterfactual question presented here has correspondingly greater bite the more redistributive a government is with its taxpayers’ dollars.

have some good *prima facie* reasons to doubt that philanthropy is redistributive in effect or eleemosynary in aim.

These problems once again target the mechanism in the U.S. and elsewhere to deliver the subsidy: the tax deduction. The plutocratic bias in the subsidy and the lack of redistribution could be altered by changing both the mechanism of the subsidy (change to a capped tax credit, for instance) and limiting the kinds of organizations that are permitted to receive tax-deductible donations (eliminating churches and elite cultural organizations, for instance). Whatever the remedy, the expectation would be that the subsidy must still be *efficient*. To be justified, the subsidy must cost less to the treasury than it produces in social benefits.

I shall not explore these sorts of remedies here. Instead, I turn now to an alternative rationale that does not displace the subsidy rationale but drops the necessity that the subsidy be an efficient use of tax dollars in producing certain social goods.

### **Pluralism Rationale**

The pluralism rationale comes in several stripes and cannot be called a unified theory. The basic idea is that the tax incentive to make charitable donations should not be justified on the basis of assessing the discrete social goods, or outputs, of the various nonprofit organizations funded through these donations. Instead, the tax incentive is justified for its role in stimulating or enhancing the voice of citizens in the production of a diverse, decentralized, and pluralistic associational sector, which is in turn thought to be a bedrock of a flourishing liberal democracy. If nonprofit organizations are the institutional face of associational life, then stimulating charitable donations to a wide array of nonprofits might amplify the voice of citizens and enhance civil society to the overall benefit of liberal democracy. Rather than focus on the matrix of goods produced by charitable organizations, the focus here is on the creation and sustenance of a diverse slate of organizations themselves. The public good or social benefit being produced is civil society itself, not the catalogue of public goods or benefits produced by the roster of organizations that constitute civil society.

Note that this is still a subsidy theory, but there is no necessary demand that the subsidy be treasury-efficient. Even if there is a net loss to the treasury in the production of the social goods generated by nonprofit organizations – if the state could more efficiently deliver these goods itself – the pluralism rationale holds that the subsidy is nevertheless worthwhile. Of course, there is no bias against the efficient production of goods, but the pluralism rationale does not demand efficiency for the success of the argument. The state might justifiably forego tax revenue for the sake of fostering citizen's voices and the sustenance of a pluralistic associational sector.

Before elaborating the pluralism rationale in greater detail, consider a few worries about the pluralism rationale. First, vigorous safeguarding of liberty is typically thought to be the institutional guarantee for associational life. Is it really necessary to subsidize the exercise of liberty to produce a vibrant civil society? There was no charitable contributions tax deduction when Tocqueville toured the United States, after all.

Second, the defender of the pluralism rationale has to answer to the disturbing historical record about associational life over the last century. It is no exaggeration to say that the rise of nonprofit organizations in the United States and the use of the charitable contributions deduction coincides with the *decline* of civic engagement and associational life, at least if the Robert Putnam-inspired literature is to be believed. The existence of professionally run nonprofit organizations may have contributed to the calcification of civil society.<sup>29</sup>

If U.S. taxpayers have spent hundreds of billions of dollars in tax expenditures to support charitable giving over the past generation, we might ask whether this has stimulated an improvement in civil society that would not have happened absent the subsidy. I do not hazard any such guess here. Perhaps the decline in civic engagement and associational life is less than it would have been in the absence of the subsidy. Whatever the actual fact, the empirical case that the subsidy has improved civil society, or lessened its decline, has to my knowledge not yet been made.

So what, then, is the case for the pluralism rationale in support of subsidizing charity or philanthropy? I believe the rationale has two main ideas: decentralizing the process of producing social goods, and promoting the pluralism of associational life and diminishing state orthodoxy in defining its contours.

