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Too Close to Home: Limiting the Organizations Subsidized by the Charitable Deduction to Those in Economic Need

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TOO CLOSE TO HOME: LIMITING THE ORGANIZATIONS SUBSIDIZED BY THE CHARITABLE DEDUCTION TO THOSE IN ECONOMIC NEED

*Shannon Weeks McCormack**

The charitable deduction allows taxpayers to deduct amounts donated to organizations pursuing statutorily designated purposes from their otherwise taxable income. By lowering the after-tax cost of giving and encouraging taxpayers to donate more than they otherwise would, the charitable deduction subsidizes a broad variety of organizations. Some of these organizations provide widespread societal benefits, while others provide narrower benefits that remain closer to the taxpayer-donor's home. To evaluate these current laws, this Article focuses on efficiency criteria, which limit subsidized organizations to those with donor support that does not cover the costs needed to optimally provide goods and services. Existing scholarship has identified the conditions that cause these underfunding issues but has not sought to apply these concepts to determine whether the organizations subsidized through the charitable deduction are actually in economic need. This Article seeks to fill this gap. While one cannot precisely determine whether and to what extent any given organization or type of organization is underfunded, the general assessment of this Article provides a starting point for evaluating the scope of the deduction. This Article suggests that some organizations currently subsidized through the charitable deduction may be able to garner sufficient donations on their own and that the tax law may provide subsidies that are economically unnecessary.

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I. INTRODUCTION

On a normal morning, a regular mom might take her daughter to her neighborhood school. Walking inside, she may make small talk with other parents and plan “play dates” and “car pools” for the week. Later, she may pick up her daughter and stroll to the nearby park where she sees the familiar faces of other parents and children with the same routine. Maybe on her way home she chooses a different route that passes her family’s church. Through the beautiful stained glass windows, she hears the sound of the pastor’s voice—a voice she also hears every Sunday at the services she attends with her family. She feels grateful for all of these places that play an important role in her life and in the lives of her family, friends, and neighbors. In fact, she makes it a point to donate to each of these organizations—her daughter’s school, her church, and the fund for neighborhood park upkeep—just like many other members of her community. She also makes it a point to deduct these contributed amounts from her taxable income each year, which the tax law fully allows.¹

1. Individuals may deduct amounts that they contribute to organizations formed for certain purposes such as those “organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals.” I.R.C. § 170(a)(1), (c)(2)(B) (West 2010). The regulations explicate on the meaning of charitable as follows:

The term *charitable*[.] . . . in its generally accepted legal sense, . . . includes: [r]elief of the poor and distressed or of the underprivileged; advancement of

Today, the charitable deduction is a veritable mainstay of the tax law.² Individuals may deduct amounts contributed to organizations formed for a variety of broad, statutorily designated purposes, such as religious, charitable, or educational purposes.³ Thus, one may deduct amounts contributed to organizations which provide food to the needy, which seek to educate underprivileged children throughout the nation or around the globe, and which attempt to eradicate decay in underprivileged neighborhoods.⁴ A taxpayer may also deduct amounts contributed to her child's school,⁵ to the local parent teacher association serving that school,⁶ to the church where she regularly attends services and events,⁷ to her child's local sports team,⁸ to local boy or girl scouts troops,⁹ and to organizations that maintain or improve parks in her neighborhood.¹⁰ In this way, the tax law allows deductions for amounts contributed to organizations that provide far-reaching benefits and to those that provide benefits remaining rather close to the taxpayer's home. This Article uses efficiency criteria to evaluate these current laws and argues that allowing deductions in many of the latter situations may result in economically

religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; . . . [lessening] neighborhood tensions; [eliminating] prejudice and discrimination; [defending] human and civil rights secured by law; [and combating] community deterioration and juvenile delinquency.

Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 2008); *see also Search for Charities, Online Version of Publication 78*, IRS, <http://www.irs.gov/app/pub-78/> (last visited Apr. 1, 2011) (providing "a [searchable] list of organizations eligible to receive tax-deductible charitable contributions").

2. The charitable deduction has been a part of the Tax Code for almost a century. *See* Chauncey Belknap, *The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy*, in 4 RESEARCH PAPERS SPONSORED BY THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS 2025, 2026 (Dep't of the Treas. 1977) (providing a historical overview of the charitable contribution deduction); *see also* CHARLES T. CLOTFELTER, FEDERAL TAX POLICY AND CHARITABLE GIVING 11 (1985) (stating that government enacted the deduction for individual contributions to eligible organizations in 1917). *See generally* Ellen P. Aprill, *Churches, Politics, and the Charitable Contribution Deduction*, 42 B.C. L. REV. 843, 848-56 (2001) (discussing the legislative history of § 170); Vada Waters Lindsey, *The Charitable Contribution Deduction: A Historical Review and a Look to the Future*, 81 NEB. L. REV. 1056, 1061-70 (2003) (discussing the legislative history of § 170).

3. I.R.C. § 170(a)(1), (c)(2)(B).

4. Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 2008).

5. I.R.C. § 170(c)(2)(B).

6. *Search for Charities, Online Version of Publication 78*, *supra* note 1 (search "parent teacher").

7. I.R.C. § 170(c)(2)(B).

8. *Search for Charities, Online Version of Publication 78*, *supra* note 1 (search, for example, "baseball").

9. *Id.* (search "boy scouts").

10. *Id.* (search, for example, "playground").

unnecessary subsidies.

Part II introduces the basic principles of the charitable deduction, which increases the ability of qualifying organizations to raise capital by lowering the cost of giving.¹¹ Thus, the deduction acts as a mechanism to subsidize organizations¹² that citizen-taxpayers select when they donate money or property.¹³ Viewed this way, in order to properly limit the charitable deduction, it is critical to determine the sorts of organizations the government should subsidize.¹⁴

Part III summarizes the predominant theories used to justify the charitable deduction. While each theory provides important reasons for having some form of charitable deduction, none provides economic limitations on the deduction's scope. Part III suggests that efficiency criteria can serve this important limiting role by granting the deduction only when needed to ensure that goods and services are optimally funded.¹⁵ Application of these criteria would therefore prevent organizations from receiving subsidies when underfunding is not an issue.

To apply this "underfunding requirement," Part IV first develops the "optimal subsidization model" to determine when goods and services are optimally provided (i.e., not underfunded) and the "rational donor model" to determine whether and to what extent a "rational" donor will contribute to a particular donee-organization. Using these models, donee-organizations should not be underfunded when those directly benefitting from the goods and services provided are both economically rational and financially capable of contributing. Thus, the charitable deduction is

11. See *infra* Part II.

12. Exactly how much depends on the "elasticity" of the deduction—that is, how much giving increases in relation to the tax savings provided by the deduction. See CLOTFELTER, *supra* note 2, at 49–63 (summarizing studies and concluding that they suggest the price elasticity of charitable giving is at least one); Aprill, *supra* note 2, at 856–59 (explaining that changes in the after tax cost of making a charitable contribution are reflected in price elasticity); Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1396–1406 (1988) (specifying how price elasticity might ensure that the benefits of a deduction outweigh its costs); Peter J. Wiedenbeck, *Charitable Contributions: A Policy Perspective*, 50 MO. L. REV. 85, 92 n.34 (1985) (suggesting that estimates of income and price elasticities indicate that the net effect on charitable giving of an overall tax rate reduction would be a substantial reduction in contributions).

13. Saul Levmore, *Taxes as Ballots*, 65 U. CHI. L. REV. 387, 405 (1998) ("[E]ach individual taxpayer's choice, deduction, or 'ballot,' not only reflects a private contribution but also triggers a matching government contribution in the form of a reimbursement of part of the taxpayer-donor's gift."); see also, e.g., Boris I. Bittker, *Charitable Contributions: Tax Deductions or Matching Grants?*, 28 TAX L. REV. 37, 45 (1972) (discussing how the charitable deduction preserves a "large degree of institutional and donor independence").

14. That is, the deduction should be provided only in the same instances in which other direct subsidies would be justified. See, e.g., Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 726 (1970) ("[W]hatever degree of scrutiny and care should be applied to direct expenditures should also be applied to tax incentives.").

15. See *infra* Part III.

economically unnecessary in those cases.

However, as also explored in Part IV, underfunding may occur for various reasons. For instance, collective action problems may prevent direct beneficiaries from “rationally” contributing because these individuals assume they can benefit from others’ contributions.¹⁶ Further, when donors fail to internalize the benefits of others, such as when donee-organizations provide benefits to unknown recipients, externality problems may result in sub-optimal distribution of goods and services.¹⁷ Allowing donors to deduct amounts contributed to organizations suffering from these problems encourages them to donate more than they otherwise would. By limiting the deduction to such circumstances, the underfunding requirement would provide subsidies only to organizations unable to garner sufficient donations on their own.

Although the underfunding requirement is an important limiting principle, existing scholarship has not sought to apply it to determine whether the organizations subsidized by the charitable deduction are actually in economic need. Part V seeks to fill this gap. While one cannot precisely determine whether and to what extent any given organization or type of organization will suffer from underfunding problems, the general assessment provided by this Part offers a starting point for evaluating the current scope of the deduction. This Part considers four hypothetical donations, all of which are generally entitled to the charitable deduction under current law: donations to an organization that provides toys to children in a remote village,¹⁸ donations to an organization that funds opera productions,¹⁹ donations made to a specific church used to fund religious activities (including those made by individuals regularly attending its services and events)²⁰ and donations made to a specific school (including those made by parents of its students).²¹ The analysis suggests that these hypothetical donee-organizations suffer a great range of underfunding problems and that the latter two organizations may experience these issues only minimally. Thus, it becomes rather difficult to use efficiency concepts to justify the charitable deduction in these and similar scenarios.

Part VI concludes with a summary of this analysis and an explanation of how it can be of general use. In addition to scrutinizing specific cases, the analysis provides a useful starting point for applying the underfunding requirement in other contexts. It reveals that underfunding may not be

16. See *infra* Part IV.B.

17. See *infra* Part IV.C.

18. See Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 2008) (defining charitable to include “[r]elief of the poor”).

19. See *Search for Charities, Online Version of Publication 78, supra* note 1 (search “opera”).

20. See I.R.C. § 170(b)(1)(A)(i) (West 2010); see also *infra* note 129 (recognizing that churches may also fund other charitable activities).

21. See § 170(b)(1)(A)(ii).

severe when donors both enjoy significant benefits from their donations and share ongoing relationships with other beneficiaries. By allowing donors to deduct amounts contributed to organizations that provide benefits remaining “too close to home,” the tax law provides subsidies that may be economically unnecessary. Part VI also offers preliminary thoughts on how to respond to these exposed issues.

II. BACKGROUND MATERIAL: THE CHARITABLE DEDUCTION AS AN ORGANIZATIONAL SUBSIDY

Individuals may deduct amounts that qualify as “charitable contributions” under § 170 of the Internal Revenue Code.²² Section 170(c) defines “charitable contribution” by reference to the ultimate recipient organization, providing, for instance, that a taxpayer may deduct amounts contributed to organizations “organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals.”²³ Section 170(c) mirrors § 501(c)(3), which exempts these organizations from federal income taxation because they “provide what is seen as significant community or public benefit (rather than just a benefit to its members or its political constituents).”²⁴

Some tax deductions are used to accurately measure income. For instance, because the U.S. tax system seeks to tax net profits as opposed to gross earnings, taxpayers may deduct the costs related to their income-producing activities in order to properly calculate their taxable income.²⁵ Many other deductions, however, are not needed in this way but are instead meant to create behavioral incentives or achieve societal goals. Such provisions, which are referred to as “tax expenditures,” have been described by Professor Stanley Surrey as follows:

The term “tax expenditure” has been used to describe those special provisions of the federal income tax system which represent government expenditures made through that system to achieve various social and economic objectives. These special provisions provide deductions, credits, exclusions, exemptions, deferrals, and preferential rates, and serve ends

22. See § 170(a)(1), (c).

23. § 170(c)(2)(B). These “community benefit” organizations will be the focus of this Article. There are, however, other organizations able to receive deductible contributions. For instance, a taxpayer may deduct amounts contributed to “[a] post or organization of war veterans,” or to “[a] cemetery company owned and operated exclusively for the benefit of its members, or any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose” I.R.C. § 170(c)(3), (5).

24. Evelyn A. Lewis, *Charitable Waste: Consideration of a “Waste Not, Want Not” Tax*, 30 VA. TAX. REV. 39, 47 n.27 (2010); see also I.R.C. § 501(c)(3).

25. See I.R.C. §§ 162(a), 212 (West 2010).

similar in nature to those served by direct government expenditures or loan programs.²⁶

While several notable scholars have argued that the charitable deduction is a necessary adjustment to the income tax base,²⁷ it is more commonly categorized as a tax expenditure provision.²⁸ By lowering the after-tax cost of giving, the charitable deduction encourages taxpayers to give to organizations pursuing the statutorily designated purposes.²⁹

26. See Surrey, *supra* note 14, at 706.

27. Professor William D. Andrews provides one of the most robust defenses of the charitable deduction as a necessary adjustment to the income tax base. William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972). Andrews first defines “an ideal personal income tax [as] one in which tax burdens are accurately apportioned to a taxpayer’s aggregate personal consumption and accumulation of real goods and services . . .” *Id.* at 313. According to Andrews, expenditures should be deductible as a needed adjustment to this tax base unless they are used for personal consumption or to accumulate savings. *Id.* Professor Andrews defines consumptive expenses as those incurred in exchange for preclusive goods, defined as “divisible, private goods and services whose consumption by one household precludes enjoyment by others, but not collective goods whose enjoyment is nonpreclusive.” *Id.* at 314–15. Andrews therefore concludes that the charitable deduction is a necessary adjustment to the income tax base because qualifying donations fund goods that can be enjoyed by individuals other than (though sometimes including) the donor and members of his household. *Id.* For vigorous commentary disagreeing with Andrews’s formulation, see, for example, Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an “Ideal” Income Tax and Why They Fit Worse in a Far from Ideal World*, 31 STAN. L. REV. 831, 838 (1979); Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 TAX L. REV. 377, 378 (1972); Stanley S. Surrey, *Federal Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352, 381–94 (1970).

28. The remainder of this Article will assume this to be the case. See John D. Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 WAKE FOREST L. REV. 657, 682 (2001) (“Despite suggestions that the section 170 deduction can be explained as an incentive for individual altruism and despite Professor Andrews’ suggestion that the deduction is consistent with the normative definition of the income tax base [discussed in this Article], the most widely accepted rationale for the section 170 deduction remains that the deduction helps subsidize the activities of charitable organizations.”). According to Professor Peter J. Wiedenbeck, “The better view is that the charitable deduction is not a proper allowance in measuring disposable income.” Wiedenbeck, *supra* note 12, at 91; see also Harold H. Hochman & James D. Rodgers, *The Optimal Tax Treatment of Charitable Contributions*, 30 NAT’L. TAX J. 1 (1977), reprinted in *THE ECONOMICS OF NONPROFIT INSTITUTIONS* 224, 228 (Susan Rose-Ackerman ed., 1986) (“Implicit in the subsidy to charity is a price reduction, which induces those in the first group, who contribute even without subsidy, to increase their nominal contributions, so long as their demands are at all elastic. The price reduction causes a second group . . . [of] noncontributors, to make some voluntary contributions.”); C. Eugene Steuerle & Martin A. Sullivan, *Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations*, 12 AM. J. TAX POL’Y 399, 403–04 (1995) (explaining that charitable deductions operate as an incentive to giving and thus a subsidy to socially desirable organizations); Wiedenbeck, *supra* note 12, at 94–95 (“The charitable contribution deduction is a tax expenditure (an indirect subsidy) . . . because it is a substitute for taxing contributors and making up for the reduction in private giving by direct budget outlays.”).

29. This is reflected in the legislative history of the charitable deduction. The government enacted the charitable deduction in the War Revenue Act of 1917, ch. 63, 40 Stat. 300, 301, 330, in

Therefore, the deduction is generally viewed as an organizational subsidy³⁰—that is, a subsidy to the donee-organization that receives the deductible contribution.

To illustrate, suppose Arnie Altruist donated \$100 to his favorite charity, entitling him to deduct his contribution under the tax laws. If Arnie's applicable tax rate is 30%, the charitable deduction would provide him \$30 in value because it would reduce his otherwise taxable income by that amount. In effect, Arnie pays \$70 to his favorite charity and the government subsidizes the remaining \$30. Thus, the purpose³¹ and economic effect of the deduction³² is to subsidize the donee-organization. Rather than subsidizing organizations in this manner, the government could provide grants directly³³ by "matching" a portion of contributed

which tax rates dramatically increased from 7% to 50% in order to fund the United States' efforts in World War I. See Wiedenbeck, *supra* note 12, at 93 n.35. Senator Henry Hollis stated:

It will work in this way: Usually people contribute to charities and educational objects out of their surplus. After they have done everything else they want to do, after they have educated their children and traveled and spent their money on everything they really want or think they want, then, if they have something left over, they will contribute it to a college or to the Red Cross or for some scientific purposes. Now, when war comes and we impose these very heavy taxes on incomes, that will be the first place where the wealthy men will be tempted to economize, namely, in donations to charity. They will say, "Charity begins at home."

Id. (quoting 55 CONG. REC. S6728 (1917)).

Due to concern that the increased tax burden would diminish people's willingness (and perhaps ability) to make charitable donations, the deduction was granted. *Id.* at 92–93. For an overview of the history of the charitable deduction, see Aprill, *supra* note 2, at 848–56; Lindsey, *supra* note 2, at 1061–70. See also generally John A. Wallace & Robert W. Fisher, *The Charitable Deduction Under Section 170 of the Internal Revenue Code* (1975), reprinted in 4 RESEARCH PAPERS SPONSORED BY THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS 2131 (Dep't of the Treas. 1977) (providing an analysis of § 170 with an "emphasis . . . [on] expressed Congressional intent and purpose, as well as historical development").

30. See, e.g., Colombo, *supra* note 28, at 661 ("[T]he section 170 deduction is best explained as an indirect government subsidy to charitable organizations and, hence, the definition of a deductible economic transfer under section 170 should relate to the underlying goals of tax exemption."). Professor John D. Colombo views the deduction as "an auxiliary subsidy for exempt organizations rather than as a stand-alone provision with a separate theoretical basis." *Id.* at 662. He further notes that "existing literature surrounding the Section 170 deduction generally accepts the subsidization role of the deduction." *Id.* at 661.

31. See Wiedenbeck, *supra* note 12, at 93 n.35 (statement of Sen. Hollis).

32. The extent to which the charitable deduction subsidizes organizations depends on price elasticity. See *supra* note 12 (summarizing literature on the topic).

33. For any provided tax incentive, a program of direct governmental expenditures can be constructed which would have the same economic effect. See Surrey, *supra* note 14, at 706. In the above example, the taxpayer was able to deduct 30% of his donation. There are indeed many other types of direct expenditure programs such as "loans, interest subsidies, guarantees of loan repayment or interest payments, [and] insurance on investments . . ." *Id.* at 713. According to Dean Saul Levmore:

amounts.³⁴ For instance, rather than receiving a charitable deduction, Arnie could donate \$70 to his favorite charity, and the government could provide the remaining \$30 directly to the donee-organization. Thus, to define the proper scope of the charitable deduction, it is important to focus upon the attributes of donee-organizations and determine which organizations should receive governmental funding.³⁵

III. NON-ECONOMIC THEORIES JUSTIFYING THE CHARITABLE DEDUCTION AND THE ROLE OF EFFICIENCY CRITERIA IN DEFINING ITS SCOPE

One might reasonably ask: Why should the tax law offer a charitable deduction at all? This Part briefly summarizes the predominant non-economic theories that justify the deduction.³⁶ This Part shows that these theories do not provide economic limitations on the scope of the deduction and suggests that efficiency criteria can play an important role in limiting the organizations subsidized by the charitable deduction to those in economic need.

