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THE OPTIMAL FISCAL TREATMENT OF CHARITABLE ACTIVITY

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ABSTRACT

Discussion of the optimal fiscal treatment of charity has hitherto been restricted largely to consideration of an efficiency (or externality) justification for subsidies to charity, and in particular to the optimal tax treatment of charitable contributions. This paper takes a broader perspective: It examines the fiscal treatment of charities as a whole--that is, both the tax treatment of contributions and the tax exemption of the income of charitable organizations--and identifies the possible forms of fiscal treatment suggested by both equity and externality rationales.

The first main conclusion is that an explanation of the fiscal treatment of charity on equity grounds offers little rationale for the tax deductions of contributions, but may, in certain limited circumstances, provide a convincing case for limited tax exemption. The second conclusion is that a comprehensive treatment of the efficiency or externality argument--that is, including the case of several charities serving different objectives--suggests that the most appropriate subsidy system is one which varies subsidies between charities on the basis of their output rather than on the basis of total income, as is the case at present. It follows that in certain circumstances a variable direct grant (awarded to some but not necessarily all recognized charities) may be more appropriate than the current combination of tax exemption and tax deduction.

The Optimal Fiscal Treatment of Charitable Activity

INTRODUCTION

Until fairly recently there has been little detailed or systematic analysis of the organization and operation of the philanthropic (charitable) sector of the economy. This lack of interest is surprising in view of emerging evidence on the size and potential social importance of the sector, and in view of the extensive (and expensive) fiscal concessions awarded to recognized charitable organizations. This paper focuses on the second of these factors with the purpose of providing a checklist of the issues and questions which need to be resolved in order to define the optimal fiscal treatment of charitable activity.

The term charity, in the legal sense, refers to a particular subgroup of all nonprofit organizations. In both the United States and England the legal and fiscal definition of charity involves three broad conditions: (1) To be charitable an organization must be organized and operated exclusively for one or more charitable purposes. These purposes may be grouped under four general heads: (a) the relief of poverty, (b) the advancement of education, (c) the advancement of religion, and (d) other socially beneficial purposes (including the prevention of cruelty to animals or children, the promotion of health, care of the elderly, and general social welfare).

In this context, "exclusively" means that an organization must not engage, except as an insubstantial part of its activities, in any noncharitable activity. Thus a charity must not be engaged to any substantial extent in unrelated business activities, nor must there be any possibility of private benefit.

(2) The organization must benefit the community as a whole or a sufficiently important section of the community, not a limited group of individuals. This restriction applies irrespective of the purpose of the organization. Thus a trust for the education of members of one family, for example, could not be defined as charitable.

(3) Particularly in the United States, and to some extent in England, charitable organizations seeking tax-exempt status and the right to receive tax-deductible contributions are restricted in the forms of activity in which they may engage. Especially important is the prohibition against any substantial involvement in attempts to influence legislation or in political campaigns. In the United States private foundations are also subject to extensive restrictions relating to the accumulation of income, self-dealing (transactions involving charity managers or other disqualified persons dealing with charity property), and certain prohibited transactions.

Recent studies point to the substantial share of national income channelled through these charitable organizations. Weisbrod and Long (1977) estimate the total income of the "philanthropic" sector in the United States in 1973 to be approximately $132.2 billion. Austin and Posnett (1979) report a total of £4.1 billion (or approximately 4% of the GNP) as the income of registered charities in England and Wales in 1975. These figures represent the total income of around 242,000 charitable organizations currently operating in the United States and 126,000 in England and Wales.

All of these recognized charities enjoy two quite distinct forms of fiscal advantage. The first is tax relief to donors through the deductibility of charitable contributions or, in England, limited relief on gifts made under deed of covenant; the second is extensive exemption from taxation of the income of charitable intermediaries from most sources. One of the implications of this dual system is that the rate of "subsidy" increases with the income of donors (given the combination of deductibility and a progressive income tax regime), and that the level of total "subsidy" increases with the size of individual gifts and with the total income of the charity.

The cost of fiscal concessions is difficult to estimate without knowing how charities might be taxed in the absence of these concessions. Some limited estimates of partial costs, however, are available. According to the official estimate of the Inland Revenue, payments to charities in England of tax deducted at source (i.e., on covenanted donations and on some investment income) amounted to some £91 million in 1975-76. The U.S. Senate Budget Committee (1978) reported a tax expenditure equivalent to the deductibility of charitable contributions for 1978 of $6,560 million (compared with the cost of the deduction of medical expenses of $2,435 million, or the deduction of mortgage interest and property taxes on owner-occupied homes of $9,560 million).

Neither of these figures gives a full estimate of the cost of fiscal privilege awarded to charities, since neither attempts to calculate the cost of exempting the income of charitable organizations themselves from tax. The fact that the Budget Committee's tax expenditure budget nowhere mentions this item may be consistent with the view discussed below that tax exemption is not properly regarded as a subsidy. Subsidy or not, however, given the total income figures mentioned here the cost of tax exemption is likely to be substantial, and clearly the alternative rationales for tax exemption are appropriate candidates for closer scrutiny.

These fiscal concessions may be, and are, justified by either of two broad rationales:

(1) As a specific decision of public policy to relieve contributors and organizations of a tax liability which they would otherwise bear. This approach has come to be associated with tax expenditure analysis and the explicit recognition of fiscal concessions as a form of fiscal subsidy to particular kinds of private activity.

(2) The alternative "equity" or "inherent tax theory" view, which states that under the rules which govern horizontal equity (the equal treatment of equals) in the tax system, certain items of income or expenditure would not be subject to taxation anyway. Specifically, if neither expenditures on contributions to charitable organizations nor the income of those organizations may properly be regarded as subject to taxation, then the fiscal concessions to charity become a matter of tax logic and not of public subsidy.

Both of these approaches raise certain questions about the form of the optimal tax treatment of charitable activity. In the first case one is prompted to ask, why does the government (society) wish to devote collective resources to this particular area of activity? In other words, why should charities be subsidized? Following directly from this is the need to consider the most appropriate (most efficient) means of achieving government objectives.