These ideas are captured in a U.S. Supreme Court opinion from Justice Lewis Powell, where he takes issue with the notion that the purpose of the nonprofit sector is efficiently to deliver or supplement services or social goods that the government would otherwise supply through direct expenditures. Powell rejects the view that

...the primary function of a tax-exempt organization is to act on behalf of the Government in carrying out governmentally approved policies. In my opinion, such a view of 501(c)(3) ignores the important role played by tax exemptions in encouraging diverse, indeed often sharply conflicting, activities and viewpoints. As Justice Brennan has observed, private, nonprofit groups receive tax exemptions because 'each group contributes to the diversity of association, viewpoint, and enterprise essential to a vigorous, pluralistic society.' Far from representing an effort to reinforce

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<sup>29</sup> See Robert Putnam, *Bowling Alone* (New York: Simon & Schuster, 2001) and Theda Skocpol, *Diminished Democracy: From Membership to Management in American Civic Life* (University of Oklahoma Press, 2004) on the rise of bureaucratic civil society.

any perceived 'common community conscience,' the provision of tax exemptions to nonprofit groups is one indispensable means of limiting the influence of governmental orthodoxy on important areas of community life.<sup>30</sup>

In a diverse society, there will be heterogeneous preferences about what kinds of social goods to supply through direct expenditures of tax dollars. Democratic mechanisms for deciding how to allocate these dollars are of course one fundamental means of dealing with heterogeneous preferences. The preferences of the median voter assume a large, if not wholly determinative, role here. But another potentially important means is to decentralize the authority for deciding what kinds of social goods are produced and to permit, indeed to enhance, citizen voice in this process by providing a subsidy for that voice. Tax incentives for charitable giving represent, on this view, an effort to stimulate every citizen to cast his or her own preferences, in the form of dollars, about their favored social goods into civil society, where the resulting funding stream is partly private (from the donor) and partly public (from the tax subsidy).

The result is that citizen groups which cannot muster a majority consensus about a particular social good provision through the regular democratic political process will still have a tax-supported means to pursue their minority or eccentric goals. Associational rights would guarantee every citizen the liberty to join with others to pursue dissenting or conflicting visions of the public good or the production of social goods; the justification for subsidizing this liberty through tax incentives is to enhance or amplify every citizen's voice, stimulate their contributions to civil society, and assist minorities in overcoming the constraints of the median voter. Philanthropy becomes a means of voting for one's favored civil society projects with dollars partially private and partially public.<sup>31</sup>

Note here that concerns about the redistributive nature of charitable dollars have receded from view. When the justification for tax incentives for philanthropy run along the pluralist line, philanthropy is not, at least in the first instance, about assisting the poor or disadvantaged; it is instead about protecting and promoting a flourishing and pluralistic civil society.<sup>32</sup> If citizens should wish

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<sup>30</sup> 461 US 574 *Bob Jones University v. United States* (1983). This case established that the IRS could revoke the tax exempt status of an organization at odds with established public policy or that fails to meet a public interest requirement in the statute which regulates nonprofit, tax exempt 501(c)(3) organizations. Bob Jones University, a 501(c)(3) organization, had a policy that denied admission to applicants who were in interracial marriages or who advocated interracial dating or marriage. Powell's opinion concurred with the majority holding but disagreed with the rationale for revoking tax exempt status as articulated by his fellow Justices, that tax exempt organizations must "demonstrably serve and be in harmony with the public interest."

<sup>31</sup> Saul Levmore nicely articulates this view, adding that the mechanism might also encourage volunteering for and oversight of nonprofits by "develop[ing] a sense of commitment to chosen charities". See Levmore, *Taxes as Ballots*, 65 *University of Chicago Law Review* 387 (1998), p. 406.

<sup>32</sup> Liam Murphy and Thomas Nagel write "The word charity suggests that [the charitable contribution] deduction is a means of decentralizing the process by which a community discharges its collective responsibility to alleviate the worst aspects of life at the bottom of the socioeconomic ladder. Since there is disagreement about what the exact nature of that responsibility is, and about which are the most efficient

to fund nonprofit organizations that provide social services to the poor or disadvantaged, they can certainly do so, but these preferences would not be privileged against, say, preferences for cultural organizations such as museums or opera.

I believe this pluralism rationale has merit, and that it may indeed supply reason to subsidize the liberty of people to give their money away for charitable or philanthropic purposes. But however compelling the pluralism rationale may be, it cannot be said to sit behind the current design of tax-supported giving in most countries. Providing tax deductions of sort typically on offer today in the United States for individuals who make charitable gifts does not honor the pluralism rationale but rather, I think, undermines and make a mockery of it.

As described earlier, a tax deduction for charitable contributions, when there is a progressive income tax, establishes a plutocratic voice in the public policy. The deduction supplies a greater subsidy to the wealthy, who, of course, already are likely to possess a more powerful voice in the political arena without any subsidy whatsoever. If the tax incentive for charitable giving is designed as a deduction from taxable income, many people are denied voice entirely (because they do not itemize their deductions) and wealthier citizens claim far more of the subsidy than others. The consequence is a troubling plutocratic bias in the contours of civil society, systematically more nonprofits favored by the rich and fewer favored by the poor. We get not egalitarian citizen voice in civil society but plutocratic citizen voice, underwritten and promoted by tax policy.