A. *Public Benefit Theory*

One justification for the charitable deduction is that subsidized donee-organizations provide “something in the nature of common or social goods or services.”³⁷ In some cases, these organizations provide goods or services

The charitable deduction makes the government a partner in every gift-giving venture; a taxpayer in the (hypothetical but arithmetically convenient) 50 percent bracket, for instance, can be seen as joining forces with the government to give equal amounts to the cause chosen by the taxpayer (with characteristics or minimum qualifications set by the government). Hence each individual taxpayer’s choice, deduction, or “ballot,” not only reflects a private contribution but also triggers a matching government contribution in the form of a reimbursement of part of the taxpayer-donor’s gift.

Levmore, *supra* note 13, at 405.

34. See Bittker, *supra* note 13, at 39–46 (discussing the propriety of the substitution of matching grants for the charitable deduction).

35. See Surrey, *supra* note 14, at 726 (“[W]hatever degree of scrutiny and care should be applied to direct expenditures should also be applied to tax incentives.”).

36. Colombo, *supra* note 28, at 659 (“The major legal articles fall into two distinct camps: those that would abolish the deduction altogether, perhaps replacing it with a different method for government support of charities, and those that defend the deduction on some ground.”). This Part will focus on those in the latter camp.

37. Andrews, *supra* note 27, at 357; see ANDREW CHAMBERLAIN & MARK SUSSMAN, TAX FOUND., CHARITIES AND PUBLIC GOODS: THE CASE FOR REFORMING THE FEDERAL INCOME TAX DEDUCTION FOR CHARITABLE GIFTS 3 (2005) (arguing that the economic justification for the tax subsidy to charities requires qualified charities to produce public goods). Economist Andrew Chamberlain and adjunct scholar Mark Sussman define “public good” as an economic concept meaning to possess properties of “non-rivalrous consumption” and “non-excludability” (meaning that people who do not pay to consume a good cannot be prevented from using the good). *Id.* at 2 & n.3. A lighthouse is a commonly cited example of a public good able to fulfill these criteria. See

that the government might otherwise be responsible for providing, “such as . . . education, scientific research, public improvements, public health, and the relief of poverty.”³⁸ In other cases, “the deduction is available for transfers that [the] government would never make” such as donations to religious organizations.³⁹ All of these organizations, however, are seen to provide sufficiently widespread societal benefits that justify their ability to receive deductible contributions.⁴⁰

The requirement that subsidized organizations provide such benefits is an important one. Because the cost of the charitable deduction is spread among all taxpayers,⁴¹ the benefits should also be somewhat dispersed.⁴² However, some organizations subsidized through the charitable deduction provide benefits that are more far-reaching than others. For instance,

generally, e.g., R.H. Coase, *The Lighthouse in Economics*, 17 J.L. & ECON. 357 (1974) (discussing the lighthouse example in the context of economics and public goods). A lighthouse is “non-rivalrous” because one’s light supply is not affected by other’s use and is “non-excludible” because individuals cannot reasonably be prevented from viewing it. *Id.* at 358–59. Further, this “public benefit” concept is supported by legislative history. Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U. L. REV. 505, 508 n.8 (2010) (“[T]he legal definition of ‘charitable’ (loosely meaning anything that benefits the community at large) is much broader than the popular and colloquial definition (meaning helping the poor).” (citing JOINT COMM. ON TAXATION, 109TH CONG., HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS 61–64 (2005))).

38. Johnny Rex Buckles, *The Community Income Theory of Charitable Contributions Deduction*, 80 IND. L.J. 947, 952 n.25 (2005). One of the primary arguments in favor of the charitable contributions deduction is that donations provide major community benefits. If these benefits relieve the federal government of some of the burdens that it otherwise would be required to bear (such as expenditures for education, scientific research, public improvements, public health, and the relief of poverty), the deduction may reduce the amount of revenues that government must raise in order to provide for the common welfare. See Lewis, *supra* note 24, at 53 (referring to these activities as “mandated functions [which] implicate activities that the federal government has primary responsibility (and often exclusive authority) to perform”).

39. Buckles, *supra* note 38, at 952 n.25.

40. *Id.* at 952.

41. Shannon W. McCormack, *Taking the Good with the Bad: Recognizing the Negative Externalities Created by Charities and Their Negative Implications for the Charitable Deduction*, 52 ARIZ. L. REV. 977, 1001 (2010) (“D’s tax rate will be higher than it would have been in the absence of a charitable deduction, as compensation for the revenue lost by the deduction necessitates a higher rate.”); see also Buckles, *supra* note 38, at 951 (“[I]f all else is held constant, the availability of the charitable contributions deduction means that tax rates must be increased to compensate for the diminished income tax base.”); Surrey, *supra* note 14, at 726 (noting that both direct expenditures (government assistance) and programs funded through deductions “keep our tax rates high”).

42. Hochman & Rodgers, *supra* note 28, at 227 (“External benefits must accrue in the demands for the specific services that charity finances . . . to justify the public subsidization of charity. Otherwise, the benefits of giving are private, and no subsidy is warranted.”); see also *id.* at 241 n.10 (“If the benefits of a charity-financed activity have a restricted domain in, say, political or spatial terms, those who do not benefit should not be required to help finance it. The members of the ‘club,’ as a self-contained community, should be fully responsible for costs.”).

organizations aiming to control nation-wide pollution or to maintain state parks benefit a rather broad segment of the population, while other organizations, such as local schools and soup kitchens, benefit a far narrower group of individuals.⁴³ Thus, while it provides an important theoretical justification for the charitable deduction, the public benefit requirement can be difficult to apply in practice because it requires one to determine when a donee-organization provides goods or services that are “public enough” to allow their donors to deduct contributed amounts.⁴⁴

To further illustrate these difficulties, suppose one were to undertake the task of determining whether the benefits provided by a small soup kitchen should be considered “sufficiently” widespread. While the tax law currently allows taxpayers to deduct amounts donated to organizations that feed the hungry,⁴⁵ a result with which few would argue,⁴⁶ it is unclear how to define the “benefit” that is provided in applying the public benefit requirement. If one were to focus upon the food provided, the benefit would seem confined to a few aided individuals.⁴⁷ If, however, one were to define the benefit more generally as the alleviation of hunger suffered by the needy, the benefit would seem more far-reaching.

Partly because of these difficulties in application, the justification

43. Lewis, *supra* note 24, at 53. In some cases, organizations may provide goods that “similarly situated members of the public can typically access and from which the public can benefit equally.” *Id.*; see also Buckles, *supra* note 38, at 969 (“The amenities offered by numerous charitable organizations are of a similar nature to those untaxed benefits offered by government, business, and the natural environment.” (emphasis omitted)). But see Lewis, *supra* note 24, at 53 (explaining that the goods and services provided by some organizations “may benefit some private parties substantially more than [others]”).

44. In economic terms the “public good” requirement can at most aspire to identify goods “similar to public goods over some range” (i.e., to be quasi-public goods). RUSSELL HARDIN, *COLLECTIVE ACTION* 19 (1982); see *id.* at 18–19 (“[W]e are left with the problem of reconciling ourselves to a neat definition of collective goods that is apparently inapplicable to nearly all the familiar instances of collective goods.” (quoting E.J. Mishan, *The Relationship Between Joint Products, Collective Goods, and External Effects*, 77 J. POL. ECON. 329, 334 (1969))); see also Robert W. Adler, *Unfunded Mandates and Fiscal Federalism: A Critique*, 50 VAND. L. REV. 1137, 1249 (1997) (stating that “‘pure’ public goods that benefit all national taxpayers equally . . . are extremely rare”); John D. Colombo, *Why is Harvard Tax-Exempt? (And Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841, 869 (1993) (explaining that pure public goods are rare and that most goods and services are imperfect hybrids).

45. I.R.C. § 170(c)(2)(B) (West 2010).

46. Organizations feeding the hungry are often cited as the base-line example of the type of organization that should be able to receive tax-deductible contributions. See, e.g., Gergen, *supra* note 12, at 1406–07, 1413–14 (discussing the Salvation Army and the Red Cross); Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 840–60 (1980) (discussing CARE and the Red Cross).

47. In economic terms, the food would fail the definition of a public good rather miserably. Once the food is eaten, there will be nothing remaining for others, meaning that it fails to be “nonrivalrous.” Further, because one can easily be prevented from consuming food for which one does not pay, it fails to exhibit the property of “nonexcludability.”

offered by the public benefit theory does not provide discernable limits on the subsidy's scope.⁴⁸ As a final (purposefully silly) example, suppose an organization aimed to paint all of a town's dogs red because the organization's supporters believed a uniformly colored canine population would increase the aesthetic appeal of the "served" locality. Red-dog lovers may feasibly claim that an entire community might "benefit" from the uniformly colored creatures. Without more than the public benefit principle, one has little guidance on how to determine whether the charitable deduction should be granted in even these circumstances where organizations pursue activities most would find "unique" and unworthy of government subsidies (a conclusion which the tax law would very likely reach).⁴⁹ Efficiency criteria (discussed in the next Part) provide an objective method of ensuring that subsidies are provided only to "economically needy" organizations.⁵⁰

B. *Theories of Democracy Promotion and Pluralism*

Other scholars justify the charitable deduction as a method of promoting important democratic values by protecting minority viewpoints and encouraging "cultural and associational pluralism."⁵¹

48. Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307, 364–84 (1991) (arguing that the community benefit theory does not adequately define or provide any way to measure the community benefits that should justify exemption).

49. It is worth noting that there are rather unique organizations currently entitled to receive charitable deductions. See ROB REICH, LACEY DORN & STEFANIE SUTTON, STANFORD UNIV. CTR. ON PHILANTHROPY AND CIVIL SOC'Y, ANYTHING GOES: APPROVAL OF NONPROFIT STATUS BY THE IRS 17–18 (2009), available at <http://www.stanford.edu/~sdsachs/AnythingGoesPACS1109.pdf> (identifying such organizations, including the Gateway Sisters of Perpetual Indulgence, an organization for "Drag" Nuns; a Christian group reaching outdoorsmen—in particular "Bubbas" for Jesus Christ; and the International Society of Talking Clock Collectors, an online museum to preserve and share talking clocks); see also CROSSHEIR OUTFITTERS, <http://www.crossheiroutfitters.org> (last visited Apr. 7, 2011); INTERNATIONAL SOCIETY OF TALKING CLOCK COLLECTORS, <http://www.talkingclocks.net> (last visited Apr. 7, 2011).

50. See *supra* Part IV. Alternatively, one runs the risk of having to determine what purposes are sufficiently "good," an inquiry which seems thorny to say the least. The only tool current law has against such a result is the so-called "public policy" exception, which has been used in rather confined circumstances and certainly would not apply to an organization such as this that seems to be pursuing a novel, yet not profoundly harmful activity. For a summary of current cases and IRS rulings using this exception, see Johnny Rex Buckles, *Reforming the Public Policy Doctrine*, 53 U. KAN. L. REV. 397, 399–403 (2005); Miriam Galston, *Public Policy Constraints on Charitable Organizations*, 3 VA. TAX REV. 291, 291–97 (1984); Nicholas A. Mirkay, *Is It "Charitable" to Discriminate?: The Necessary Transformation of Section 501(c)(3) into the Gold Standard for Charities*, 2007 WIS. L. REV. 45, 61–68.

51. Wiedenbeck *supra* note 12, at 96. Wiedenbeck also argues "[t]hat the charitable deduction may reflect a judgment that pluralism should be valued in its own right." *Id.* at 96–97; see also, e.g., Bittker, *supra* note 13, at 45 ("No public program is immune to . . . attempts to foster one set of values and discourage another, but the definition of exempt organizations by . . . the Code and

The charitable deduction acts as a taxpayer-triggered subsidy,⁵² granting individual citizens the ability to allocate public funds to the organizations of their choosing.⁵³ Some argue that this is superior to a program in which members of Congress would be responsible for these allocations. While the deduction ensures that subsidies are granted even to organizations with small support bases, a direct assistance program would fail to do so since politicians would cater to majority wishes at the expense of projects supported by less politically powerful groups.⁵⁴ In contrast, the argument continues, deductions allow each taxpayer to transform contributions into votes⁵⁵ and form diverse groups that can fund minority projects.⁵⁶

While also an important justification for the charitable deduction, this rationale still fails to provide discernible limitations on its scope. A pure application of the idea that deductions should be granted whenever it would promote diversity would seem to allow almost limitless subsidies. Even those supporting the dog painting organization could argue that these organizations (like any other) would add to the mixture of expressed viewpoints and that a charitable deduction is therefore justified. While it is not suggested that all those promoting these theories would support this

the administration of this definition by the tax authorities have been relatively free of bias.”); Miranda Perry Fleischer, *Generous to a Fault? Fair Shares and Charitable Giving*, 93 MINN. L. REV. 165, 168 (2008) (“[C]haritable tax subsidies allow individuals whose preferences differ from the classic majority to redirect a portion of funds otherwise flowing to the federal treasury toward their preferred visions of the public good.”); Levmore, *supra* note 13, at 404 (“[T]he tax system can be seen as allowing taxpayers individually to allocate federal money to worthy causes.”); Burton A. Weisbrod, *Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*, in THE ECONOMICS OF NONPROFIT INSTITUTIONS 21, 31 (Susan Rose-Ackerman ed., 1986) (“[T]he relative size of the voluntary sector . . . can be expected to be a function of the heterogeneity of population demands.”).

52. See Bittker, *supra* note 13, at 39 (discussing the power of private persons to allocate government funds); Levmore, *supra* note 13, at 405 (“Hence each individual taxpayer’s choice, deduction, or “ballot,” not only reflects a private contribution but also triggers a matching government contribution in the form of a reimbursement of part of the taxpayer-donor’s gift.”). See generally Fleischer, *supra* note 51, at 189 (“[U]sing a deduction or credit means that individual taxpayers decide which charities receive the subsidies and how large the subsidies should be.”).

53. Fleischer, *supra* note 51, at 189.

54. See Weisbrod, *supra* note 51, at 23–26, 36–37 (using an economic model to suggest that the government provision of nonprofit services will align with interests of the majority of voters). See Bittker, *supra* note 13, at 46 (“I must say that I have very little confidence that a system of matching grants could be administered without administrative and congressional investigations, loyalty oaths, informal or implicit warnings against heterodoxy and the other trappings of governmental support that the tax deduction has, so far, been able to escape.”).

55. Levmore, *supra* note 13, at 389 (characterizing the charitable deduction as balloting through the tax system).

56. Fleischer, *supra* note 51, at 207–10 (arguing that the charitable deduction acts as a bargain between a democratically defined majority and a majority of individual donors which represent minority interests, characterized as the “dual majority bargain”).

result,⁵⁷ it does suggest the need for (or, at the very least, the desirability of considering) additional economic limits on the deduction's scope.

C. Altruism Theory

Proponents of what might be referred to as "altruism theory" would provide deductions for all altruistic transfers, thereby subsidizing altruism as a good in and of itself. For instance, famous tax scholar Professor Boris I. Bittker argues that "something can be said for rewarding activities which in a certain sense are selfless, even if the reward serves no incentive function."⁵⁸ Thus, altruism theory would allow a charitable deduction for donations made to any donee-organization so long as the donor-taxpayer possessed the requisite motivation.

To state the obvious, in implementing these ideas, lawmakers would confront many practical challenges. For instance, they would need to define altruism, which some economic and behavioral scholars do not believe exists.⁵⁹ Further, even if a workable definition were possible, one would also have to devise a mechanism to separate acts that meet this definition from all others.⁶⁰ This would all seem rather subjective, perhaps requiring a thorny moral inquiry into "what is ultimately good."⁶¹

57. Professor Miranda Perry Fleischer describes the ambiguity eloquently:

Unfortunately, it is somewhat unclear exactly what these theorists mean when they invoke "pluralism" and related terms (such as "diversity"). Often, it seems they believe our society should affirmatively seek to encourage numerous views in order to promote a counter-weight to government power, experimentation in the way public goods are produced, a rich debate, a marketplace of ideas, and the like. Another take on pluralism, however, is that we live in a pluralistic society where individuals have differing conceptions of what is beneficial to society and that, in the interests of neutrality, the tax subsidies should not differentiate among them. Pluralism can thus encompass either a positive duty to promote alternative viewpoints *or*, more simply, a duty not to discriminate among various viewpoints. Both understandings of "pluralism" seem to be present in discussions of the charitable tax subsidies.

Fleischer, *supra* note 37, at 524 n.101.

58. Bittker, *supra* note 13, at 60. In his article, Bittker "offer[s] a defense of the deduction even if it turns out to be 'inefficient,' failing to operate effectively as an incentive to private philanthropy." *Id.*

59. As Colombo explains, "Economics is the most dependent upon the view of individuals as self-interested, rational actors striving to maximize their own utility." Colombo, *supra* note 28, at 670 (citing Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 624 (1998); Thomas S. Ulen, *Rational Choice and the Economic Analysis of Law*, 19 L. & SOC. INQUIRY 487, 487-91 (1994)).

60. See Colombo, *supra* note 28, at 677 ("[I]gnoring motive may be a necessity for the tax system; the search for purity of charitable intention would be an unmanageable task, even ignoring the complications caused by psychoanalytic theory." (quoting John G. Simon, *The Tax Treatment of Nonprofit Organizations: A Review of Federal and State Policies*, in *THE NONPROFIT SECTOR: A RESEARCH HANDBOOK* 67, 86 (Walter W. Powell ed., 1987))).

61. Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 630 (1990).

Some scholars, however, have sought to objectify the definition.⁶² For instance, Professor Rob Atkinson offers a definition of altruism⁶³ that does not require one to assess the internal motivations of giving.⁶⁴ Instead, Atkinson suggests that the tax law use “weak” altruism as its measure, which exists whenever “one party confers a benefit on another without the expectation of a material reward.”⁶⁵ Recognizing that this puts “considerable pressure on defining the forbidden reciprocal benefit,”⁶⁶ Atkinson appears to find donors sufficiently altruistic so long as they do not receive “preclusive benefits” (benefits confined to members of the donor’s household)⁶⁷ in exchange for their donations. He, for instance, finds altruism in donations to performing arts organizations that allow attendees to pay a price of their own choosing in return for admission, explaining that even if “patrons pay no more . . . than [what] admission . . . is worth to them personally . . . they are necessarily conferring a benefit on others, and a benefit that they need not confer in order to enjoy the same benefit for themselves.”⁶⁸

However, even this objective version of altruism theory fails to provide discernible limitations on the scope of the charitable deduction.⁶⁹ Without further criteria, donors could deduct contributions made to any organization (including the dog painting organization) so long as they did not receive the “forbidden” benefit in return.⁷⁰ Once again, efficiency

62. I by no means address all possible theories of altruism. See, for example, Colombo, *supra* note 28, at 667–79, for a summary of other methods of defining altruism.

63. I must be clear that Professor Atkinson seeks to determine when an organization should receive a tax exemption. However, because §§ 501(c)(3) and 170 effectively mirror one another, I have assumed that he would also support a charitable deduction in the same instances.

