CHAPTER II

THE NONPROFIT SECTOR AND ITS TAX TREATMENT

As of 1995, nearly 1.2 million institutions in the United States were registered as tax-exempt entities under section 501(c) of the Internal Revenue Code. A much smaller number of organizations were exempt under other sections of the code (notably sections 401(a), 501(a), 501(d), 501(e), 501(f), 521, and 527). Institutions that are exempt from paying federal income taxes frequently are also exempt from state and local income taxes, sales taxes, and property taxes.

Tax-exempt institutions are a diverse group. They include foundations, colleges and universities, art museums, hospitals, churches, social welfare institutions, fraternal beneficiary societies, war veterans' organizations, employee-funded pension trusts, religious and apostolic organizations, farmers' cooperatives, and many others.

Overall, the nonprofit sector represents a significant slice of the national economy. In 1995, tax-exempt organizations held $1.4 trillion in assets and generated $784 billion in revenue. They accounted for nearly 11 percent of gross domestic product (GDP), up from about 6 percent two decades ago.[1]

CURRENT TAX BENEFITS FOR NONPROFIT ORGANIZATIONS

Nonprofits benefit from special treatment under federal tax law—a practice that dates to the mid-19th century (see Box 1). All organizations that meet the requirements of sections 501(c) or other relevant sections of the Internal Revenue Code are exempt from paying income taxes. Organizations that satisfy the more stringent requirements of section 501(c)(3) receive two additional benefits: access to tax-deductible contributions and eligibility to raise capital in the tax-exempt bond market. (Federal law imposes strict limits on the use of tax-exempt financing by other tax-exempt and taxable entities.)

1. Unpublished data from the Internal Revenue Service's Statistics of Income Division.

BOX 1.
A BRIEF HISTORY OF THE TAX TREATMENT OF NONPROFIT ORGANIZATIONS

In the United States, the practice of exempting institutions from federal taxes evolved during most of this century, but its beginning goes back to the Civil War and stems from British common law. At the state level, institutions dedicated to religion, education, poverty relief, or social welfare have received special treatment under tax law since Colonial times.

In 1863, when the federal government imposed a corporate income tax for the first time, it exempted charitable organizations.[1] The Revenue Act of 1894 and the Revenue Act of 1913 also provided that organizations operated for charitable purposes would be exempt from tax.[2] Donations by individuals to charitable organizations were made tax-deductible in 1917. Corporate donations have been tax-deductible since 1935. In the Revenue Act of 1968, the federal government for the first time placed limits on the use of tax-exempt bonds for private purposes. Section 501(c)(3) institutions were exempted from those limits; but today, only acute care hospitals are exempt from limits on the amount of tax-exempt financing available to them. Before 1968, the use of tax-exempt bonds to finance the projects of health care or educational institutions depended entirely on state law.

The Congress has never provided a statutory definition of the term "charitable." In 1923, an Internal Revenue Service ruling narrowly defined "charitable" as the relief of poverty. That definition remained in force until 1959, when the Treasury's final regulations putting into effect the Internal Revenue Code of 1954 changed it to conform to a much broader "generally accepted legal definition."[3] The broader definition had its roots in common law, which recognizes as charitable activities several that go beyond providing relief for the poor, such as advancing education, religion, or community benefit. In writing the regulations for the Internal Revenue Code of 1954, the Treasury relied on judicial decisions, which echo the British Statute of Charitable Uses of 1601. A British legal decision of 1891 defined "charity" as consisting of "four principal divisions: trusts for the relief of poverty; trusts for the advancement of education; trusts for the advancement of religion; and trusts for other purposes beneficial to the community."[4] That broad standard of charitable activity remains in effect and underlies current U.S. policy.

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1. David A. Hyman, "The Conundrum of Charitability: Reassessing Tax Exemption for Hospitals," *American Journal of Law and Medicine*, vol. 16, no. 3 (1990), p. 334.

2. The Revenue Act of 1894 was declared unconstitutional in *Pollack v. Farmers' Loan and Trust Company*, 158 U.S. 601 (1895).

3. Treasury Regulations, section 1.501(c)(3)-1(d)(2).

4. *Commissioners for Special Purpose of Income Tax v. Pemsel* (1891), as cited in Boris I. Bittker and George K. Rahdert, "The Exemption of Nonprofit Organizations from Federal Income Taxation," *Yale Law Journal*, vol. 85, no. 3 (January 1976), p. 131.

