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TAX-INDUCED DISTORTIONS IN THE VOLUNTARY SECTOR

Charles T. Clotfelter*

In comparison with most other countries, the United States government relies heavily on its voluntary, or nonprofit, sector to undertake important social functions.¹ Not coincidentally, that sector enjoys some of the world’s most generous tax concessions.² To what extent this tax treatment is the cause, and to what extent it is the result, of this historic dependence on the nonprofit sector is unclear and would make an interesting question for research. What seems certain is that, in the case of the nonprofit sector, public policy is to a large extent synonymous with tax policy. In general, this tax policy appears to be designed to stimulate support for its institutions and subsidize its operation, and there is a good bit of evidence to suggest that this tax policy is effective toward those aims. But, like any broad social policy carried out in different ways at different levels of government, this tax policy has various effects, not all of which were intended or could have been predicted.

Public debate over nonprofit tax policy reflects both this policy’s significance within the larger scope of American social policy

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1. For a general discussion of the history of the nonprofit sector in the United States, see Hall, A Historical Overview of the Private Nonprofit Sector, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 3 (W. Powell ed. 1987). Clearly the federal government depends on the services provided by nonprofits. Whether the special tax treatment given to nonprofits induced governmental dependence is not known. Perhaps the opposite is true and the favored tax status came about only after government recognized its dependence upon the services nonprofits supply. The answer to this question would make an interesting question for further research.

and its financial importance to the well-being of the nonprofit sector. One important state law issue in this ongoing debate is the property tax exemption enjoyed by nonprofit institutions. At the federal level, one of the most hotly-debated domestic issues in recent years is the tax treatment of commercial activity by nonprofit organizations. An even more intense debate occurred two decades ago over the tax treatment of charitable foundations. The deduction for charitable contributions, itself a fixture in the federal income tax almost from its inception, has also been an issue of debate.

The possibility that a change in the tax law may alter the level of charitable funding which flows into the nonprofit sector overshadows the argument on all of these important issues. The effect on contributions was argued in Congress prior to the introduction of a standard deduction following World War II and concern for the level of charitable contributions is still evident today. For instance, in the unprecedented debate over income tax reform in the mid-1980s, few issues attracted as much sustained interest as the treatment of charitable contributions.


5. C. Clotfelter, supra note 2, at 31-34.

6. To illustrate the debate over the standard of deduction, see 90 Cong. Rec. 4029 (1944) (statement of Rep. Curtis):

This bill, when carried into effect, means that the individual who gives a portion of his hard-earned money in contributions will have the same amount of taxes . . . as if he had given nothing.

This administration . . . has chosen for all practical purposes to disregard the principle that that portion of a man's wages that he gives away . . . should not be touched by the tax gatherer. Can it be possible that the masterminds behind the scenes who determine the policy for the Treasury Department . . . want to cripple all of these worth-while institutions so that they must come to the Federal Government for a subsidy?

Id.
The tax concessions given to the voluntary sector are argued on other grounds as well. The more prominently voiced concerns are that the tax concessions: (1) are abused by taxpayers or institutions; 7 (2) do not benefit all income classes; or (3) do not produce benefits worth their cost in foregone revenues. 8 For example, prominent among the arguments used to support the 1969 tax rules for foundations were examples of individuals who retained substantial control of their assets after setting up foundations and receiving the associated tax benefits. That the direct beneficiaries of these tax provisions were usually quite wealthy was not lost on populists in Congress. Similarly, the issue of abuse of privileged tax position is central to the current debate over the taxation of the commercial income of nonprofit organizations. At issue in any of these debates is not only the economic vitality of the nonprofit sector but also the shape of an important component of American public policy.

Like other kinds of public policy, tax policy directed toward the voluntary sector can be evaluated using a number of different yardsticks. One might empirically measure the tax law’s impact on the behavior or on the finances of nonprofit institutions. Taking a normative perspective, one might use concepts of equity to ask whether tax policy in this area is “fair.” Presumably, these equity concerns underlie the debate over “unfair competition” 9 and the taxation of commercial income earned by nonprofits. 10 Another normative concern, and the aspect focused on in this paper, is the efficiency of resource allocation in the economy. Resource allocation — concerning, for example, the uses of labor and capital in the economy — is affected by taxes in the same way that prices affect the commodities that people purchase and wages affect the

7. See Bennett & Rudney, A Commerciality Test to Resolve the Commercial Nonprofit Issue, 36 TAX NOTES 1095, 1096 (Sept. 14, 1987) (The current tax law has created a “public controversy about [the] competitive advantage of nonprofits in the marketplace.”); Klott, Tax Watch: Nonprofit Groups May Face a Tax, N.Y. Times, May 23, 1988, at D2, col. I (small businessmen claim that a tax is needed to cure the “unfair competition” posed by nonprofits).
8. Some argue that the services provided by nonprofits are lower in quality than the services provided by for-profit firms. See, e.g., Herzlinger & Krasker, Who Profits from Nonprofits?, HARV. BUS. REV., Jan.-Feb. 1987, at 93, 93 (“while nonprofit hospitals receive more social subsidies than for-profits, they do not achieve better social results.”).
9. See supra note 7 and accompanying text.
10. UNITED STATES GENERAL ACCOUNTING OFFICE, COMPETITION BETWEEN TAXABLE BUSINESSES AND TAX-EXEMPT ORGANIZATIONS (February 1987) (Briefing Report to the Joint Committee on Taxation, U.S. Congress).
jobs that they take. Any policy that disturbs an otherwise well-functioning price system creates "distortions" which tend to lower economic welfare. There is a vast literature in public finance that identifies the conditions under which taxes do and do not create distortions. The literature suggests that distortions arise when taxes change the ratio of prices away from the value that would otherwise exist in the absence of taxation. For example, consider a pre-tax situation in which the price of apples is twice that of bananas. Taxes create distortions if they disturb this 2:1 ratio. There are, however, a few commodities that a free functioning market will always mis-allocate even in the absence of tax induced distortions. Public goods are one such commodity, and overall economic welfare will suffer unless public policy is used as a corrective measure. One principal justification for using tax policy to subsidize nonprofits is that it remedies this inefficiency.

This Article examines tax policy toward the nonprofit sector through the economist’s lens of efficiency. Without attempting to construct a complete model of the sector, several apparent deviations from efficiency are identified. Most of these distortions were not intended by lawmakers, and their large impact makes them worth considering. The first section of the Article surveys the many roles assumed by the nonprofit sector in the United States. This provides the needed perspective for analyzing public policy and tax policy toward that sector. The second section examines some prominent apparent distortions that affect choices within the voluntary sector. These distortions are distinguished from those aspects of tax policy that tend to promote, rather than diminish, efficiency. In the third section, the behavioral consequences of those distortions are discussed. The concluding section notes the relevance of the analysis to several current policy questions related to the tax treatment of the voluntary sector.

13. See infra notes 17-47 and accompanying text.
14. See infra notes 48-88 and accompanying text.
15. See infra notes 89-135 and accompanying text.
16. See infra notes 136-41 and accompanying text.
I. THE ROLE OF THE NONPROFIT SECTOR, PUBLIC POLICY, AND DISTORTIONS

A. Function and Shape of the Nonprofit Sector

Before looking at distortions, it is helpful to consider why nonprofits exist in the first instance. The growing literature about the nonprofit sector offers several theories. Broadly speaking, most of these theories suggest two principal reasons which explain the existence of nonprofit organizations: market failure and government failure.

It is well known that freely operating markets, despite their much-heralded advantages, fail to produce efficiency in resource allocation under some conditions. One such market failure involves public goods — commodities or services whose benefits flow to all consumers, not just those who purchase them. This creates a "free rider" problem which causes public goods to be under-supplied in a free market. Those who would benefit from these goods have an insufficient incentive to pay for them. By default, the government becomes the provider for public goods since it can use its taxation power to make everyone pay the cost of providing the goods.

Imperfect information is another cause of market failure. Hansmann has argued that information asymmetry explains the

17. See generally THE NONPROFIT SECTOR: A RESEARCH HANDBOOK (W. Powell ed. 1987)(offering several theories which explain the existence of nonprofit organizations). For instance, one author justifies nonprofit organizations on three grounds:

(1) to perform public tasks that have been delegated to them by the state; (2) to perform public tasks for which there is a demand that neither the state nor for-profit organizations are willing to fulfill; or (3) to influence the direction of policy in the state, the for-profit sector, or other nonprofit organizations.

Hall, supra note 1, at 3.