Economists approaching the analysis of the optimal fiscal treatment of charity have concentrated almost exclusively on seeking answers to these types of questions. In doing so they have relied heavily on the possible external benefits arising from private provision of charitable goods and services. The reason society wishes to encourage philanthropy is the existence of Pareto-relevant externalities at the margin of voluntary provision. That is, the existing level of voluntary provision of certain goods and activities is suboptimal from a social point of view. The choice of optimal subsidy then becomes one of choosing the form of incentive which minimizes the cost to society of achieving the desired level of output. I will refer to this approach as the externality argument.

If, on the other hand, one argues that the tax treatment of charitable activity follows from some conception of the appropriate definition of taxable income, no subsidy or incentive is implied and the type of questions outlined above become redundant. Alternative questions offer themselves, however. In particular, how is the tax base to be defined and what are the characteristics of appropriate exclusions from taxable income? Do personal expenditures on charitable donations and the income of charitable intermediaries fit closely into the categories of exemption delimited? Throughout this paper I will refer to this approach as the horizontal equity argument.

Discussion of the optimal fiscal treatment of charitable activity has hitherto been restricted largely to a consideration of the externality type of argument noted above, and within this to the optimal fiscal treatment of contributions. In particular, the question of whether subsidies should vary with the income of donors has been addressed.[1] In my view this focus is misdirected. Voluntary income (donations and gifts) constitutes a minority share of the total income of charitable organizations in both England and the United States, amounting to no more than 23% of total income.[2] The comprehensive exemption from taxation is thus potentially of considerably more importance than the tax incentives afforded to donors.

The purpose of this paper is to consider the fiscal treatment of charities as a whole and to seek guidelines on the characteristics of the optimal fiscal framework. The paper considers the possible forms of tax treatment suggested by both the equity and externality rationales, and assesses the intellectual appeal of these rationales. Two main conclusions emerge: (1) The equity argument offers little help in explaining the deductibility of gifts to charity from the tax base. A convincing argument, however, may be made, in certain circumstances, for the tax exemption of charitable intermediaries. (2) A justification of fiscal subsidy based on the externality characteristics of charitable activity is more appealing, and suggests that the optimal subsidy is one which varies neither with the income of donors nor with the income of charities (as is the case at present) but rather with the objectives or activity of the charity itself. This implies that a direct grant may be more appropriate than the current combination of tax deduction and tax exemption.

The broader question of the optimal tax treatment of charitable activity cannot be answered until the particular objectives which prompt society to look favorably on certain uses of resources are clearly specified. Typically the appropriate fiscal devices suggested by considerations of equity will not be the same as those prompted by externality or incentive objectives. This paper attempts to provide a framework for discussion within which these questions might be resolved.

I. HORIZONTAL EQUITY AND THE OPTIMAL FISCAL TREATMENT OF CHARITABLE ACTIVITY

The Taxation of Charitable Contributions

In both Canada and the United States donations to recognized charitable organizations are deductible from the tax base of the donor, subject to certain limitations. In Canada individual and corporate donations to registered Canadian charitable organizations of up to 20% of total taxable income are deductible. Any gifts in excess of the limitation may be carried forward for one year.[3] In the United States gifts by individuals "to" (but not "for the benefit of") certain categories of charity are deductible up to 50% of total income. Favored charities in the 50% group include churches, governmental units, publicly supported organizations and charities whose primary activity is education, health or medical research. Together these categories are known as public charities. Gifts to so-called private charities or gifts "for the use of" public charities are subject to a 20% limitation. Deductible gifts by companies are subject to the restriction that they should not exceed 5% of income, but any gifts to public charities in excess of the personal or corporate limitations may be carried over for five years.[4]

In the United Kingdom no tax deduction is allowed. Instead, by virtue of their tax-exempt status, charities benefit from the rule that any payment made by irrevocable covenant for a period of at least seven years is regarded for tax purposes as the income of the recipient rather than of the donor.[5] Since 1946, however, gifts to registered charities have been less favorably treated under the covenant provisions than gifts to other recipients.[6] Gifts to charity (and to corporations) are exempt from tax in the hands of the donor at the basic rate of income tax only. The reasoning presumably is that since both charities and corporations are subject to lower rates of tax than individuals, some limitation of relief is justified in order to control the cost to the Inland Revenue of the covenant provisions. Both individuals and companies may covenant income to charities without any percentage limitation.

<u>The definition of income and the tax base</u>. Any discussion of the appropriate definition of income for the purpose of taxation must properly start with the definition (or definitions) proposed by Henry Simons in 1938 (Simons, 1938, p. 49):

> Personal income connotes, broadly, the exercise of control over the use of society's scarce resources. It has to do not with sensations, services, or goods but rather with rights which command prices (or to which prices may be imputed). Its calculation implies estimate (a) of the amount by which the value of a person's store of property rights would have increased, as between the beginning and end of the period, if he had consumed (destroyed) nothing, or (b) of the value of rights which he might have exercised in consumption without altering the value of his store of rights. In other words, it implies estimate of consumption and accumulation.[7]

This definition suggests two concepts: control over the use of scarce resources, and consumption and accumulation, which apparently are to be regarded as equivalent. The transition from income to the income tax base proceeds on the premise that income is to be regarded as an appropriate index of an individual's ability to pay, and that horizontal equity in taxation requires that those similarly taxed should be those with correspondingly similar measured ability. Since ability to pay may be expected to vary systematically with factors other than income, some adjustment based on individual circumstances will be necessary in order to refine the tax base to conform more closely with the desired view of horizontal equity. Thus gross income is reduced by the exclusion from the tax base of certain receipts which may be difficult to assign between individuals and to value accurately (some in-kind transfers or imputed income), and by the exclusion of certain forms of expenditure. It is on the question of the types of expenditure which should properly be excluded that the appropriate treatment of gifts generally, and gifts to charity in particular, will turn.