Exemption from Federal Income Taxes

Tax exemption makes it possible for those institutions with net income to retain their earnings and use them to advance their programs. Most tax-exempt institutions fall under either section 501(c)(3) or 501(c)(4) of the tax code. Section 501(c)(3) states that entities are eligible for exemption from federal income taxes if they are organized as nonprofit corporations for charitable, religious, educational, scientific, or literary purposes, or to foster national or international amateur sports, or for the prevention of cruelty to children or animals; if no part of their net earnings benefits members of the board, officers, managers, staff, employees, or other individuals associated with the enterprise; and if "no substantial part" of their activities consists of participating in political campaigns or attempting to influence legislation. Under section 501(c)(3), public charities include organizations that receive substantial support in the form of contributions from the public as well as churches, schools, hospitals or other health care institutions, or nursing homes. (Section 501(c)(3) does not specifically mention hospitals or other health care institutions, but it has always applied to them.) Although private foundations are also charitable organizations, they are subject to a 2 percent tax on investment income and to restrictions that do not apply to public charities.

In 1995, about half of the tax-exempt organizations in the United States, roughly 626,000, were registered as public charities under Section 501(c)(3).[2] About 67 percent of those institutions were religious in nature, 13 percent provided social services, 7 percent were devoted to health, and 5 percent were educational.[3] In 1995, public charities held about $948 billion in assets and generated $589 billion in revenue. They accounted for 8 percent of GDP, up from 4 percent in 1975.[4]

Many nonprofit organizations that do not meet the criteria of section 501(c)(3) are eligible for exemption from federal income taxes under the less stringent requirements of section 501(c)(4), which apply to organizations that "promote social welfare." One of the differences between the two sections is that 501(c)(3) organizations are subject to restrictions on lobbying activities, whereas 501(c)(4) organizations are not, so long as such activities are germane to their exempt

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2. Internal Revenue Service, *1995 Data Book*, Publication 55B (7-96), p. 25. The total does not include all religious organizations because some, such as churches, integrated auxiliaries, and associations of churches, need not apply for recognition of exemption unless they desire a ruling from the Internal Revenue Service.

3. American Association of Fund-Raising Counsel, *Giving USA 1995: The Annual Report on Philanthropy for the Year 1994* (New York: AAFRC Trust for Philanthropy, 1995), p. 31. Data on section 501(c)(3) institutions by type are for 1990.

4. Unpublished data from the Statistics of Income Division of the Internal Revenue Service. The data do not include private foundations.

purpose. Until recently, 501(c)(4) organizations were also not subject to prohibitions on private inurement that apply to 501(c)(3) organizations. The Taxpayer Bill of Rights (Public Law 104-168), enacted in July 1996, extended the prohibitions to 501(c)(4) organizations. About 139,000 institutions are registered as social welfare organizations under section 501(c)(4).[5]

Tax-exempt organizations that earn income from business activities unrelated to their tax-exempt purposes must pay taxes at the regular corporate rates on that income. In addition, some tax-exempt organizations that fall under sections of the code other than 501(c)(3) or 501(c)(4)—specifically, social clubs, voluntary employee beneficiary associations, and political organizations—are required to pay taxes on their investment income. But for most section 501(c)(3) institutions, investment income—dividends, interest, royalties, or rents (excluding those derived from debt-financed property or certain types of subsidiaries)—is exempt from the corporate income tax.

Tax-Deductible Contributions

Under section 501(c)(3), charitable organizations have access to tax-deductible contributions; that is, donors to those institutions may deduct their contributions, up to specified limits, when computing their income for tax purposes. That benefit generally does not apply to institutions that are tax-exempt under any other provision of the tax code. Thus, in appealing for charitable donations, institutions with tax-exempt status under section 501(c)(3) have an advantage over other nonprofit organizations.