18. Hansmann, Economic Theories of Nonprofit Organizations in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 27, 29 (W. Powell ed. 1987)(because the market aims to satisfy the median voter, other citizens' demands for goods and services will remain unsatisfied).

19. Once a public "good is provided, the additional resource cost of another person consuming the good is zero." H. ROSEN, supra note 11, at 62. See also Hansmann, The Role of Nonprofit Enterprises, 89 YALE L.J. 835 (1980).

[1]Individuals have an incentive to contribute little or nothing toward the cost of producing [public goods] for two reasons: first, the individual's contribution is likely to be so small in proportion to the total that it will not appreciably affect the amount of the good provided, and second, the individual will in any case be able to enjoy the amounts of the good that are financed by the contributions of others.

Id. at 848-49.
existence of many nonprofit firms. Since nonprofit firms are prohibited from distributing profits, nonprofit managers do not have the same incentives to take advantage of uninformed consumers that for-profit managers do. This explains why the nonprofit form plays a vital role in markets where consumers have difficulty assessing the quality of the service offered for sale.

A second reason for the existence of nonprofit organizations is the failure of government to provide an adequate amount of goods and services to all of its citizens. Some citizens demand more of a particular public service than others, but government can generally provide only one common amount, leaving some citizens with unfulfilled demand. As Weisbrod has argued, many nonprofit organizations fill these gaps left by government.

Two basic types of nonprofit institutions emerged in response to these failures of the market and the government: public service organizations and mutual benefit organizations. The former would include the churches, hospitals, and charities that are commonly associated with the nonprofit sector. Except for churches, there is no special reason why many of these organizations exist in the nonprofit sector as opposed to the government. The latter group includes clubs, unions, and other associations run for the benefit of their members. In sum, public service organizations undertake activities that have a significant public good component, like many functions of government. Mutual benefit or-

20. Hansmann, supra note 19, at 862-63 (the inability of consumers to monitor the quality and worth of services through private contract justifies the existence of commercial nonprofits).

21. See, e.g., I.R.C. § 501(c)(3) (1986) (to remain tax exempt, an organization must make certain that it does not distribute any "part of the net earnings of which inures to the benefit of any private shareholder or individual"). See also Hansmann, supra note 19, at 838 ("A nonprofit organization is, in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it . . . ").

22. Hansmann, supra note 18, at 29.

23. See, e.g., Hansmann, supra note 19, at 866 n.90 (offering the example of a hospital patient as a consumer lacking the knowledge and capacity to evaluate the service being provided).

24. Hansmann, supra note 18, at 29.

25. Id.


28. Id. at 305.

29. U.S. CONST. amend. I (the establishment clause of the first amendment requires the government to avoid activities relating to the establishment of religious organizations).

ganizations, on the other hand, tend to have little impact on individuals outside the organization's membership.\textsuperscript{31}

\subsection*{B. Tax Policy in the United States}

In the United States, federal tax policy toward the voluntary sector has two basic components: tax exemption for the nonprofit organizations themselves\textsuperscript{32} and deductions for donors who make contributions.\textsuperscript{33} At the state level, nonprofit organizations are generally exempt from state corporate income taxation\textsuperscript{34} and from sales and property taxation.\textsuperscript{35}

Both of these components — the exemption and the deduction — are surrounded with numerous exceptions and restrictions. The most important ones define the range of allowable deductions. For instance, deductability will be denied unless the gift goes to a group officially recognized by the tax code.\textsuperscript{36} A group that attempts "to influence legislation" can lose its favored tax status.\textsuperscript{37} Even if these and other impediments to deductibility are met, the taxpayer might nonetheless be precluded from taking the full deduction for his donation.\textsuperscript{38} There are restrictions placed on a nonprofit's tax exempt status as well. For example, federal law provides for the taxation of so-called unrelated business income.\textsuperscript{39} It also subjects private foundations to an excise tax\textsuperscript{40} plus an elaborate set of extra requirements.\textsuperscript{41}

\begin{itemize}
    \item \textsuperscript{31} \textit{Id.} at 305-06.
    \item \textsuperscript{32} I.R.C. § 501(a) (1986)("An organization [listed herein] shall be exempt from taxation . . . ").
    \item \textsuperscript{33} I.R.C. § 170(a)(1) (1986)("There shall be allowed as a deduction any charitable contribution . . . "). The deduction may be used to reduce the tax liability of individuals, I.R.C. § 170(b)(1) (1986), corporations, I.R.C. § 170(b)(2) (1986), and estates, I.R.C. § 2055(a) (1986).
    \item \textsuperscript{34} \textit{See} E. LASHBROOKE, TAX EXEMPT ORGANIZATIONS 97 (1985).
    \item \textsuperscript{35} \textit{Id.} at 108-17.
    \item \textsuperscript{36} I.R.C. § 170(c) (1986)(defining the eligible groups). These groups correspond roughly to the "public service" organizations discussed earlier. \textit{See supra} note 19 and accompanying text.
    \item \textsuperscript{37} I.R.C. § 170(c)(2)(D) (1986).
    \item \textsuperscript{38} I.R.C. § 170(b)(1) & (2) (1986)(expressing a percentage limit on deductibility in terms of the taxpayer's "contribution base").
    \item \textsuperscript{39} I.R.C. § 501(b) (1986).
    \item \textsuperscript{40} I.R.C. § 4940 (1986).
    \item \textsuperscript{41} I.R.C. §§ 4941-4948 (1986); \textit{see also} C. CLOTFELTER, \textit{supra} note 2, at 263 (many of these measures were intended to limit the potential for abuse of foundations by donors).
\end{itemize}
C. The Rationale for Tax Policy

As discussed earlier, market failure and government failure are two explanations for the existence of nonprofit organizations. Tax policy toward the nonprofit sector thus may seem as a corrective measure for this basic problem in resource allocation. Assuming this stylized description of the structure and function of the nonprofit sector is reasonably accurate, one could easily imagine public policies which would enhance the nonprofit sector’s operation. Public policy could be used, for example, to provide certain kinds of information that would lessen the likelihood of informational asymmetry. Product labelling requirements and inspections would assist on this score. As another example, the legal system could be used to enforce the nondistribution requirement for nonprofit organizations.\(^2\) Of the many public policy options, this article examines tax policy and the justification for the way tax law is used in the nonprofit sector.

One rationale for using tax policy in the voluntary sector is equity. A prominent argument offered to justify the income tax deduction on equity grounds is that money given away by the donor should not properly be counted in his income.\(^3\) Equity may also be the reason for subjecting the commercial income of nonprofits to the same type of taxation that for-profit competitors must pay.\(^4\) The other principal rationale is based on efficiency — the focus of this Article.

Based on economic efficiency alone, a persuasive argument can be made for the use of tax policy in the nonprofit sector. Many of the products and services supplied by public service organizations are “public goods.” As noted above, public goods and other goods with beneficial “externalities” tend to be undersupplied by an unregulated market because those who benefit from them have insufficient incentive to pay for them.\(^5\) One solution offered by applied microeconomics is to subsidize the production or consumption of such goods. The greater the external benefit relative to the cost to the consumer, the greater the subsidy should be.\(^6\) It is at this point that tax policy comes into play. Any tax

\(^{42}\) The nondistribution requirement is explained at supra note 21.


\(^{44}\) Id. at 363.

\(^{45}\) See supra note 19 and accompanying text.

\(^{46}\) C. CLOTFELTER, supra note 2, at 281-84.
system as pervasive as ours is an ideal vehicle for granting such subsidies. An individual or organization can receive a subsidy simply by having its tax liability reduced (i.e. deduction for donors and exemption for the charitable organization). Tax policy toward the voluntary sector becomes, then, a corrective measure for a basic problem in resource allocation, namely, the undersupply of goods with beneficial externalities.

A risk inherent in using tax policy to subsidize desirable activities is the possibility that distortions will be introduced into the market. Distortions harm resource allocation by subverting the function of the price system; price information becomes a twisted and unreliable conveyer of information to firms and households. If there are no other forces disturbing the allocation of resources, the ratio of the prices of two commodities after taxation should be the same as it was before taxation. If not, the taxes are said to distort the choice between the commodities. Distortions caused by tax policy are usually not intended by lawmakers. That appears to be the case for tax policy toward the voluntary sector. Tax features that are justifiable on the basis of efficiency, if not created for that reason, nevertheless have the effect of creating distortions. The following section describes six of the most important distortions created by nonprofit tax law.

II. SIX PROMINENT DISTORTIONS

There are many distortions that today's tax system introduces into the market. Of the six discussed in this section, three are created by the individual income tax, and the remaining three are the result of other taxes.