64. Atkinson, *supra* note 61, at 527–29. Atkinson, for instance, expressly rejects Amartya Sen’s notion of “strong altruism,” which requires one to distinguish between actions motivated by sympathy and those motivated by commitment. It is only the latter, according to Sen, which can be considered true altruism, as sympathy-motivated actions cause pleasure for the individual who helps correct the situation for which the sympathy arose. *Id.* at 527 (citing Amartya Sen, *Rational Fools: A Critique of the Behavioral Foundations of Economic Theory*, 6 PHIL. & PUB. AFF. 317, 326 (1970)). Atkinson, along with other scholars, recognize the impossibility of determining these psychological nuances. Atkinson writes: “How can we ever know that what prompts the rescue of a drowning child is not the desire for social acclaim, even at the risk of death, or the desire for a conscience clear of having refused assistance, even if such a conscience must be purchased with one’s life?” *Id.* at 527 (citing Gergen, *supra* note 12, at 1433 n.137). Thus, he concludes, “[W]ith an eye toward identifying a characteristic of nonprofits that can serve as an objective basis for their tax exemption, ‘weak’ altruism seems the better candidate.” *Id.* at 529.

65. *Id.* at 523.

66. *Id.* at 531.

67. See Andrews, *supra* note 27, at 313–15.

68. Atkinson, *supra* note 61, at 540; see also Hansmann, *supra* note 46, at 858 (using also performing arts to illustrate price discrimination).

69. In his words, Atkinson recognizes that his definition requires one to confront the “risks in letting a thousand flowers bloom.” Atkinson, *supra* note 61, at 636.

70. See *id.* at 531. Alternatively, it could require one to engage in the moral inquiry into

criteria would provide objective, economic limits on the deduction.

It should be noted that some scholars of altruism theory would not support the use of efficiency based constraints. Professor Atkinson, for instance, would explicitly allow donors to deduct amounts “altruistically” donated to “eccentric” organizations⁷¹ stating that “even [when] the particular purposes for which donors set aside resources [are] truly pointless, this . . . loss must be counted against the more general gain of allowing . . . the choice of altruistic objects.”⁷² Similarly, Professor Bittker explicitly justifies the deduction to reward selflessness “even if the reward serves no incentive function.”⁷³

With due recognition of these objections, most would find it important to (at least) explore the way in which efficiency criteria can limit the organizations subsidized by the charitable deduction to those in economic need,⁷⁴ a task which the predominant theories justifying the deduction fail to accomplish.

IV. LIMITING THE SCOPE OF THE CHARITABLE DEDUCTION TO UNDERFUNDED ORGANIZATIONS: THE UNDERFUNDING REQUIREMENT DEVELOPED AND EXPLAINED

In his often-cited article, *The Case for a Charitable Contributions Deduction*, Professor Mark P. Gergen uses efficiency concepts to limit the scope of the deduction. Gergen would use the charitable deduction only when the goods or services provided by the donee-organization would be underfunded (or sub-optimally provided) in its absence⁷⁵ (the

“what is ultimately good.” Atkinson explicitly recognizes that this is required but (understandably) declines to articulate how to do so. *Id.* at 630; *see supra* note 50 (discussing the “public policy” exemption, which would not apply to “unique” organizations such as the dog painting organization).

71. Atkinson, *supra* note 61, at 636. As to more morally questionable organizations, Atkinson would allow the public policy exception to limit the deduction. *Id.* at 625.

72. *Id.* at 636.

73. Bittker, *supra* note 13, at 60.

74. As Professor Stanley Surrey has stated:

A government that decides it is wise to pay out tax credit money via a simple tax schedule would be highly irrational if it also decided that it would be unwise to pay the same amount directly on the same basis. A dollar is a dollar—both for the person who receives it and the government that pays it, whether the dollar comes with a tax credit label or a direct expenditure label.

Surrey, *supra* note 14, at 717.

75. *See* Gergen, *supra* note 12, at 1396–1406. Professor Gergen would also grant the deduction only when the transfer is efficiency-enhancing, determined by utilizing the Kaldor-Hicks method of efficiency. *Id.* at 1397. There are various methods of evaluating whether a transfer is efficient. The Pareto method deems a transfer efficient so long as it “make[s] at least one person better off and no one worse off.” ANTHONY B. ATKINSON & JOSEPH E. STIGLITZ, LECTURES ON PUBLIC ECONOMICS 337 (1980). Realistically, however, a transfer will never truly be Pareto

“underfunding requirement”). Underfunding occurs when donor support does not meet the needs of donee-organizations. It is, therefore, essential to describe two models. First, this Part will develop a “rational donor model” to explain the circumstances in which a “rationally economic donor” will contribute to a given organization. Second, this Part will develop an “optimal subsidization model” to determine when goods and services can be considered optimally funded (i.e., not underfunded).

A. Developing a “Rational Donor Model” and “Optimal Subsidization Model”

Under standard economic assumptions, an economically rational individual should be willing to contribute an amount equal in value to the monetized benefits he experiences as a result of the donation.⁷⁶ There are various ways in which a donor might benefit from his contribution. First, a donor may directly benefit from his contribution if he enjoys the goods or

efficient, since all donations will cause some harm. As Professor Gergen recognizes, there is a “darker aspect to this picture: Some people will lose because of a deduction.” Gergen, *supra* note 12, at 1412. Even if nobody is harmed by a particular transfer, the cost of a deduction is spread among all taxpayers, such that those who do not benefit from the deduction will suffer harm, rendering the deduction inefficient under the Pareto method. Thus, were the Pareto model used, all deductions would be disallowed. See McCormack, *supra* note 41, at 1001–06. Using the Kaldor-Hicks model allows efficiency to be considered, while not disallowing deductions in all cases. Formally stated, under the Kaldor-Hicks model, “[o]ne state of affairs (*E*) is Kaldor-Hicks efficient to another (*E'*) if and only if those whose welfare increases in the move from *E* to *E'* could fully compensate those whose welfare diminishes with a net gain in welfare.” See JULES L. COLEMAN, *MARKETS, MORALS, AND THE LAW* 98 (1988). The Kaldor-Hicks method is by no means a perfect solution, however. As I have written elsewhere, the Kaldor-Hicks method will not always sensibly separate transfers that should and should not receive a charitable deduction. McCormack, *supra* note 41, at 1006–11 (discussing the failure of Kaldor-Hicks to sufficiently analyze negative externalities that may arise from the charitable deduction). This point, however, need not be explored further in this Article, which focuses on the separate underfunding requirement.

76. A rational economic actor should be indifferent between receiving the good and retaining an amount of money equal to the benefit enjoyed by that good. Thus, absent transaction costs, a rational purchaser will pay any amount that does not exceed the benefit the good can provide. See MICHAEL ANTHONY LEWIS & KARL WIDERQUIST, *ECONOMICS FOR SOCIAL WORKERS* 16–24 (2001) (discussing marginal analysis within assumption of rational self-interested behavior). More formally, a donor should be willing to make a particular donation so long as the utility increase he experiences from that donation exceeds the utility decrease he experiences by relinquishing the money or property. See, e.g., Louis Kaplow, *A Note on Subsidizing Gifts*, 58 J. PUB. ECON. 469, 470–71 (1995) (“There are two types of individuals, donees—each of whose utility is a concave function, V , of his own wealth—and donors—each of whose utility is the sum of a concave function, U , of his own wealth and λ times a respective donee’s utility. (Each donor is paired with a donee.) Donors’ and donees’ initial levels of wealth are w and y , respectively. Each donor chooses a gift, $g \in [0, w]$, to transfer to a donee, to maximize $U(w - g) + \lambda V(y + g)$.”). This Author fully recognizes that economists would develop the “rational donor model” using different terms, by, for instance, referring to “utility functions” and measuring benefits in “utils.” In order to avoid this terminology, which might unnecessarily alienate the non-economist, the remainder of this Article will express benefits in monetized terms.

services provided by the donee-organization. For instance, one who contributes to an organization using donated funds to build a park in his neighborhood may enjoy direct benefits.⁷⁷ Next, donors may experience “giving benefits,”⁷⁸ which refer to benefits derived from the act of giving itself.⁷⁹ A donor may, for example, experience a “warm glow”⁸⁰ benefit if he experiences positive feelings for helping others⁸¹ and might enjoy “reputational enhancement” if others are made aware of his contributions.⁸² Continuing with the neighborhood park example, a donor may “feel good” for helping his neighbors enjoy the newly constructed park and may enjoy an increase in status because of his perceived beneficence.⁸³

Direct and giving benefits are considered “egoistic” because the donor’s benefit is not based on anyone’s enjoyment but his own.⁸⁴ Additionally, the donor may experience a “non-egoistic”⁸⁵ or “other-regarding”⁸⁶ benefit if he internalizes the benefits of others. In economic terms, this occurs when the donor’s so-called “utility function”—which describes how one’s satisfaction changes in response to various conditions (such as changes in wealth)⁸⁷—is “interdependent” with the utility

77. See *infra* Part V.A (discussing the various ways in which a donor may directly benefit from his contribution).

78. See *infra* Part V.B (discussing the various ways in which a donor may experience “giving benefits” from his contribution). As discussed in that section, some of these benefits might also be considered direct benefits. However, this Article will categorize “giving benefits” as all benefits that can only be derived by the act of giving itself, because of the inability of donors to free-ride to enjoy these benefits. See *infra* Part V.B.

79. See James Andreoni, *Giving with Impure Altruism: Applications to Charity and Ricardian Equivalence*, 97 J. POL. ECON. 1447, 1448–49 (1989) (“[P]eople get some private goods benefit from their gift per se, like a warm glow.”).

80. *Id.* at 1448 (coining the term).

81. *Id.*; see also Colombo, *supra* note 28, at 672 (discussing how donors are motivated by “personal pleasure from having been the instrument by which . . . welfare has been increased”).

82. See *infra* Part V.B; see also, e.g., Joel Sobel, *Interdependent Preferences and Reciprocity*, 43 J. ECON. LITERATURE 392, 403 (2005) (“Because agents will forgo consumption to increase their status, this formulation is sufficient to be consistent with many apparent departures from self interest. Fremling and Posner suggest that dictators will not take the entire surplus in order to signal that they are altruistic. Being known as a generous person enhances your status, which will put you in a better position to advance your material self interest in the future.” (citing Gertrud M. Fremling & Richard A. Posner, *Market Signaling of Personal Characteristics* 1–40, 28–31 (John M. Olin Law & Econ., Working Paper No. 87, 1999)).

83. For another example, see Colombo, *supra* note 28, at 671–72 (“[N]aming or commemorative opportunities . . . obviously supply such status or reputation enhancement.”).

84. See Andreoni, *supra* note 79, at 1449 (“[W]e could imagine a person who cares nothing at all for the public good, but gives only for the warm glow The warm glow is an increasing function of what is given. We could call such preferences ‘egoistic.’”).

85. *Id.*

86. See, e.g., LOUIS KAPLOW & STEVEN SHAVELL, *FAIRNESS VERSUS WELFARE* 424 (2002) (discussing the “care and concern that individuals have for others—friends, family, and sometimes even society at large”).

87. See F.Y. Edgeworth, *The Pure Theory of Taxation*, 7 ECON. J. 46, 57 (1897) (describing

functions of other beneficiaries of his gift. For instance, the donor in the neighborhood park example may experience a benefit because his neighbors, for whom he has a degree of affection, have experienced one. Put more simply, the donor may consider some of his neighbor's benefits "his own."⁸⁸

Putting this together, if a donor is economically rational, he should be willing to donate an amount equal in value to the sum of his monetized⁸⁹ direct benefits, giving benefits, and internalized benefits. This will be referred to as the "rational donor model."

The next task is to determine when goods or services should be considered optimally funded (i.e., not underfunded), by developing an "optimal subsidization model." Using the so-called "benefits pricing" model,⁹⁰ goods and services should be "funded at the level where the sum of the incremental benefits individuals derive from the last unit of the good [or service] equals the marginal cost of that unit."⁹¹ In other words, goods and services should be provided so long as the benefits created exceed production costs.⁹²

the phenomenon that when income increases, utility decreases); Harvey S. Rosen, *Income-Tax Progressivity: A Century-Old Debate*, BUS. REV., Jan./Feb. 1990, at 3, 6 ("When income increases . . . utility increases at a decreasing rate. According to this assumption, when your income doubles, you become happier, but not twice as happy. This seems quite sensible. If you give a billionaire another billion dollars, chances are that he will value the second billion a lot less than he did the first."). For more on the concept of utility curves and the marginal utility of wealth, see generally, Edgeworth, *supra*.

88. For another example, see John D. Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction* 17 (U. Ill. Coll. of Law, Law & Econ. Working Papers Series, Working Paper No. 00-11, 2000), available at http://ssrn.com/paper.tar?abstract_id=253058 ("[T]he husband may buy an expensive anniversary gift for his wife not because of his pleasure at having been the gift-giver but because he gains pleasure by seeing his wife pleased by the gift. Here, their interests have merged, so that her gain becomes his . . .").

89. All benefits will be presumed to be monetized. This Article will not always explicitly state this for ease of reading.

90. Gergen, *supra* note 12, at 1400 (citing Hochman & Rodgers, *supra* note 28, at 224). The benefits pricing model is also referred to as the Lindahl solution. See Erik Lindahl, *Positive Lösung [Just Taxation—A Positive Solution]*, in DIE GERECHTIGKEIT DER BESTEUERUNG 85–98 (1919), reprinted in CLASSICS IN THE THEORY OF PUBLIC FINANCE 168, 173 (Richard A. Musgrave & Alan T. Peacock eds., Elizabeth Henderson trans., 1958) ("[P]rovided the taxpayers are all in an equal position to defend their economic interests when tax laws are passed, the financial process would result in each individual having to pay a tax amount corresponding to his valuation of public services."). See generally Duncan K. Foley, *Lindahl's Solution and the Core of an Economy with Public Goods*, 38 ECONOMETRICA 66 (1970) (summarizing Lindahl's work).

91. Gergen, *supra* note 12, at 1400.

92. There is a second condition to the benefits pricing model: "[E]ach individual [should contribute] an amount equal to her marginal benefit from the last unit of the good times the number of units provided." *Id.* This requirement would ensure that no individual would be harmed by provision of the good (which would occur if individuals paid more than their benefit.). It is important, however, to see that this second condition will not be achieved in practice. See McCormack, *supra* note 41, at 1002 ("Assume . . . that Z is . . . a member of the universe of

In developing the rational donor model, the various benefits a donor might experience were discussed. It is not clear, however, that all of these benefits should be incorporated in the “optimal subsidization model.” Put another way, it is not clear that one should account for all of these benefits to determine when a particular good or service is underfunded and a deduction needed to correct the issue. Most importantly, accounting for internalized benefits—i.e., the benefits enjoyed by a donor as a result of the benefits of others—would result in “double counting.”⁹³ Consider two simplified scenarios illustrating this issue.

First, imagine an organization providing goods to individuals with whom a potential donor has no contact or association.⁹⁴ Suppose that under a “hypothetical cost function” it would cost \$900 to provide the first unit of the good, \$600 to provide the second unit, and \$100 to provide the third unit. Assume that under a “hypothetical aggregate benefits function,” beneficiaries would enjoy an aggregate \$1,000 benefit from the first unit, \$700 from the second unit, and \$70 from the third unit.⁹⁵ Finally, assume a

taxpayers and that she is not affected by provision of the public good (that is, she is indifferent). [In this] example, Taxpayer A will pay the producer of the public good \$7 and claim a deduction worth \$2, allowing the organization to produce the good at the optimal level. Taxpayer A will have paid \$5 for the good and the cost of his \$2 tax savings will be spread between B and Z. Taxpayer B will pay less than his marginal benefit for the public good, which is optimal. Thus, the benefit B enjoys from the good’s provision will outweigh his universal subsidization harm, so that he is better off. However, Taxpayer Z will pay more than her marginal benefit, presumed to be zero. This ‘excess’ payment is Z’s universal subsidization harm, as it is not outweighed by any related benefit.”). As a result, the focus of the underfunding discussion in this Article will be on the first condition of optimal provision, which is realistically achievable.

93. Many scholars have argued for excluding moral sentiments in cost-benefit analysis. See, e.g., Peter A. Diamond & Jerry A. Hausman, *Contingent Valuation: Is Some Number Better than No Number?*, 8 J. ECON. PERSP. 45, 47–48 (1994) (asking whether it is useful to have in mind some preferences, including moral preferences, as alternatives to true economic preferences); Peter A. Diamond & Jerry A. Hausman, *On Contingent Valuation Measurement of Nonuse Values*, in CONTINGENT VALUATION: A CRITICAL ASSESSMENT 3, 4 (Jerry A. Hausman ed., 1993) (discussing whether nonuse values measured by contingent value methods are internally consistent with the economic theory on which they are based and concluding that, “[I]t is not appropriate to include [contingent value] measures of stated willingness to pay (WTP) in . . . benefit-cost analysis . . .”); K. E. McConnell, *Does Altruism Undermine Existence Value?*, 32 J. ENVTL. ECON. & MGMT. 22, 26 (1997) (arguing that counting benefits representing moral sentiments will distort choice); Paul Milgrom, *Is Sympathy An Economic Value? Philosophy, Economics, and the Contingent Valuation Method*, in CONTINGENT VALUATION: A CRITICAL ASSESSMENT 417, 420 (Jerry A. Hausman ed., 1993) (arguing that including internalized benefits would lead “to inclusion of projects that violate principles of Kaldor-Hicks efficiency and would, therefore, exclude moral sentiments in cost-benefit analysis). But see, e.g., Richard O. Zerbe, Jr. et al., *An Aggregate Measure for Benefit-cost Analysis*, 58 ECOLOGICAL ECON. 449, 450–51 (2006) (arguing that moral sentiments should be included as an aggregate measure in the Kaldor-Hicks model).

94. This assumes for simplicity that there is only one potential donor. This is not an uncommon analytical approach. See, e.g., Kaplow, *supra* note 76, at 470 (illustrating this approach by explicitly pairing donors with donees).

95. Marginal utility is often declining. LEWIS & WIDERQUIST, *supra* note 76, at 22. They

potential donor does not experience any benefits from his donation—i.e., he does not experience direct, giving, or internalized benefits. Under the benefits pricing model, it is optimal for the first two units to be provided but not the third (because the benefits do not exceed the costs of that unit). Thus, in this “independent scenario,” a deduction should be granted when needed to ensure two units are provided.

Consider a second scenario that differs in one respect from the first: the donor fully internalizes the benefits of the potential beneficiaries. If one were to account for internalized benefits in determining the optimal subsidization level, benefits would be “double counted.” Specifically, the benefits of providing the first unit would be \$2,000 (the \$1,000 enjoyed by beneficiaries and the \$1,000 enjoyed by the donor who internalizes their benefits), \$1,400 for the second unit, and \$140 for the third. Under this “double counting” model, it would be optimal to provide an additional third unit because the benefits would outweigh the costs of providing it. Thus, a deduction would be warranted in this “interdependent scenario” when needed to ensure that three units are provided.

If this “double counting” model were used, the government would provide greater subsidies (by providing charitable deductions to ensure the production of more goods) in the interdependent scenario than the otherwise comparable independent scenario.⁹⁶ It is not at all clear that this “subsidy bias” is desirable.⁹⁷ A donor is increasingly likely to internalize the benefits of those with whom he shares some relationship and is increasingly unlikely to do so when his relationship with beneficiaries is

provide the following example:

If a cookie costs \$1, then for every cookie I eat, I have one less dollar to spend on all other goods. The marginal benefit of a cookie is a little bit trickier. You have to ask yourself how much you would pay for this cookie. What would be the *most* I would give up for this cookie if I had to? Suppose you eat one cookie and it tastes so good that you would be willing to sacrifice \$4 worth of other goods to buy it. . . . Luckily, you had to pay only \$1, so it was a good deal for you. So you have another. Now that you have already had a cookie, the second one is not nearly so satisfying, but it is still good—so you would pay \$2 for it. Still a good deal. Now that you are becoming satisfied, the third cookie is only worth \$1 to you. It costs \$1, so it is worth it but just barely. You are indifferent to this third unit. That is how you know you have reached the optimum, and it is time to stop eating cookies.

