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A Failure of Philanthropy
American charity shortchanges the poor, and public policy is partly to blame

By Rob Reich

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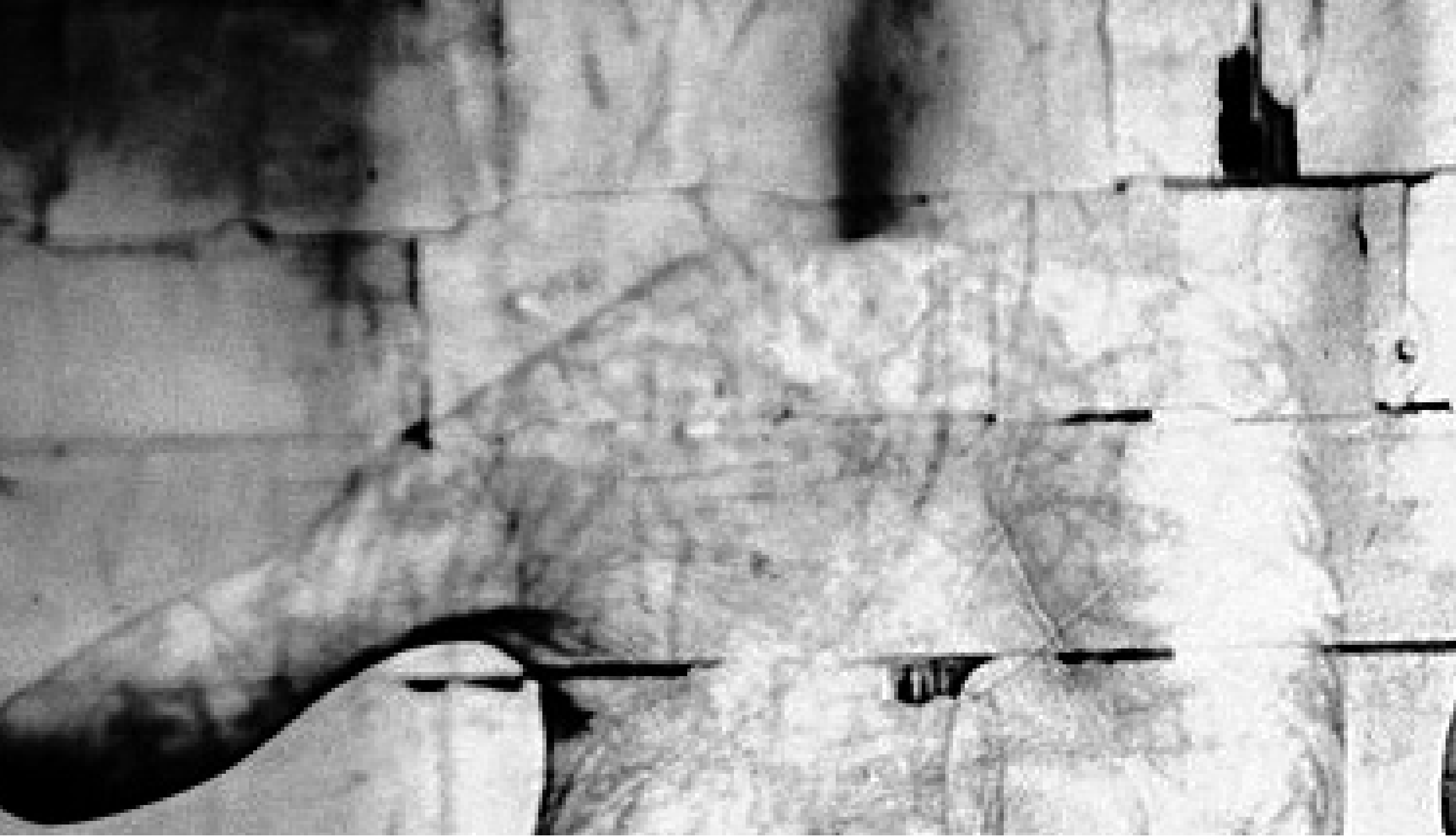