The literature displays two broad approaches to this question. Following Simons, it might be argued that all forms of expenditure represent "the exercise of control over the use of society's scarce resources," and the exclusion of particular forms of expenditure must follow as an explicit policy decision based on more or less clearly defined rules relating to the appropriate concept of the relation between income and ability to pay. Thus most writers and legislators agree that expenses incurred in earnings income and casualty losses should be deductible items of expenditure, on the grounds that their inclusion in the tax base would give an inappropriate reflection of relative standards between individuals. Other writers have apparently taken the second of Simons's two concepts to be the most important--namely, income as measured by consumption and accumulation. It follows that consumption (and accumulation) may be defined in a particular way such that certain items of expenditure (e.g., gifts) do not appear as consumption and are thus properly excluded from the tax base. The deductibility of particular types of expenditure becomes a matter of definition rather than a specific policy decision. These two approaches may produce conflicting recommendations whenever the definition of consumption differs from that implied by the ability to command resources.

Following the first line of argument, the principle which apparently distinguishes tax deductible expenditures is not the fact that they do not represent control over resources, but rather that the exercise of that control is somehow involuntary. Thus expenditure on taxes or expenses, or expenditure occasioned by unforseen losses, represents necessary or unavoidable uses of funds which should not be included in taxable income on grounds of horizontal equity.[8] This approach is made explicit by the Canadian Royal Commission on Taxation (The Carter Commission) in their discussion of personal income taxation. Personal taxes should be related to ability to pay, as appropriately measured by "discretionary economic power." Economic power is defined, following Simons, as the ability to command goods and services for personal use, whether or not that power is exercised. Economic power is adjusted to conform with the appropriate tax base by the exclusion of "the power necessarily exercised to maintain the appropriate standard of living of the unit relative to other units." Canada, Royal Commission on Taxation (1966, Vol. 3, p. 32), and the exclusion of specific nondiscretionary expenses such as extraordinary medical expenses, gifts to close relatives to provide them with support, and the special expenses of working mothers with young children (p. 19). The emphasis is placed firmly on the necessary or nondiscretionary quality of deductible expenditures.

Taking the argument one step further, it appears that the deduction of necessary or unavoidable expenditures is justified on the grounds that the taxpayer enjoys no immediate return from the use of resources in these particular ways. In some real sense these expenditures represent an alienation rather than an application of funds.

Charitable contributions. Viewed in this light, full or partial deductibility of donations to charity, or indeed any gifts, must be based on the proposition that a gift represents necessary or unavoidable expenditure which divests the taxpayers of the use of the resources making up the gift. The charitable deduction has been rationalized in this way. The Congressional Record of 1917--the year in which the deduction for philanthropic contributions was introduced in the United States--contains the following statement:

> By means of this exemption contributions to recognized religious, charitable, and educational institutions are put on the same basis as the loss of money in business, or the payment of money in taxes. Since the taxpayer, or the bad investor, or the donor does not have the use of the money he is not asked to pay the income tax on it [U.S. Congress, 1917, p. 6729].[9]

However, it would appear that this represents more a statement of the logical consequences of the deduction rather than its raison d'être. When the deduction was introduced it was fairly widely conceived as being designed to encourage philanthropic contributions, or at least to protect them from the possible disincentive effects of the increasing burden of taxation. The sponsor of the amendment allowing the deduction of certain contributions up to 20% of income, Senator Hollis, justified it in the following terms:

> Usually people contribute to charities and educational objects out of their surplus . . . . 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' [U.S. Congress, 1917, p. 6728].

The tax exemption granted to convenanted expenditure in the United Kingdom may be easier to fit within this overall logic. A covenant is a promise made under seal, and the law treats such a promise as a sufficiently binding obligation that annual payments made under covenant are treated as alienating that portion of the income of the donor in favor of the recipient. The favored treatment of gifts to charity, therefore, follows the application of this general rule and is in no way related to the characteristics of charitable transactions in particular. Thus, in the United Kingdom all of the fiscal concessions to charity are, in fact, contained in the tax exemption of the income of recognized organizations. Nonetheless, in terms of equity, it appears to be inconsistent with the premise that an annual obligation is not income to the payer that gifts to charity should receive exemption only up to the basic rate of income tax. Clearly here there is some moderation of the principle in view of its revenue implications.

The Royal Commission on the Taxation of Profits and Income in their final report, while endorsing the alienation principle embodied in the covenant provisions, sought to justify a separate treatment of charitable contributions on the grounds that all gifts to charity (not only those made by covenant) divest the taxpayer of the use of resources.

> A charitable contribution does not appear to us to be well compared with personal expenditure or investment of income. It is more truly an act by which a man surrenders his personal decision as to the employment of that part of his income in favour of the decision of the managers of the charity. In a real sense his income is transformed into income of the charity. The same could indeed be said of all gifts of income to other persons, though with less general cogency, since such donors may have much more say as to the use of their gifts [Great Britain, Royal Commission on the Taxation of Profits and Income, 1955, para. 182].

The Commission argued (correctly) that such a view calls for full tax deductibility of gifts to registered charities, but declined to recommend such a change on the grounds that it would lead to some uncertainty with respect to the effect on total donations, the distribution of donations between charities and the regularity of income which is reasonably assured by the necessity of making annual payments under the covenant provisions (para. 184).[10]

Perhaps paradoxically the Carter Commission, while explicitly justifying tax exemption as an incentive to donors rather than as a means of refining the tax base, preferred a tax credit system similar to the one in the United Kingdom to the existing tax deduction system. The reasoning appears to be that a tax credit, which varies the rate of subsidy with the size of total gifts, would be more equitable than a tax deduction, which increases subsidy rates with the income of donors. The Carter Commission rejected the proposal, however, on the grounds that a tax credit would have an adverse effect on donations:

> The credit approach would, however, tend to stifle charitable giving by upper income individuals and families. Because we believe that private philanthropy performs a worthwhile social purpose we recommend that the fundamental feature of the present system, the deduction of charitable donations from income, should be continued [Canada, Royal Commission on Taxation, 1966, Vol. 3, p. 222].