Section 501(c)(3) institutions vary widely in their reliance on charitable contributions. Such donations account for about 85 percent of the total revenue of religious organizations.[6] By contrast, they account for only 10 percent of the total revenue of all other types of 501(c)(3) organizations, excluding foundations (see Table 1). Even that figure masks differences. In 1993, charitable contributions made up 21 percent of the revenue of publicly supported organizations (such as the American Red Cross, United Way and its affiliated agencies, voluntary health and community service agencies, museums, and other cultural institutions); 12 percent of the revenue of educational institutions; and only 1 percent of hospital revenue. The primary source of income for hospitals and educational institutions is program revenue, such as hospital service charges and tuition payments. Overall, program

5. Internal Revenue Service, *1995 Data Book*, p. 25.

6. American Association of Fund-Raising Counsel, *Giving USA, 1995*, p. 86.

TABLE 1. REVENUES AND EXPENSES OF SELECTED TYPES OF CHARITABLE ORGANIZATIONS, 1993
(In millions of dollars, unless otherwise indicated)

Type of Organization	Total Revenue	Percentage of Revenue in the Form of: Contributions and Gifts	Government Grants	Program Service Revenue	Total Expenses	Excess of Revenue Over Expenses
Educational Institution	89,495	12.0	11.1	63.1	80,482	9,013
Hospital	256,661	1.3	1.0	94.0	246,294	10,367
Hospital Research Organization	2,990	16.4	11.3	47.8	2,673	317
Publicly Supported Organization[a]	158,778	20.6	19.2	49.9	149,962	8,816
Organization Supporting a Public College	6,411	37.3	18.4	27.9	5,244	1,167
Organization Supporting Other Charitable Institutions[b]	44,816	12.0	1.0	43.7	39,095	5,721
Other[c]	5,305	15.3	26.0	51.5	4,944	360
Total	564,457	9.9	8.2	71.3	528,695	35,762

SOURCE: Congressional Budget Office based on unpublished tabulations from the Statistics of Income Division of the Internal Revenue Service.

NOTE: Data are from form 990 filed by nonprofit charitable organizations that are tax-exempt under section 501(c)(3) of the Internal Revenue Code. The data exclude private foundations and most religious organizations (religious organizations are not required to file income tax returns). The data also exclude organizations that file form 990-EZ. Those organizations accounted for less than 1 percent of both revenues and contributions.

a. Publicly supported organizations are ones that normally receive a large part of their funds from a governmental unit or from the general public in the form of contributions or revenue from services or products related to their tax-exempt functions. Such organizations include United Way, the American Red Cross and its affiliated agencies, voluntary health and community service agencies, and cultural institutions.

b. Organizations that support other charitable institutions include the College Retirement Equities Fund, the Teachers Insurance and Annuity Association of America, and the Common Fund for Nonprofit Organizations.

c. Other organizations include those that did not report or incorrectly identified their type, those with religious affiliations that filed voluntarily, those involved with testing for public safety, and governmental units.

revenue accounts for roughly 70 percent of income for section 501(c)(3) institutions, excluding foundations and religious organizations.[7]

Donations by individuals make up the bulk (about 80 percent) of charitable contributions, which in 1994 amounted to nearly $130 billion. Foundation grants, bequests, and corporate donations account for the rest.[8] Religious institutions are the largest single recipient of charitable donations. In 1994, they received 45 percent of donations, compared with 13 percent for educational institutions, 9 percent for human service agencies, 9 percent for health-related organizations, and 7 percent for arts and cultural institutions (see Table 2).[9]

The tax deduction for charitable contributions, which is available only to taxpayers who itemize deductions, provides an incentive for charitable giving by lowering the after-tax cost of contributions. For a taxpayer in the 28 percent bracket, the cost after taxes of giving an additional $1 to a charitable organization is 72 cents. The federal government, in effect, contributes the other 28 cents in the form of forgone revenue. The amount of forgone revenue—or the tax subsidy—depends on the person's tax bracket. The higher the tax bracket, the lower the cost and the greater the tax subsidy for additional charitable contributions. For a taxpayer in the 36 percent bracket, for example, the cost of an additional contribution of $1 is only 64 cents. If the deduction was eliminated, the price would rise to $1 for all taxpayers.