A. Distortions Created by the Individual Income Tax

The individual income tax creates three prominent distortions. First, it distorts the price of cash donations. Second, it creates a variety of prices for the taxpayer considering a gift of appreciated property. Finally, it distorts the cost of donating time in comparison to a gift of money.

1. The Price of Cash Donations

Under the individual income tax, taxpayers have the option

47. See, e.g., H. ROSEN, supra note 11, at 297-98.
of itemizing their personal deductions. Those who decide to itemize are permitted to deduct their charitable contributions. For taxpayers who itemize, a contributed dollar ends up costing less than a dollar once the reduction in tax is counted. If a taxpayer's marginal tax rate is, for example, 15 percent, there is an implicit subsidy of 15 cents per dollar of giving. Each dollar of contribution costs only 85 cents, which is the dollar minus the 15 cents of tax savings. This 85 cents per dollar of giving can be viewed as the "price" of making a contribution in the same sense that apples might be priced at 89 cents a pound. Distortions in the price of giving can lead to inefficiencies just as distortions in the price of food or other products can lead to over- or under-consumption.

Distortions in the price of giving arise because different people face different subsidy rates (and prices) which bear little relationship to any objective characteristics of the gift. Two factors determine the subsidy rate applied to a person's contributions: itemization status and the marginal tax rate applicable to the taxpayer. Since only those who take itemized deductions can reduce their taxable income when they make gifts, a nonitemizer receives no subsidy and his price of giving a dollar is the full dollar. In 1985, three out of every five taxpayers were nonitemizers and thus faced this full dollar price. For the minority of taxpayers who do itemize, the subsidy rate is equal to the marginal tax rate. The price of giving for itemizers varies inversely with the marginal tax rate. Therefore, those in the highest tax brackets en-

48. The elective nature of the itemization decision is spelled out in I.R.C. § 63(e) (1986). By choosing to itemize, the taxpayer gains access to numerous deductions. I.R.C. §§ 161 & 211 (1986)(allowing itemizing taxpayers to use the deductions specified in §§ 162-96 & 212-19). Taxpayers who do not itemize calculate their tax per I.R.C. § 63(b) & (c) (1986).

49. It is the fact of itemization that allows deductability for charitable donations under § 170. See supra notes 33 & 48 and accompanying text.


51. See supra notes 48-49 and accompanying text.

52. The marginal tax rates for individuals, estates and trusts are found in I.R.C. § 1 (1986). The corporate marginal tax rates are codified in I.R.C. § 11 (1986).

53. See supra note 49 and accompanying text.

54. Tax returns in 1985 totalled 101,660,287. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME — 1985 INDIVIDUAL INCOME TAX RETURNS 15, table 1.2, col. 1 (1988). Of this total, 61,812,103 returns were nonitemized. See infra note 107. Thus, three out of every five taxpayers did not itemize.
joy the lowest price per dollar of charitable giving. Because the range of marginal tax rates was reduced significantly in the 1981 and 1986 tax acts, the variation in the price of donating is now more limited. As shown in the fourth column of Table 1, however, it is nonetheless substantial. The table illustrates how the price

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55. Prior to 1977 the top marginal tax rate for unmarried individuals was 87%. In that year, however, the rate was reduced to 70%. Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, § 101(a), 1977 U.S. CODE CONG. & ADMIN. NEWS (91 Stat.) 126, 129-30 (amending I.R.C. § 1(c)). The next reduction occurred in 1981 when the rate was changed downward to 50%. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101(a), 1981 U.S. CODE CONG. & ADMIN. NEWS (95 Stat.) 172, 178-80 (amending I.R.C. § 1(c)). This rate has been reduced even further and it now stands at 28%. I.R.C. § 1(e) (1986).

56.

Table 1
Net Cost per Dollar of Contributions
Six Illustrative Taxpaying Couples, 1988

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Itemization Status</th>
<th>Marginal(a) Tax Rate</th>
<th>Net Cost of Giving One Dollar(b)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Cash</td>
<td>Asset with a gain-to-value ratio of 0.5 (c)</td>
</tr>
<tr>
<td>$15,000</td>
<td>Nonitemizer</td>
<td>15%</td>
<td>$1.00</td>
</tr>
<tr>
<td>$40,000</td>
<td>Nonitemizer</td>
<td>28%</td>
<td>$1.00</td>
</tr>
<tr>
<td>$40,000</td>
<td>Itemizer</td>
<td>28%</td>
<td>$.72</td>
</tr>
<tr>
<td>$100,000</td>
<td>Itemizer</td>
<td>33%</td>
<td>$.67</td>
</tr>
<tr>
<td>$250,000</td>
<td>Itemizer</td>
<td>28%</td>
<td>$.72</td>
</tr>
<tr>
<td>$250,000</td>
<td>Itemizer subject to alternative minimum tax</td>
<td>21%</td>
<td>$.79</td>
</tr>
</tbody>
</table>

(a) Calculated for joint return with two dependents. Ratio of itemized deductions assumed to be equal to that for the Adjusted Gross Income class in 1986.

(b) The price of giving a dollar of cash is $(1 - m)$ for itemizers, where $m$ is the marginal tax rate. It is $1$ for nonitemizers. In general, the price of giving assets is $P = 1 - mRg*$ for nonitemizers and $P = 1 - m - mRg*$ for itemizers under the regular tax, where $m$ is the marginal tax rate, $R = 1$ if the asset would otherwise have been sold, $R = 0$ if the asset would otherwise have been bequeathed, and $g*$ is the asset's gain-to-value ratio when sold. Under the alternative minimum tax, the price is $P = 1 - .21 - .21Rg* + .21g$, where $g$ is the current gain-to-value ratio. See C. Clotfelter, supra note 2 for a discussion of the price of giving assets.

Two cases are used to illustrate the cost of making gifts of stock. That shown in column (d) assumes that the couple would otherwise have kept the asset until death ($R=0$) and
of giving differs among taxpayers by showing the prices for six hypothetical taxpaying couples. In contrast to nonitemizers for whom gifts cost the full amount, itemizers subject to an effective marginal tax rate of 33 percent give up only 67 cents for every dollar contributed to a charitable organization. Because the tax system encourages contributions by means of an itemized deduction, taxpayers who make similar charitable contributions face different prices. The resulting distortion is qualitatively no different from a situation where some people in a store pay higher prices for apples than other customers. This inconsistent treatment is undesirable because it causes inefficient allocation of resources.

2. Gifts of Appreciated Assets

The individual income tax system encourages donations in the form of appreciated property such as stock or works of art as compared to cash. It creates this favoritism by subsidizing gifts of property in two distinct ways. First, the taxpayer receives a deduction for the market value of the asset. Next, the government generally forgives the tax liability on any capital gains that would have been due had the taxpayer sold the asset. A few examples will illustrate the powerful incentive taxpayers have to contribute appreciated property instead of cash.

Consider a taxpayer who owns stock worth $1000, for which he paid $500. In 1988, if the taxpayer faced a tax rate of 28 percent and chose to sell the stock, he would owe $140 in tax to cover the capital gains ($500 x .28). If the taxpayer instead gave the stock to a charitable organization, the taxpayer’s gross cost of

that the current gain-to-value ratio (g) is 0.9. Thus \( P = 1 - m \) under the regular tax and \( P = 1 - .21 + 21(.9) \) under the alternative minimum tax. That shown in column (c) assumes the asset would otherwise have been sold immediately (\( R = 1; g^* = g \)) and that the gain-to-value ratio is 0.5. Thus \( P = 1 - m - 0.5m \) and \( P = 1 - .21 \) under the normal and alternative taxes, respectively.

(c) It is assumed that taxpayers in this column would have sold the asset and paid tax on capital gain if they had not donated the asset.

(d) It is assumed that taxpayers in this column would have bequeathed the asset thereby escaping capital gain taxation if they had not donated the asset.

57. "Deduction is allowed under § 170(a) whether the taxpayer makes his contribution in money or in 'property.' Where the property has appreciated in the taxpayer's hands . . . the full value of the property (not merely its cost) is deductible . . . ." M. Chirelstein, Federal Income Taxation 150 (5th ed. 1988).

58. "[T]he appreciation is not regarded as realized by virtue of the gift." Id. (emphasis in original).
$1000 would be reduced by the value of the deduction, $280, plus the capital gains tax that would otherwise have been due, $140. This makes the net cost of the gift only $580 ($1000 - $280 - $140).