Leaving aside the rather special circumstances in which gifts made under covenant are seen as an alienation of personal income under the income tax laws in Britain, it appears that no serious attempt has been made to justify fiscal concessions to charitable donations on anything other than incentive grounds. Simons, while accepting that some forms of expenditure of an unavoidable nature may be excluded from the tax base as a matter of public policy, argues strongly that gifts do not constitute a form of expenditure of this type and as such are properly included in the taxable income of both donor and recipient: "The proposition that everyone tries to allocate his consumption expenditure among different goods in such manner as to equalize the utility of dollars--worths may not be highly illuminating; but there is no apparent reason for treating gifts as an exception [Simons, 1938, pp. 57-58]." And further: "One may persevere stubbornly in the contention that, as a matter of principle, gifts are consumption to the donor and therefore not properly deductible. They are not expenses of acquiring 'income,' and they are not capital losses. Broadly they represent merely personal expenditure [Simons, 1938, p. 139]."

In view of the correspondence between Simons's definition of income in terms of the power to allocate resources, and the definition adopted by the Carter Commission, the Commission's agreement with his position on the general treatment of gifts is not surprising. Their operational definition of taxable income (discretionary economic power) includes three items: the market value of rights exercised in consumption, the market value of gifts, and changes in net worth. Gifts, other than those in support of close relatives (nondiscretionary expenditure), are to be included in the tax base of both donor and recipient:

> The value of gifts made by the tax unit to other tax units, item 2, are included because they represent consumption goods and services the tax unit could have commanded in the year had it chosen not to transfer this command to someone else. The making of a gift is a form of exercise of economic power [Canada, Royal Commission on Taxation, 1966, Vol. 3, pp. 23-24].[11]

If one accepts the proposition that gifts in general do represent a form of consumption which does not fit easily into the category of necessary or unavoidable expenditure, then the logic of tax deductibility of charitable gifts can only be rescued by the fact that gifts to charity are somehow different from gifts to other recipients. A rather unconvincing argument along these lines is suggested by the United Kingdom Royal Commission at paragraph 182 quoted earlier. However, an alternative approach has been suggested by Andrews (1972).

Emphasizing the second of Simons's concepts noted above, Andrews argues that the appropriate tax base is measured by aggregate consumption and accumulation of real goods and services. Defining income in this way is consistent with the intended primary purpose of income taxation, which he sees as being to divert real resources from private to public use in order to reduce inequalities in living standards.[12] The adjustment of measured income necessary to bring it into line with the tax base involves both positive and negative items. The benefits received from consumption which is not included in money income (in-kind or imputed income) must be brought within the definition just as items of expenditure which do not constitute consumption must be excluded. A clear distinction is implied in the treatment of income according to uses, and this requires at the outset a working definition of consumption: "The personal consumption at which progressive personal taxation with high graduated rates should aim may well be thought to encompass only the private consumption of divisible goods and services whose consumption by one household precludes their direct enjoyment by others [Andrews, 1972, p. 346]."

The defining characteristic of consumption, then, is the existence of a quid pro quo in terms of real goods and services.[13] Clearly this stricture removes all genuine gifts from the realm of consumption and thus from the tax base, although it is by no means clear why one should wish to define consumption in such a way.

Gifts to philanthropic causes exhibit two characteristics:

(1) Giving does not involve a transfer of resources away from the satisfaction of others but rather represents a diversion of real resources toward the needs of others.

(2) Philanthropic gifts produce public or shared benefits rather than purely private benefits.

It is these characteristics "which provide the basis for principled arguments in favor of deduction [of philanthropic contributions] [Andrews, 1972, p. 357]."

The first characteristic is shared by all nonexchange transactions and would clearly imply, on the current interpretation, that all gifts should be deducted from the tax base of donors.[14] However, the second characteristic is the one on which most emphasis is placed. Why exactly should it be that expenditures producing external benefits are not properly subject to tax? In the case of gifts directed toward the poor, Andrews argues that since it is the primary purpose of the income tax to redistribute resources, and since almsgiving achieves this end, it would be inefficient to tax such transfers. The argument rests in this case on the belief that private gifts are a substitute for public expenditure, and on the fact that taxpayers do not exhibit preferences at the margin between private and public expenditure directed toward reducing inequality.

In the case of donations to philanthropy generally, for which there can be no presumption of redistribution, Andrews advances three types of argument in support of the tax deduction.

(1) Gifts to philanthropy should not be taxed because they do not represent a positive use of economic power in directing resources toward

donors. This distinction between consumption as the exercise of power and consumption as the personal destruction of real resources implies that mere transfers do not give rise to any opportunity cost in terms of real resources. One could argue, of course, that the direction of resources toward particular uses, whether for the direct benefit of the donor or not, does represent a positive exercise of power. Resources are directed away from other uses, including the personal consumption of taxpayers or public expenditure. There appears to be no a priori reason why the direction of resources should be treated differently simply because that direction is to a third party of the donor's choosing rather than to the donor himself--unless, and this is the real significance of the distinction, society values the alternative use.

(2) The benefits of collective goods cannot be assigned to particular individuals, nor can such benefits be convincingly valued. The problem of valuation is one which is common to all expenditures. How do we ever know that the value to the taxpayer of any expenditure is exactly equal to its cost?

The only sensible way around the impasse is to value consumption at market prices. "To abandon amounts paid and market prices as measures is to leave one's self stranded in the intellectual desert of subjective values and psychic _numéraires_ [Simons, 1938, p. 119]." Thus unpriced goods are not normally included in consumption. However, taxing gifts is not an attempt to tax the collective-good benefits of philanthropy, but merely to tax the private-good benefits, as valued by market prices, enjoyed by the donor.

(3) We do not seek to tax expenditures directed toward the provision of collective goods because this represents a use of resources which society wishes to encourage. Andrews makes this view explicit on a number of occasions. The deductibility of gifts to the poor is specifically justified on the grounds that such expenditure merely represents a substitute for government expenditure, and in discussing the effects of taxing donors Andrews (1972) states, "Thus, the imposition of a tax on this latter kind of expenditure [almsgiving] will ultimately fall on the poor . . . . [p. 356]" He also states that "a rationally self-interested taxpayer might be tempted to let his contributions bear more of the burden of the tax than do his private consumption expenditures [p. 361]."