What kind of mechanism would better track the pluralism rationale? There are many options, but for the sake of illustration, consider two possible designs. First, a flat and capped nonrefundable tax credit for charitable donations. By offering an equivalent tax credit to all donors (say 25% of any donation) with the credit capped at some level (say \$1,000), the mechanism avoids the upside-down structure of the deduction, offers an equal credit to all donors, and of course affords donors the liberty to continue to give money away after the cap has been reached, but no longer with any state subsidy to do so. Second, consider the practice of so-called “percentage philanthropy” which has arisen recently in several central and eastern European countries. In Hungary, for instance, a law passed in 1996 permits citizens to allocate 1% of their income taxes to a qualifying nongovernmental organization. This is not a tax credit, as in the previous example, because citizens here do not pay less tax. Citizens redirect what would otherwise be state revenue in form of income taxes to the civil society organizations of their choice. It must be said, however, that there is

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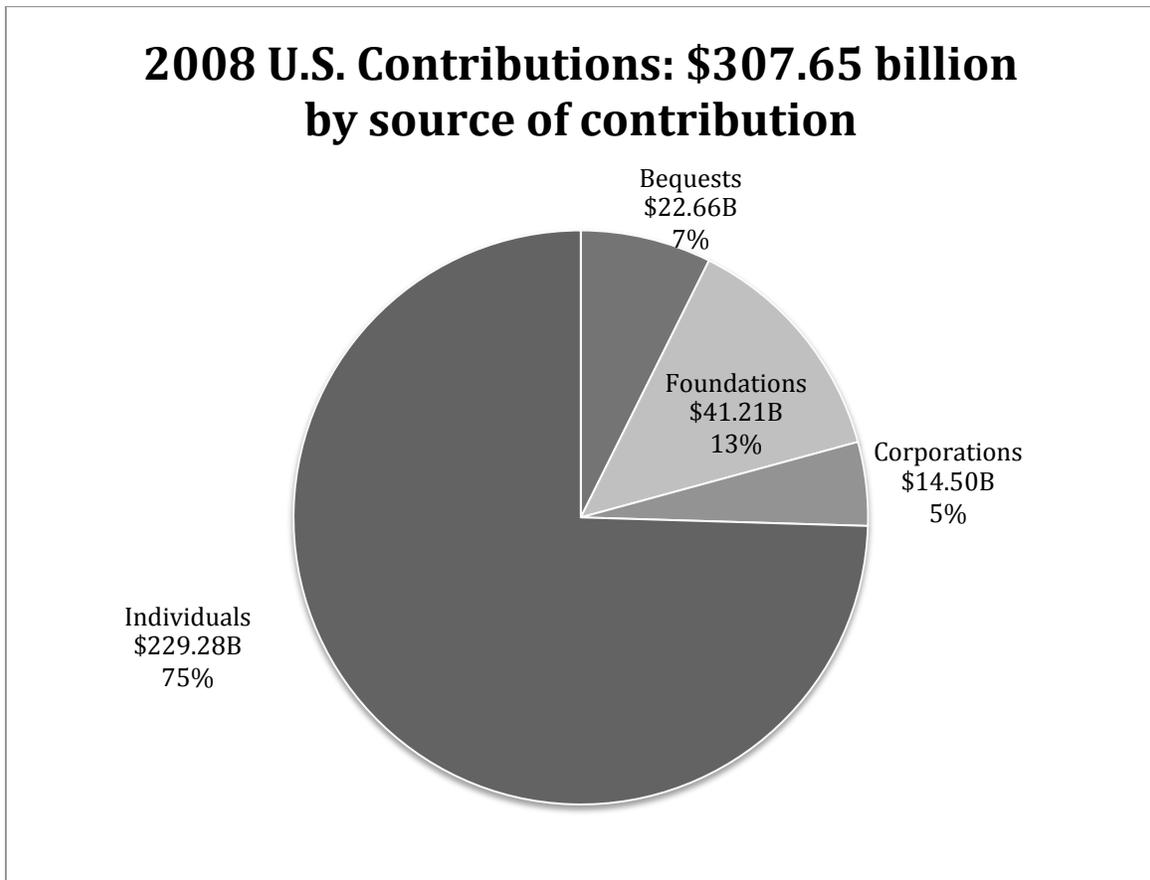
agencies, it is arguably a good idea for the state to subsidize individuals' contributions to agencies of their choice rather than itself making all the decisions about the use of public funds for this purpose. But even if that is so, the existing deduction cannot be defended on those grounds, because many currently deductible 'charitable' contributions go to cultural and educational institutions that have nothing to do with the poor, the sick, or the handicapped. State funding of such institutions may or may not be desirable, but the argument would be very different, and 'charity' is hardly the right word" (*The Myth of Ownership*, 127). The pluralism rationale is an attempt to supply this "very different" argument.