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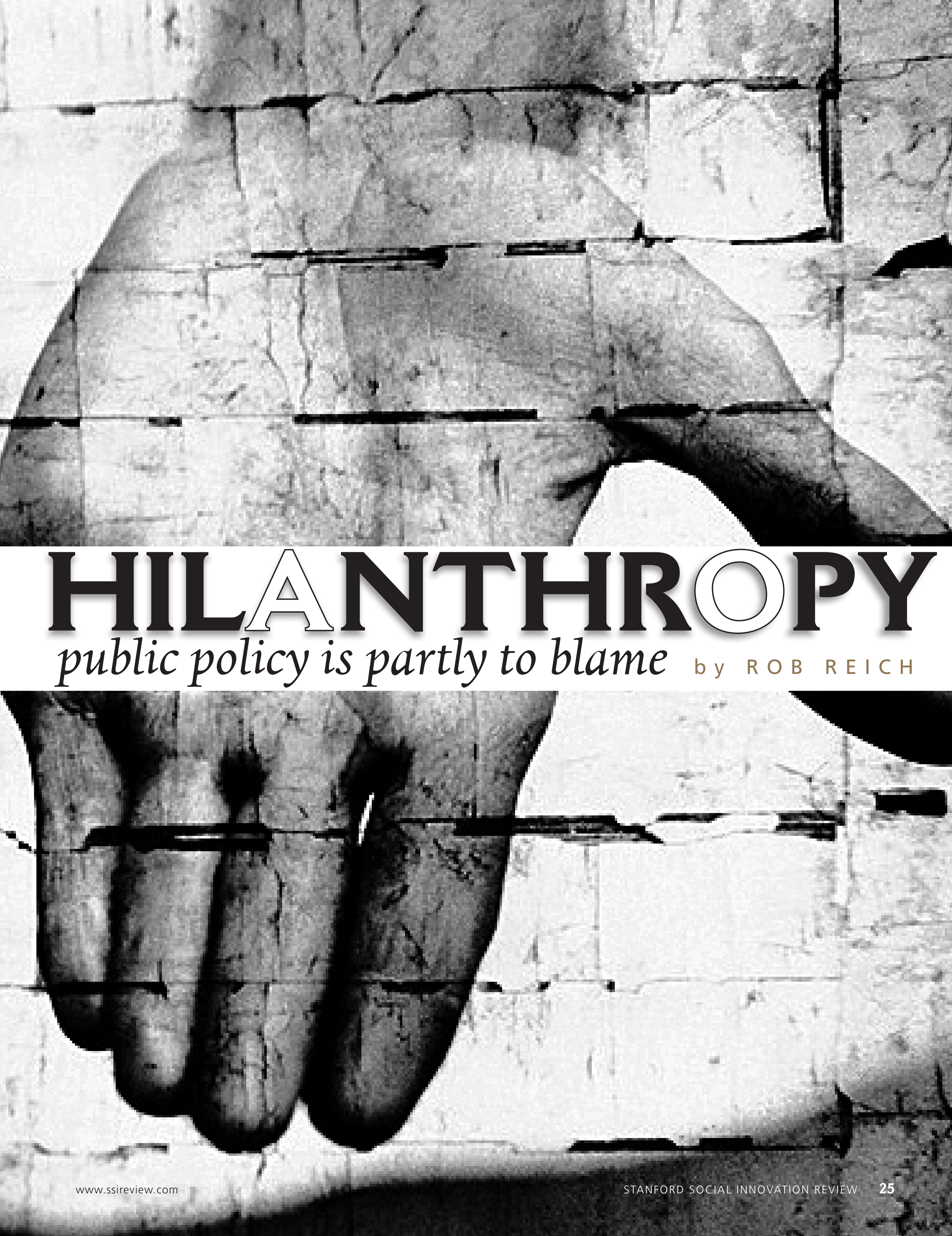

HILANTHROPY

public policy is partly to blame

by ROB REICH

The Woodside School Foundation in Woodside, Calif., is a fantastically successful local education foundation (LEF). Since 1983, it has been raising money for the Woodside School District, which is made up of a single public elementary school that enrolls fewer than 500 students. Between 1998 and 2003, the last year for which data are available, the foundation collected more than $10 million, adding several thousand dollars per student per year to public funds for the school. Woodside Elementary uses that money for programs in music, art, physical education, and technology, says Superintendent Dr. Daniel A. Vinson. The school has won the top rating on California's Academic Performance Index (API) for the past six years.

Less than 10 miles away in East Palo Alto is the Ravenswood City School District. Ravenswood does not have its own school foundation, although it could use more funding. The district, which serves 4,500 students in grades K-8, regularly struggles to provide such basics as textbooks, classroom supplies, and building maintenance, says interim Superintendent Maria de la Cruz. Families are not in a position to help, since 94 percent of Ravenswood students currently qualify for free or reduced lunches, as compared to fewer than 10 percent in Woodside. (Median household income in East Palo Alto was $45,000 in 2000, as compared to $171,000 in Woodside.) Ravenswood schools are among the lowest performing in the Bay Area, with half of them earning the lowest rating on California's API.

It's not surprising that wealthy school districts like Woodside can raise substantially more money for their students than can poor school districts like Ravenswood. Across California, for example, LEFs in wealthy suburban school districts generate vastly more charitable dollars per pupil than do LEFs in poorer urban school districts. (See graph, p. 27.) And who could fault wealthy parents and townspeople for wanting to do best by their children and local institutions? That their efforts may widen the gap between their own children and children growing up in more disadvantaged districts is an unfortunate, yet unintended, side effect of their generosity.

What is surprising is that public policies governing philanthropy encourage and reward this gap-widening. Laws grant the Woodside School Foundation's status as a 501(c)(3), and laws allow donors to deduct their contributions to the foundation from their income. These deductions constitute a kind of federal subsidy for charitable giving – a subsidy that is greater for wealthier people than for poorer people.[1] The effect of these unequal subsidies is to increase inequalities between the rich and the poor, not only in education, but also in other domains of charitable giving.

With funding from a private foundation, Woodside, Calif.'s, public elementary school can offer its students instruction on both Macs and IBMs.

PHOTOGRAPHS BY PETER STEMBER

If public policies governing philanthropy, such as tax subsidies, are indeed worsening social inequalities, then American philanthropy is failing. For isn't charity supposed to remedy inequalities by assisting the poor and disadvantaged?

Why Give?

Of course, there are many reasons to support the philanthropic and nonprofit sector other than helping the poor and disadvantaged. A robust sector can decentralize the production of public goods, so that the government does not solely decide how to spend tax dollars. It can support those institutions in civil society that mediate between individuals and the state. And it can produce public goods that are more sensitive to local demand and delivered with greater efficiency than would governmental institutions.