The implication is that removal of the tax deduction would reduce contributions, which would be an undesirable effect. The particular definition of consumption chosen--one which excludes expenditure on collective goods--thus conforms with the belief that the provision of such goods is socially desirable. The case for the deductibility of philanthropic contributions thus becomes a matter of social judgment rather than one of definition. This is not to say that some form of favorable fiscal treatment might not be justified, but this must be based on incentive or externality arguments rather than on any consideration of equity. Analyzed in this way, deductibility becomes but one of a range of policy options, and not necessarily the most preferred or the most efficient way of stimulating socially desirable activity.

The Taxation of Charitable Intermediaries

In the United Kingdom, Canada, and the United States, the income of recognized charitable organizations is substantially free of tax, subject to certain general limitations. In all cases, the income of the charity must be applied exclusively for charitable purposes and no part of that income must accrue for the benefit of any shareholder or individual. In addition, penalties will normally be applied to income derived from the profits of any unrelated business activity. In the United States income derived from the regular operation of a business not substantially related to the purpose for which a charity received exemption will be taxed at corporate rates.[15] In the United Kingdom the same penalty applies to any profits from trade unless carried out in the course of the actual implementation of a charitable purpose or unless carried out by the beneficiaries of the charity.[16] The Canadian regulations are more severe. Only certain kinds of charities are permitted to engage in related business activity, any charity involved in unrelated business may have its registration revoked. All Canadian charities are also subject to rules governing disbursements which require at least 80% of total income (or in some cases total donations) to be expended on charitable activity each year. Any organization contravening the rule is liable to have its registration withdrawn, and this may involve not only the loss of tax exemption, but also a special tax designed to ensure that all of the assets of a deregistered charity are distributed or confiscated by the government within one year.[17]

Almost without exception such widespread exemption is justified on the grounds that the output of charitable organizations has social utility and that the taxation of their income would create an undesirable disincentive to voluntary effort. Apparently no consideration has been given in the literature to the way in which charities might be taxed if it was thought desirable to do so.

Charities as intermediaries. A charity is an intermediary in the same way as any other form of private collective organization--the corporation, trust, cooperative, collective or club. The primary characteristic of all of these organizations is that they exist for, and act in the interests of, their members. In this context members may be defined as those who hold an equity interest in the organization (shareholders or owners), those who hold a claim to residual income, or those who enjoy any direct benefit from the operation of the organization. The appropriate tax treatment of different forms of intermediary should presumably be one which ensures (1) that there is no discrimination between income arising to individuals by means of an intermediary and income arising from any other source, and (2) that there is no discrimination between income arising by means of one type of organization rather than another. These principles conform with the notion that the income tax is primarily a tax on individuals adjusted for personal circumstances, but not adjusted for differences in the source from which income accrues.[18]

In practice, the tax treatment of different forms of organization appears to turn on the degree to which managers may exercise discretion over the employment of funds for profit (i.e., the extent to which advertising, investment, and trading are policy variables for managers), and over the distribution of funds to beneficiaries. This distinction determines the extent to which income arising from collective action is to be regarded for tax purposes as the income of the intermediary, or as the income of its members. Thus, a corporation is regarded as an autonomous income-creating entity one step removed from its owners, and as such it is taxed separately on its income in addition to any tax levied on owners. A trust, on the other hand, is seen as a conduit through which funds flow directly to beneficiaries, and the primary purpose of the trust is to conserve income and assets for the benefit of its members. Thus trusts are taxed on their income minus amounts disbursed, so that in effect recipients are taxed once rather than twice as in the case of the corporation.

In considering the tax treatment of charitable intermediaries, therefore, two questions will be of primary interest: Is a charity best regarded as an income-creating or income-preserving organization--a corporation or a trust? And is a corporation or trust to be regarded as a separate entity taxable in its own right, or should all of the income of any organization be regarded as the income of its members for tax purposes?

Charities as corporate entities. The owners of a corporation are the shareholders who hold claims to both capital and residual income. In terms of a personal income tax it is not inappropriate to regard all of the net surplus accruing to a corporation as the income of its owners. Shareholders are best regarded as suppliers of capital, and business profits as a net return or gain. The gain will take the form of income in three ways: distributed profits, realized capital gains or losses on the sale of shares of ownership, and unrealized capital gains or losses in the form of changes in share values. All of these items fall within the scope of a comprehensive income tax base. Viewed in this light taxes on corporate earnings are merely a convenient means of collecting taxes from individuals and the most appropriate procedure would be to levy a flat-rate tax on distributions and to include in the income of shareholders the gross amount of all dividends received plus a refundable tax credit representing the tax withheld at source. If all profits were distributed this would be equivalent to taxing each shareholder on his income arising from the corporation.

However, if some share of profits were retained by the company, the shareholder would be enabled to reinvest part of his income free of tax. This portion of income not subject to tax is the value of unrealized capital gains. Two alternative procedures are suggested. On the grounds that under current legislation unrealized capital gains are not normally subject to annual charge, no tax should be levied on retained earnings but rather all gains should be taxed when they accrue--that is, when shares are traded. The disadvantage of this approach is that so long as gains are not realized, tax may be postponed indefinitely. The alternative is to tax retained earnings as a proxy for unrealized gains. The value of a shareholder's claim to retention plus a full tax credit would then be included in his personal income tax base. While it is not impossible that a company should be able to allocate all of its profits to shareholders without actually making a full cash payment, however, it will typically prove difficult to ascertain the interest of a shareholder in profits not distributed. Therefore, the taxation of all profits at a flat rate will necessarily involve some disadvantage to shareholders whose income would normally be subject to a lower charge. Nonetheless, such a system, coupled with a full credit to the shareholder for any tax paid on distributed income, is probably the one which accords most closely with the idea of corporate taxation as a withholding tax on the income of shareholders.