A different set of circumstances would change this net cost. For example, consider a second taxpayer who holds a different asset that is worth $1000 but was originally purchased at a cost of only $100. In contrast to the first taxpayer, who contemplated selling the asset, this taxpayer plans to leave the asset to her heirs when she dies. If she changes her mind and donates the asset as a charitable contribution, she saves no capital gains tax because no such tax is applied to property transferred at death. She does benefit from her section 170 deduction — a $280 value if her income is taxed at the 28% marginal rate. Therefore, the net cost of the gift is $720 ($1000 - $280), the same as if she had given cash. These two hypothetical cases capture an important bit of reality: the assets in a portfolio that have appreciated the most are least likely to be sold because taxpayers can avoid the capital gains tax altogether on those assets by donating them to charity or by leaving them to their heirs.

The final two columns of Table 1 show the wide variation in cost for couples who make donations of appreciated property. The fifth column corresponds to the first example illustrated above (gain-to-value ratio of .5 and taxpayer would have sold the asset had he not donated it). The sixth column corresponds to the second example illustrated above (gain-to-value ratio of .9 and taxpayer would have bequeathed the asset had she not donated it). As in the case of cash gifts, there is substantial variation in the net costs faced by the six hypothetical couples. The taxpayers who fall within column five experience the wider range of donative cost. It varies from 50.5 cents per dollar for taxpayers in the highest tax bracket to 92.5 cents for nonitemizing taxpayers in the lowest bracket. The taxpayers grouped under column six are confronted with a smaller variation in price, from 67 cents to the full one dollar price. In general, the net cost for these taxpayers is the

59. The Internal Revenue Code taxes the individual only after the income has been "realized" by her. See, e.g., Eisner v. Macomber, 252 U.S. 189, 212 (1920)(Holding that no income tax could be levied because the taxpayer had "not realized . . . any income in the transaction"). No tax is assessed for property passed at death because "there is no realization of gain . . . by [the] decedent . . ." M. CHIRELSTEIN, supra note 57, at 59.
60. Table 1 is reproduced supra note 56.
same as the net cost of giving cash. Thus, column six matches column four except for the relatively few high-income taxpayers subject to the Alternative Minimum Tax.61

Table 1 clearly shows that the federal income tax, even in its "simplified" post-reform incarnation, creates a variety of prices for taxpayers considering charitable contributions. Because different taxpayers face different prices, these distortions create the danger of inefficient resource allocation in society. In addition, the heavy tax subsidies encourage taxpayers to contribute appreciated property instead of cash. For nonprofit organizations, receiving gifts in asset form is no more than an inconvenience when they are marketable assets such as stock. But this bias in favor of appreciated assets may have a significant impact on the asset holdings of some nonprofit organizations, those which receive gifts of real property, closely-held businesses, or works of art.

3. Time vs. Money

The complaint is sometimes made that the income tax allows a deduction for gifts of money but not for time spent in volunteer service.62 In fact, closer to the opposite is the case. Volunteering is accorded an automatic deduction for all taxpayers because the value of the service rendered to a nonprofit organization — approximately, what the taxpayer could have earned if she had worked instead — is not taxed in the first instance.63 The income

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61. The Alternative Minimum Tax is found in I.R.C. §§ 55-59 (1986). It is intended to narrow some of the "loopholes" customarily used by wealthy individuals and corporations to avoid paying income tax.

To accomplish this the Code establishes what amounts to a second tax system — one that defines the income base more broadly than the regular tax system, but then applies a lower rate of tax to that broadened income-base. Taxpayers otherwise benefitting from certain preferences [i.e. charitable deductions under § 170] are required to compute their regular tax liability (on the narrower base) and their minimum tax liability (on the broader base), compare the two, and finally pay whichever is the greater . . . [T]he minimum tax [calculated per § 55] establishes a floor below which the taxpayer's actual liability may not fall.

M. CHIRELSTEIN, supra note 57, at 160 (footnote omitted).

When applicable, the Alternative Minimum Tax uses a process of "constructive realization" to reduce the § 170 tax subsidy enjoyed by donors who give appreciated property to charity. See I.R.C. § 57(a)(6)(A) (1986).

62. Treas. Reg. § 1.170-2(a)(2) (as amended in 1976) ("No deduction is allowable for contribution of services."). See also C. CLOTFELTER, supra note 2, at 151.

63. Treas. Reg. § 1.61-2(e) (as amended in 1979) ("The value of services is not includible in gross income when such services are rendered . . . gratuitously to [a charitable] organization . . . .").
TAX-I N DUCED D I S T OR T I O N S

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tax in effect allows all taxpayers to spend an "extra" hour doing volunteer work, implicitly contributing the forgone salary to the charity, and in the process leaving the amount of tax owed to the government unchanged. Therefore, all volunteering is fully "deductible" in the sense that no tax is levied on the value of the contributed work.

For the itemizing taxpayer who can deduct her charitable donations from taxable income, the income tax is symmetrical in its treatment of gifts of time and money. The taxpayer can work the hour and contribute the proceeds or volunteer the hour — the tax consequences are the same. For the nonitemizing taxpayer who cannot deduct his contributions, however, the income tax creates a distortion in favor of gifts of time.\textsuperscript{64} Since well over half of American taxpayers do not itemize their deductions,\textsuperscript{65} this distortion touches a large number of households.

B. Distortions Created by Other Taxes

Taxes other than the individual income tax also create distortions. The corporate income tax, for instance, raises the cost of doing business for for-profit firms as compared to nonprofits. State and local taxes also create distortions because they differ from one locality to another. Thus, the relative cost of operating for-profit and nonprofit firms differs by state and local jurisdiction. Finally, the federally-mandated ceiling limits on tax-exempt bonds and lobbying restrictions introduce yet further distortions into the market.

1. Exemption From the Corporate Income Tax

Nonprofits are not strictly "nonprofit" because they are permitted to earn net income. The distinguishing difference between nonprofits and for-profits is that nonprofits cannot distribute their income to shareholders.\textsuperscript{66} Another difference is that for-profit corporations are taxed on their income\textsuperscript{67} while nonprofit organizations pay no corporate income tax on net income they earn as a by-product of their principal, tax-exempt function.\textsuperscript{68} Only the in-

\textsuperscript{64} For an analysis of this distortion, see Long, Income Tax Effects on Donor Choice of Money and Time Contributions, 30 Nat'l Tax J. 207, 207-11 (1977).

\textsuperscript{65} See supra note 54.

\textsuperscript{66} See supra note 21 and accompanying text.

\textsuperscript{67} I.R.C. § 11 (1986).

\textsuperscript{68} I.R.C. § 501(a) (1986).
come deemed not to be directly related to the nonprofit organizations’ tax-exempt purposes is taxed. This special tax is called the Unrelated Business Income Tax.\(^69\)

Of concern here is the type of distortion this treatment creates. Where there are two otherwise similar organizations, one taxed on net income and one not, it is not hard to see that a distortion is introduced. The tax raises the cost of doing business for the for-profit firms but not for the nonprofits. At the margin, this difference in tax treatment could increase the amount of capital going into nonprofit as opposed to for-profit organizations in the same industry. The relative impact of this effect depends on the rate of profit in the for-profit industry. If the profit rate is small, the tax, and thus the distortion, will also tend to be small. As stated above, these general statements apply to firms operating in essentially the same industry, such as nursing care or hospitals. The potential for serious distortion is less in an industry dominated by nonprofit firms, as in the case of research universities.

The Unrelated Business Income Tax reduces this distortion but does not eliminate it. Only a portion of the nonprofit’s income will be unrelated business income.\(^70\) Thus, a nonprofit that has large income overall but only a small unrelated business income will enjoy the lowest marginal tax rates.\(^71\) This creates a situation where the tax rate on the nonprofit firm’s business income will almost always be lower than the tax rate applied to otherwise similar for-profit firms.

2. Exemption from State and Local Taxes

Every U.S. state grants tax exemptions to nonprofit organizations, but practices differ widely.\(^72\) State exemption is based on neither the Constitution nor common law, but rather on tradition.\(^73\) In the case of educational institutions, one authority has

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70. Unrelated Business Income is defined in I.R.C. §§ 511(a) & 512(a) (1986) (income derived from a business that is not “substantially related” to the organization’s charitable purpose).
71. The corporate tax rates are 15, 25 and 34 percent. A nonprofit must earn more than $50,000 in unrelated business income before it moves out of the 15% marginal tax rate. I.R.C. § 11(b)(1) (1986).
72. For an overview of the exemption practices, see E. LASHBROOKE, supra note 34, at 97-108.
73. "The exemption of religious, educational, and charitable institutions from property taxation has existed from ‘time out of mind.’" Gabler & Shannon, supra note 3, at
said that the "principle of exemption of educational institutions from taxation has been so grounded in the nature of our Government as to represent a practically irrevocable law." Based on one estimate of tax-exempt property, as much as a ninth of all such property may be so classified due to the nonprofit exemption.