nothing in this latter scheme that deserves the description “charity” or “philanthropy”, for the scheme redirects only tax dollars, not private dollars. Percentage philanthropy does not require any donation of an individual’s own after-tax dollars.

## **Conclusion**

Though people have engaged in philanthropy for millennia, the practice of giving money away has only recently become a tax-subsidized activity. Philanthropy is now embedded within a framework of public policies, usually centered on the tax regime, that structure its practice and alters its shape from what it would otherwise be without the state’s intervention. Though nearly all liberal democracies have tax incentives for charitable donations, the justification for this practice is not well understood or theorized. I have canvassed three distinct justifications for providing tax incentives for philanthropy: a tax base rationale, a subsidy rationale, and a pluralism rationale. While I find nothing to recommend the tax base rationale, the subsidy and pluralism rationales do offer potentially good reasons to support subsidies for philanthropy. Neither of these latter two justifications, however, provides support for the actual design of most tax subsidized giving, where a wide array of eligible recipient organizations and a tax deduction for giving are the favored mechanisms. A political theory of philanthropy might offer a defense, or several distinct defenses, of state incentives for giving money away, but the current practice of state-supported philanthropy, especially in the United States, is indefensible.

GRAPH 1

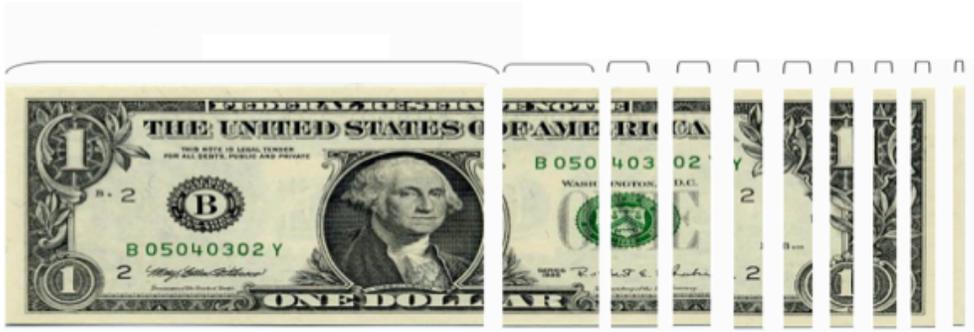


Source: Giving USA 2009

# Donor Allocations

Religion 61%

Umbrella Org 10%  
 Basic Needs 10%  
 Health 5%  
 Education 4%  
 Arts & Culture 2%  
 Environmental 3%  
 Youth or Family 2%  
 Other 2%  
 International 1%