Clearly some adjustment to this analysis must be made if charitable intermediaries are to be considered in the same light as corporations for tax purposes. The most obvious difference is that charities have no body of owners or shareholders holding an equity interest in the capital of the charity, nor is there any identifiable group of residual claimants. Nonetheless, with the view that the charity is an intermediary between donors and recipients, it is the case that the net income available for distribution (profit) does accrue to the benefit of recipients. If corporate taxation is seen as a convenient means of collecting revenue at source then a case may be made for the taxation of income distributed by charities and the inclusion of benefits received plus a full refundable tax credit in the income of recipients. There could be no justification under this rationale for the taxation of retained earnings since no capital gains accrue to recipients. However, if retained earnings are used for investment, any further gains would be subject to tax as and when income is expended.

Although this approach appears to have some merit in its consistent treatment of income flowing through intermediaries, there may be some problems in treating charities in this way.

Unlike shareholders, many recipients of charity (although by no means all or even necessarily the majority) will not be subject to tax because of the level of their incomes. Thus, the full exemption of charities from tax may be justified as an administrative convenience. However, a justification of this kind would require a good deal more evidence on the actual operation of the philanthropic sector of the economy than is currently available, and one would hesitate to accept it as an irrefutable proposition. Although charity has historically been the preserve of the poor, to acquire tax exempt status today organizations in Britain, Canada, and the United States need not restrict benefits to those of limited means.

A second complication is that current legislation relating to gifts does not require that they be included in the tax base of the recipient. To the extent that charities are funded by voluntary donations, a withholding tax would not be appropriate if recipients were not subject to tax on gifts irrespective of their income.[19] However, charities are not funded exclusively, or even predominantly, through gifts. Any income arising from the investment of donations or any income from sales, fees, or trading profits would be subject to tax.

No matter how persuasive the logic of treating gifts as income to recipients, consistency with current practice would require a distinction to be made between receipts from different sources--donations on the one hand and investment, fees, and trading income on the other. Only the latter source of income would be subject to tax. Although this distinction is currently made to some extent with the profits of unrelated trading activity coming within the charge of corporation tax in Britain and the United States, the administrative complexity of a fully differentiated tax system may render it infeasible.

A third consideration is the extent to which charities provide goods and services rather than income to recipients, which may raise some problems in valuing the appropriate addition to taxable income. One straightforward solution is to value in-kind receipts at the cost of their provision.[20] In general, market prices will be the only practical means of measuring consumption and this will be a reasonable procedure in cases in which the value of consumption may be assumed to be at least equal to the value of resources expended. However, this will be a less attractive procedure in cases where the receipt is gratuitous--that is, when consumption is not a voluntary choice of the recipient.[21]

A compromise may be to include only in-kind transfers which could be converted into cash, on the grounds that the recipient could be deemed to enjoy an addition to consumption at least equal to the resale value of the goods. A realization condition of this type would, however, introduce two serious problems into the taxation of charities. The relevant income of the charity to be taxed would have to be computed on the basis of resale values rather than the costs of provision, and only expenditure on goods, but not services, could be included in the tax base.

In any event, the appropriate treatment would be that applied to other forms of income in kind within the tax system--the exclusion of charitable income from taxation would only be justified if the costs involved were expected to exceed the likely revenue.

A distinct alternative to this view of the corporation as nothing more than an income-holding intermediary is to regard the corporation as an entity quite separate from its shareholders. Thus it may be argued that a corporation should be taxed on income in its own right, since the corporation is an income-receiving unit with power to consume and accumulate quite separate from that of its owners. In practice, this is the way in which corporate income is taxed.

In the United Kingdom and Canada (with respect to public corporations at least) the system of corporate taxation is essentially similar in its effects. A corporation is taxed at a flat rate on all of its income (excluding intercompany dividends received) and shareholders receive credit for part of the tax paid on income distributed. In Canada, for example, shareholders are required to include in personal income all dividends received grossed-up by a factor of 4/3 to take account of tax deducted at source. A credit of 1/3 of dividends actually received is then allowed against the tax liability of the shareholders. The credit is equivalent to a refund of corporate tax of 25%; the difference between this and the basic rate of corporate tax (currently around 46%) is the tax levied on the income of the corporation in its own right. In the United Kingdom shareholders receive a credit for tax paid at the basic rate of income tax, and since the corporation pays tax at a rate considerably in excess of this, an additional separate tax is levied on corporate income.[22]

In the United States the separation between corporation and owners is complete. A corporation pays tax on all of its earnings at a normal rate of 22% plus 26% on income in excess of $25,000. Shareholders must include the full amount of any dividends paid in personal income, but receive no credit for tax paid by the corporation.[23]

The analogy between a corporation and a charitable intermediary is quite close. Charity managers do have consideration discretion over both the employment of funds in the creation of income and the distribution of funds (or goods) to recipients. In fact, since the group of beneficiaries (members) is usually not clearly specified, it is much more difficult to consider a charity as anything other than a completely separate income-receiving entity. Consistency in taxation would thus require that a charity be taxed at corporate rates (or slightly lower rates to take account of the fact that no part of the tax is a tax on recipients) on all of its net (distributable) income. Recipients would then be subject to tax on any benefits received, to the extent that the form of receipt is one normally included in taxable income, as a separate matter. There would probably be little merit in requiring charities to withhold tax at source on distributed income and then granting a tax credit to recipients, for the reasons already mentioned.

Charities as trusts. Unlike a corporation, which may exercise substantial discretion in the management and allocation of its income, a trust is regarded as an essentially passive intermediary which acts primarily as a conduit through which income flows directly to beneficiaries. Viewed in this way there is a real sense in which the property of a trust (and any income which is subsequently produced) is best regarded as accruing to the beneficiary at the time the trust is created. It is for this reason that the income of a trust is normally taxed as it if were the income of an individual.

In the United States and Canada trusts pay tax at progressive rates on all income, including capital gains; any income distributed or "properly distributable" to beneficiaries is excluded from the tax base and included in the income of the beneficiary.[24] In Canada inter vivos trusts created since 1971 may be subject to a minimum tax of around 51%, and all trusts are assumed to realize the full value of all capital assets every 21 years. In the United Kingdom all trust income is subject to tax at the basic rate of income tax, and beneficiaries receive full credit for all tax paid on distributions, which are then included at their gross value in personal income.