Assessing the impact of this tax policy raises many of the same issues arising under the federal corporate income tax scheme. For example, if two otherwise similar firms are treated differently for the purpose of property taxation, market distortions might alter the allocation of capital between the taxed and untaxed firms. An additional potential for distortion is created by the variations in tax treatment among the states. In the early 1970s, for example, thirty-four states exempted YMCAs and YWCAs from property taxation while 16 states did not. Income-producing property of educational institutions was exempt in 11 states but not in 39, and so on. As a result of these inconsistencies, the relative cost of operating for-profit and nonprofit firms differs by state and local jurisdiction and this hampers the ability of the market to allocate social resources efficiently.

3. Debt Ceiling Limits and Lobbying Restrictions Placed on Nonprofits

There are other distortions of a smaller magnitude that are created by the tax system. One obvious distortion introduced by the 1986 tax law is the $150 million cap on total tax-exempt borrowing applicable to each educational institution. Otherwise similar institutions now face different costs of borrowing. These divergences arise between the relatively few private institutions already over the borrowing limit on the one hand and all public universities and remaining private ones on the other.

Another distortion is induced by the lobbying restrictions. Most 501(c)(3) organizations are permitted to engage in lobbying

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2536.
75. Gabler & Shannon, supra note 3, at 2535 (one-third of all property is tax-exempt and one-third of this exempt property can be traced to the exemption of private holdings).
76. Gabler & Shannon, supra note 3, at 2541 (Table 3).
77. Id.
78. I.R.C. § 145(b) (1986).
as long as it is "minor." By contrast, for-profit firms face no limit on their lobbying activities and they are permitted to deduct many of the associated costs. Consider, for example, an individual who wishes to contribute to a firm that will influence a legislative body through lobbying. If the itemizing taxpayer chooses a nonprofit organization and the organization has not reached its lobbying limit then the federal government subsidizes her contribution with the section 170 deduction. She gives up $(1-m)$ for every dollar spent on lobbying, where $m$ is her marginal tax rate. This net cost is the same as making any kind of donation to the organization. If the nonprofit has reached its lobbying limit, however, it can only lobby by setting up separate political units. These units are not eligible for deductible contributions. Without the section 170 government subsidy, she pays a full dollar for each dollar spent on lobbying. If instead the taxpayer can persuade a for-profit corporation to do her lobbying, she will be able to have it done at a lower cost. This follows because each dollar spent by the for-profit firm on lobbying is deductible under the corporate tax. Further savings are obtained because the money spent on


80. I.R.C. § 162(e) (1986). The expense involved when the business lobbies either the state or federal legislature may be deducted. I.R.C. § 162(e)(1) (1986). Certain expenses, although political in nature, are nondeductible. For instance, money spent in a "political campaign on behalf of any candidate for public office" may not be deducted. I.R.C. § 162(e)(2)(A) (1986). Similarly, money spent "to influence the general public . . . with respect to legislative matters" may not be deducted. I.R.C. § 162(e)(2)(B) (1986).

81. A § 501(c)(3) nonprofit that has reached its lobbying limit can set up a § 501(c)(4) nonprofit to conduct all further lobbying. Contributions to this separate nonprofit firm will not, however, be deductible. See Regan v. Taxation with Representation of Washington, 461 U.S. 540 (1983). For purposes of our analysis, there are two principal differences between § 501(c)(3) organizations and § 501(c)(4) organizations. Taxpayers who contribute to § 501(c)(3) organizations are permitted by § 170(c)(2) to deduct the amount of their contributions on their federal income tax returns, while contributions to § 501(c)(4) organizations are not deductible. Section 501(c)(4) organizations, but not § 501(c)(3) organizations, are permitted to engage in substantial lobbying to advance their exempt purposes.

Id. at 543.

82. See supra note 80 and accompanying text.
lobbying was not taxed at the individual level as dividends.\textsuperscript{83} The cost to the taxpayer for each dollar the corporation devotes to its lobbying activities is \( $(1-m)(1-t) \), where \( m \) is her marginal tax rate and \( t \) is the corporate marginal tax rate. A simple calculation will show that it is cheaper to do lobbying through for-profit organizations, and that this difference grows even greater where the nonprofit has reached its limit of allowable lobbying. If the personal tax rate is 28 percent and the corporate rate is 34 percent then: (1) the net cost of for-profit lobbying is 48 cents per dollar;\textsuperscript{84} (2) the net cost of nonprofit lobbying is 72 cents per dollar if the lobbying limit has not been reached;\textsuperscript{85} and, (3) the net cost of nonprofit lobbying is the full dollar if the lobbying limit has been reached.\textsuperscript{86}

Two distortions are introduced into the market by this treatment: those between lobbying and other activities within nonprofit organizations and those between nonprofit and for-profit firms in the net cost of lobbying. The seriousness of these distortions depends on the importance one attaches to the lobbying activity of nonprofit organizations. This issue was addressed directly by the Supreme Court in \textit{Regan v. Taxation with Representation of Washington}.\textsuperscript{87} There, the Court implied that the lobbying activities of nonprofits are not valued as highly as other functions undertaken by nonprofits. The Court reasoned that this was the judgment of Congress because that body "chose not to subsidize lobbying as extensively as it chose to subsidize other activities that non-profit organizations undertake to promote the public welfare."\textsuperscript{88}

\section*{III. Some (Mostly Unintended) Effects}

The previous section identified instances in which the tax system has distorted resource allocation in the voluntary sector of the economy. This section estimates the actual effect of these distortions on individual behavior and on the behavior of economic insti-

\begin{itemize}
  \item \textsuperscript{83} This assumes that the corporation withheld money that might have been used to pay its shareholder a dividend and used it instead to lobby. By removing this step, a level of tax was avoided. \textit{See} I.R.C. § 61(a)(7) (1986)(dividends received by an individual are includable in the individual's gross income).
  \item \textsuperscript{84} \( $(1-.28)(1-.34) = 0.4752 \).
  \item \textsuperscript{85} \( $(1-.28) = 0.72 \).
  \item \textsuperscript{86} \textit{See supra} note 81.
  \item \textsuperscript{87} 461 U.S. 540 (1983).
  \item \textsuperscript{88} \textit{Id.} at 544.
\end{itemize}
tutions. For the most part these descriptions are qualitative, since few econometric estimates are available. This section identifies six likely effects of the combined distortions described above.

A. Capriciousness

One of the two central planks in American tax policy toward the voluntary sector is the income tax deduction given to donors for their charitable contributions. One consequence of using the deduction to encourage contributions is a certain whimsy in the resulting pattern of subsidies. Only itemizers are allowed to use the deduction, and subsidy rates for itemizers depend on taxpayers' marginal tax rates. These aspects cause otherwise similar individuals to face different net costs of making contributions. In particular, home owners — by virtue of their usual status as itemizers — are usually subsidized in their donations more generously than renters since the latter usually do not itemize their deductions. Consider, for example, the two hypothetical couples in Table 1 who have incomes of $40,000. Although both face the same 28 percent marginal tax rate, the nonitemizing couple's price of making gifts is over a third larger than the price faced by the itemizing couple. Thus, itemization status — determined by factors quite unrelated to the purported worthiness of a person's donation — is a critical determinant of the subsidy rate accorded to that donation.

Added to the inordinate importance of itemization is the substantial variation over time in the number of taxpayers who fall into this category. Over the past four decades, the percentage of taxpayers who itemize has fluctuated as a result of two forces: inflation, which tends to erode the real value of the standard deduction and thus makes it advantageous for more taxpayers to itemize; and Congress, which has periodically increased the standard deduction (and adjusted the width of tax brackets) to offset this inflationary effect. Although these changes in the law have

89. The other plank is tax exemption for the donee. For further discussion of these two subsidies, see supra notes 32-33 and accompanying text.
90. Homeowners are more likely than renters to be itemizers because homeowners can deduct their interest payments on mortgages — an amount which, when itemized, puts them over the amount of the standard deduction. See I.R.C. § 163(a) (1986)(interest paid on mortgages is deductible).
91. Table I is located supra note 56.
tended to neutralize the effects of inflation over time, the process has occurred in fits and starts, resulting in substantial variation in the percentage of itemizers among the population of taxpayers. The percentage of itemizers increased from 16.4 percent in 1948 to 42.5 percent in 1962, then dropped to 40.9 percent in 1966, then rose again to an all-time high of 48.0 percent in 1970, after which it fell again to 28.7 percent in 1978. The percentage then rose steadily, to 39.2 percent in 1985, but the 1986 tax act will probably cut the percentage to near 30 percent in 1988. Combined with variations in effective marginal tax rates — which change over time due to inflation and legislation — these changes in the coverage of itemization mean that the net cost of contributing is constantly fluctuating for a substantial portion of the population for reasons unrelated to the voluntary sector itself. This occurs because the income tax subsidizes charitable giving by granting a deduction only to itemizers. This capriciousness could be cured if the subsidy were given instead through a credit because all taxpayers would then face the same unchanging net cost of contributions.