Id. at 22.

96. See *supra* note 93 (discussing various arguments for and against the inclusion of moral benefits in a cost benefit analysis).

97. This illustrates one argument economists have advanced against including “moral sentiments” in cost-benefit analysis—that is, projects that would generally be deemed inefficient (such as shipping the third unit) would be rendered efficient only because of the inclusion of these benefits. See *supra* note 93.

more attenuated.⁹⁸ It would seem odd for the government to provide discrepant subsidies solely because of these differing relationships and, specifically, to provide greater subsidies to organizations having beneficiaries and donors that are acquainted. In fact, one might think it should be the very opposite. As discussed above, one justification for the charitable deduction is that it subsidizes organizations providing sufficiently widespread benefits.⁹⁹ Giving increased subsidies to organizations in which donors share relationships with beneficiaries would seem to run against this goal. The remainder of this Article will assume that internalized benefits should not be used to determine the optimal subsidization level.¹⁰⁰ This would eliminate the bias illustrated in the independent and interdependent scenarios by eliminating double counting and yielding the same optimal subsidization level for each project.¹⁰¹

There is one further question: Whether giving benefits should be accounted for in determining the optimal subsidization level. Conducting a similar analysis to the one above, one sees that accounting for this effect would provide different subsidies to projects that are identical in all respects other than the giving benefits enjoyed by the donor. The question is whether subsidy levels should depend on the ability of organizations to make donors “feel good” about their contributions.¹⁰²

To illustrate, consider two organizations providing goods to residents in neighboring impoverished villages. Imagine that the organizations have identical cost functions and, for simplicity, that each organization has the “hypothetical cost function” developed above—it would cost \$900 to provide one shipment of goods, \$600 to provide the second shipment, and \$100 to provide the third shipment. Further, assume for simplicity that the “hypothetical aggregate benefits function” developed above applies—residents would enjoy a \$1,000 benefit from the first shipment, \$700 from the second shipment, and \$70 from the third shipment. Assume a potential donor will neither enjoy direct benefits nor internalize the benefits of the needy beneficiaries. Assume, however, that there is one difference between

98. For instance, it is well recognized that “interdependent preferences are likely to be particularly strong between family members.” Theodore C. Bergstrom, *Systems of Benevolent Utility Functions*, 1 J.PUB. ECON. THEORY 71, 76 (1999); see also Shelly Lundberg & Robert A. Pollak, *Bargaining and Distribution in Marriage*, 10 J. ECON. PERSP. 139, 142–46 (1996) (discussing common preferences within the family); cf. Robert A. Pollak, *Interdependent Preferences*, 66 AM. ECON. REV. 309, 311–12 (1976) (“[A] man’s preferences will be influenced more by the consumption of those with whom he has close contact than by those with whom his contact is more distant.” (citing JAMES S. DUESENBERY, *INCOME, SAVING AND THE THEORY OF CONSUMER BEHAVIOR* 27 (1962))).

99. See *supra* Part III.A.

100. Non-donors might internalize the benefits of other beneficiaries as well. For similar reasons, these internalized benefits will also be excluded from the optimal subsidization model.

101. That is, in both cases, it would be optimal to provide the second unit but not the third.

102. See Andreoni, *supra* note 79, at 1457.

these two otherwise identical organizations: the first organization sends out an annual pamphlet showing pictures of beneficiaries while the other does not (or cannot afford to) do so. As a result, a hypothetical donor contributing to the first organization will enjoy a “warm glow” benefit of \$50 per shipment but will not experience “warm glow” benefits when donating to the second organization.¹⁰³ If giving benefits (such as “warm glow” benefits) were used to calculate the level of optimal provision, it would be optimal to make three shipments to the village served by the “warm glow” organization because the addition of these giving benefits would cause the total benefits of the third shipment to exceed its costs. It would, however, be optimal to make only two shipments to the village served by the “non-warm glow” organization.

This result again seems strange. It is not clear why the government should subsidize the provision of more goods to one impoverished village than another purely because one organization possesses the ability to make donors feel good about their donations.¹⁰⁴ More generally, it seems odd for the government to provide greater subsidies to projects of “warm glow organizations” over otherwise identical projects of “non-warm glow organizations.” The remainder of this Article will assume that giving

103. In reality, the warm glow is dependent on the amount the donor gives—i.e., the greater the gift, the larger the warm glow effect. *See id.* at 1449. While making the benefit dependent on shipment illustrates the point more simply, the point is unchanged if one were to express the warm glow benefits in terms of dollars donated.

104. In fact, one might again think it should be the opposite. As will be discussed below, the warm glow may cause free-riders to make some contribution, suggesting that the “warm glow” organization should, if anything, be provided a lesser subsidy. *See* RICHARD CORNES & TODD SANDLER, *THE THEORY OF EXTERNALITIES, PUBLIC GOODS, AND CLUB GOODS* 264 (1986); Richard Cornes & Todd Sandler, *Easy Riders, Joint Production, and Public Goods*, 94 *ECON. J.* 580, 580 (1984); Akram Temimi, *Does Altruism Mitigate Free-riding and Welfare Loss?*, 8 *ECON. BULL.* 1, 6–7 (2001). Professor Gergen has explained the way in which the “joys of giving” can lead not only to optimal provision but “supraoptimal provision.” He writes:

Because of the joys of giving, philanthropy (and other forms of charity) may be a “supraoptimal” solution to funding collective goods. It makes philanthropists happier, because undoubtedly they enjoy giving voluntarily more than they would enjoy paying similar amounts in taxes or in user fees. Their philanthropy also benefits the rest of us. Philanthropists give more than they would pay for a good under a pricing regime, so that the rest of us may pay less for the good while still enjoying it at an optimal level. Philanthropists, in essence, redistribute resources to us in return for our respect or their own self-respect.

Circumstances may arise in which the pleasures of giving induce people to overinvest in goods. If a good is already funded at close to an optimal level, gifts made for the pleasure or prestige of giving will allocate excessive resources to it. Overbuilding on campuses because of a donor “edifice complex” is an example of this.

benefits should not be used to account for the optimal subsidization level, eliminating this second “subsidy bias.”¹⁰⁵

The resulting “optimal subsidization model,” which excludes internalized and giving benefits, will be used for the remainder of this Article. According to this model, goods and services should be produced so long as the sum of the direct benefits experienced by donors and the direct benefits experienced by non-donors exceed the costs of production. For the reasons discussed, this model seems an intuitive interpretation that eliminates “subsidy biases” for otherwise identical projects that differ only in the relationship shared by the donor and the beneficiaries of his donation¹⁰⁶ and in the ability of the donor to experience giving benefits. This Article does not, however, claim to resolve definitively the issue of whether and to what extent one should account for these benefits. This resolution must be reserved for future work and to the extent contrary conclusions are reached (i.e., it is deemed desirable to “double count” benefits or account for giving benefits in determining optimal provision), the analysis of this Article would change.

Returning to the now-developed models, a rational donor should be willing to donate an amount equal to the sum of the monetized benefits he receives as a result of his contribution. Thus, when those that directly benefit from the goods or services provided by a donee-organization are economically rational and financially capable of donating, optimal provision should be achieved without the need for the charitable deduction. To illustrate,¹⁰⁷ imagine an organization would build a public park in one-acre increments. Using the “hypothetical cost function” for simplicity, assume it would cost \$900 to construct one acre, \$600 to construct the second acre, and \$100 to construct the third. Further, let us use the hypothetical aggregate benefits function but now explore how benefits are distributed. Assume that both *A* and *B* would enjoy direct benefits from the park by, for instance, using it for recreational purposes. Assume *A* would enjoy an \$800 benefit from the first acre of park and *B* would enjoy a \$200 benefit from that acre (resulting in an aggregate \$1,000 benefit). Further, assume that *A* would enjoy a \$500 benefit from the second acre, that *B* would derive a \$200 benefit (resulting in an aggregate \$700 benefit), and

105. Importantly, this seems consistent with Erik Lindahl’s original articulation of the benefits pricing model, in which each individual “pay[s] [an] amount corresponding to his valuation of public services.” Lindahl, *supra* note 90, at 173 (emphasis added). Giving benefits are not, by definition, derived from the public service provided but from the act of donating. See Andreoni, *supra* note 79, at 1448–49.

106. The argument for excluding internalized benefits of non-donor beneficiaries would use the same reasoning—it is not clear why the government should provide discrepant subsidies to identical projects differing only in the relationship shared by other beneficiaries. See *supra* note 100.

107. See McCormack, *supra* note 41, at 992–95 (providing another numerical illustration of the benefits pricing model).

that *A* and *B* would each enjoy a \$60 and \$10 respective benefit from the third acre (resulting in a \$70 aggregate benefit). As with the other examples, it is optimal for the organization to provide two units (here, acres) of park.¹⁰⁸ The park will be provided at this optimal level if both *A* and *B* (as well as Organization *C*) are rational economic actors because each should be willing to pay an amount equal to the benefit they receive from the two-acre park.¹⁰⁹ Specifically, *A* should be willing to donate \$1,300 and *B* should be willing to donate \$400 to help Organization *C* fund these two acres. This will enable Organization *C* to construct the optimal park because donations cover needed costs. Because Organization *C* does not suffer underfunding problems, it is economically unnecessary to allow *A* and *B* to deduct their contributions.

However, underfunding may occur even when direct beneficiaries are financially capable of contributing. These beneficiaries may not donate rationally—i.e., they may contribute less than the rational donor model predicts—because they assume that others will contribute and they can enjoy benefits free of cost. In this way, collective action problems may cause goods and services to be sub-optimally provided,¹¹⁰ creating a situation in which the charitable deduction is economically needed to prevent underfunding.

B. *Using the Deduction to Correct Collective Action Problems*

Modifying the last example, suppose that *A* is still willing to pay \$1,300 for the two-acre park (which equals his direct benefit) but that *B* is no longer willing to pay anything, even though he will still directly benefit in the assumed manner. *A*'s \$1,300 donation will not cover the costs needed to construct the two-acre park, resulting in underfunding. In this example, where *B* is not willing to pay for a good or service that would directly benefit him, he may be acting as a “free-rider.” A collective action or free-rider problem occurs when individuals fail to contribute toward a particular goal or project (here, funding a park) even though each “would gain if, as a group, they acted to achieve their common interest or

108. The \$1,000 and \$700 aggregate benefits enjoyed by *A* and *B* from the respective first and second acres exceeds the \$900 and \$600 respective costs. The third acre should not be produced because the \$70 aggregate benefits do not exceed the \$100 cost.

109. Under the rational donor model, a donor will make a donation at least equal to his monetized benefits.

110. This has been long recognized by notable scholars. See generally MANCUR OLSON, JR., *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 27–28 (1965); Hochman & Rodgers, *supra* note 28, at 225 (“To the extent that voluntary cooperation, unassisted, produces suboptimal levels of provision, the preferential tax treatment of voluntary contributions is one way of improving matters.”); Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 *REV. ECON. & STAT.* 387, 389 (1954) (identifying the “heart of the whole problem of social economy: . . . any one person can hope to snatch some selfish benefit in a way not possible under the self-policing competitive pricing of private goods”).

objective . . . ”¹¹¹ Individuals often free-ride because they hope “to enjoy the amounts of the [goods or services] . . . financed by the contributions of others.”¹¹² Here, *A*’s large contribution will enable Organization *C* to construct a large percentage of the two-acre park.¹¹³ Because *B* is able to enjoy this portion, he may not donate the remaining \$200 needed to construct the optimal park even though his benefit exceeds that amount.¹¹⁴

A perfectly designed charitable deduction can correct these underfunding issues.¹¹⁵ Using the provided example, if *A* received a deduction worth \$200 when he donated to Organization *C*, he would be willing to contribute at least \$1,500 because the after-tax cost of his donation would still be \$1,300 (his direct benefit). Thus, this charitable deduction would restore optimal provision. This example is obviously oversimplified in various respects. It, for instance, assumes there are only two individuals who could potentially donate and directly benefit from the donation. When one expands the universe of potential beneficiaries, one sees how free-riding can create more drastic underfunding problems. If many beneficiaries act like *B* and fail to donate in hopes of benefitting from the contributions of others, then “little or none of the good will be supplied, even though collective demand for the good is quite high.”¹¹⁶ The charitable deduction can, therefore, act as an important mechanism for subsidizing organizations that cannot garner sufficient donations on their own.

When underfunding is caused by free-rider problems, those that directly benefit from the goods or services provided by the donee-organization fail to contribute because they hope to benefit from others’ donations. There is, however, another way that underfunding may occur, which will be referred to in this Article as the externality problem.

111. OLSON, *supra* note 110, at 2.

112. Hansmann, *supra* note 46, at 849.

113. Even assuming the park can only be provided in acre-increments, *A*’s donation will allow one acre to be provided. However, it is even more likely that the park can be provided in continuous increments so that something far closer to two acres can be provided by *A*’s donation.

114. See, e.g., Hochman & Rodgers, *supra* note 28, at 227 (arguing that, “[S]ome individuals fail to contribute, not because they place no marginal value on the activity, but because they are better off as ‘free riders,’ to wit, they view the cost of its expansion, so long as they must contribute, as excessive and permit others to pay for their benefits.”); George J. Stigler, *Free Riders and Collective Action: An Appendix to Theories of Economic Regulation*, 5 BELL J. ECON. MGMT. SCI. 359, 359 (providing an example of the free rider problem).

115. See Gergen, *supra* note 12, at 1403 (explaining that the deduction corrects underfunding caused by collective action problems by “enabl[ing] people with a high preference for a good [here, *A*] to shift some of its cost to low-preference free-riders [here, *B*]”); Hochman & Rodgers, *supra* note 28, at 227–32. The authors argue that the deduction shifts costs to free-riders across communities.

116. Hansmann, *supra* note 46, at 849.

C. Using the Deduction to Correct Externality Problems

Reconsider the public park example. Recall that it is optimal for a two-acre park to be provided, which will cost \$1,500 to construct and which will result in *A* and *B* enjoying direct benefits of \$1,300 and \$400, respectively. Because *B* may be content to enjoy the majority of the park funded by *A*'s \$1,300 contribution, collective action problems may cause underfunding.¹¹⁷ However, optimal provision could still be achieved if *A* were to contribute the remaining \$200 needed to cover the costs of the two-acre park. Under the rational donor model, a donor will contribute an amount equal to the sum of his (monetized) direct benefits, giving benefits, and internalized benefits. Thus, if *A* were to internalize at least \$200 of *B*'s benefit from the park—that is, if he were to make \$200 of *B*'s benefit “his own”—he would be willing to donate that additional amount. As discussed, donors (such as *A*) will internalize the benefits of others (such as *B*) only to the extent that their utility functions are interdependent. Depending on *A*'s relationship with *B*, *A* may not internalize a sufficient portion of *B*'s benefit to allow optimal funding.

Thus, in this example, underfunding may be caused by a combination of collective action problems and what will be referred to as externality problems. The collective action problem explains the failure of direct beneficiaries (such as *B*) to contribute an amount equal to their benefit while the externality problem explains the failure of donors (such as *A*) to internalize the benefits of other beneficiaries (such as *B*). In addition to responding to the former problem, a properly designed charitable deduction can be used to correct the underfunding issues caused by the latter problem.¹¹⁸ Building from the public park example, suppose that *A* and *B* are neighbors and that their utility functions are somewhat interdependent. Because of this interdependence, suppose *A* will internalize \$50 of *B*'s benefit. Using the rational donor model, *A* should be willing to donate an additional \$50, so that \$150 is still needed for optimal provision. If *A* were also allowed a deduction worth \$150, he would be willing to donate the full \$200 needed to optimally fund the park.¹¹⁹

117. See *supra* Part IV.B.

118. Kaplow, *supra* note 76, at 475. Professor Louis Kaplow argues that the deduction should be granted for many “other-regarding” transfers, not only including charitable donations (which are, of course, deductible) but also including intra-family gifts (which are not currently deductible) so long as these transfers are welfare-enhancing. This Article does not explore the exact circumstances in which transfers will be welfare enhancing. For a detailed analysis of this point, see generally Kaplow, *supra* note 76. In essence, Kaplow argues that the transfer is welfare enhancing (and a deduction warranted) whenever the utility gain from the transfer exceeds the utility loss the donor suffers as a result of his donation. *Id.* at 470.

119. *A* is willing to give an additional \$200 because his after tax cost of giving this additional amount would be only \$50 (the additional amount *A* is willing to contribute as a result of the assumed internalized benefits from the park). A deduction such as this is economically desirable if it is also welfare-enhancing. *Id.*

In other cases, underfunding problems will be primarily caused by externality problems. Consider, for instance, organizations that directly benefit groups that are financially incapable of donating, such as the needy, children, and animals.¹²⁰ Those who donate to these organizations are unlikely to enjoy significant direct benefits from their contributions.¹²¹ In these cases, donations will be increasingly dependent on the donor's internalized benefits and underfunding issues most aptly described by the externality problem (the failure of donors to make the benefits of others "their own"). To illustrate, assume that an organization serving the needy could optimally provide food for a cost of \$1,500, resulting in a much greater \$5,000 monetized benefit for those nourished. Assume that a potential donor would not enjoy direct or giving benefits and would internalize only a small \$50 portion of the benefits of the unknown food-recipients. If a deduction worth \$1,450 were provided, the externality problem would be resolved and this donor would be willing to contribute the \$1,500 needed for optimal provision.¹²² These examples are again oversimplified but illustrate how the charitable deduction can be used to correct underfunding caused by externality problems.

V. APPLYING THE UNDERFUNDING REQUIREMENT

The last Part showed how application of the efficiency-based underfunding requirement can theoretically limit the organizations subsidized by the charitable deduction to those in economic need. Of course, unlike the simplified examples provided, it is not realistically possible to provide a perfectly tailored subsidy that corrects the specific underfunding problems suffered by individual organizations. To do so, one would have to apply the optimal subsidization model to every subsidized organization, which seems implausible not only because of the vast number of these organizations,¹²³ but also because it would be exceedingly

120. There are many organizations such as these. For instance, there are 4,357 organizations registered with the IRS using "animal" descriptors. *Search for Charities, Online Version of Publication 78*, *supra* note 1 (search "animal"). Though, note, this simplified search yields a list of organizations and intended beneficiaries ranging from the American Society for the Prevention of Cruelty to Animals to the Society of Animal Artists.

121. While it "could be argued . . . that we are all members of humanity, and any gift that improves the lot of the race redounds to the donor's benefit," Atkinson, *supra* note 61, at 536, the direct benefits seem rather slight.

122. Using Kaplow's model, it is desirable to use the deduction in this way when the donation is welfare-enhancing. See Kaplow, *supra* note 76 (arguing in favor of deductions for charitable gifts that increase social welfare). This donation is welfare enhancing if the utility loss suffered by the donor when he contributes the needed \$1,500 is less than the utility gain enjoyed by the beneficiaries. This Author recognizes these additional limitations but has not discussed them at length in this Part's simplified discussion of efficiency concepts.