Yet a primary motivation for charity has always been to provide for the poor and disadvantaged, and to attack the root causes of poverty and disadvantage. Certainly this is true of the world's traditions of charity – think of almsgiving in var-

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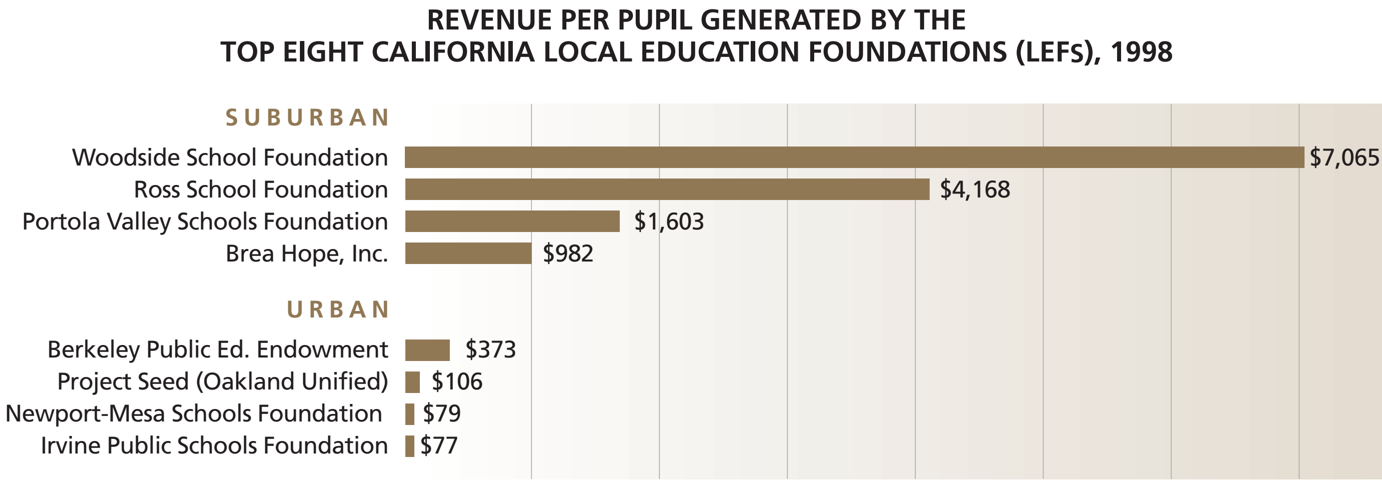


–*Rob Reich*

ious religious traditions. One of the world's first laws concerning philanthropy, the Charitable Uses Act of 1601 in Elizabethan England, also strongly connected philanthropy with relief for the poor.

Today, philanthropy continues to imply, at least to most people, some kind of charity, where "charity" is defined as "the kindly and sympathetic disposition to aid the needy or suffering" and "an act or series of acts of aid to the needy."[2] Beyond simple definitions, the connections between philanthropy, charity, and helping the needy can be seen in the "thousand points of light" arguments, which favor the nonprofit sector over the welfare state as the purveyor of social services.

Given charity's historical roots, dictionary meaning, and conventional usage, state policies governing the philanthropic and charitable sector would seem to be obliged to help the needy. At the very least, the state's generous incentives for charitable giving and philanthropic aid should not hurt the needy, as they do in the case of local education foundations. It is one thing to defend the liberty of individuals to give their money away as they please; it is quite another to provide public subsidies for it.

Most Ravenswood (Calif.) schools lack science labs, gyms, and enough desks and overhead projectors. None has bells, clocks, or a PA system.

Tax Policies Encourage and Reward Giving

Though philanthropy may be as old as humanity itself, in modern society it is firmly embedded within the political institutions of the state. Laws govern the creation of nonprofit organizations and spell out the rules under which they operate. In the United States, laws not only confer upon nonprofit 501(c)(3) organizations the privilege of not paying taxes on income, they also grant tax deductions to those who make donations to 501(c)(3)s.[3] Put simply, public policies shape – through regulations and incentives – philanthropic behavior.

The abstract language of the tax code makes it hard to appreciate how much the state subsidizes charitable contributions. To get a better picture, consider the example of a wealthy woman

ISN'T CHARITY SUPPOSED TO REMEDY INEQUALITIES *by assisting the poor and disadvantaged?*

who made a $1,000 donation to her city's modern art museum. Because of her affluence, this woman occupies the top tax bracket – in 2004, her income was subject to a 35 percent tax. The deduction, however, permitted her to subtract her donation from her income, which meant that she paid less tax than if she had not deducted the donation. Since the money she saved by making the donation was $350 (that is, 35 percent of the $1,000 she could deduct), her donation actually "cost" her only $650.[4] The federal government effectively chipped in the other $350. Likewise, going back to the example of the Woodside School Foundation, because most Woodside households are easily in the top tax bracket, the federal government paid approximately $3.5 million of the roughly $10 million in donations collected between 1998 and 2003.

If the federal government had not allowed the woman to deduct the $1,000 donation from her income, it would have collected an additional $350 in tax revenue. And if it had not allowed the Woodside School Foundation's donors to deduct their contributions, it would have collected an additional $3.5 million.