B. Plutocratic Bias

William Vickrey's phrase, "plutocratic bias," captures a second apparent effect of the existing tax policy toward charitable giving. Because the net cost of giving falls as the taxpayer's income level increases, the section 170 deduction has been criticized for being an "upside-down" subsidy. Musgrave and Musgrave

FIN. Q. 131 (1984); C. CLOTZFELTER, supra note 2, at 134-35.
93. C. CLOTZFELTER, supra note 2, at 136 (table 3.12).
94. Id.
95. Id.
96. Id.
97. Id.
98. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME — 1985 INDIVIDUAL INCOME TAX RETURNS (1988). The total number of individual itemized returns for 1985 was 39,848,184. Id. at 60, table 2.1, col. 1. The total individual returns for 1985 were 101,660,287. Id. at 15, table 1.2, col. 1. 39,848,184 divided by 101,660,287 yields a figure of 39.2%.
99. See supra note 49 and accompanying text. There was, of course, a brief experiment during 1985 and 1986 which allowed nonitemizers to deduct their contributions. This interlude further contributed to recent fluctuations in the net cost of contributions. See infra notes 111-13 and accompanying text.
100. C. CLOTZFELTER, supra note 2, at 103-04.
wryly note that "the opportunity cost of virtue falls as one moves up the income scale." Combined with the special rules for donating property and the ability to establish foundations, this inverse pattern of subsidy rates raises what Simon half-facetiously called "the spectre of privilege." Another look at Table 1 will amply illustrate how the subsidy varies with income. Those at the bottom of the income scale (earning below $40,000 per year) typically bear a full dollar's cost for each dollar donated, while those near the upper end (earning over $40,000 per year) seldom do. The assumption implicit in the table, that nonitemizers are clustered in the lower income brackets, is very realistic. In 1986, for example, only 14 percent of taxpayers making between $10,000 and $11,000 itemized their deductions, compared to 88 percent for those with incomes between $40,000 and $50,000 and 97 percent for those in the $75,000 to $100,000 class. In 1985, the average nonitemizer had an income of $11,700, compared to $39,700 for the average itemizer. One has only to compare the collection plates in prosperous churches with those in churches serving poor neighborhoods to see this income-related bias. The former are filled with checks, which leave a neat paper trail for the tax accountant, while the latter contain mostly cash. If this plutocratic bias was only an equity issue then the remedy would be simple — amend the tax code to effect any desired change in


105. Table I is reproduced supra note 56.


107. The actual figures are as follows:

The adjusted gross income (AGI) for nonitemized returns was $723,364,581,000. This figure was calculated by subtracting the AGI of itemized returns ($1,582,586,902,000, Internal Revenue Service, supra note 98, at 60, table 2.1, col. 2), from total AGI ($2,305,951,483,000, id. at 15, table 1.2, col. 2).

The number of nonitemized returns was 61,812,103. This figure was calculated by subtracting itemized returns (39,848,184, id. at 60, table 2.1, col. 1) from total returns (101,660,287, id. at 15, table 1.2, col. 1).

723,364,581,000. divided by 61,812,103 yields an average income figure of $11,702.64 per nonitemized return.

108. The actual figures are as follows:

Adjusted gross income for itemized returns was $1,582,586,902,000. Id. at 60, table 2.1, col. 2. The number of itemized returns was 39,848,184. Id. at 60, table 2.1, col. 1. $1,582,586,902,000 divided by 39,848,184 yields an average income figure of $39,715.41 per itemized return.
after-tax income. The real issue, however, is efficiency and the differential rates of subsidy. Charities favored by the rich simply receive more favorable rates of subsidy through the itemized deduction than those favored by the poor.

It is clear that a bias exists, but more analysis is necessary to determine its effects. If households at lower incomes were entirely insensitive to tax subsidies then the existing income-related bias would be a moot issue due to its negligible impact on the amount or distribution of charitable giving, or on the efficiency of the tax subsidy. Some observers argue that this is the case and that low-income donors are insensitive to the tax-defined net cost of giving.\textsuperscript{109} I believe there is little support for that view. Simply because there has been little subsidy given to gifts made by those at the lower end of the income scale does not mean that those donors would not respond to incentives in a manner similar to their heavily-subsidized high income counterparts. The little econometric evidence on the charitable giving of lower income individuals has in fact produced mixed results concerning the magnitude of the price elasticity of giving.\textsuperscript{110} The closest thing to a controlled experiment that has ever occurred to test the potential responsiveness of lower income donors was Congress' brief experiment with the charitable deduction for nonitemizers. In 1985, nonitemizers could deduct 50 percent of their charitable gifts, and in 1986, they were allowed a full deduction, after which time the deduction was dropped.\textsuperscript{111} Tax statistics for these two years offer a unique glimpse into the behavior of nonitemizers. Itemizers, who saw no significant change in tax treatment between one year and the next, actually decreased their average giving in virtually every income class over this two-year period.\textsuperscript{112} In contrast, nonitemizers — all of whom experienced a one-time decrease in the net cost of giving — in-

\begin{footnotesize}
\begin{enumerate}
\item[109.] C. Clotfelter, \textit{supra} note 2, at 66 (two studies are cited to support the prevailing view prior to 1975 that there was little if any price sensitivity among low-income donors).
\item[110.] For a discussion of price elasticity, see Clotfelter & Steuerle, \textit{Charitable Contributions}, in \textit{How Taxes Affect Economic Behavior} 403 (H. Aaron & J. Pechman eds. 1981). \textit{See also} C. Clotfelter, \textit{supra} note 2, at 71 (responsiveness of lower-income individuals has been imprecisely determined).
\item[111.] Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 121(a), 95 Stat. 172, 196 (codified at I.R.C. § 170(i))(A negligible tax subsidy was given to non-itemizing charitable donors for the tax years 1982-84. They received a 50% subsidy in 1985 and a 100% subsidy in 1986. The Act also contained a sunset provision in subsection (4) which terminated the subsidy altogether on December 31, 1986.).
\item[112.] C. Clotfelter, \textit{supra} note 50, at 13.
\end{enumerate}
\end{footnotesize}
increased their average contributions in every income class above $7,000.\textsuperscript{113} While these findings do not prove that lower income households respond to tax subsidies in the same way as middle and upper income households, they do suggest that donors at all income levels respond to tax-induced incentives to contribute.\textsuperscript{114}

C. The Form of Gifts.

As discussed above, contributions of appreciated assets receive a two-part incentive under the income tax. Not only is there a reduction in taxable income due to the section 170 deduction, but the tax on the unrealized capital gains of the asset is usually forgiven as well.\textsuperscript{115} Not surprisingly, this feature of the tax law encourages donors to make gifts in the form of appreciated property. Table 2 shows the importance of gifts of non-cash assets (of which appreciated property is the major component at middle and upper incomes) by income class in 1985.\textsuperscript{116} Clearly, gifts in non-cash form are a significant part of total giving, especially in the

\begin{table}[h]
\centering
\begin{tabular}{|c|c|}
\hline
Adjusted Gross Income & Percentage of Contributions Not in Cash or Carryover \\
\hline
Under $5,000 & 9.6 \\
$5,000 under $10,000 & 7.1 \\
$10,000 under $15,000 & 9.7 \\
$15,000 under $20,000 & 7.6 \\
$20,000 under $25,000 & 8.5 \\
$25,000 under $30,000 & 8.4 \\
$30,000 under $35,000 & 8.9 \\
$35,000 under $40,000 & 8.3 \\
$40,000 under $45,000 & 10.0 \\
$45,000 under $50,000 & 9.4 \\
$50,000 under $55,000 & 11.1 \\
$55,000 under $60,000 & 13.9 \\
$60,000 under $75,000 & 13.8 \\
$75,000 under $100,000 & 14.8 \\
$100,000 under $200,000 & 17.2 \\
$200,000 under $500,000 & 13.5 \\
$500,000 under $1,000,000 & 36.7 \\
$1,000,000 or more & 42.6 \\
\hline
\end{tabular}
\caption{Percentage of Itemized Contributions in Non-Cash Assets, 1985}
\end{table}

\textsuperscript{113} Id.
\textsuperscript{114} Id.
\textsuperscript{115} See supra notes 57-58 and accompanying text.
upper income levels. This increase in non-cash giving as income rises may be explained by patterns of asset holdings and the convenience of making gifts in asset form (such as properties that are not actively traded). Yet, it seems likely that much of the observed pattern is due to the more generous subsidy for gifts of appreciated property given to taxpayers at high income levels.