123. See *Search for Charities, Online Version of Publication 78*, *supra* note 1. A recent article in the *New York Times* reported that "[t]he number of organizations that can offer their donors a tax break in the name of charity has grown more than 60 percent in the United States, to 1.1 million in

difficult to quantify the marginal benefits created by the goods and services provided (as required by the model).¹²⁴ Further, to precisely assess the severity of individual collective action problems, one would need to apply the rational donor model to each potential donor and to assess the severity of specific externality problems one would need to determine the extent to which the utility functions of donors and beneficiaries were interdependent.¹²⁵ However, while one cannot precisely determine whether and to what extent any given organization or type of organization will suffer from underfunding problems, a general assessment can provide a starting point for evaluating the current scope of the charitable deduction.

The remainder of this Article will provide this assessment. To do so, four hypothetical donations will be considered, all of which are generally entitled to the charitable deduction under current law: donations to an organization that provides toys to children in a remote village,¹²⁶ donations to an organization that funds opera productions,¹²⁷ donations to a specific church¹²⁸ used to fund religious, as opposed to other charitable, activities¹²⁹

[the last] decade.” Stephanie Strom, *Charities Rise, Costing U.S. Billions in Tax Breaks*, N.Y. TIMES, Dec. 6, 2009, at A1. A recent study conducted by the Stanford University Center on Philanthropy and Civil Society explains this growth and shows that the IRS approved over 98% of applications filed by organizations seeking tax-exempt status. REICH ET AL., *supra* note 49, at 8.

124. For instance, there is the “preference revelation” problem. In order to meaningfully apply the Lindahl solution in which each individual contributes an amount equal to his benefit, individuals must reveal their true preferences for goods. It is, however, in each individual’s interest to underreport his preferences. Samuelson, *supra* note 110, at 388–89 (“[I]t is in the selfish interest of each person to give false signals, to pretend to have less interest in a given collective consumption activity than he really has, etc.”); see also Edward H. Clarke, *Multipart Pricing of Public Goods*, 11 PUB. CHOICE 17, 18–22 (1971) (discussing the preference revelation problem); Roger B. Myerson, *Incentive Compatibility and the Bargaining Problem*, 47 ECONOMETRICA 61, 67–73 (1979) (discussing incentive efficiency); William Vickrey, *Counterspeculation, Auctions, and Competitive Sealed Tenders*, 16 J. FIN. 8, 24–26 (1961) (articulating a theoretical auction method that would later be called the Vickrey-Clarke-Groves auction, which would lead each individual to reveal his true preference). While theoretically interesting, it is not clear that this can be practically applied. See, e.g., Michael H. Rothkopf, *Thirteen Reasons Why the Vickrey-Clarke-Groves Process Is Not Practical*, 55 OPERATIONS RES. 191, 191–95 (2007) (arguing that the process is of limited value because it compromises on other practical issues).

125. Professor Kaplow fully recognizes these administrative difficulties. It would, for instance, require “social authorit[ies] to know] which individuals were donors, . . . donees, [and beneficiaries], the level of altruism, the initial levels of wealth, and the functional form for utility of individuals’ own wealth . . . [M]uch of this information will be unobservable (or costly to observe).” Kaplow, *supra* note 76, at 471.

126. Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 2008) (defining charitable to include “[r]elief of the poor”).

127. *Search for Charities, Online Version of Publication 78, supra* note 1 (search “opera”).

128. This Article uses available data to discuss the case of church donations. The Article uses the term “church” because relevant data have tended to focus on organizations categorized in these terms. This Author recognizes, however, that the discussion is necessarily generalized. Further analysis on different religious practices must be reserved for future work.

129. This, therefore, recognizes that a religious organization can perform both religious and

(including those made by congregants who regularly attend its services and events),¹³⁰ and donations to a specific school (including those made by parents of its students).¹³¹ While current tax law generally allows donors to claim the charitable deduction in each of these situations, the analysis suggests that the severity of underfunding problems experienced by these donee-organizations may be greatly varied and that the latter two organizations may suffer these issues only minimally. Part VI will explain how this analysis can be of more general use.

In order to analyze these cases, recall that a rational donor will contribute an amount equal to the sum of the (monetized) direct benefits, giving benefits, and internalized benefits experienced. This Part will proceed by analyzing each of these benefits in turn. It will discuss whether and to what extent donors can be expected to enjoy these specific benefits in the four hypothetical scenarios. Further, it will explain how the presence of these benefits could affect the relative severity of collective action and externality problems and discuss how this affects the likelihood that goods and services will be underfunded according to the optimal subsidization model. Numerical examples will be provided for illustrative purposes only and are in no way meant to imply mathematical certitude.

This Part begins with a discussion of the direct benefits experienced by donors who are able to enjoy the goods or services funded by their donations.

A. *Direct Benefits*

As discussed above, donee-organizations should not be underfunded when those who directly benefit from the goods and services provided are both economically rational and financially able to donate. In these cases, goods and services should be optimally provided without the charitable deduction, rendering the subsidy economically unnecessary.¹³²

charitable functions. This Article focuses upon donations used to finance the former purpose only and the analysis is not meant to apply to donations used to finance the latter functions. For ease of reading, this Article will refer to this hypothetical donation as the “church donation” or in other similar terms without explicitly mentioning this limitation. This Author wishes to recognize and be sensitive to possible objections to this approach. It might be argued that one cannot categorize expenses this way. However, statistical data are available which does perform this categorization, and importantly, this data suggest that a large percentage of church donations are used for the “sacramental” functions upon which the analysis focuses. See Aprill, *supra* note 2, at 865. Another objection is that church donors may not always know for which functions their donations are being used. While true, to the extent one found that deductions should not be allowed for donations made to specific churches to fund religious functions (i.e., because underfunding was not an issue), various mechanisms could be devised to preserve deductions for donations used for other charitable activities. See *infra* note 234.

130. I.R.C. § 170(b)(1)(A)(i) (West 2010).

131. I.R.C. § 170(b)(1)(A)(ii).

132. See *supra* Part IV.A.

Because the toy organization will provide little, if any, direct benefit to potential donors (those who might benefit—needy children—are unable to donate), contributions will be largely dependent upon giving and internalized benefits, discussed later.¹³³ However, one can expect many of the donors contributing to the other hypothetical organizations—the opera organization, a specific school, or a specific church—to experience a variety of direct benefits.

Nonetheless, as discussed, collective action problems may prevent these donors from contributing the rational amount, resulting in underfunding issues that can be corrected with the charitable deduction. There are various reasons why collective action problems are especially likely to cause “charitable” organizations to be underfunded. Recall that “charitable” organizations are presumed to provide goods and services offering sufficiently widespread benefits¹³⁴ that must be shared among large groups of beneficiaries.¹³⁵ As a result, an individual may perceive “little relationship between the size of [his] contribution and the amount of the good [he actually] enjoys.”¹³⁶ Further, it has been explained:

[T]he 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 that is provided, and . . . the individual will . . . be able to enjoy the amounts of the good that are financed by the contributions of others.¹³⁷

Whether and to what extent these identified conditions will lead to collective action problems and sub-optimal funding depends in part on the way in which direct benefits are distributed among beneficiaries.

1. Assessing Underfunding Problems Based on the Distribution of Direct Benefits

Consider an organization providing a “sufficiently” public good (or service) with the now familiar hypothetical cost and aggregate benefit functions. It will cost the organization \$900 to produce the first unit, \$600 to produce the second, and \$100 to produce the third. Next, the first unit will produce a \$1,000 aggregate benefit, the second unit a \$700 aggregate benefit, and the third unit a \$70 aggregate benefit. Assuming discrete units, it is optimal for two units to be produced. If each beneficiary enjoys only small benefits (i.e., the beneficiaries comprise a low-preference group),

133. See *infra* Part V.B–C.

134. See *supra* Part III.A.

135. See Richard A. Musgrave, *The Voluntary Exchange Theory of Public Economy*, 53 Q. J. ECON. 213, 224 n.9 (1939) (“The product of public economy is ‘divisible,’ in the sense that its supply may be increased by small units, but ‘indivisible,’ in the sense that no separate ‘benefit shares’ may be attributed to individual purchasers.”).

136. Hansmann, *supra* note 46, at 849.

137. *Id.*

collective action problems are extremely likely to occur. For instance, if benefits are divided equally among one thousand low-preference individuals so that each enjoys a \$1 benefit from the first unit, a seventy cent benefit from the second unit, and a seven cent benefit from the third unit, the conditions causing free-riding are quite clearly present, making underfunding likely.¹³⁸ Each beneficiary in this low-preference group will believe his small contribution to have little consequence because it will not significantly affect the quantity or quality of the good ultimately provided. In such situations, the charitable deduction is likely needed to correct underfunding issues.

However, the severity of the free-riding problem may change dramatically if direct benefits are distributed differently. Suppose one individual in a one-thousand member beneficiary group, *T*, has a very high preference for the good and would benefit \$910 from provision of the first unit, \$610 from provision of the second unit, and \$60 from provision of the third unit. Assume that the remaining individuals enjoy small benefits that maintain the hypothetical aggregate benefits function (i.e., these individuals enjoy a total \$90 benefit from the first unit so that the aggregate benefit for that unit totals \$1,000, and so on). Even if all other members of the group fail to contribute, the good can be optimally provided if *T* donates an amount equal to his direct benefit for the two units.

Recognizing that high-preference groups can greatly reduce collective action problems, economic literature suggests that *T* is rather likely to make this donation. In fact, when a so-called "privileged group" exists, collective action problems may be eliminated entirely.¹³⁹ A privileged group requires one individual (in the example above, *T*) to receive a benefit from the good or service that exceeds the total cost to provide it.¹⁴⁰ The conditions which generally lead to free-riding are not prevalent in these cases because the donor's high preference ensures that his "contribution [is not] so small in proportion to the total that it will not appreciably affect the amount of the good [or service] that is provided."¹⁴¹ When the high-preference individual donates an amount roughly equal to his benefit, it will "appreciably affect"¹⁴² the funding of the good. Because the high-preference individual has such a strong interest in the particular good or service provided by the donee-organization, he is likely to donate an amount sufficient for optimal provision. In this way, both the high-preference donor and the other lower-preference beneficiaries can enjoy the

138. *Id.*

139. See OLSON, *supra* note 110, at 49-50; see also HARDIN, *supra* note 44, at 38-42.

140. Mathematically, a group will be privileged if there exists an *i* such that $A_i = B_i - C > 0$, where B_i represents the benefits to individual *i*, *C* represents the cost to produce the public good, and A_i , therefore, represents the net benefits to individual *i*. See HARDIN, *supra* note 44, at 39.

141. Hansmann, *supra* note 46, at 849.

142. *Id.*

good or service, even if the latter group does not contribute at all.¹⁴³ Because underfunding is unlikely to be an issue when organizations benefit “privileged” groups, it seems economically unnecessary to subsidize these organizations through the charitable deduction.

In practice, privileged groups are rare because it requires a single individual to have a rather strong preference for the good or service provided.¹⁴⁴ Nonetheless, if there is a group of individuals with a significantly high preference for the good or service provided, economic literature suggests free-rider problems may be reduced even if the group is not “purely” privileged.¹⁴⁵ Modifying the above scenario, assume that instead of one high-preference individual, a group of high-preference individuals shares the large benefit described (for example, ten individuals might each benefit \$91 from the first unit and \$61 from the second). While the group is not purely privileged (no single individual’s benefit exceeds the cost needed to optimally provide the two units), free-rider problems may still be mitigated. Because the individuals’ combined benefit exceeds the total cost needed for optimal provision, the good can be optimally funded if each donates the “rational” amount equal to his direct benefit. This “quasi-privileged” group¹⁴⁶ may be less susceptible to free rider problems than lower preference groups.¹⁴⁷

143. HARDIN, *supra* note 44, at 39 (“[I]f A_i is positive for some i , the group is *privileged* and likely to succeed.”).

144. Professor Russell Hardin refers to such groups as “latent groups.” *Id.* For a real example of a privileged group, see Gergen, *supra* note 12, at 1411 (citing users of a Las Vegas television station purchased by billionaire magnate Howard Hughes to broadcast western and aviation films through the night). See also Yochai Benkler, *Coase’s Penguin, or, Linux and the Nature of the Firm*, 112 YALE L.J. 369, 376 (2002) (discussing the use of a “commons-based peer production” model that requires group collaboration).

145. More formally, this occurs when a group of high preference individuals “just barely stands to benefit from providing the good [or service], even without cooperation from other[s].” HARDIN, *supra* note 44, at 41. In mathematical terms, if k is used to “designate the size of any subgroup that just barely stands to benefit from providing the good, even without cooperation from other members of the whole group,” the group will have an increased likelihood of overcoming collective action problems if k is small. *Id.* Put another way, “a relatively small fraction of the whole group would already stand to benefit . . . if that fractional subgroup alone paid the full cost of the group good.” *Id.* at 40–41.

146. Hardin calls them “intermediate groups.” *Id.* at 40 (internal quotation marks omitted).

147. See, e.g., *id.* (“[C]ommon sense suggests that there is a strong empirical relationship between groups’ sizes and their prospects of failure.”). The notion is explained:

“Two neighbours may agree to drain a meadow, which they possess in common; because ’tis easy for them to know each other’s mind But ’tis very difficult . . . that a thousand persons shou’d agree in any such action; it being difficult for them to concert so complicated a design, and still more difficult for them to execute it”

Id. (quoting DAVID HUME, A TREATISE OF HUMAN NATURE 538 (1740)). For a more complicated example of a latent group, see *id.* at 41–42.

With these concepts in mind, consider the three scenarios in which donors can be expected to enjoy direct benefits—donations made to the opera organization, specific church, and specific school. Literature suggests that the opera organization is likely to provide significant direct benefits to a relatively small group of high-preference beneficiaries. Organizations providing “high-culture entertainment such as opera, ballet, and classical music,” have been described as having “appeal[] only to a small segment of the population.”¹⁴⁸ The economics of such productions have been explained as follows:

[T]here are seldom more than a few performances of a given production. The substantial start-up costs . . . account for a large portion of the total costs that must be spread over the resulting performances. Once one performance of an opera has been staged, the additional cost of adding another performance is relatively small. Similarly, so long as the theater is not yet filled, the additional cost incurred by adding another member to the audience is very small, since it costs little more to stage a performance for a full house than it does to play to one individual.

The result is that, once a commitment has been made to have at least one performance of a given production, it becomes worthwhile to admit additional persons to the audience at a given performance, or to extend the number of performances, so long as the individuals who attend will pay a price just high enough to cover the small additional—marginal—cost involved.¹⁴⁹

By allowing attendees to pay an admission price of their choosing (i.e., by making discretionary donations), productions are funded in a way that may not be achieved if a uniform fee were charged.¹⁵⁰ Each individual is assumed to contribute an amount reflecting the value of the production to him¹⁵¹ so that a small group of donors funds the bulk of production costs

148. Hansmann, *supra* note 46, at 856.

149. *Id.* at 856–57.

150. *Id.* at 857.

151. This is known in economic terms as “price discrimination.” The use of this method to fund performances is discussed in Professor Henry Hansmann’s seminal work, *The Role of Nonprofit Enterprise*. *Id.* at 857–58; see also Robert Charles Clark, *Does the Nonprofit Form Fit the Hospital Industry?*, 93 HARV. L. REV. 1416, 1438–39 (1980) (using Hansmann’s theory of price discrimination in the case of nonprofit hospitals); Jennifer Kuan, *The Phantom Profits of the Opera: Nonprofit Ownership in the Arts as a Make-Buy Decision*, 17 J.L. ECON. & ORG. 507, 510 (2001) (discussing voluntary price discrimination in nonprofits); Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 EMORY L.J. 1475, 1539 n.212 (2005) (discussing Hansmann’s theory of the non-distribution constraint and price discrimination in donor participation in nonprofit art giving).

by contributing an amount reflective of their high preferences while lower preference consumers need only donate enough to cover the “marginal costs” needed to fund additional showings.¹⁵² This suggests that organizations such as the opera organization tend to provide goods and services offering significant direct benefits to a relatively small group of donors. Because of their high preference for the provided performances, these donors may be able to overcome collective action problems to fund a large portion of the cost needed for optimal provision.

It seems even more likely that specific churches will provide goods and services to high-preference groups. Statistical data suggest that churches use a large portion of donations to support their own operations, such as maintaining and improving facilities and funding services and events.¹⁵³ Data also suggest “contributions by members of churches primarily benefit other members.”¹⁵⁴ Because those who attend a specific church’s services and events are generally the same individuals that make donations,¹⁵⁵ church donors can be expected to enjoy a unique array of direct benefits.

Most obviously, a large percentage of donations will be used to maintain or increase the frequency and quality of services and events

152. Hansmann, *supra* note 46, at 857.

153. Professor Ellen Aprill summarizes statistics related to giving to religious organizations:

A 1972 estimate put “‘nonsacramental’ expenditures, those for social welfare, health functions, and nonreligious education,” at less than 20%, and available data indicate that “sacramental functions account for a preponderance of church expenditures.” . . . A 2000 study by Independent Sector reported that of \$9.6 billion in donations by America’s more than 350,000 religious congregations, 66% was distributed within the denomination, 23% to organizations outside the denomination, and 11% was given in direct assistance to individuals. . . . A 1999 survey with a nationally representative sample of congregations reported that . . . [s]pending on [social service projects] . . . constituted on average only between 2% and 4% of a congregation’s total budget.

Aprill, *supra* note 2, at 865 (quoting CLOTFELTER, *supra* note 2, at 23–25). See *supra* note 129 (recognizing that some donations will be used for other charitable purposes).

154. Aprill, *supra* note 2, at 865 (citing Mark Chaves, The Urban Inst., *Congregations’ Social Service Activities*, CHARTING CIVIL SOC’Y, Dec. 1999, at 1, 2, available at http://www.urban.org/uploadedpdf/cnp_6.pdf).

155. See Hansmann, *supra* note 46, at 891 (“[O]ne motivation for keeping the membership of a church relatively well defined is undoubtedly so that the members can be approached, and made to feel responsible, for contributions beyond those made during services or in the form of unsolicited gifts.”). This has been explicitly recognized by some churches. See, e.g., *Donations*, THE RIVERSIDE CHURCH, <http://www.theriversidechurchny.org/stewardship/?donations> (last visited Apr. 6, 2011) (“Fulfilling the programmatic mission of The Riverside Church is made possible primarily through the generosity of members and friends.”); The Church of Jesus Christ of Latter-day Saints, *How Does the Church Finance Its Operations?*, MORMON.ORG, <http://www.mormon.org/faq/church-operations/> (last visited Apr. 6, 2011) (“Gordon B. Hinckley, prior President of The Church of Jesus Christ of Latter-day Saints, said: ‘Our major source of revenue is the ancient law of the tithe. Our people are expected to pay 10 percent of their income to move forward the work of the Church.’”).

offered. Church events may extend well beyond traditional religious services and may provide opportunities for almost daily activity.¹⁵⁶ These direct benefits, therefore, seem greater than those provided to “opera donors” who are able to attend occasional performances partly funded by their donations.

The donors’ ability to attend church functions and associate with fellow-congregants likely provides an additional “solidary benefit”¹⁵⁷ derived from “the act[] of associating.”¹⁵⁸ These social benefits are unique to organizations where donors share relationships with other beneficiaries.¹⁵⁹ Without seeking to quantify these benefits, recent studies suggest that they should not be underestimated as remote or overly speculative. For instance, according to a study conducted by Professors Robert D. Putnam of the Harvard Kennedy School and Chaeyoon Lim of the University of Wisconsin-Madison, the satisfaction individuals derive

156. For discrete examples of churches offering an especially full variety of events, see *Calendar of Services*, GRACE CATHEDRAL, <http://www.gracecathedral.org/calendar/> (last visited Apr. 6, 2011), offering yoga classes; *Music & Events*, THE RIVERSIDE CHURCH, <http://www.theriversidechurchny.org/events/> (last visited Apr. 6, 2011), which shows a schedule of events including, among many other things, weekly French, yoga, and meditation classes; and *Weekly Calendar*, ST. MARK’S EPISCOPAL CHURCH, <http://www.stmarks.net/calendar/week> (last visited Apr. 6, 2011), offering weekly yoga, meditation, and dance classes.