Gifts of appreciated property receive particularly favorable treatment under current law. Subject to specified limits and exclusions, donors may deduct the full market value of gifts of property, including works of art, even though they have paid no taxes on the amount of appreciation. The effect on the price of giving depends on when the taxpayer would have otherwise disposed of the asset and the amount of appreciation as a share of the total value of the asset. For example, if a taxpayer was in the 28 percent tax bracket, the value of the asset had doubled, and the taxpayer would have sold the asset immediately, the price of giving $1 in appreciated property would be 58 cents (72 cents minus 14 cents in unpaid taxes on capital gains). If, at the other extreme, the taxpayer would have made a bequest of the asset, the price of giving it to a charitable institution would be the same as giving cash, since current law provides for a step-up in basis at death (in other words, the original cost of a

7. Data are based on unpublished tabulations from the Statistics of Income Division of the Internal Revenue Service. In addition to foundations and religious organizations, the data exclude organizations with annual revenues of less than $25,000, which are not required to file annual returns with the Internal Revenue Service.

8. American Association of Fund-Raising Counsel, *Giving USA, 1995*, p 12.

9. Ibid., p. 13.

bequeathed asset is revalued at its market price, so no appreciation is recognized or taxed).

The tax deduction for charitable contributions is effective only if people are responsive to the after-tax cost of charitable giving. If people choose to give the same amount regardless of the tax subsidy, then the deduction does not stimulate additional giving and is only a windfall to the taxpayers who claim it. If taxpayers are responsive to the after-tax cost of contributions, then the deduction stimulates added giving, and charitable organizations gain part or all of the benefits of the tax subsidy. Although several studies suggest that taxpayers do respond to the after-tax cost of giving, recent work has raised questions about the size of that response (see Chapter IV for details).

Tax-Exempt Financing

Apart from being able to solicit tax-deductible gifts, section 501(c)(3) institutions also have access to funds raised in the tax-exempt bond market. In most cases, an

TABLE 2. RECIPIENTS OF CHARITABLE CONTRIBUTIONS IN 1993 AND 1994, BY TYPE OF ORGANIZATION (In billions of dollars)

Type of Organization	1993	1994
Religious	56.29	58.87
Educational	15.40	16.71
Human Services	12.47	11.71
Health	10.83	11.53
Arts, Culture, and Humanities	9.57	9.68
Public and Social Benefit	5.44	6.05
Environment and Wildlife	3.19	3.53
International Affairs	1.86	2.21
Other	10.24	9.59
Total	125.27	129.88

SOURCE: Congressional Budget Office based on American Association of Fund-Raising Counsel, *Giving USA, 1995: The Annual Report for the Year 1994* (New York: AAFRC Trust for Philanthropy, 1995), p.13.

NOTE: These figures include only organizations that are tax-exempt under section 501(c)(3) of the Internal Revenue Code.

agency of a state or local government will issue the bonds on an institution's behalf. Because the interest income on such bonds is exempt from federal taxation, investors are willing to accept lower rates on them than on comparable taxable bonds. That allows 501(c)(3) institutions to borrow at more favorable rates than generally prevail in the market.

In order to borrow funds in the bond market, institutions must have a steady and reliable source of revenues to make principal and interest payments. Consequently, the 501(c)(3) institutions most likely to avail themselves of tax-exempt financing are hospitals and other health care facilities, universities, colleges, and scholarship funding corporations. Tax-exempt financing for health care facilities amounted to nearly $13.3 billion in 1995, down from an annual average of $22.5 billion from 1991 to 1994.[10] (The drop reflects a steady decline in new construction, particularly of acute care hospitals, since 1991 and an even sharper decrease in refinancing, which reached a record high in 1993.) About three-fourths of tax-exempt financing for health care facilities is for nonprofit acute care hospitals. Tax-exempt financing for higher education totaled $7.2 billion in 1995, compared with an annual average of $9.5 billion between 1991 and 1994. Of the tax-exempt bonds issued for higher education in 1995, about $2.1 billion was for public colleges; the remainder was for private institutions.[11]

Section 501(c)(3) institutions may use tax-exempt bonds to finance capital facilities and working-capital needs. Most 501(c)(3) institutions, such as colleges, universities, health maintenance organizations, and clinics, are not allowed to have more than $150 million in tax-exempt bonds outstanding at any time. Hospitals are the exception. Hospital facilities that are integrally related to acute care—for example, same-day surgery centers—are not subject to any limit. But other facilities that a hospital may construct, such as physicians' offices, are subject to the $150 million limit. Non-acute care facilities that are under common ownership are subject to an overall limit of $150 million per institution.