The effect of these provisions is that all income distributed or assigned to individuals is taxed at the applicable personal rate and income accumulated in a trust is also subject to assessment in order to avoid undue postponement of tax.

In some ways it may be relevant to think of a charitable intermediary as nothing more than a mechanism by which funds are transferred from donor to recipient. In this case a charity would bear tax on that portion of total income not distributed, and recipients would bear tax on the remainder. To the extent that many recipients would not be subject to tax, either because of the form in which benefits are received or because of their low income from other sources, a withholding tax on distributions would probably not be appropriate.

However, the full exemption of charitable income from tax may find some justification if charities are to be regarded as trusts. To the extent that a charity does not accumulate any income, no tax would be justified. In addition, if recipients would not normally be expected to bear tax on benefits received, a tax on retained income would not be appropriate either, since the tax on retentions is merely a means of avoiding the deferral of tax by beneficiaries. The fiscal treatment of charities in Canada, with its regulations requiring substantial annual distribution of income, appears to fit quite closely with this rationale of charities as trusts.

But to what extent do charities in fact possess the essential qualities of trusts? In some ways the characterization is quite valid. Donors contribute money or property for the benefit of recipients, not for the benefit of the charity itself, and indeed one of the most persuasive ways of rationalizing the existence of charities is in terms of a mechanism by which donors may transfer resources to recipients at least cost. Historically, in Britain at least, most charities were created by a declaration of trust.

However, the analogy has several weaknesses. The vast majority of charitable activity is financed not by donations, but by the returns to investment, by sales of goods, or by fees for services.[25] A direct link between donor and recipient may be presumed to exist in only a small minority of cases. Nor is the view of trust managers as essentially passive holders of funds appropriate to the modern fund-raising charity. Most charity managers are concerned as much with the creation of income as with its distribution, and in this respect charities come much closer to the conception of corporations than trusts.

The implication which appears to follow this reasoning suggests that in determining the appropriate fiscal treatment of charitable organizations it will be necessary for the law to distinguish, as it does now for other organizations, between those whose characteristics dictate that they should be regarded as corporations, and those more properly regarded as trusts. The distinction will be based on differences in mode of operation rather than on differences in legal form.

Conclusions

The purpose of Part I has been to consider a rationale for the current fiscal treatment of charitable activity on the basis of equity—that is, as a necessary result of attempts to achieve neutrality and horizontal equity in the tax treatment of individuals and intermediaries.

In the case of charitable contributions it was argued that the appropriate tax base is that specified by the comprehensive definition of income. Exclusions from the income base are normally justified for "quasi-involuntary" expenditures--that is, for expenditures which are either necessary (in earning income) or unavoidable. If charitable contributions are construed in this way, then the deductibility of all gifts to recognized charitable organizations is the only appropriate adjustment. If necessary or unavoidable expenditures are not to be regarded as income, then their exclusion from the tax base follows as a matter of logic.

However, expenditure on charitable activity does not appear to fit readily into this category, and there seems to be little reason why such expenditures should be seen as essentially different in nature from other voluntary uses of resources. Thus the justification of the current tax deduction in the United States and Canada must lie outside an attempt to refine the tax base.

There may be more justification for the current concessions granted in the United Kingdom for gifts made by covenant if covenants generally continue to be regarded as an alienation rather than an application of resources.

The appropriate treatment of charitable intermediaries is more complex--depending to a large extent on the nature of the charity itself. However, there would appear to be some logic in the total exclusion of the income of charities from tax if (1) the income of trusts and corporations is to be taxed as if it were the income of individuals, and (2) the benefits enjoyed by the recipients of charity would not normally be subject to tax either because (a) benefits are received in kind, (b) benefits take the form of a gift, or (c) recipients have incomes below the tax threshold.

However, to the extent that the income of corporations is properly regarded as subject to tax in its own right, and this is the current interpretation, and to the extent that the characteristics of charities may be regarded as similar to those of corporations, consistency with current fiscal practice would require charities to be taxed at corporate rates on all income.

Given the weak equity basis of the extensive concessions to charitable activity, it is then legitimate to consider the form of optimal treatment suggested by incentive or externality arguments in favor of subsidy. This is the subject of Part II.

II. EXTERNALITIES AND THE OPTIMAL FISCAL TREATMENT OF CHARITABLE ACTIVITY

The Public Good Characteristics of Charitable Activity

An attempt to justify the fiscal subsidization of philanthropy is often made on the grounds that the outcome of charitable activity embodies the characteristics of the Samuelsonian "public good." It is well known that in the provision of such goods the private market may fail to reach an individually desired social optimum--too little of the good is produced--and as a result some form of government intervention is required to correct for that failure.

While such a description captures the spirit of the case for fiscal subsidy, two reservations should be noted at the outset: (1) It is possible that the private market may not in fact undersupply certain (intangible) public goods because market participants lack the necessary information about the behavior of others--in particular, the existing level of provision; (2) Even when Pareto-relevant market failure is shown to exist, this does not in itself justify any form of government involvement. In a choice between two imperfect markets, private and public, there can be no a priori presumption that one will be preferred over the other.

Market failure, the emergence of collective intermediaries, and the case for fiscal subsidy. Assume a society of three individuals, A, B and C, in which both A and B exhibit positive concern about C's consumption of a particular commodity χ_1 (e.g., food, health care, education). C is selfish in the widely accepted sense that his utility is a function of his own consumption alone. The utility functions of the three individuals may be represented in the following way:

$$U_a = u(\chi_i^a \ldots, \chi_n^a, \chi_1^c)$$

$$U_b = u(\chi_i^b \ldots, \chi_n^b, \chi_1^c)$$

$$U_c = u(\chi_i^c \ldots, \chi_n^c).$$

Since both A and B care about C's consumption of χ_1, it follows that both $\partial u^a/\partial \chi_1^c > 0$ and $\partial u^b/\partial \chi_1^c > 0$ at the private equilibrium level of consumption $(\overline{\chi_1^c})$ achieved by C.[26] In these circumstances, any additional quantity of the good transferred to C by the donation of A will enter as a positive argument in the utility function of B, and similarly will B's contribution affect u^a. Thus A's gift increases B's utility and vice versa. It is this type of relationship which defines the public good (or more generally the externality-generating) characteristics of charitable activity. If two potential donors both share the same concern, the gift of one produces benefits which are nonrival and from which the other (given perfect information) cannot be excluded.