Instead, the state gave up this revenue. And so tax incentives for philanthropy are a kind of spending program, or "tax expenditure."[5] Just as a direct spending program – defense spending, for example – has an effect on the annual budget of the United States, so too does a tax deduction affect the national budget. In fact, the fiscal effects of direct spending programs and tax expenditures are exactly the same.[6] Seen in this light, tax incentives for philanthropy amount to state subsidies for the individuals and corporations who make charitable donations.

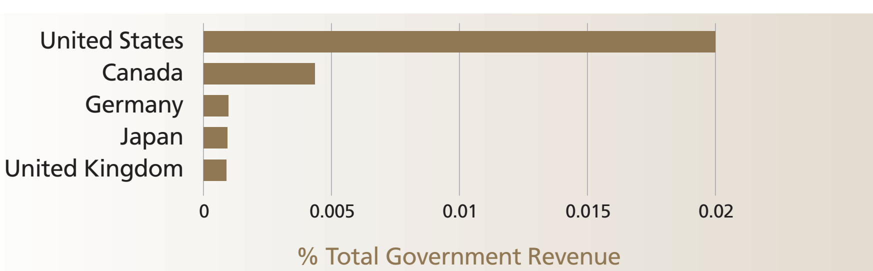
Those subsidies add up. As economist Charles Clotfelter writes, the U.S. has "the world's most generous tax concessions" for philanthropy.[7] Economist Burton Weisbrod similarly notes that "no other nation grants subsidies at such a high level or across so many types of activities."[8] (See chart, left.)

Evelyn Brody, a legal scholar, estimates that in 2000 the charitable deduction alone cost the U.S. Treasury nearly $26 billion in forgone income tax.[9] That amount is expected to jump to $36 billion in 2005, according to the 2005 U.S. federal budget. By way of comparison, the U.S. government spends more on subsidizing charitable contributions than it does on TANF (Temporary Assistance for Needy Families, the successor to Aid to Families With Dependent Children), one of our nation's largest welfare programs, which received $25.4 billion in 2002. Moreover, the charitable contributions deduction is the fourth largest (out of 130) tax expenditure given to individuals, after deductions for mortgage interest, contributions to 401(k) plans, and state and local taxes.

Not All 501(c)(3)s Are Created Equal

Donors receive these massive tax subsidies only for their contributions to 501(c)(3)s. And so one place for our public policies to encourage helping the poor through philanthropy would be in selectively granting 501(c)(3) status. Yet the way our government confers that status seems remarkably indifferent to aiding the poor.

TAX INCENTIVES* FOR INDIVIDUAL GIVING IN FIVE COUNTRIES



**As percentage of total government revenue (i.e., lost revenue supporting nonprofits / [total government revenue + lost revenue from tax expenditures supporting nonprofits]). Data do not include revenue lost from tax exemptions.*

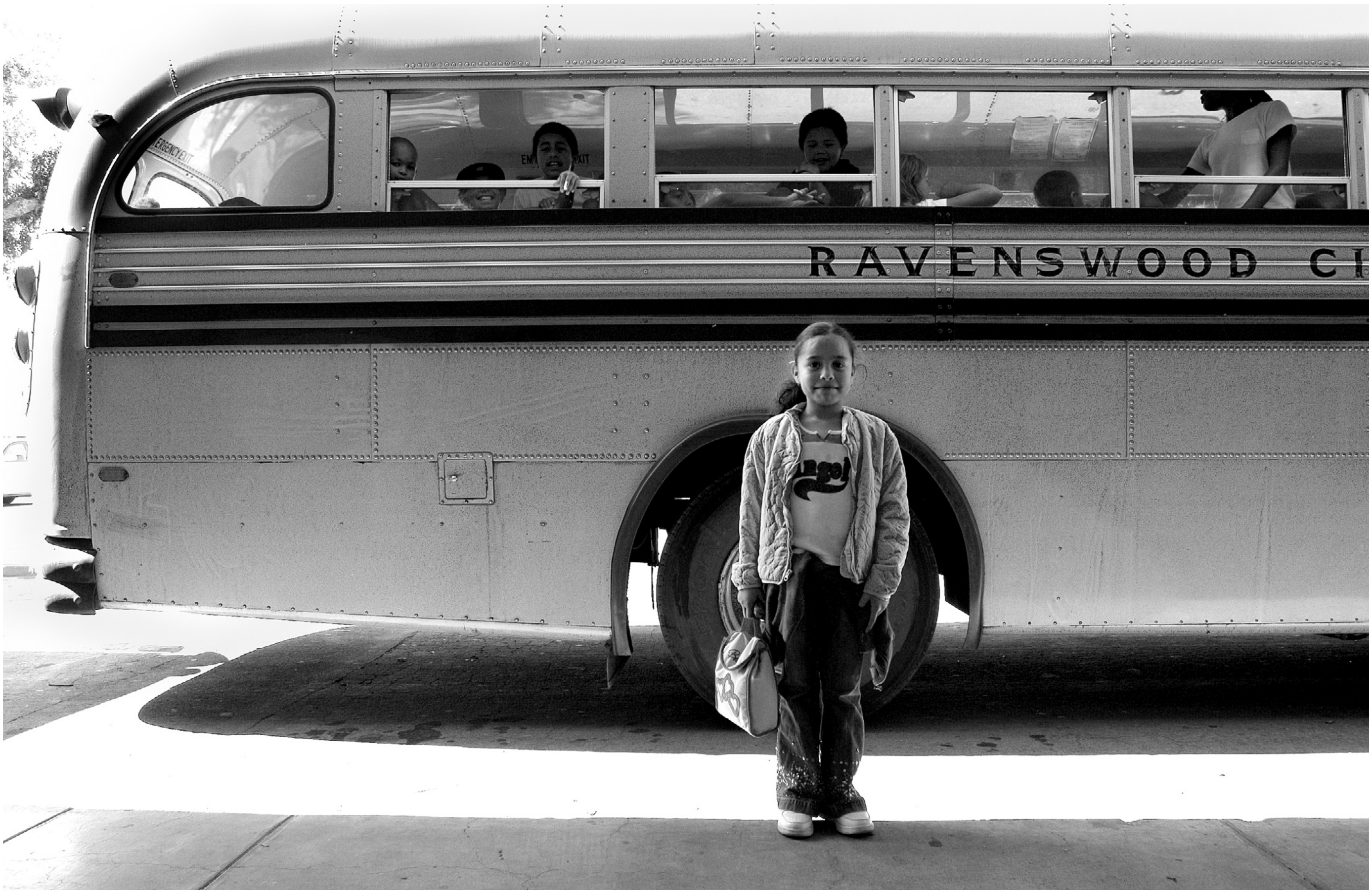
SOURCES:
U.S.: Joint Committee on Taxation (2002). "Estimates of Federal Tax Expenditures for Fiscal Years 2002-2006." Washington, D.C.: U.S. Government Printing Office.