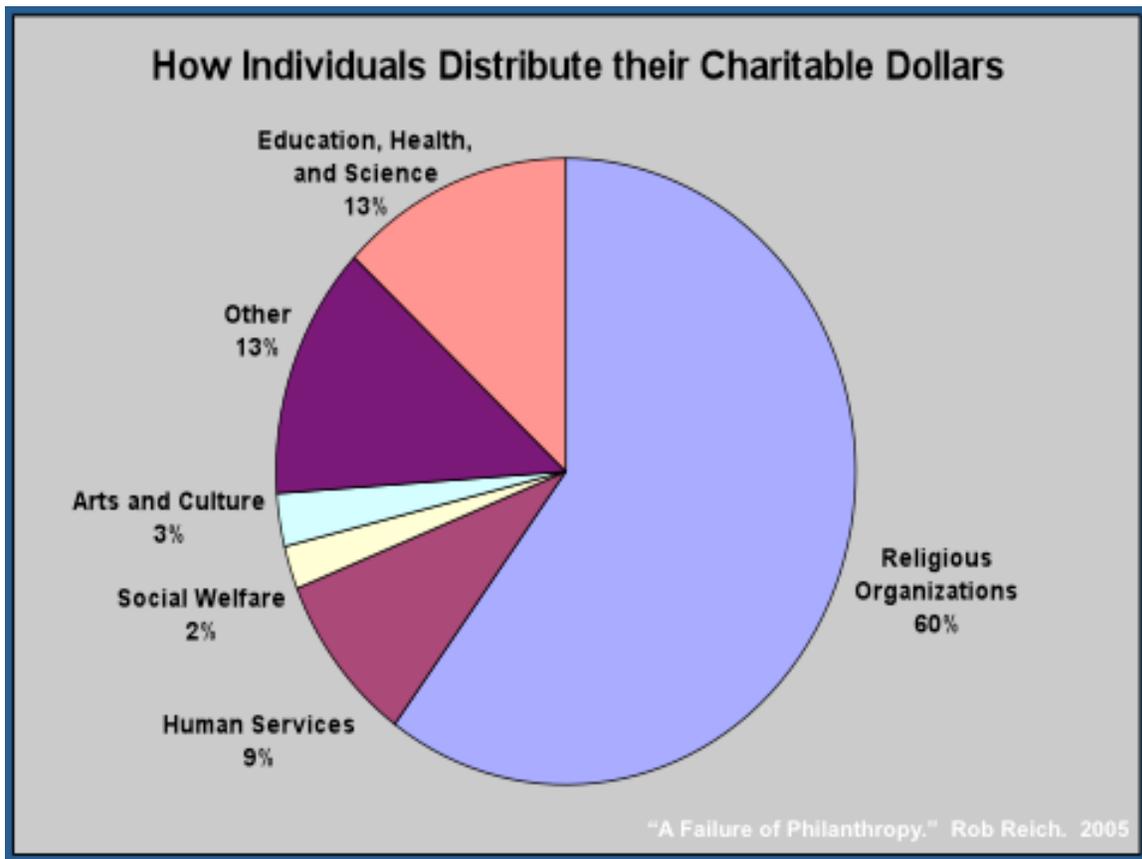


Category	Religious	Umbrella	Basic Needs	Health	Education	Arts	Other
% of total giving	61	10	10	5	4	2	8
% of giving by inc. >\$1M	17	4	4	25	25	15	10

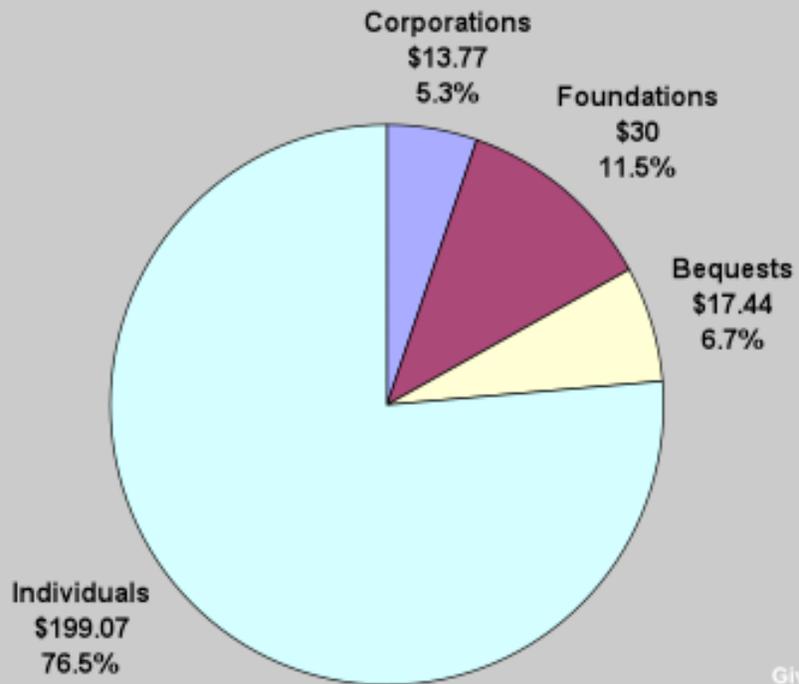
Source: Patterns of Household Charitable Giving, 2007 based on COPPS/PSID 2005

GRAPH 2

GRAPH 3



**2005 Contributions: \$260.28 billion  
by source of contributions**



Giving USA 2006