To indicate the extent of this subsidy, Table 3 presents calculations of the net cost of making contributions of cash and appreciated property in selected years for hypothetical couples at two constant income levels. For example, consider a couple with an

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross income in current dollars</th>
<th>Marginal tax rate(a)</th>
<th>Net Cost of Giving One Dollar(b)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Cash</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Asset with a gain-to-value ratio of 0.5 that would have been sold if not donated</td>
</tr>
<tr>
<td>1955</td>
<td>$ 61,151</td>
<td>59</td>
<td>.41</td>
</tr>
<tr>
<td>1970</td>
<td>94,424</td>
<td>56.4</td>
<td>.436</td>
</tr>
<tr>
<td>1980</td>
<td>192,670</td>
<td>64</td>
<td>.36</td>
</tr>
<tr>
<td>1985</td>
<td>250,000</td>
<td>50</td>
<td>.50</td>
</tr>
<tr>
<td>1988</td>
<td>267,536</td>
<td>28</td>
<td>.72</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1955</td>
<td>$ 244,604</td>
<td>87</td>
<td>.13</td>
</tr>
<tr>
<td>1970</td>
<td>377,698</td>
<td>71.8</td>
<td>.282</td>
</tr>
<tr>
<td>1980</td>
<td>770,683</td>
<td>70</td>
<td>.30</td>
</tr>
<tr>
<td>1985</td>
<td>1,000,000</td>
<td>50</td>
<td>.50</td>
</tr>
<tr>
<td>1988</td>
<td>1,070,144</td>
<td>28</td>
<td>.72</td>
</tr>
</tbody>
</table>

Note: GNP price deflator used to convert incomes into current dollars. With 1985 = 111.2, the 1988 index was assumed to be 119.

(a) For each gross income, taxable income was estimated by multiplying the ratio of taxable income to adjusted gross income (AGI) for the corresponding AGI class in that year by the gross income figure. Using that taxable income, marginal tax rates were taken from the tax table for joint returns. The rates for 1970 reflect a 2.5 percent surtax for that year.

(b) See Table 1 supra note 56. The price of giving stock assumes: P = 1 - m - .5mg, where mg is the marginal tax rate on capital gains. For 1955 and 1970, mg = .5m, with a maximum of .25; for 1980 and 1985, mg = .4m, with a maximum of .20; for 1988 mg =
income of $250,000 in constant 1985 dollars in each of five different years between 1955 and 1988. The table shows, first, the degree to which marginal tax rates have varied over this period and how this variation is reflected in the net cost of contributions. The net cost of giving cash for a couple at this income level varied by a factor of two: from 0.36 in 1980 to 0.72 in 1988. The net cost of giving away an asset with a 50 percent gain-to-value ratio varied even more: from 0.26 in 1980 to 0.58 in 1988. For a couple with an income of $1 million in 1985 dollars, the differences are even greater. In the case of gifts of appreciated property, the net cost varied from 0.005 in 1955 to 0.55 in 1988. These figures serve as further evidence of the dramatic variability of the tax code's subsidy for charitable giving. They also show how inexpensive it can be to make gifts of appreciated property.

One clear effect of this pattern of tax subsidies, notwithstanding its tremendous variability, is to encourage gifts of appreciated assets as opposed to cash.118 Gifts of appreciated assets, however, often place effective limits on their disposition by donee organizations. Some appreciated assets, such as real estate or closely-held corporations, are not readily marketable, leaving the donee organization to choose between holding it or disposing of it at a price significantly below its long-term value. Furthermore, where the donor retains part ownership or an active role in the management of such assets, there exists a continuing relationship between donor and donee beyond that which might otherwise exist for a gift of cash. Other assets, such as works of art or depreciable assets, are eligible for the maximum tax deduction only if the donee organization can use the asset.119 Thus, a donor can take full advantage of the tax provisions for giving a painting to a nonprofit organization only if the organization holds onto it rather than selling it immediately. This rule creates an obvious advantage for universities that maintain art museums — they are able to use works of

m. Couple is assumed not to be subject to the Alternative Minimum Tax.

118. Auten & Rudney, Comment on Donations of Appreciated Property, 34 Tax Notes 71, 71 (Jan. 5, 1987). See also Lindsey, Gifts of Appreciated Property: More to Consider, 34 Tax Notes 67, 69 (Jan. 5, 1987)(the 13,400 donors who made gifts of appreciated property over $50,000 in value represented 0.2 percent of all donors of appreciated property, but their gifts represented 38 percent of all appreciated gifts).

119. I.R.C. § 170(e)(1)(B)(i) (1986)(in the case of donation of "unrelated property" the maximum deduction is reduced by the amount the donor would have recognized as long term capital gain had he instead sold the property); see also Treas. Reg. § 1.170A-4(b)(3) (as amended in 1988).
art. The special advantage accorded to noncash giving may thus have real effects on the range of activities carried out by nonprofit organizations.

An analogous effect may be seen in the deduction under the corporate income tax for articles of inventory. Manufacturers who hold obsolete or otherwise unmarketable products may recover some of their costs if they are able to donate these products to a 501(c)(3) organization. This tax advantage has spawned a market in obsolete products which are catalogued and warehoused for possible use as in-kind donations. While such markets serve to link donors and donees who would otherwise not find each other, the generosity of the tax deduction may result in nonprofits' accepting products that are of marginal value to them.

Probably the most important tax rules affecting the form of contributions, however, are those relating to the establishment and operation of private foundations. Although the 1969 Tax Act limited the advantages of setting up private foundations, the American tax law has for many years offered wealthy individuals a unique opportunity to "do good" while maintaining some measure of control, both during life and after death. This organizational form was made more attractive by the favorable treatment of gifts of appreciated assets (constituting the basis for the great bulk of foundations) and the degree of control afforded by the foundation form. Foundations have indeed made a discernible impact and the tax law is a major contributor to their importance.

D. Regional Effects

Charitable giving varies with geographic region, and this creates regional patterns of activity in the nonprofit sector. Since most contributions are directed to institutions geographically close to the donor, there are regional patterns of growth in the voluntary sector which track the movement of population and income. A dramatic illustration of these trends is presented in Table 4, which gives the regional distribution of foundations, by net assets,

120. I.R.C. § 170(e)(3)(A) (1986)(no deduction unless the donee uses the donated articles of inventory in a manner related to its charitable purpose).
121. Id.
123. C. CLOTFELTER, supra note 2, at 261-64.
124. C. CLOTFELTER, supra note 2, at 264.
from 1934 to 1983. As regions outside the traditional Northeastern financial centers grew in importance, so too did their shares of foundation assets. Over the five-decade period reflected in Table 4 the proportion of foundation net assets in New York declined from 74 to 27 percent, while the combined proportion for

Table 4
Distribution of Foundation Net Assets by Region, Selected Years (Percent)

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>New York</td>
<td>74.3</td>
<td>52.4</td>
<td>55.8</td>
<td>63.8</td>
<td>36.8</td>
<td>27.1</td>
</tr>
<tr>
<td>Other Middle Atlantic</td>
<td>5.1</td>
<td>9.5</td>
<td>8.9</td>
<td>6.1</td>
<td>14.0</td>
<td>12.4</td>
</tr>
<tr>
<td>East North Central</td>
<td>10.9</td>
<td>20.4</td>
<td>14.1</td>
<td>12.2</td>
<td>19.3</td>
<td>18.7</td>
</tr>
<tr>
<td>Pacific</td>
<td>0.3</td>
<td>0.9</td>
<td>2.6</td>
<td>2.0</td>
<td>5.4</td>
<td>12.2</td>
</tr>
<tr>
<td>West South Central</td>
<td>0.6</td>
<td>3.6</td>
<td>3.2</td>
<td>3.6</td>
<td>4.5</td>
<td>5.4</td>
</tr>
<tr>
<td>South Atlantic</td>
<td>7.2</td>
<td>6.0</td>
<td>7.2</td>
<td>4.8</td>
<td>7.6</td>
<td>7.8</td>
</tr>
<tr>
<td>West North Central</td>
<td>1.3</td>
<td>3.1</td>
<td>3.4</td>
<td>2.8</td>
<td>4.0</td>
<td>3.9</td>
</tr>
<tr>
<td>New England</td>
<td>0.2</td>
<td>1.2</td>
<td>1.1</td>
<td>1.2</td>
<td>1.3</td>
<td>1.4</td>
</tr>
<tr>
<td>Mountain</td>
<td>0.2</td>
<td>1.2</td>
<td>1.1</td>
<td>1.2</td>
<td>1.3</td>
<td>1.4</td>
</tr>
<tr>
<td>East South Central</td>
<td>0.2</td>
<td>1.2</td>
<td>1.1</td>
<td>1.2</td>
<td>1.3</td>
<td>1.4</td>
</tr>
</tbody>
</table>