Canada (for 2002): "Tax Expenditures and Evaluations." Retrieved Sept. 1, 2005, from Canada's Department of Finance Web site: http://www.fin.gc.ca/toce/2004/taxexp04_e.html.

Germany (for 2003): Personal communication with Michael Ernst-Pörksen, of C.O.X., a German tax consulting company and trust company, who in turn consulted Germany's "19th Subsidies Report of the Federal Government."

Japan (for 2003): Personal communication with Tatsuo Ohta, president and CEO of the Japan Association of Charitable Organizations, who in turn consulted Japan's National Tax Agency (NTA).

UK (for 2003): "Charitable Donations and Tax Reliefs." Retrieved Sept. 1, 2005, from HM Revenue and Customs Web site: http://www.hmrc.gov.uk/stats/charities/menu.htm.



To qualify as a 501(c)(3), an organization must serve some public good, such as religious, charitable, scientific, public safety, literary, or educational purposes. As a result, the 501(c)(3) sector includes a broad rainbow of organizations – churches, social service agencies, foundations, institutions of higher learning, arts organizations, think tanks, neighborhood associations, and hospitals, to name a few.

From the perspective of the state, the benefits produced by a nonprofit puppet theater are as valuable as those produced by a soup kitchen. Indeed, one of the most familiar criticisms of U.S. policy is that its tax subsidies fail to differentiate between the public benefits produced by various nonprofits. For example, assuming that we are in the same tax bracket, your $1,000 donation to baldness research is worth exactly the same as my $1,000 donation to Pakistani earthquake relief. U.S. tax policy encourages us equally to give to these two causes, because we will receive the same rewards in the form of tax subsidies.

Who Gets Americans' Charitable Dollars?

Perhaps because American policies governing philanthropy are indifferent toward helping the poor, American individuals and institutions likewise fail to funnel their money to those in need. Charitable and philanthropic giving in the United States comes from four sources: living individuals, individual bequests, corporations, and foundations. Of the $248.52 billion given in 2004, an impressive 76 percent came from liv-

(top) A Ravenswood student boards her bus in East Palo Alto, Calif. (bottom) A local education foundation funds Woodside Elementary School's physical education program. Compared to Woodside, Ravenswood has a very limited PE program.

ing individuals. Within this lion's share of the giving, the majority goes to religion (see pie chart, below) – as it has for more than 20 years, says Melissa Brown, managing editor of *Giving USA*.[10] These donations are not going to religious schools or to faith-based social services, whose funding has been sectioned off and assigned to the appropriate categories of education and human services.

Instead, the largest piece of America's charitable pie is going to the sustenance of religious groups – for their facilities, their operating costs, and their clergy salaries.[11] In this sense, religious groups look less like public charities and more like mutual benefit societies (i.e., other nonprofit organizations whose supporters are not entitled to tax deductions for their donations).

Some observers, like sociologist Robert Wuthnow, argue that at least some of this religious giving should be understood as assisting the needy. But Wuthnow, who writes admiringly of faith-based social services, nevertheless observes that "the amount spent on local service activities is a relatively small proportion of total giving, probably on the order of 5 percent."[12]

Others argue that charitable contributions to religion are redistributive in the sense that wealthier congregants support the spiritual activity of poorer congregants.[13] This function is by no means irrelevant, but it does depart from usual understandings of the richer helping the poorer. Overall, then, private giving to religion does not seem to redistribute wealth in any significant way.