157. Robert H. Salisbury, *An Exchange Theory of Interest Groups*, 13 *MIDWEST J. POL. SCI.* 1, 20 (1969). These benefits “include such rewards as socializing, congeniality, the sense of group membership and identification, the status resulting from membership, fun and conviviality, the maintenance of social distinctions, and so on.” Peter B. Clark & James Q. Wilson, *Incentive Systems: A Theory of Organizations*, 6 *ADMIN. SCI. Q.* 129, 134–35 (1961).

158. Salisbury, *supra* note 157, at 16. Anthropologist Marshall D. Sahlins discussed this concept, stating: “In an uncommon number of tribal transactions material utility is played down, to the extent that the main advantages appear to be social, the gain coming in good relations rather than good things.” MARSHALL D. SAHLINS, *TRIBESMEN* 9 (1968). These notions have also been worked into economic frameworks. See, e.g., Sobel, *supra* note 82, at 401–02 (discussing the way in which notable economists George J. Stigler and Gary S. Becker have worked these social benefits into their economics models which seek to determine giving.).

159. Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Exemption*, 52 *OHIO ST. L.J.* 1379, 1404 (1991) (referring to churches as “spiritual clubhouse[s]”). The importance of such relationships is something some churches have explicitly recognized. For example, the St. Dominic’s Catholic Church Web site states:

Think for a moment about what St. Dominic’s means to you. Has St. Dominic’s made a difference in your life or the life of your family? Do you have warm memories of Dominicans, past and present, who have served you here? Maybe you or your children attended St. Dominic School or St. Rose Academy, or were baptized or married here. Maybe you were inspired by the church’s soaring Gothic beauty, or made lasting friendships through our peer community groups or our many volunteer ministries.

Planned Giving, ST. DOMINIC’S CATHOLIC CHURCH, <http://www.stdominics.org/donations/planned> (last visited Mar. 16, 2011).

from attending church and other religious organizations may be largely attributable to these “social aspects.”¹⁶⁰

In light of this, it seems likely that churches provide a rather unique array of direct benefits and are, therefore, likely to offer goods and services to high-preference beneficiaries. This suggests that these groups may be able to overcome collective action problems to donate in a “rational” manner, reducing underfunding problems.¹⁶¹ A similar analysis would likely apply to donations made to specific schools. It seems likely that a relatively small group of parents would value the education of their own children so highly that they would happily donate large amounts to their children’s school, providing benefits both to their children and to other students.¹⁶²

160. See Chaeyoon Lim & Robert D. Putnam, *Religion, Social Networks, and Life Satisfaction*, 75 AM. SOC. REV. 914, 927 (2010).

[In part,] Lim and Putnam find that the connection between happiness and religion is not a result of theology (what you believe and what religion you belong to) or private religious practices (e.g., frequency of prayer or feeling God’s presence in one’s life). Instead, they find that frequent churchgoers are more satisfied with their lives because they build intimate social networks in their congregations, anchoring a strong sense of belonging in these religious communities and receiving morally-infused social support.

Media Abstract of Professor Lim and Putnam’s Article, AM. SOCIOLOGICAL REV., http://asr.sagepub.com/content/suppl/2010/12/10/75.6.914.DC1/ASR386686_mediaab.pdf (last visited May 9, 2011). In describing their findings, Professor Lim stated:

“We show that [life satisfaction] is almost entirely about the social aspect of religion, rather than the theological or spiritual aspect We found that people are more satisfied with their lives when they go to church, because they build a social network within their congregation.

. . . .

“We think it has something to do with the fact that you meet a group of close friends on a regular basis, together as a group, and participate in certain activities that are meaningful to the group At the same time, they share a certain social identity, a sense of belonging to a moral faith community. The sense of belonging seems to be the key to the relationship between church attendance and life satisfaction.”

Stephanie Pappas, *Why Religion Makes People Happier (Hint: Not God)*, LIVESCIENCE (Dec. 6, 2010, 10:32 PM), <http://www.livescience.com/9090-religion-people-happier-hint-god.html> (quoting Professor Lim).

161. This Article is not the first to suggest that churches may not be severely underfunded. See, e.g., Gergen, *supra* note 12, at 1394–95 (arguing that allowing the charitable deduction when donors contribute “to churches is not justified as a subsidy because churches do not seem to suffer greatly from freeriding and so should not be underfunded,” while reserving the possibility that it might be justified on other grounds).

162. This Author recognizes that the analysis is more nuanced in this situation. A parent will experience direct benefits from her child being better educated. Her child may, for instance, have greater earning potential and be able to care for her in the future. But most of the benefits the

In sum, it is likely that many individuals that donate to the opera, church, and school experience direct benefits. Further, because each organization is likely to provide significant direct benefits to high-preference groups, there is an increased likelihood that these beneficiaries will overcome collective action problems to fund a sizeable portion of the cost needed to optimally fund goods and services. It is important, however, to fully understand the implications of these observations. While high-preference groups may contribute a large percentage of the needed amount, these donations may not completely cover all costs.¹⁶³ For instance, while high-preference groups may fund the bulk of the opera organization's start up costs, the smaller donations of low-preference beneficiaries may still be needed to fund additional productions.¹⁶⁴ Similarly, while high-preference donors may fund the bulk of the cost needed to optimally fund churches and schools, there is certainly no guarantee these donations will cover all expenses. Thus, while underfunding problems may be far less severe in these cases, they may not be completely eliminated simply because a high-preference group exists.¹⁶⁵

parent-donor will experience are probably best categorized as the internalized benefits of her child. The parent might, for instance, internalize a substantial portion of the benefits of his being better educated, the benefits of his being able to enjoy improved or additional facilities, and the "solidarity benefits" her child might experience by being able to associate with classmates who are also able to enjoy these things. To be precise, one may want to characterize these internalized benefits as quasi-direct benefits and be clear that it is these benefits that lead to the presence of high-preference groups. However, it seems unnecessary to fully explore this point to illustrate the basic similarities of the church and school donations.

163. Thus, the group does not meet the definition of a true quasi-privileged (or intermediate) group, which requires a group of individuals whose combined benefits exceed total costs. *See supra* notes 143–46 and accompanying text.

164. *See supra* notes 149–55 and accompanying text.

165. Close consideration of the optimal subsidization model reveals further reason why this might be so. In the numerical scenarios above, the optimal subsidization level was held constant (i.e., the examples used a "fixed" aggregate benefit function). This was useful to illustrate how collective action problems might be minimized when organizations provided goods and services that significantly benefited small groups of potential donors. However, the presence of a high-preference group may itself change the optimal subsidization level.

Recall the example above where one thousand individuals enjoyed slight benefits. Using the assumed cost function, it was optimal for two units to be provided. *See supra* Part V.A.1. In the immediately following example, a high-preference individual was introduced, but the aggregate benefit function was held constant so that the optimal subsidization level remained unchanged. Assume, however, that aggregate benefits are no longer held constant and that in addition to the one thousand low-preference beneficiaries described there is a high-preference individual *T* that would enjoy \$910 benefit from the first unit of the good, \$610 benefit from the second unit, and a \$60 benefit from the third. Because *T* has such a high preference for the good, he may pay enough for two units to be provided even without the contributions of the low-preference beneficiaries. *See supra* Part V.A.1. This is significant—without the existence of this high preference donor, collective action problems may well prevent the funding of these units. Nonetheless, the optimal subsidization level will increase because one must account for *T*'s high preference. It is now optimal for an additional third unit to be provided. However, a donation equal to *T*'s direct benefit

Suppose, for instance, that a high-preference group would provide donations to cover 90% of the costs needed for a donee-organization to optimally provide a particular good or service. The remaining “underfunding gap” (the 10% of costs not donated) may be filled if the remaining low-preference beneficiaries “rationally” contribute an amount equal to their smaller benefits. This is unlikely to occur if the donee-organization can use the donations of high-preference donors to provide a substantial (albeit sub-optimal) quantity of the good or service. In these cases, low-preference donors may be content to enjoy amounts provided cost free.¹⁶⁶ However, this “lingering collective action problem” may be overcome (and the underfunding gap narrowed or eliminated) if the good or service cannot be provided in divisible units.

2. Assessing Underfunding Problems Based on the “Lumpy” Nature of Direct Benefits

Suppose that a donee-organization must collect a set amount before it can construct the most minimally adequate facility to suit its purposes and that a high preference group has provided donations to cover 90% of this figure. Low-preference donors cannot rely on enjoying the portion of the facility constructed with these “high-preference” donations because construction cannot commence until total donations cover needed costs. Because every donation has increased significance,¹⁶⁷ low-preference beneficiaries may no longer perceive their contributions to be “so small in proportion to the total that it will not appreciably affect the amount of the good . . . provided.”¹⁶⁸

In economic parlance, a good that cannot be provided in continuous increments but must instead be provided in total or not at all is called a “step good.”¹⁶⁹ Economists have recognized that when these goods are provided, free-rider problems may be eliminated under certain conditions. Specifically, where “other members of [a] group have already contributed the bulk of the cost of a step good . . . an individual might stand to benefit more from final supply of the good than the additional increment required for its provision.”¹⁷⁰ In other words, in these situations low-preference

(\$1,580) is not sufficient to cover the total costs of three units. Thus, while *T*'s high-preference donation funds a large portion of the cost needed for optimal provision, an “underfunding gap” may remain.

166. See *supra* notes 136–38 (describing conditions likely to lead to free-riding).

167. HARDIN, *supra* note 44, at 55–56 (explaining conditions that must exist for the good to be provided).

168. Hansmann, *supra* note 46, at 849.

169. HARDIN, *supra* note 44, at 50 (stating that scholars often assume that “the collective good [can] be supplied at varying levels,” but that this may not be correct). A step good can also be described as a good whose provision is binary. *Id.* at 55.

170. HARDIN, *supra* note 44, at 57. In this scenario, there may be “numerous local regions in which noncontribution is not the preferred strategy for an individual.” *Id.* For a more complicated

beneficiaries may overcome lingering collective action problems and donate the “rational” amount (equal to their small direct benefits) to ensure that the good or service is provided.

This has important implications for the “high preference” organizations discussed—the opera organization, church, and school. As discussed, a high-preference donor group may cover a large portion of the costs needed to optimally fund the goods and services provided by these donee-organizations. With the “bulk of the cost”¹⁷¹ covered, lingering collective action problems may be reduced or eliminated if the provided goods or services are sufficiently “lumpy.”¹⁷² Each of the “high preference” organizations seems capable of providing goods and services possessing some of these qualities. One would not, for instance, expect the opera organization to stage an increment of a production or a church to hold a fraction of a mass. While the quality of these goods and services might vary according to the total funds ultimately collected, a threshold amount must be donated before an additional performance or religious service could be held. Larger projects seem even “lumpier” in nature. For instance, churches sometimes establish “building funds” that set aside donated amounts for the construction of designated projects, such as new places for congregating and holding services.¹⁷³ Schools also establish similar funds explicitly designating donated amounts toward the construction or improvement of particular facilities, such as gymnasiums, libraries, or technology classrooms.¹⁷⁴ Again, while quality might vary with total

example, see *id.* at 56.

171. *Id.* at 57.

172. Gergen, *supra* note 12, at 1411 (using this term “lumpy” or “step” goods).

173. See, e.g., *Battle Lake Baptist Church Building Fund*, BATTLE LAKE CMTY. BAPTIST CHURCH, <http://www.battlelakechurch.ca/buildingfund.html> (last visited Apr. 6, 2011); ST. NICHOLAS RUSS. ORTHODOX CHURCH, <http://www.orthodox.net/aboutus/building-fund.html> (last visited Apr. 6, 2011); *Donations*, ST. DOMINIC’S CATH. CHURCH, <http://www.stdominics.org/donations> (last visited Apr. 6, 2011) (“Your gift to the *Saving God’s House Appeal* will help us to complete the restoration of the church’s glorious stained glass windows and exterior masonry, and to undertake other projects such as cleaning of the interior walls, polishing of the altars, carvings, and statues, and refinishing of the pews, kneelers, and floors.”); *Make a Donation*, PENTECOSTAL TEMPLE COGIC, <http://pentecostal-temple.org/aboutus.aspx> (last visited Apr. 6, 2011); *A Wondrous Gift is Given*, HOLY APOSTLES ORTHODOX CHURCH, <http://www.holyapostlesorthodoxchurch.org/fundraising.html> (last visited Apr. 24, 2011) (“The wonderful news has probably traveled to most of you, that the Lord has given our parish a beautiful temple, the historic St. Joseph’s cemetery church. . . . With the Lord’s help we will need to raise \$1,000,000.00 to cover the costs of the restoration/renovation. Additional funds will be needed for the beautification of the church, and to build a parish hall (we estimate another \$1,000,000.00.) [sic] We have begun fund-raising efforts, and welcome any ideas or suggestions for ways to raise the funds. To all of our brothers and sisters in Christ, please keep us in your prayers as we begin this process.”).

174. See, e.g., *Class Wishlist—Donate to the Classroom*, JOINT SCH. DIST. NO. 2 EDUC. FOUND., <http://www.meridianschools.org/Community/EducationFoundation/DonateToTheClassroom/Lists/Class%20Wishlist/Opened.aspx> (last visited Apr. 6, 2011). This Web site displays

contributions, the organization must first collect a certain amount before construction can reasonably commence. While it is certainly not claimed that these goods or services meet the pure definition of a “step” good, they seem to possess lumpy characteristics.

When lumpy goods like these are provided, lingering collective action problems may be reduced if low-preference donors believe their donations have consequence¹⁷⁵—that is, if these donors understand that there is a meaningful “relationship between the size of [their] contribution[s] and the amount of the good [they] enjoy[.]”¹⁷⁶ However, unless low-preference beneficiaries are provided the information needed to make this assessment, the lingering collective action problem will persist. This is exemplified by voter behavior in political elections, “the most renowned of all genuine step good collective actions . . .”¹⁷⁷ A candidate’s election is a step good, as one’s favored candidate either wins or loses the contest. However, this fact alone may have little impact on a citizen’s willingness to vote (i.e.,

teachers’ “wishlist” items along with prices for those items. Donors may select to donate amounts to fund those particular items. *Id.* The Web site states:

Do you have a specific school, project or teacher you would like to help? You can make a donation to the Foundation and we will disperse the funds according to your wishes. If you are a teacher, you can even direct a contribution right to your own classroom. We just have to make sure it’s for an approved, educational use. We take care of the bookkeeping and you get the tax benefit of contributing to a not-for-profit 501(c)(3) organization.

Support Us, JOINT SCH. DIST. NO. 2 EDUC. FOUND., <http://www.meridian.schools.org/Community/EducationFoundation/Pages/SupportUs.aspx> (last visited Apr. 6, 2011). For another example of such a fund, see Jeremy Mayo, *Miazga’s Donate \$250,000 to RHS Improvements, Gym to be Renamed in Honor*, HODAGSPORTS.COM (Jan. 15, 2011), <http://www.hodagsports.com/stories.html?SKU=20110114161615>. The Web site reports that the school has already collected a substantial portion of the money needed to fulfill the

\$1 million capital campaign program by the Hodag Facilities Foundation to make improvements to Rhinelander High School. . . . The capital campaign is targeted to improve and enhance facilities with private money beyond the referendum projects. These facility improvements include ceiling upgrades in the auditorium, a brand new digital media center, lighting and tiling in the pool, a new science lab, and enhancements in the gymnasium.

Id. (internal quotation marks omitted). The Hodag Facilities Foundation is a 501(c)(3). *Fast Facts*, HODAG FACILITIES FOUND., <http://www.hodagfacilities.com/fastfacts.html> (last visited Apr. 6, 2011). Taxpayers are encouraged to purchase “pavers” (bricks) with their names inscribed. *2011 Paver Sale*, HODAG FACILITIES FOUND., <http://www.hodagfacilities.com/paver.html> (last visited Apr. 6, 2011).

175. In other words, it is no longer the case that “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 that is provided . . .” Hansmann, *supra* note 46, at 849.

176. *Id.*

177. HARDIN, *supra* note 44, at 59.

donate), as he often lacks the information needed to assess whether his vote will be of any particular import.¹⁷⁸ In this way, citizens routinely fail to vote because “the fact that some contribution [i.e., vote] might make [a] difference . . . is discounted by the low probability that a particular [vote] will be the one that makes the difference.”¹⁷⁹

Thus, lingering collective action problems will be reduced only if low-preference beneficiaries can assess the probable influence of their donations. Perhaps most importantly, these individuals must be aware that others have contributed the “bulk of the cost”¹⁸⁰ needed to fund the lumpy good, assuring them that their small contributions will significantly increase the probability of the good’s provision. Intuitively, this information can be most easily provided for larger projects¹⁸¹ when the donee-organization is able to identify likely donors and, therefore, effectively target communications. Because schools and churches can focus communication efforts on parents and congregants¹⁸² these organizations should have little trouble providing needed information.¹⁸³ It might be more difficult for the opera organization to cost-effectively provide needed information because the identity of potential donors (particularly low-preference donors) may not be as clear.¹⁸⁴

3. Summary of Direct Benefit Analysis

In sum, when those who directly benefit from the goods or services provided by donee-organizations are economically rational and financially capable of donating, goods and services should not be underfunded. In these cases, the charitable deduction is economically unnecessary. However, collective action problems may cause direct beneficiaries to stray from the rational donor model, resulting in underfunding.

This Part has shown that free-rider problems can be partly overcome

178. *Id.* (referring to elections as “a game with, at best, poor communication . . . that . . . can be seen as a one-shot rather than an ongoing game”).

179. *Id.* at 60.

180. *Id.* at 57.

181. It would, for instance, seem impractical for a church to “advertise” the remaining amount needed to fund smaller projects, such as an additional church service. Thus, even though services may be somewhat lumpy in nature, it seems unlikely that this will solve lingering collective action problems. However, as discussed in the remaining Parts, there are other reasons to believe that church services will not be significantly underfunded.

182. In this vein, Professor Hansmann has surmised “one motivation for keeping the membership of a church relatively well defined is undoubtedly so that the members can be approached, and made to feel responsible, for contributions beyond those made during services or in the form of unsolicited gifts.” Hansmann, *supra* note 46, at 891.

183. In fact, schools and churches already provide this information in some fund-raising efforts by specifying a goal amount needed to fund a particular project and providing update on progress being made. See *supra* notes 173–74 and accompanying text regarding churches and school wishlists.

184. The maintenance of lists of past donors might aid in this task.

when organizations provide goods or services that offer significant direct benefits to high preference individuals. In these cases, the group is increasingly likely to overcome collective action problems and donate a large portion of needed costs. Because the opera organization, church, and school are likely to provide goods and services to high-preference beneficiaries, underfunding may not be particularly severe in these cases.

Nonetheless, low-preference donors may be required to contribute if optimal provision is to be fully achieved. In many cases, this will not occur because of lingering collective action problems. However, when organizations are able to provide lumpy goods, low-preference donors may overcome free-rider issues. As shown, the opera organization, the church, and the school all seem to provide goods with lumpy characteristics, but churches and schools likely possess a superior ability to communicate needed information. Because of this ability, when churches and schools seek to fund large projects that seem extremely lumpy (such as the construction of new or improved facilities) there is reason to believe that underfunding issues may be minimal. In these final cases, it becomes rather difficult to use efficiency concepts to justify the charitable deduction and the tax subsidy may be economically unnecessary.