Tax-exempt bonds appeal to investors—especially those in high tax brackets—because purchasing and holding the bonds gives them an opportunity to shelter some of their income from taxation. That situation occurs because of the relationship of marginal tax rates to the spread in yields on tax-exempt and taxable bonds. The marketplace offers investors a wide variety of choices, which include tax-exempt bonds, taxable bonds, and equities. The traditional model maintains that

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10. That amount includes refundings. New financing issues in 1995 amounted to nearly $8.3 billion; issues that combined new financing and refunding totaled nearly $2.3 billion, and refunding issues amounted to $2.8 billion. American Banker, *The Bond Buyer: 1996 Yearbook* (New York: American Banker, 1996), p. 148.

11. Ibid., p. 116.

yields on tax-exempt and taxable bonds must adjust so that, in equilibrium, a taxable investor is indifferent between holding the two kinds of securities. Thus, the marginal tax rate of the investor who purchases the last bond of a tax-exempt issue (the so-called marginal investor) would determine the ratio of the tax-exempt to taxable yield. An alternative—but not inconsistent—model suggests that the ratio may fluctuate with the yield on equities as well as marginal tax rates because different types of investors hold tax-exempt and taxable securities, and in each case they would compare the return on those securities to the return on equity. That model predicts a narrower spread between tax-exempt and taxable yields than the more traditional one.[12]

At present, interest rates on long-term tax-exempt bonds are roughly 80 percent of the rates on comparable taxable bonds. Thus, for example, if the long-term interest rate on a high-grade taxable bond is 6.5 percent and the rate on a similar tax-exempt bond is 5.2 percent, the investor in a marginal tax bracket of 20 percent would realize an after-tax return of 5.2 percent from either bond. For an investor in a marginal tax bracket of 36 percent, however, the after-tax return on the taxable bond would be 4.2 percent—a full percentage point less than the after-tax return on the tax-exempt bond. The higher return on the tax-exempt bond, which is a windfall for high-income investors, reduces the efficiency of the tax subsidy. In other words, the borrowers of funds do not reap the full benefits of tax-exempt financing; rather, they share them with investors in the bonds.

In sum, tax-exemption under section 501(c)(3) probably stimulates donations, reduces the cost of assets that are purchased with borrowed funds, and, in some cases, increases the retained earnings of nonprofit institutions compared with for-profit ones.

REVENUE LOSSES FROM THE CURRENT SYSTEM

By exempting some institutions from taxation, the federal government incurs costs in the form of forgone revenue, known as tax expenditures. Tax expenditures are measured by comparing existing law with a "normal," or basic, income tax structure that does not include special provisions, such as preferential rates, exclusions, exemptions, deductions, special credits that are subtracted from tax liability, or deferrals of tax liability. The government's official lists of tax expenditures include two related to nonprofit institutions: the revenues forgone by exempting from taxation the interest that investors earn on bonds for financing construction or acquisition of health care or educational facilities and equipment, and the revenues

12. N. Gregory Mankiw and James M. Poterba, *Stock Market Yields and the Pricing of Municipal Bonds*, Working Paper No. 5607 (Cambridge, Mass.: National Bureau of Economic Research, June 1996).

forgone by permitting individuals and corporations to deduct their contributions to 501(c)(3) institutions from taxable income.

The Congress's Joint Committee on Taxation estimates that revenue losses from outstanding issues of tax-exempt bonds for health care and educational facilities and equipment will amount to $2.5 billion in 1997 and about $14.3 billion over the 1997-2001 period. The estimated revenue losses from deductions for charitable contributions will amount to $21.3 billion in 1997 and about $118.1 billion through 2001.[13]

At present, official estimates of tax expenditures do not include the revenues forgone by exempting nonprofit institutions from federal income taxes. For many organizations, that exemption is minor because their revenues do not exceed expenses. The exemption from state and local sales and property taxes represents a greater savings. But some organizations—particularly those that derive most of their income by charging for services, such as schools and hospitals—frequently generate surplus revenue (see Table 1 on page 7).