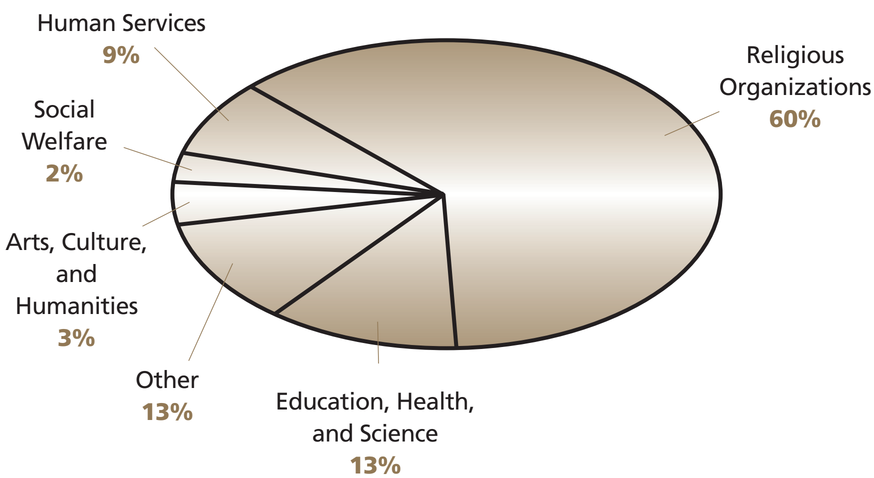
Even if we ignore religion – an elephant in the room of charitable giving – the remainder of Americans' contributions likewise seem not to serve the less fortunate. Social welfare groups receive only 2 percent of charitable dollars and human services only 9 percent. A larger amount goes to education, health, and science (13 percent), which is potentially redistributive but not obviously so. If we look simply at the distribution of individuals' charitable donations, the bulk does not seem to flow from haves to have-nots. Clotfelter similarly concludes that "relatively few nonprofit institutions serve the poor as a primary clientele."[14]

Private foundations likewise do not seem to be redistributing wealth. Foundations account for only 11.6 percent of the charitable universe in dollars given in 2004.[15] Although foundation dollars are certainly distributed more evenly across grant categories than are individual charitable contributions (see pie chart, p. 31), the grant categories do not reveal whether the donations are redistributive or not. Take the education category: Almost half of foundation dollars to education go toward higher education. But we have no way of knowing if these dollars are funding boutique centers for research, the endowment of a professorial chair, or scholarships for disadvantaged and poor students. The other grant categories are similarly opaque when it comes to revealing whether their funds are going to help the less fortunate.

Even if we were to conclude, as does Julian Wolpert, that foundations are at best "modestly redistributive,"[16] their effect would not tip the scale of the whole of charity to the side of redistribution because they are responsible for such a small share of giving in the United States.

Finally, for all forms of charitable giving – from individuals (living and dead), foundations, and corporations – the money given away is subsidized through tax concessions. Had the money not gone to charity, the IRS would have collected taxes on it. And so the question becomes: Do charitable donations flow more sharply downward than would government spending? In other words, does philanthropy do a better job of redistributing wealth than the state would if it had fully taxed the charitable donations in the first place? Answering this question is extremely difficult, but at least it is the

HOW INDIVIDUALS DISTRIBUTE THEIR CHARITABLE DOLLARS



Notes: "Religious Organizations" does not include giving to religious schools or faith-based social services; these dollars are tallied in education and human services, respectively.

"Other" includes giving to international aid and development, private and community foundations, recreation, and still other charities.

SOURCE: Independent Sector, "The New Nonprofit Almanac and Desk Reference" (2002).

Woodside's local education foundation funds the elementary school's art program (left), as well as its classes in instrumental and vocal music. But fewer than 10 miles away (right), Ravenswood schools offer neither art nor music classes.

right question, for this is the standard the sector must meet: It must be more redistributive than the state would have been. Given the evidence already presented, philanthropy does such a poor job of channeling money to the needy that it would not be difficult for government to do better.

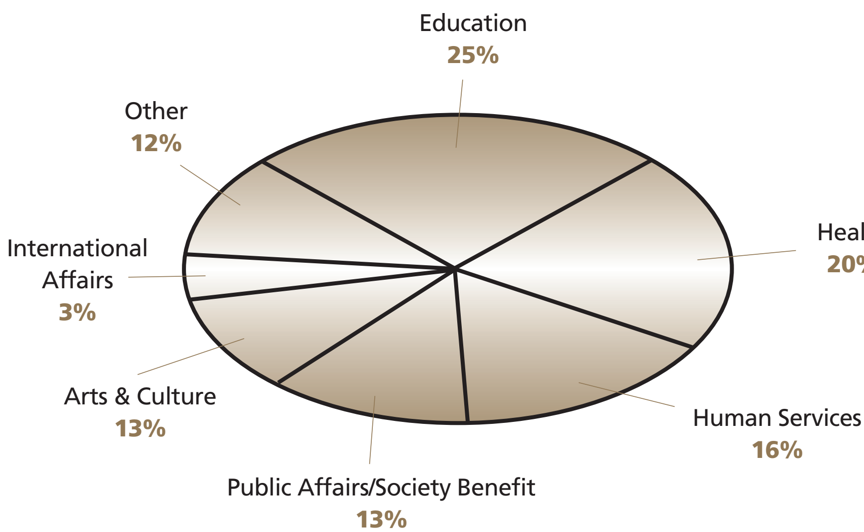
The Costs of Virtue Are Uneven

American tax policies regulating philanthropy promote inequality in two additional ways. First is the fact that a great many people are capriciously excluded from enjoying the charitable tax deduction simply because they do not itemize their deductions.[17] In 2000, for example, 89 percent of American households made a charitable contribution. Yet only 30 percent of them – the itemizers, who tend to be wealthier than those who take the so-called standard deduction – were rewarded for doing so. The remaining 70 percent of all taxpayers did not receive a tax subsidy for their charitable contributions.[18] To give a concrete example: A low-income renter who made a $500 donation to her church, but did not itemize her deductions, received no tax concession; a high-income homeowner who made the same $500 donation to the same church and itemized her deductions received a sizable tax subsidy.