Of course, this identifies a very discrete set of circumstances. To proceed with an analysis of the hypothetical donations, this Part turns to giving benefits, the next variable in the rational donor model.

B. *Giving Benefits*

It is useful to remind the reader of the way giving benefits—benefits derived from the act of giving itself¹⁸⁵—factor into the analysis. In some cases, high-preference groups may fund a bulk of the cost needed for optimal provision by donating an amount equal to their direct benefit but an underfunding gap may remain. This gap may be (at least partially) filled if high-preference donors contribute an amount exceeding their direct benefits. Recalling the rational donor model, this may occur if, in addition to their direct benefits, high preference beneficiaries experience giving benefits, internalized benefits, or a combination of the two.¹⁸⁶ The gap may also be (at least partially) filled if low-preference beneficiaries donate.

185. See Andreoni, *supra* note 79, at 1448–49 (“[P]eople get some private goods benefit from their gift per se, like a warm glow.”).

186. It is important to remind the reader that this analysis depends on the assumptions made to develop the optimal subsidization model, which disregarded internalized and giving benefits to eliminate what were referred to as subsidization biases. Under these assumptions, goods are considered optimally provided for purposes of this Article when produced up to the point where the sum of the direct benefit enjoyed by the donor and the benefits enjoyed by non-donors exceed the costs of production. This Article purposefully excluded internalized benefits and the warm glow effect from this latter determination. See *supra* note 100. Without these assumptions in place, the increase in these benefits would increase the amount the donor would be willing to donate but would also increase the optimal subsidization level, and the below analysis would change.

Where a high-preference group exists but the lingering collective action problem remains, low-preference beneficiaries may fail to contribute because they are content to enjoy goods and services funded by others. However, because giving benefits are (by definition) derived from the act of giving itself, one cannot enjoy such benefits by free-riding.¹⁸⁷ A donor cannot, for instance, “feel good” about helping fund his neighborhood park unless he actually makes a contribution.¹⁸⁸ Thus, if low-preference beneficiaries enjoy giving benefits, they may donate some amount regardless of their tendency to free-ride.

In other cases, where a high-preference group is unlikely to exist, donors will not enjoy significant direct benefits. Thus, donations will be largely dependent on giving and internalized benefits, the remaining benefits potentially available to the donor under the rational donor model.¹⁸⁹ The analysis will proceed by discussing giving benefits and internalized benefits in turn.

There are various types of giving benefits.¹⁹⁰ A donor may enjoy “warm glow” benefits if he experiences satisfaction for being the “instrument” of giving.¹⁹¹ For instance, a donor may not only be pleased that a specific group or organization benefited from his contribution but may also be pleased that he was personally able to make this happen.¹⁹²

Additionally, a donor may experience “reputational enhancement” because of his gift.¹⁹³ As explored by Economist Gertrud M. Fleming and Judge Richard A. Posner, the act of giving may improve the donor’s status by “signaling” altruism “to the people with whom [he has] or seek[s] to

187. As Professor James Andreoni puts it, “people get some private goods benefit from the gift per se, like a warm glow.” Andreoni, *supra* note 79, at 1448–49; see Temimi, *supra* note 104, at 1 (discussing whether warm-glow mitigates or exacerbates inefficiency).

188. As Andreoni explains, when individuals enjoy such benefits, “giving by others is no longer a perfect substitute” for the act of giving. Andreoni, *supra* note 79, at 1451.

189. See *supra* Part IV.

190. Some of the giving benefits discussed might also be construed as direct benefits but have been purposefully characterized in this way because they represent benefits non-donors cannot enjoy by free-riding. See *supra* note 187 accompanying text.

191. Colombo, *supra* note 28, at 672–73.

192. See Benkler, *supra* note 144, at 375–76 (using similar examples to study the nature of giving and discussing the “common-based-peer production” model, which requires group collaboration); Colombo, *supra* note 28, at 672–73 (describing a gift from husband to wife, wherein the husband derives pleasure from being able to increase his wife’s happiness); John P. Conley & Fan-chin Kung, *Private Benefits, Warm Glow, and Reputation in the Free and Open Source Software Production Model*, 12 J. PUB. ECON. THEORY 665, 668 (2010) (providing an example of pure giving benefits in which, “Software engineers contribute code to . . . projects simply because they enjoy writing code; they take pleasure in the act of production itself. In economic terms, this is a manifestation of ‘warm glow.’ . . . The idea is that the act of contributing is its own reward. This is not influenced by the desire to consume the public good itself or by the level of contributions others make.”).

193. See *supra* note 82 and accompanying text.

have interactions.”¹⁹⁴ This requires the donor’s gift to be “visible” to those with whom he shares existing or desired relationships.¹⁹⁵ Put another way, in order for a donor to experience status benefits, a “third party audience” must not only be made aware of the donor’s contribution, but the donor must “care about the inferences drawn by [these] third parties.”¹⁹⁶ The ability to enjoy reputational enhancement may be further increased if the donor shares ongoing (as opposed to more temporary or fleeting) relationships with this “audience.”¹⁹⁷ When interactions are continuing—that is, when actors operate in what economists call “repeated games” or “supergames”¹⁹⁸—there are more opportunities for reputational enhancement. “In a repeated interaction . . . [i]ndividuals forgo their short-term selfish gains because being nice . . . will lead to nice treatment in the future.”¹⁹⁹ Thus, a donor who has continuing interactions with other donors and beneficiaries may be willing to donate more than he otherwise would in order to increase his reputation with these individuals.

It seems that donors contributing to the toy organization will enjoy rather limited giving benefits. Presumably, donors will not share

194. Fremling & Posner, *supra* note 82, at 2. The authors seek to develop

a framework that considers future opportunities for social or economic interaction and so the incentive for signaling behavior. An individual will often forgo small immediate economic gains to protect or enhance his future opportunities. The perfectly rational motive to portray oneself as an economically well-off, caring person can have a multitude of interesting consequences for market behavior.

Id.; see Sobel, *supra* note 82, at 392 (explaining that individuals will often be willing to “[r]espond[] to kindness with kindness in order to sustain a profitable long-term relationship or to obtain a (profitable) reputation for being a reliable associate”).

195. Fremling & Posner, *supra* note 82, at 5 (arguing that reputational enhancement cannot occur if donors are “anonymous,” as, “[T]here is little room for signaling personal characteristics . . . if one is invisible to . . . the transaction.”).

196. *Id.* at 6. Fremling and Posner provide a market-based example: “Attending a public auction in a small town (or shopping in a small town in a store where one is constantly bumping into one’s neighbors and friends, who observe one’s purchasing in the store) involves more signaling to third parties than participating in a similar auction on the internet.” *Id.*

197. According to Professor Joel Sobel, “In order for conventional repeated-game arguments to apply, the future must be important. Agents must be patient and there must be opportunities to reward and punish today’s behavior. When these conditions fail, theory predicts a return to myopic selfish behavior.” Sobel, *supra* note 82, at 411.

198. For a seminal work on the topic, see generally James W. Friedman, *A Non-cooperative Equilibrium for Supergames*, 38 REV. ECON. STUD. 1 (1971).

199. Sobel, *supra* note 82, at 411. Sobel refers to these benefits as “reciprocal” benefits. “Responding to kindness with kindness in order to sustain a profitable long-term relationship or to obtain a (profitable) reputation for being a reliable associate are examples of instrumental reciprocity.” *Id.* at 392 (emphasis omitted). The concepts presented above regarding reputational benefits, repeated games, and reciprocal benefits are considered distinct from one another but are treated together in this Article as they represent the same idea that individuals might derive benefits from giving when certain relationships exist.

relationships with the children-beneficiaries or personally witness their enjoyment. In this case, the donor's "warm glow" benefits would be limited to those derived from the general knowledge that he has helped unknown children.²⁰⁰ Recognizing this, the toy organization may attempt to "create" a connection by providing donors with photographs, letters, and other similar items that supply personal information about beneficiaries.²⁰¹ If this is done, "toy donors" may at least experience some "warm glow" benefit from their donation.

The ways in which the toy donor may enjoy reputational enhancement also seem limited. In order for the donor to experience this benefit, individuals with whom the donor hopes to have future relationships must know of the donor's gift.²⁰² The donor might enjoy status benefits if, for instance, the toy organization provided promotional material revealing the donor's generosity to a "third party audience" whose opinion mattered to the donor.²⁰³ While by no means impossible, the opportunities for significant reputational enhancement seem somewhat remote.

Donors (particularly high-preference donors) contributing to the opera organization may enjoy more significant giving benefits. A high-preference donor may experience a "warm glow" by helping to fund an art form she values highly and by providing others who could not otherwise attend the opera with the opportunity to do so.²⁰⁴ While the donor is unlikely to share any future relationship with these other audience member-beneficiaries—i.e., these individuals are unlikely to share ongoing relationships—the donor will at least have the opportunity to attend performances and witness some of these benefits. Further and perhaps more importantly, because desired groups are more likely to be informed of (particularly high-

200. See Hansmann, *supra* note 46, at 851 (discussing the monitoring problem faced by certain nonprofits when there is "no observable connection between the amount of the individual's contribution and the quality of the [product]"); see also Atkinson, *supra* note 61, at 531 (arguing some attenuated benefits to the donor, beyond the mere psychological, may have to be ignored); Mark Pauly & Michael Redisch, *The Not-For-Profit Hospital as a Physicians' Cooperative*, 63 AM. ECON. REV. 87, 98 (1973) ("These contributions could be motivated by a desire on the part of contributors to make output available to themselves or to those whom they would like to see consume it. That is, the motivation could either be based on the potential receipt of private benefits or of external benefits.").

201. This is something which organizations serving the needy often do. See, e.g., *Sponsor a Child*, FEED THE CHILDREN, http://www.feedthechildren.org/site/PageServer?pagename=org_child_sponsorship (last visited Apr. 6, 2011) (providing a means to allow donors "to personally connect with children in need . . . As a monthly sponsor, you will receive a photo and personal profile of the child you are sponsoring . . . and notes, drawings or correspondence from your child once a year.").

202. Fremling & Posner, *supra* note 82, at 2, 5.

203. *Id.* at 6.

204. See *supra* Part V.A.1 (discussing economics of opera productions and the importance of high-preference donations to fund a bulk of costs so that lower preference consumers need only fund marginal costs).

preference) donors' gifts, there are increased opportunities for reputational enhancement. Consider the program established by the Metropolitan Opera, which provides for various levels of "[g]uild membership."²⁰⁵ Each level of membership is increasingly expensive to purchase but, in turn, offers increased access to priority seating, back stage tours, dress rehearsals, and other similar privileges.²⁰⁶ This provides a way for the donor's contribution to become "visible."²⁰⁷ For instance, a donor who sits in the opera hall's most desirable seats may be able to "signal" to fellow-opera attendees and aficionados that he has made the requisite donation allowing access. Whether and to what extent this will result in a particular donor enjoying reputational enhancement depends on whether and to what extent each particular donor values the opinions of this created "third party audience."²⁰⁸

Finally, many church and school donors can be expected to enjoy rather substantial giving benefits as a result of their gifts. These donors may experience rather significant "warm glow" benefits by helping support donee-organizations that play an important role in their lives and by being able to help other beneficiaries with whom they share continuing relationships—fellow-congregants (in the case of church donations) and the donor's children, his child's classmates, and their families (in the case of school donations).²⁰⁹ Further, the opportunities for reputational enhancement may increase significantly in these cases (as compared to the other cases) because the relationship between the donor and the beneficiaries of his donation is likely an ongoing one.²¹⁰ Because church and school donors will have "repeated interactions" with other donors and beneficiaries, giving generously is more likely to result in valuable status benefits.²¹¹

To summarize these preliminary observations,²¹² because the toy

205. *Guild Membership Levels*, THE METROPOLITAN OPERA, http://www.metoperafamily.org/metopera/support/membership_patron/guild_membership/levels.aspx (last visited Apr. 6, 2011). Importantly, a fraction of the cost will not be deductible, as set forth on the Web site. For instance, according to the Web site, for those who donate \$1,750 for the highest level of membership, \$1,710 is deductible and \$40 is not deductible. *Id.* See generally also Melanie Leslie, *The Wisdom of Crowds? Groupthink and Nonprofit Governance*, 62 FLA. L. REV. 1179, 1187 n.27 (2010) (discussing the private benefit doctrine in relation to charities).

206. *Guild Membership Levels*, *supra* note 205.

207. See Fremling & Posner, *supra* note 82, at 2.

208. *Id.* at 6.

209. See *supra* Part V.A.1.

210. And these beneficiaries will, in turn, be a readily accessible "third party audience." Fremling & Posner, *supra* note 82, at 6.

211. See Sobel, *supra* note 82, at 397, 411, 420.

212. Because there is somewhat conflicting evidence regarding giving benefits, this Part seeks only to provide preliminary observations and recognizes that further empirical evidence must tease out the more difficult question of when these benefits exist. Professors John P. Conley and Fan-chin Kung explain: "There are [several] areas at least that merit deeper study. The first is modeling more

organization offers only slight direct benefits and limited giving benefits, it will likely suffer severe underfunding problems unless donors internalize a large portion of the benefits of other beneficiaries.²¹³ In the other three high-preferences cases, giving benefits may narrow the “underfunding gap” by causing low-preference donors to provide some contribution and by causing high-preference donors to make donations exceeding their direct benefits. This underfunding gap may be further reduced or eliminated if donors also enjoy internalized benefits, the final benefit in the rational donor model.

C. *Internalized Benefits*

As discussed in Part IV.C, when donors experience internalized benefits they, in essence, make the benefits of others “their own.”²¹⁴ The extent to which this occurs depends on the extent to which the donor’s utility function is interdependent with that of other beneficiaries.²¹⁵ As also illustrated, underfunding may occur because donors do not adequately internalize the benefits of others, referred to as the externality problem. In assessing the relative likelihood that donors will internalize benefits (and

explicitly the details of how and why contributors benefit from reputation. . . . Games of status and gifting economies are also understudied in the context of voluntary contributions.” Conley & Kung, *supra* note 192, at 683. To read an explanation of the difficulty of studying these motivations, see generally Cagri S. Kumru & Lise Vesterlund, *The Effect of Status on Voluntary Contribution*, 12 J. Pub. Econ. Theory 709 (2010). One transnational research team noted:

It is difficult if not impossible to use field data to determine the extent to which individuals are willing to invest in resources to improve their status aside from potential (eventual) financial remuneration, and how this behavior is affected by the conditions in which status can be improved. Survey data have trouble identifying status-seeking activities and since they cannot precisely delineate reference groups, it is difficult to know to whom individuals compare themselves.

Gary Charness et al., *Competitive Preferences and Status as an Incentive: Experimental Evidence 2* (CIRANO Scientific Publications 2011s-07, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1752213. The team sought to overcome these obstacles: “By controlling the environment and the composition of the reference group, experimental methods offer the possibility of directly evaluating the individual’s willingness to invest in status seeking.” *Id.* Further, because giving benefits will generally be small in comparison to direct and internalized benefits, their discussion, while significant, need not be quite as comprehensive. See Conley & Kung, *supra* note 192, at 672 (“Agents tend to be motivated to contribute more by the Personal Benefits they get from consuming the correspondingly higher levels of public good that their own contributions produce than a desire to receive credit for these contributions. Of course, agents are still partially motivated by Warm Glow.”).

213. Even if the toy organization were able to “create” increased warm glow benefits by providing pictures, letters, and other personal items, this benefit alone is exceedingly unlikely to cause donors to contribute an amount sufficient for optimal provision.

214. See *supra* Part IV.C.

215. See *supra* note 125 and accompanying text.

the relative severity of the externality problem)²¹⁶ in the four hypothetical donations, the first point is somewhat intuitive: internalized benefits will increase (and externality problems will be less severe) as the relationship between donors and potential beneficiaries becomes more substantial.²¹⁷

The externality problem is, therefore, likely to be rather severe for the toy organization. The only feasible relationship shared by donors and the beneficiary-children is one “created” by the organization’s possible provision of personal letters or photographs.²¹⁸ As a result, the respective utility functions of donors and beneficiaries will likely be largely independent and donors will generally be unlikely to adequately internalize the children’s benefits.²¹⁹ Putting the analysis together, because toy donors are unlikely to enjoy any significant benefits from their donations, the toy organization is likely to suffer rather severe underfunding problems.

The externality problem is also likely to be rather severe for the opera organization. While several fellow-opera lovers might share a relationship with one another, there is no reason to think that potential donors share significant ongoing relationships with many potential audience members (the beneficiaries of their donations). Internalized benefits are, therefore, unlikely to have a significant impact on a donor’s willingness to contribute. Thus, while high-preference opera donors will enjoy significant direct benefits from their donations (which may reduce collective action problems) and may also enjoy giving benefits (further reducing any remaining “underfunding gap”), the externality problem may remain severe. As a result, the opera organization may still suffer mild to moderate underfunding problems.

The externality analysis is rather different for the final two cases. The utility functions of church donors and their fellow congregants will almost certainly be somewhat interdependent, as these individuals will share a (sometimes rather significant) relationship.²²⁰ A similar analysis may apply

216. See *supra* note 125 and accompanying text.

217. See *supra* note 98.

218. See *supra* Part V.B.

219. Cf. Hansmann, *supra* note 46, at 847. Where there is a great “separation between the [donor] and the [beneficiaries],” it seems likely that market failure will occur. *Id.* As discussed *supra* note 213, if the toy organization provides pictures, letters, and other personal documents, some relationship may be “created,” which could, in turn, lead to some internalized benefits.

220. See, e.g., *Core Values*, FRIENDSHIP CMTY. CHURCH, <http://www.friendshipcommunity.org/#/About/Core%20Values> (last visited Apr. 6, 2011) (“Core Values[:] People are more important than things. . . . We build each other up and encourage the Church’s leaders and workers.”); FRIENDSHIP CHURCH, <http://friendshipchurchsa.org/index.htm> (last visited Apr. 6, 2011) (“*Where New & Old Friends Love to Meet!*” (emphasis added)); *Planned Giving*, *supra* note 159 (“Think for a moment about what St. Dominic’s means to you. Has St. Dominic’s made a difference in your life or the life of your family? Do you have warm memories of Dominicans, past and present, who have served you here? Maybe you or your children attended St. Dominic School or St. Rose Academy, or were baptized or married here. Maybe you were inspired by the church’s soaring Gothic beauty, or made lasting friendships through our peer community

when one donates to the school of one's child.²²¹ The parent-donor's utility function is likely to be extremely interdependent with that of her child,²²² and will likely be somewhat interdependent with her child's classmates and their families.²²³ This suggests that externality problems may be much milder in these final two circumstances. Because high-preference beneficiaries may internalize a portion of the benefits of non-contributing low-preference beneficiaries, any underfunding gap may be drastically reduced. Still, one might argue that these donors will not fully internalize relevant benefits so that some underfunding problems may persist.

A more sophisticated analysis suggests the underfunding problem may be even more slight than this simple analysis suggests. Those donating to specific churches and schools will generally be the same individuals that benefit from these organizations.²²⁴ Further, each member of this donor/beneficiary pool is likely to share ongoing relationships with at least some other members of the pool. As a result, each donor will likely internalize some of the benefits enjoyed by the other beneficiaries.²²⁵ This may cause high-preference beneficiaries to donate the amount (or something close to the amount) needed to optimally fund goods and services even if low-preference beneficiaries completely fail to contribute.

This possible "compounding effect"²²⁶ can be illustrated with a final,

groups or our many volunteer ministries." (emphasis added)).