THE ECONOMIC RATIONALE FOR THE NONPROFIT SECTOR AND ITS TAX TREATMENT

Quite apart from its historical roots, the nonprofit sector has an economic rationale: it may compensate for the failure of the private sector and government to produce collective goods (products or services that benefit all members of society regardless of whether they pay for them) or it may correct for "contract failure," which occurs when consumers are inadequately informed about the products or services they are buying. The rationale for the special tax treatment of nonprofit institutions is a separate—and much debated—issue.

The Economic Rationale for a Nonprofit Sector

In the simple competitive model of a classic market economy, an industry is composed of many private firms acting to maximize their profits and many consumers acting to maximize their welfare. If firms can enter and leave an industry readily, and if consumers have enough information to make informed decisions, prices will serve as signals for how much firms should produce. In a state of equilibrium, firms will produce the quantity and mix of goods and services that

13. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1997-2001*, JCS-11-96 (November 26, 1996).

consumers will want to buy. When competitive markets work well, the price system naturally leads to an efficient allocation of resources.

In some cases, though, the private sector may fail to produce the goods or services that society desires, or it may produce them in insufficient quantities. The reason may be that certain conditions, such as adequate information for consumers to make informed decisions, are lacking, or that production and consumption of some goods or services have benefits or costs that extend to other parties beyond those involved in the transaction. Even if all conditions for an efficient private market exist, some goods or services may be too expensive for the poor to afford. Society may decide that all people, regardless of income, should have access to such goods as education, housing, and health care because their benefits spill over to the public in general. When the outcome of the private market is inadequate, the government may intervene by producing a service itself or subsidizing some or all of its private production. If government intervention does not adequately compensate for the shortfall, the nonprofit sector may help fill the gap. In practice, some nonprofit institutions receive federal funds and help deliver public services.

Nonprofit organizations may also correct for the contract failure that can occur when consumers are insufficiently informed about the products they are buying and high transaction costs inhibit their ability to switch from one supplier to another. Many analysts cite contract failure as a rationale for nonprofit medical institutions, for example. When buyers are at an informational disadvantage and cannot easily switch suppliers, for-profit producers might take advantage of them by selling inferior goods or services at excessive prices or in excessive quantities. A nonprofit organization, which has goals other than maximizing profits, may be more likely to act in the interests of consumers and earn their trust.[14] Nonprofit institutions generally operate under a "nondistribution constraint"—a prohibition against distribution of their net earnings or assets. Although nonprofit institutions must be sensitive to costs, they are free from concern about providing returns to shareholders and thus might strive harder than for-profit institutions to hold down prices or improve quality.[15]

14. See Henry B. Hansmann, "The Role of Nonprofit Enterprise," *Yale Law Journal*, vol. 89, no. 5 (April 1980); Dennis Zimmerman, "Nonprofit Organizations, Social Benefits, and Tax Policy," *National Tax Journal*, vol. 44, no. 3 (Fall 1991); and Burton A. Weisbrod, *The Nonprofit Economy* (Cambridge, Mass.: Harvard University Press, 1988).

15. See, for example, Robert A. Boisture, "Maintaining a Strong Nonprofit Health Care System Will Be More—Not Less—Important After Health Care Reform," *Exempt Organization Tax Review*, vol. 9, no. 4 (April 1994), pp. 785-787.

The Rationale for Tax Benefits

Tax preferences for nonprofit institutions raise two basic questions: do they provide a public benefit that is commensurate with their associated loss of revenue, and are they efficient (that is, to what extent do they benefit the donor rather than the charity, and to what extent do they lead to poor allocation of resources)? Public benefit is difficult to measure and has been the subject of much debate. Under current law, a wide variety of institutions and activities receive tax benefits. Some serve a broad stratum of society, others a relatively narrow one. Some provide aid to the poor; others appeal to the interests of many socioeconomic groups, including the relatively well educated and well-off. Some institutions depend on small donations from a large number of contributors; others rely on large donations from relatively few wealthy givers. In practice, the implicit definition of public benefit for the purposes of tax law seems to reflect longstanding precedent and prevailing social values.

If education, health care, aid to the poor—to name a few—have positive effects that extend beyond their recipients, and private markets fall short of meeting the needs of all members of society, the case for public assistance may become compelling. The question then becomes how best to deliver that assistance. Should it be given directly to consumers, directly to providers, or indirectly to providers through the tax system? For example, the federal government directly subsidizes health care through the Medicaid and Medicare programs and by supporting public hospitals. It could increase its direct funding subsidies and reduce its indirect tax subsidies, thereby relieving health care providers of some of the burden of caring for lower-income patients. Similarly the federal government provides direct payments to educational institutions; it could increase them and decrease the levels of subsidy it provides through the tax system.