One may argue that the standard deduction rewards the charitable contributions of nonitemizers. But nonitemizers receive the standard deduction whether they make a charitable contribution or not. And so the standard deduction cannot be properly viewed as a reward for charity – let alone an incentive – because one need not be charitable to get it. Likewise, if the tax deduction is meant to stimulate greater giving, its availability should not depend on whether people itemize their taxes.

A second way that public policies regulating philanthropy

HOW FOUNDATIONS DISTRIBUTE THEIR CHARITABLE DOLLARS



Notes: "Other" includes giving to religion, social sciences, science and technology, and the environment and animals.

Due to rounding, percentages total to 102 percent.

SOURCE: "Foundation Giving Trends, 2005."

PHILANTHROPY DOES SUCH A POOR JOB OF *channeling money to the needy that it would not be difficult for government to do better.*

may contribute to inequality is that the wealthiest people garner the largest tax advantages for philanthropy, and the poorest the smallest – what is known as an "upside-down effect." Because the amount of the charitable deduction is based on the percentage at which one is taxed, those in the highest tax bracket (35 percent in 2005) receive the largest deduction, and those in each lower tax bracket receive an increasingly smaller deduction. In other words, "the opportunity cost of virtue falls as one moves up the income scale," as two scholars wryly noted.[19]

As a result, 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 percent bracket costs the person less than the same donation to the same place by the person in the 10 percent bracket. Because the same social good is ostensibly produced in both cases, the differential treatment appears unjust. If anything, lower-income earners would seem to warrant the larger subsidy and incentive.[20]

Both of these features of the tax code benefit the well-off, either excluding nonitemizers (who tend to have less income than itemizers) from the benefit of a deduction, or giving poorer itemizers smaller subsidies for their donations. This is so because the tax code, as applied to charitable and philanthropic donors, arbitrarily discriminates between individuals on the basis of a characteristic – status as itemizers or tax bracket position – that is unrelated to the purpose of the tax incentive in the first place.

Would Americans Make Charitable Donations Without Tax Incentives?

Tax incentives may not be as vitally important to giving as researchers and policymakers originally thought. Classic studies on how changes in tax incentives impact donors' giving in the following year found rather substantial effects: A 50 percent increase in the price of a donation – that is, the amount of money donors give minus the amount they receive as income tax deductions – decreased donations by up to 125 percent.[1]

These short-term studies, however, failed to take into account the fact that donors often return to their original levels of giving once they get used to new tax laws. More recent studies that take a longer view find that tax incentives play a smaller role in motivating charitable donations, with a 50 percent increase in the price of donations decreasing charitable contributions over the next two to three years by as little as 25 percent.[2]

How much tax incentives matter also depends on who donors are. High-income donors seem to be more responsive to tax incentives than low-income donors. Economist Laura Tiehen, for example, reports that over 50 percent of donors with incomes over $100,000 cite tax incentives as a motivation to give, while only about 30 percent of donors with incomes under $50,000 cite tax incentives as a motivation to give.[3]

Some organizations are more affected by changes in the tax code than others. Charitable giving to educational institutions and hospitals is quite sensitive to policy changes, reports Martin Feldstein, a professor of economics at Harvard University.[4] He estimates that if income tax deductions for charitable contributions were eliminated altogether, contributions to educational institutions and hospitals would drop 40 percent to 65 percent. In contrast, religious organizations are minimally influenced by tax incentives. Feldstein speculates that eliminating tax deductions would reduce giving to them by only 7 percent to 13 percent. *–Rob Reich*

1 Boskin, M.J. & Feldstein, M. *Effects of the Charitable Deduction on Contributions by Low and Middle Income Households: Evidence From the National Survey of Philanthropy* (1978).
2 Barrett, K.S., McGuirk, A.M., & Steinberg, R. "Further Evidence on the Dynamic Impact of Taxes on Charitable Giving," *National Tax Journal* 50 (1997): 321-334.
3 Tiehen, L. "Tax Policy and Charitable Contributions of Money," *National Tax Journal* 54 (2001): 707-723. Retrieved Aug. 28, 2005, from http://ntj.tax.org/.
4 Feldstein, M. "The Income Tax and Charitable Contributions: Part II – The Impact on Religious, Educational, and Other Organizations," *National Tax Journal* 27 (1975): 209-226.

Should We Change Public Policy?

The philanthropic and nonprofit sector is often described as separate from the state – the "independent sector" or "third sector." And yet the public policies designed to support it represent a wide-scale, costly governmental intervention. As things currently stand, this intervention does not do much to enhance equality through helping out the less fortunate. And in some circumstances – such as local education foundations, like the Woodside School Foundation, which inadvertently augment the disparities between wealthy and poor school districts – our public policies reward individuals for creating inequalities. The state is therefore implicated in these philanthropic harms, unjustifiably.