221. As noted above, the analysis is a bit more nuanced in this case because most of the benefit experienced by the parent-donor is the internalized benefit of her child. In this way, it may be more accurate to characterize the internalized benefit of the parent-child as a quasi-direct benefit, which results in the presence of a high-preference donor group, *see supra* note 162, and to only focus on the benefits of other students and their families in analyzing internalized benefits and the externality problem. This more detailed analysis seems unnecessary to make the general point that the school donation seems roughly analogous to the church donation. This Author recognizes, however, the additional nuances presented by the school donation.

222. Bergstrom, *supra* note 98, at 76. She might, therefore, internalize a substantial portion of the benefits of his being better educated, the benefits of his being able to enjoy improved or additional facilities, and the "solidarity benefits" her child might experience by being able to associate with classmates who are also able to enjoy these things. *See id.*

223. *See supra* note 147 and accompanying text (discussing shared interests among neighbors).

224. *See supra* Part V.A.1.

225. Effects similar to these are often referred to as "two-sided" altruism. Economists have tended to focus on the case of intergenerational transfers. *See, e.g.,* Miles S. Kimball, *Making Sense of Two-Sided Altruism*, 20 J. MONETARY ECON. 301, 301 (1987) (analyzing generational altruism). *See generally* Lakshmi K. Raut, *Two-Sided Altruism, Lindahl Equilibrium, and Pareto Optimality in Overlapping Generations Models*, 27 ECON. THEORY 729 (2006) (also analyzing generational altruism).

226. *Cf.* Kimball, *supra* note 225, at 304 & n.4 (describing the "Hall of Mirrors" effect from attempting to calculate parents' and their children's concern for one another, which also is a function of how each cares for the other, thus resulting in a compounding effect); *cf. also* Bergstrom, *supra* note 98, at 76 ("[I]ntrafamilial utility interdependence often has an interesting special structure. For example . . . parents care about the happiness of their children and children care about the happiness of their parents."). Professor Theodore Bergstrom notes that this effect also

(over)simplified numerical example.²²⁷ Suppose it would cost a church \$900 to provide one religious service, \$600 to provide the second, and \$100 to provide the third. Assume a low-preference group would enjoy an aggregate direct benefit of \$200 from the first service, an aggregate \$150 direct benefit from the second, and an aggregate \$50 direct benefit from the third. Next, assume ten high-preference individuals would together enjoy direct benefits of \$750 from the first service, \$500 from the second, and \$70 from the third. The optimal subsidization level is to provide three services. For reasons discussed in Part V.A.1, the high-preference group may donate a large percentage of needed costs, or the \$1,320 equal to their total direct benefit. However, while this covers a large portion of the \$1,600 cost, an additional \$280 is needed to fund the optimal three services.²²⁸

If each of the ten high-preference individuals internalized just one-fiftieth of the other churchgoers' benefits, each high-preference individual would contribute an additional \$32,²²⁹ which would allow the church to collect the needed \$280. Because each member of the high-preference group internalized this rather slight fraction of the others' benefits, a "compounding effect" occurred which allowed the donee-organization to collect the donations needed for optimal provision. This is not meant to suggest that underfunding will be perfectly eliminated in the neat way provided by this numerical example. It does, however, suggest another possible reason to believe that churches may suffer only minimal underfunding problems.

A similar analysis likely applies to donations made to specific schools. As discussed, it seems likely that parents will form a high-preference group that contributes a bulk of the cost needed to optimally fund the schools of their own children. Further, donors are likely to internalize a large portion of the benefits experienced by their children²³⁰ and to partially internalize the benefits experienced by other children and their families, with whom

occurs in other contexts, such as "a population of individuals living along a road, each of whom is concerned about his own consumption and that of his neighbors on either side." *Id.* at 83.

227. Though stated earlier, it seems important to remind the reader that numerical examples such as these are provided for illustrative purposes only and are in no way meant to imply mathematical certitude. *See supra* Part V.

228. As discussed, there may be substantial "warm-glow" benefits associated with giving, particularly to these high-preference individuals who give substantial sums. However, temporarily assume that there are no giving benefits in order to isolate the internalized benefits and illustrate the compounding effect.

229. Total benefits are the \$1,320 benefits enjoyed by the high-preference donors plus the \$400 benefits of low-preference beneficiaries, or \$1,720. Each of the ten high-preference individuals benefits \$132 so the remaining benefits for him to internalize are $\$1,720 - 132 = \$1,588$. If each high preference individual internalized one-fiftieth of this, he would donate an additional \$31.76.

230. *See* Bergstrom, *supra* note 98, at 76 (discussing intrafamily transfers).

the donor is likely acquainted.²³¹ Because of this, the compounding effect described above may occur and the sum of the partially internalized benefits contributed by the high-preference group might fill any underfunding gap even if the low-preference group completely fails to donate.

D. *Analytical Synthesis*

Current tax law generally allows donors to deduct amounts contributed to each of the hypothetical organizations discussed. However, the analysis suggests that the severity of underfunding problems suffered by these organizations is likely to vary greatly and that current law may provide economically unnecessary subsidies to organizations already providing goods and services at optimal (or nearly optimal) levels.

231. See *supra* notes 162 and 221 (discussing the possible nuances to this analysis). If one were to categorize the internalized benefits of the donor's child as quasi-direct benefits (as suggested earlier) and to focus only on the benefits of other students and their families in analyzing internalized benefits, the compounding effect would occur to the extent that high-preference donors internalized a portion of these individuals' benefits. This seems likely because of the relationship donors likely share with these other beneficiaries.

Below is a tabular summary of the analysis:

Organization	High-Preference Group	Step/Lumpy goods	Giving Benefits	Internalized Benefits	Underfunding assessment
Toy	Unlikely	N/A	Limited to "created" warm glow	Little	Likely severe
Opera	Likely	Somewhat but limited ability to provide needed information	Small to moderate, especially reputational enhancement	Little	Likely mild to moderate
Specific Church	Very Likely	Yes, especially for large projects where information can be meaningfully communicated	Possibly significant warm glow and reputational enhancement because of ongoing relationships	Significant, possibly leading to compounding effect	Likely minimal
Specific School	Very Likely	Yes, especially for large projects where information can be meaningfully communicated	Possibly significant warm glow and reputational enhancement because of ongoing relationships	Significant, possibly leading to compounding effect	Likely minimal
Importance of benefit	May reduce collective action problems	May reduce lingering collective action problems when high preference group exists and effective communication possible	May allow low-preference free-riders to contribute and high-preference donors to contribute more than direct benefits	Assesses extent of externality problem	

VI. CONCLUDING REMARKS AND PRELIMINARY THOUGHTS

The above analysis not only provides useful insights about the specific hypothetical donations but can also serve more general purposes. The hypothetical donations may be seen as representative of more general transfer types that differ with respect to two variables: the benefits the donor can be expected to receive as a result of his donation and the relationships shared with other beneficiaries. While one would need to account for the specific facts and circumstances of each case, the analysis acts as a useful starting point for exposing the large range of underfunding problems suffered by organizations currently subsidized by the charitable deduction.

As exhibited by the analysis of the “toy donation,” when organizations do not provide significant benefits to donors and instead provide goods and services to beneficiaries with whom the donor shares little, if any, relationship, the charitable deduction is easily justified under efficiency analysis because underfunding problems are likely severe. Similar analyses would seem to apply to most organizations serving the needy, such as soup kitchens and homeless shelters as well as organizations serving non-humans such as those focused on animal cruelty or widespread environmental pollution.

As exhibited by the “opera donation,” when organizations provide significant direct benefits to high-preference donors but also provide goods and services to other beneficiaries with whom the donor shares little, if any ongoing relationship, underfunding problems are likely to be moderate or mild. While some donors will experience large direct benefits and may enjoy some giving benefits, externality problems are still likely to exist. Similar analyses likely apply to donations made to other organizations promoting the arts such as the ballet, symphony orchestra, and museums.

The analysis also provides a useful starting point for analyzing donations that seem to fall in between these two types, such as donations to local blood banks, local medical facilities, and research organizations dedicated to the cure of (perhaps rather rare) diseases. While some donors may experience direct benefits from these organizations (for example, a donor may need a transfusion or be infected with the perhaps rare disease upon which the donee-organization is focused), many donors will not do so. Further, donors are unlikely to share relationships with other beneficiaries so that the externality problem will probably be severe.

Finally, as exhibited in the “church” and “school donations,” when organizations provide significant direct benefits to high-preference donors and also provide goods and services to other beneficiaries with whom donors share substantial, ongoing relationships, underfunding problems may be rather minimal. Put more simply, by allowing donors to deduct amounts contributed to organizations that provide benefits remaining “too close to home,” the tax law provides subsidies that may be economically

unnecessary. Similar analyses may apply to donations made to local parent teacher associations, local recreational sports teams, local boy and girl scouts troops, and to organizations which maintain neighborhood parks or other similar venues.²³²

This Article will not attempt to craft a final resolution to these exposed issues but will offer a non-inclusive list of possible responses. The more detailed analysis needed to precisely define the mechanics of these responses and to provide a comparison of their merits will be reserved for future work.

The most direct response would require revision of § 170, which determines which organizations are entitled to receive subsidies through the charitable deduction.²³³ This would require one to determine how severe the underfunding problem should be before a deduction is warranted. Quite clearly, severely underfunded organizations would retain their ability to receive deductible contributions. Whether moderately underfunded organizations such as the opera organization should retain their subsidy would be a question upon which reasonable minds might differ. However, efficiency analysis would suggest that it is economically unnecessary to allow donors to deduct amounts contributed to organizations such as specific schools and churches²³⁴ that generally suffer minimal underfunding issues.

Future work is needed to precisely determine how lawmakers might modify § 170 to reflect this analysis. Without opining on specifics, this Author suggests that even a modest modification would be helpful. For

232. The IRS allows deductions for some charitable organizations in each of these types of organizations. *Search for Charities, Online Version of Publication 78, supra* note 1 (search, for example, “parent teacher,” “baseball,” “boy scouts,” or “playground”). For recreational teams, however, taxpayers may not deduct amounts that constitute “membership fees” or other expenses to allow their child to take part in these recreational activities. IRS, DEPT. OF THE TREASURY, PUBLICATION 526, CHARITABLE CONTRIBUTIONS 4 (2011), *available at* <http://www.irs.gov/pub/irs-pdf/p526.pdf>.

233. *See generally* Gergen, *supra* note 12 (suggesting a major overhaul of the charitable deduction framework).

234. Additional work is needed to reflect the fact that churches use donations both for religious and non-religious purposes. *See supra* note 129 (recognizing this dual use of funds and explaining why the analysis remains significant). As discussed, this Article focuses upon donations used to finance religious functions and is not meant to apply to donations used to finance other charitable functions. However, this Article has suggested that, under efficiency criteria, church donations used to fund religious functions should not be deductible because underfunding will be slight—i.e., one can generally expect these services to be optimally, or close to optimally, provided. Various mechanisms could be devised to preserve deductions for donations used for other charitable functions. For instance, churches could establish separate entities under § 501(c)(3) to perform these non-religious functions. Further, donors could designate the purposes to which their funds are to be used, or they could be allowed to deduct a percentage of their contributions equal to the percentage of total donations used by the church for non-religious, charitable activities. Because this Article’s main aim is to provide an analysis of underfunding issues, however, working out the precise details of this solution extends beyond the scope of this Article.

instance, while donors might not be able to deduct amounts contributed to specific schools, they might be able to deduct amounts donated to organizations that funded schools of a designated town or county. Similarly, while donors might not be able to deduct amounts contributed to specific churches, they might be able to deduct amounts donated to fund same-denominational churches of a designated locality.

Keeping the proposal sufficiently modest would respond to an anticipated objection to this Article's admittedly generalized analysis. While the analysis suggests that organizations such as specific churches and schools will often be optimally, or nearly optimally, funded in the absence of the charitable deduction, this will certainly not be true in all cases. For instance, while many churches might thrive on the contributions of high-preference donors, some may struggle because their congregants, while possessing similarly strong preferences, lack the financial ability to donate accordingly. Similarly, while some schools might receive ample donations from the financially capable parents of attending students, other schools may be underfunded because they serve communities that value education highly but that cannot afford to donate in a way reflective of this preference.²³⁵ A modest modification such as that described may achieve a desirable balance. On one hand, it would create some separation between donee-organizations and the beneficiaries of their donations, increasing the likelihood that the charitable deduction was addressing some level of underfunding. On the other hand, the modification would reflect the economic reality that not all "close to home" organizations are optimally funded and might enable a more even allocation of resources among organizations serving similar purposes but suffering from a range of underfunding issues caused by wealth disparities.²³⁶

235. This issue is one that is often reported. Consider, for instance, a recently reported problem faced by the township of Albany, California. Two of its schools are extremely well-funded by the donations and efforts of the students' relatively wealthy parents, providing students with "parent-funded academic extras like chess, art and music class." Jill Tucker, *Albany Schools Try to Balance Parent-Funded Extras*, S.F. CHRON., Nov. 27, 2010, http://articles.sfgate.com/2010-11-27/news/24948346_1_public-schools-foreign-language-programs-public-education. Meanwhile, students of Albany's "less affluent sister school[] went without" because of inadequate funding. *Id.* A modest change in the law allowing donors to deduct amounts contributed to the town's education fund rather than individual schools might help address this disparity. As reported, "Parent contributions in some districts tip the scales even more, raising hundreds if not thousands of dollars extra for each child. That means some students get library books and librarians, art, music and technological gizmos, while the less affluent may go without enough paper and pencils." *Id.*

236. This Article, of course, does not seek to make a definitive claim as to whether this would be the final effect, as this would require careful econometric analysis. Such analysis must be reserved for future work. It also should be noted that even this modest proposal might be controversial and politically difficult to achieve. The charitable deduction has become rather sacrosanct, with many citizens believing that they are entitled to receive tax benefits when they donate to the organizations they support. REICH ET AL., *supra* note 49, at 3 ("[W]hen people form associations today, they tend to expect not merely the liberty to associate but also a raft of special

Lawmakers might also respond to this Article's analysis by altering the so-called limitation amounts, which prevent a taxpayer from deducting amounts exceeding a provided ceiling.²³⁷ For instance, current tax law allows a taxpayer to claim a charitable deduction for cash donations made to religious,²³⁸ educational,²³⁹ and charitable organizations²⁴⁰ so long as that donation does not exceed 50% of her taxable income.²⁴¹ Thus, a hypothetical donor having taxable income of \$100,000 may generally claim a charitable deduction for cash donations made to these organizations for amounts up to \$50,000. This limitation applies regardless of whether the donor contributes to an organization serving the needy in a remote location or to the local church where she regularly attends services and events. The law might vary limitation amounts depending on the relative severity of underfunding issues suffered by recipient organizations. For instance, the limitation on donations made to severely underfunded organizations like the toy organization could be extremely large (perhaps even exceeding the current 50% threshold) while the limitation on donations made to "close to home" organizations like specific churches and schools could be rather slight.

Finally, some may point out that not all taxpayers who donate to "close to home" organizations will have the close ties described in this Article. One may therefore suggest that the law disallow deductions for those

tax benefits for their associations. Specifically, they seek to obtain formal recognition from the federal government as nonprofit organizations, a status which entitles organizations, and often their donors, to tax exemptions.").

237. It would be interesting to explore whether this might be a more subtle and, therefore, less politically controversial way of responding to the issue. However, this Article will not opine on the desirability of utilizing less politically salient methods. For a discussion on political salience and taxes, see Brian Galle, *Hidden Taxes*, 87 WASH. U. L. REV. 59 (2009) (exploring the public policy behind taxes that are easy or difficult for taxpayers to notice and process) and Deborah H. Schenk, *Exploiting the Salience Bias in Designing Taxes*, 28 YALE J. ON REG. (forthcoming 2011).

238. Section 170(b)(1)(A) states that a taxpayer may deduct charitable donations to "a church . . . or association of churches" so long as the donations do not exceed 50% of her taxable income for the year. I.R.C. § 170(b)(1)(A) (West 2010).

239. *Id.* (including within the 50% contribution cap those donations to "an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on").

240. IRS, *supra* note 232, at 14 n.6 (listing as an organization subject to the 50% contribution cap: "Corporations, trusts, or community chests, funds, or foundations organized and operated only for charitable, religious, educational, scientific, or literary purposes, or to prevent cruelty to children or animals, or to foster certain national or international amateur sports competition" and adding that these organizations "must be 'publicly supported,' which means they normally must receive a substantial part of their support, other than income from their exempt activities, from direct or indirect contributions from the general public or from governmental units").

241. See *supra* notes 238–40. Other limits apply to other types of donations, which could be as low as 30% or 20% depending on the asset donated and the recipient charity. See, e.g., I.R.C. § 170(b)(1)(B), (D).

donors having sufficiently close connections with donee-organizations or their beneficiaries while allowing deductions for those lacking these ties. For instance, one might suggest expanding the current “quid pro quo” requirement, which requires a donor to reduce his charitable deduction if he receives certain benefits from the donee-organization.²⁴² Generally, the quid pro quo limitation applies only to tangible benefits, such as money or property given directly to the donor. Thus, if a donor contributed to his favorite charity in return for a concert ticket worth \$100, the taxpayer would be required to reduce the amount of his deduction by that amount.²⁴³ However, the quid pro quo limitation does not generally require taxpayers to reduce their deductions by less tangible benefits such as those described in this Article.²⁴⁴ One might propose an expansion to this quid pro quo limitation to reduce or deny deductions to high-preference donors (such as those donating to their child’s school or to the church where they regularly attend services) while allowing other donors who have no connection to the donee-organization or its beneficiaries to retain their tax break. This would certainly be a step in the right direction. It does, however, seem a rather indirect (and possibly insufficient) response to the issues exposed in this Article.²⁴⁵

Certain organizations currently able to receive deductible contributions are unlikely to suffer underfunding problems even in the absence of the deduction. Allowing any taxpayer to deduct amounts donated to these organizations would result in the subsidization of organizations that are generally able to provide goods and services optimally. It, therefore, seems more appropriate to focus on the donor-organization in crafting a response to the issues identified in this Article and to limit the organizations subsidized through the charitable deduction to those in economic need.

242. IRS rules limit the amount of one’s charitable deduction to “the excess of the payment to the charity over the value of any benefit . . . received by the donor.” WILLIAM A. KLEIN ET AL., *FEDERAL INCOME TAXATION* 372 (14th ed. 2006); see also Rev. Rul. 67-246, 1967-2 C.B. 104 (1967) (“[T]he full fair market value of the admission and other benefits or privileges must be taken into account.”). Fair market value must be included regardless of whether the taxpayer subjectively values it at this figure. See Kent Greenawalt, *Hands Off: When and About What*, 84 *NOTRE DAME L. REV.* 913, 919 (2009).

243. *Substantiating Charitable Contributions*, IRS, <http://www.irs.gov/charities/article/0,,id=96102,00.html> (last updated June 29, 2010).

244. See, e.g., *Hernandez v. Commissioner*, 490 U.S. 680, 690 (1989) (“The legislative history of the ‘contribution or gift’ limitation, though sparse, reveals that Congress intended to differentiate between unrequited payments to qualified recipients and payments made to such recipients in return for goods or services. Only the former were deemed deductible.”); see also Colombo, *supra* note 28, at 662–67 (providing a summary of the current interpretation of the quid pro quo limitation).

245. This is not to imply that there are not circumstances in which an expansion of the quid pro quo requirement would be appropriate. For an excellent discussion of this issue, see generally Colombo, *supra* note 28 (analyzing the utility in expanding the definition of quid pro quo transactions).