Tax-exemption, tax-deductible contributions, and, in most cases, tax-exempt financing provide subsidies indirectly to the providers, not the consumers, of goods and services. Assuming a public benefit, the rationale for those preferences may vary by the type of organization. In general, nonprofit organizations lack access to equity capital and therefore are limited to three sources in raising funds: donations, debt, and retained earnings. Those sources may or may not be adequate. Nonprofits that depend heavily on donations may not have sufficient contributions to meet the needs of their programs or services. At the same time, they generally cannot issue debt because they lack a steady stream of income to secure it.

Nonprofits that depend primarily on the sale of services for their revenue —so-called commercial nonprofits, such as hospitals—usually receive only a small portion of their funds from donations. Thus, expanding their programs or facilities must depend largely on using retained earnings and whatever capital they can raise by issuing debt. Exemption from taxation increases the amount of earnings that

nonprofits can accumulate, retain, and use either to finance expansion directly or to help secure debt. And those nonprofits that have access to the tax-exempt bond markets can borrow funds at below-market interest rates.

At present, tax-exempt financing for health care and educational facilities is broadly available to 501(c)(3) institutions and is not targeted toward any particular purpose or area. Thus, the subsidy may stimulate investment where facilities are in short supply, but it may also lead to overinvestment in other areas. If capital subsidies are necessary, a more direct approach would be to provide federal loans at below-market interest rates or federal grants to subsidize interest costs. An institution would then benefit from the full amount of the subsidy instead of sharing it with the buyers of tax-exempt bonds.

Whether direct subsidies would compensate for contract failure is more debatable. Even if tax benefits were unavailable, a nonprofit sector might exist to fill a need for information that would otherwise be unmet. A nonprofit sector that operates independently might be better at meeting such needs than are profit-seeking firms or the federal government. If such needs for information exist, a rationale for tax exemption and other tax preferences is that they help to compensate for the constraints on capital formation that nonprofits commonly face.[16]

Policymakers and social scientists have justified the deduction for charitable contributions on the grounds that such contributions reallocate income from private to public purposes; they do not enrich the giver and therefore should not be included in the tax base. The tax-favored treatment of charitable institutions may promote social-policy objectives by providing goods or services that the government might otherwise have to supply or by serving educational, religious, cultural, medical, or scientific purposes that benefit the public. Further justifications for the deduction are that it stimulates private initiatives, avoids governmental intrusiveness, encourages pluralism, and in the case of contributions to support the social assistance programs of religious organizations, avoids compromising the principle of separation of church and state.

A counterargument is that the electorate as a whole, not individual donors, should determine which activities deserve taxpayer support. A further argument against the deduction is that, regardless of benefits to third parties, donations to charitable causes also benefit the giver. In some cases, the benefit may simply be the gratification associated with giving. In other cases, the benefit may be tangible. For example, many individuals contribute to institutions that provide them or their families with such benefits as education, cultural enrichment, or places of worship.

16. See Henry B. Hansmann, "The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation," *Yale Law Journal*, vol. 91 (November 1981), pp. 54-100.

And businesses and corporations frequently donate as a means of projecting a positive image without directly advertising particular products or services.

Some critics of the current tax deduction would distinguish among different types of charities and argue, for example, that providing assistance to the poor serves a broad social purpose and therefore merits tax subsidies, whereas contributing to a performing arts center, an opera company, or a ballet troop does not because it serves the interests of the donors and, in any event, primarily benefits the wealthier and better educated. Others would argue that contributions to the arts promote broader access by making it possible to provide training scholarships, support programs on public television, and subsidize the cost to students and other groups of attending museums and cultural events.

In part, the rationale for the deduction for charitable contributions rests on the notion that it stimulates increased giving. But empirical studies on how much it does that show varying results. If giving is less responsive to the deduction, the rationale for the subsidy is weakened. Likewise, if the availability of tax-exempt financing stimulates overexpansion of capital facilities and results in an inefficient allocation of resources, the rationale for that subsidy is weakened as well.