Public policy can do better, and sometimes quite simply. For example, to equalize the tax benefits of giving for more and less affluent Americans, Congress could allow all donors – itemizers and nonitemizers alike – a tax credit that is linked to the amount donated, rather than a tax deduction that is linked to the donor's tax bracket. This fix would be of the greatest value to lower-income people, but would still provide a subsidy for all. Congress has at times debated this remedy, but it has never become law.

In order to channel charitable giving toward equality-enhancing organizations, Congress could give additional tax advantages for programs redressing poverty. In 2001, President Bush urged Congress to adopt such a measure – a targeted tax credit to individuals who make donations to organizations that spend 75 percent of their budget on direct services for the very poor. (Bush also suggested, unfortunately, taking money from TANF to offset the cost of the tax credit.) Alternatively, Congress could make subdivisions within the 501(c)(3) category – poverty-redressing organizations in one subdivision, others in another – with smaller incentives for giving to the latter. Furthermore, organizations that tend to worsen inequalities might be removed from the 501(c)(3) category altogether. People could still make donations to them, but they would not receive any public subsidy.

In the end, public policy changes are limited only by our creativity. And so when we think about philanthropy, we must not limit ourselves to justifying the current arrangement. Instead, we must aim to identify what role the state should play in the creation and operation of the philanthropic and charitable sector. Though pursuing greater equality is not the only aim of social policy, it is certainly one of the central aspirations of social justice. If the massive tax subsidies given to philanthropy do not enhance equality, then either the political regulation of philanthropy will have to change, or the justifications for state-supported philanthropy will have to lie elsewhere. It is very possible that justifications do lie elsewhere, but we should then stop kidding ourselves that charity and philanthropy do much to help the poor. □

1 As discussed later, tax deductions for charitable contributions are subsidized at the same rate at which a person would have been taxed, had he not made the donation. Since wealthier people are taxed at a higher rate than poorer people, their charitable contributions are also subsidized at a higher rate.
2 *Webster's Third New International Dictionary, Unabridged* (Merriam-Webster, 2002). Webster's also notes that the meaning of charity is rooted in Christian doctrine.
3 This latter provision is perhaps the most well known institutional incentive for charitable activity, and some version of it has existed since shortly after the creation of a federal income tax by the U.S. Congress in 1913.
4 Similar incentives exist for the creation of private and family foundations, and for contributions to community foundations.
5 The "tax expenditure" concept was pioneered by Stanley Surrey in the late 1960s, and it applied to every tax concession in the tax code. Surrey equated tax expenditures with direct spending programs in terms of their impact on the federal treasury. For a comprehensive overview, see Surrey S.S. & McDaniel, P.R. *Tax Expenditures* (Cambridge: Harvard University Press, 1985).
6 The idea that the charitable contribution deduction constitutes a tax expenditure is not without critics. Some scholars assert that a person's taxable income quite legitimately ought not to include donations to charity. This view is to me, however, rather implausible, given that so much of charitable giving looks like some form of consumption.
7 Clotfelter, C. "Tax-Induced Distortions in the Voluntary Sector," *Case Western Law Review* 39 (1988/1989): 663-694.
8 Weisbrod, B. "The Pitfalls of Profits," *Stanford Social Innovation Review* (Winter 2004): 45.
9 Brody, E. "Charities in Tax Reform: Threats to Subsidies Overt and Covert," *Tennessee Law Review* 66 (1999): 687-763.
10 Brown, M.S. (ed.) *Giving USA 2005: The Annual Report on Philanthropy for the Year 2004* (50th ed.) (New York: Giving USA Foundation, AAFRC Trust for Philanthropy, 2005).
11 See Brown, *Giving USA 2005: The Annual Report on Philanthropy for the Year 2004*.
12 Wuthnow, R. *Saving America? Faith-Based Social Services and the Future of Civil Society* (Princeton, NJ: Princeton University Press, 2004): 49.
13 Biddle, J.E. "Religious Organizations," in *Who Benefits From the Nonprofit Sector?* ed. C. Clotfelter (Chicago: University of Chicago Press, 1992): 92-133.
14 Clotfelter, *Who Benefits From the Nonprofit Sector?* (Chicago: University of Chicago Press, 1992): 22.
15 *Giving USA*, p. 79.
16 Wolpert, J. "Redistributional Effects of America's Private Foundations," in *The Legitimacy of Philanthropic Foundations*, eds. K. Prewitt, M. Dogan, S. Heydemann, & S. Toepler (New York: Russell Sage, forthcoming 2006).
17 Independent Sector, "Giving and Volunteering in the United States, 2001."
18 Calculated from the Internal Revenue Service, Statistics of Income Bulletin, Table 1 (Individual Income Tax Returns: Selected Income and Tax Items for Specified Tax Years, 1985-2002) (Fall 2004). Available at: http://www.irs.gov/pub/irs-soi/02in01si.xls.
19 Musgrave R.A. & Musgrave, P. *Public Finance in Theory and Practice, 4th Edition* (New York: McGraw-Hill, 1984): 348.
20 The upside-down phenomenon is not specific to the tax deduction for charitable donations, of course. Deductions in general overwhelmingly favor the wealthy. In 1999, 50 percent of all tax deductions were claimed by the wealthiest decile of earners.

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