TOTAL | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Note: Regions are defined as Other Middle Atlantic: New Jersey and Pennsylvania; East North Central: Ohio, Indiana, Illinois, Michigan, and Wisconsin; Pacific: Washington, Oregon, California, Alaska, and Hawaii; West South Central: Arkansas, Louisiana, Oklahoma, and Texas; South Atlantic: Delaware, Maryland, District of Columbia, Virginia, West Virginia, North Carolina, South Carolina, Georgia, and Florida; West North Central: Minnesota, Iowa, Missouri, North Dakota, South Dakota, Nebraska, and Kansas; New England: Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, and Connecticut; Mountain: Montana, Idaho, Wyoming, Colorado, New Mexico, Arizona, Utah, and Nevada; East South Central: Kentucky, Tennessee, Alabama, and Mississippi.

the Pacific and West South Central states, dominated by California and Texas, grew from less than 1 percent to 22 percent.

The focus now shifts to the role of tax policy on these changes. Undoubtedly, these regional effects would still be present in the absence of taxation. Yet, it appears that tax policy played a role as well and that its impact was unintended. Government subsidizes charitable contributions for itemizing taxpayers only. This allows the deduction for state and local taxes to impart an unmistakable regional spin. States with particularly high taxes tend to have more itemizers than other states. This results in higher federal tax subsidies for contributors who reside in these higher tax states. Although this bias has little effect on the formation of foundations, since almost anyone setting up a foundation is likely to be an itemizer in the top federal bracket, it might well have a small impact on the overall pattern of contributions. For example, the average (income-weighted) subsidy rate for taxpayers in Michigan in 1983 was 0.21, compared to 0.12 in Maine. Of this 9 percentage point difference, 2 points were attributed to the existence of the state and local tax deduction, which caused Michigan to have more itemizing taxpayers than would otherwise be justified on the basis of other deductible expenditures. Unconsciously, Congress through the individual income tax, gives an edge to nonprofits from high-tax states.

E. Allocation of Capital

The tax laws also affect the allocation between economic sectors and within the nonprofit sector itself. Certainly one issue involved in the current debate over "unrelated business income" is the competitiveness of for-profit firms which sell products also produced by nonprofit organizations. Leaving to one side issues of fairness, the current tax treatment of allowing nonprofits to sell tax-free as long as it is within the general scope of its tax exempt function appears to result in nonprofits obtaining larger shares in certain markets than they would if they paid taxes on these activi-
ties.\textsuperscript{131} This is probably negligible in most markets, but it could well have a discernible impact on others — for instance, textbooks and personal computers. If nonprofit managers are more prone to managerial inefficiencies ("x-inefficiency"),\textsuperscript{132} then the overall efficiency of some markets may be impaired due to the current tax treatment.

Distortions in the allocation of capital within sectors may also be observed. Accelerated depreciation and other capital subsidies work in the for-profit sector to increase the capital-labor ratio. Nonprofit firms are not subject to the corporation income tax,\textsuperscript{133} however, and such an effect is not present. The overall effect of this aspect of tax policy, then, is to make the for-profit sector relatively more capital-intensive than the nonprofit sector. There is little empirical work, however, which indicates the magnitude of these effects. These questions, for now, must await future study.

F. Segregation

As discussed above, one important class of nonprofit institutions, the mutual benefit organizations, include private clubs.\textsuperscript{134} Mutual benefit organizations rarely receive the benefit of the charitable deduction, but they are generally tax-exempt.\textsuperscript{135} In the case of private clubs, this tax exemption may be questioned on the basis that the organizations' aims or behavior are inconsistent with more broadly-defined public policy. Rather than being a distortion between alternative activities, tax exemption in this case would be questioned as being an unjustified subsidy, the purpose of subsidies being to encourage activities with beneficial externalities. By their nature, some if not most private clubs tend to increase economic and racial segregation in society by bringing together similar individuals. When our tax laws treat these

\begin{itemize}
  \item 132. Hansmann, supra note 131, at 380. For the definitive treatment of x-efficiency, see Leibenstein, Allocative Efficiency Versus X-Efficiency, 56 Am. Econ. Rev. 392 (1966).
  \item 133. I.R.C. § 501 (1986).
  \item 134. See supra notes 27-31 and accompanying text.
  \item 135. I.R.C. § 501(a) & (c)(7) (1986) (private clubs "organized for pleasure, recreation, and other nonprofitable purposes" are tax exempt).
\end{itemize}
organizations favorably, the cost of the resulting segregation is reduced and its extent presumably expanded. The same type of analysis applies for communities where clubs are taxed at reduced rates. Unfortunately, there is little empirical evidence to suggest that differences in tax treatment affect the extent of racial or economic segregation in a community. These questions invite further research.

**CONCLUSION**

It is useful to conclude by considering the implications of the various tax-induced distortions in the voluntary sector. Despite the existence of these distortions, there is little justification for dismantling the major tax provisions which sustain the nonprofit sector — tax exemption and the charitable deduction — because these provisions are supported by the most fundamental models of welfare economics. Where activities produce external benefits that reach beyond the actors who engage in the activity, there is justification for a subsidy. The justification is based on efficiency, arising out of a concern that society might not otherwise devote sufficient time and money to such activities.\(^{136}\) The tax system nevertheless creates distortions between alternative activities within the voluntary sector and these distortions bear little relationship to the degree that the activities benefit society.

Probably the most important distortion is between those who itemize their income taxes and those who do not. Virtually any change in the income tax that affects the number of people who itemize will have an impact on the severity of this distortion. In addition, proposals specifically aimed at limiting the revenue impact of itemized deductions in general or the charitable deduction in particular would have an effect.\(^{137}\) In recent years, proposals have been made to place floors under deductions, separately or in total. Floors of either type would tend to reduce the number of taxpayers who receive a subsidy for their contributions. On the other hand, proposals to enhance the current charitable deduction, by doubling the value of the deduction, re-extending the deduction to nonitemizers, or offering an alternative tax credit — however

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136. See supra notes 19 & 45 and accompanying text.

137. C. CLOTFELTER, supra note 2, at 25 ("Besides the general tax-exempt status of nonprofit organizations itself, the income tax deduction is probably the most important single tax policy affecting the vitality of the nonprofit sector in the United States.); see also id. at 276-79.
unlikely politically — would tend to reduce the current distortion among taxpayers. Perhaps the most direct method of alleviating this distortion is to replace the deduction with a tax credit available to all taxpayers.\textsuperscript{138} Apparently, one problem with any subsidy for charitable contributions, and especially one for current nonitemizers, is compliance. There appears to be a deep suspicion in the halls of the Internal Revenue Service that many taxpayers succumb to the temptation to overstate their contributions. A floor is seen as an easy way to limit enforcement costs as well as the revenue losses from any extension of the subsidy.

Another active area of debate concerns the current controversy over "unfair competition" and the taxation of commercial income of nonprofits.\textsuperscript{139} This Article analyses this question in terms of resource allocation, not fairness. From this perspective, tax treatment may well have allocative effects, but the extent of these effects is another question. At one extreme in the current debate are proposals to tax the investment income of nonprofits.\textsuperscript{140} As it demonstrated with the introduction of new taxes and restrictions on foundations in 1969,\textsuperscript{141} Congress can certainly increase the overall tax burden on the nonprofit sector through a combination of taxes and new requirements. One implication of this current analysis is that the impact of these proposals on the allocation of resources in the voluntary sector deserves far closer scrutiny.

\textsuperscript{138} Id. at 101-04 & 277.
\textsuperscript{139} See supra notes 7, 44 & 71 and accompanying text.
\textsuperscript{140} Bennett & Rudney, supra note 7, at 1095-96.
\textsuperscript{141} See supra note 123 and accompanying text.