Figure 1 illustrates the outcome of independent adjustment. At the existing level of consumption $(\overline{\chi_1^c})$ A not only cares about C's consumption but cares sufficiently to make a gift of q_a to C. A continues to donate until his marginal valuation of one extra unit of consumption by C is equal to the marginal valuation of the same unit (or numéraire equivalent) in his own use. At q_a, therefore, $\partial u^a/\partial \chi_1^c = \partial u^a/\partial \chi_i^a$ where χ_i^a is a numéraire commodity and $\partial u^a/\partial \chi_1^c$ represents the marginal cost to A of donating one unit of χ_1 to C. (For simplicity it is assumed that χ_1 is scaled so that MC = 1.)

B does not make a donation, indicating that at the pretransfer level of consumption $(\overline{\chi_1^c})$ his concern, though positive, is less than the marginal cost of donating--that is, $\partial u^b/\partial \chi_1^c < \partial u^b/\partial \chi_i^b$.

It follows in the standard public finance tradition that the independent adjustment equilibrium is one in which the good χ_1^c is undersupplied. Both A and B are in a state of private equilibrium in which $MV_a = MC$ and $MV_b < MC$ (but $MV_b > 0$), thus $MV_a + MV_b > MC$.

The optimal (mutally desired) level of output is given by the equality $MV_a + MV_b = MC$ (at $\bar{Q}$). It follows that independent adjustment leads to a suboptimal level of provision and that the market "fails" to satisfy individual preferences.

The independent adjustment equilibrium is one in which both individuals favor a further expansion of output to $\overline{Q}$, at some cost. An optimal outcome is possible, by definition, if A is faced with a cost p_a per unit of χ_1^c and B with a cost p_b per unit. Both have an incentive to bargain in an attempt to reach a mutually beneficial solution, and in the small number case discussed here such bargaining is likely to succeed. The outcome will be a

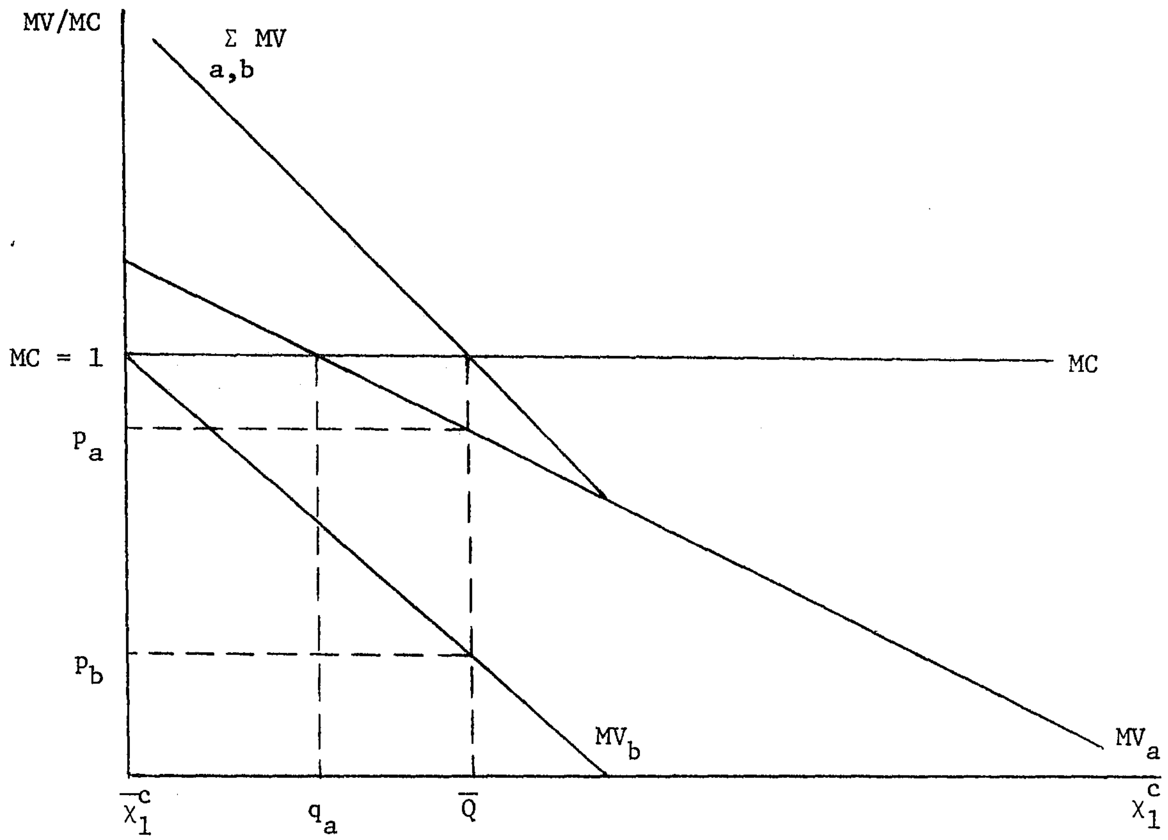


Figure 1. Independent Adjustment Equilibrium

cost-sharing arrangement in which $p_a = (1 - p_b)$ and $p_b = (1 - p_a)$. Analytically this is equivalent to B subsidizing A's gift to the extent of $(1 - p_a)$ per unit or $(1 - p_a)\overline{Q}$ in total.

In the event that the number of externality-affected parties (potential donors) is large, the costs of bargaining to reach unanimous agreement about both the total level of output and the appropriate cost shares will increase, and may even exceed the expected benefits. In these circumstances individual bargaining may either be impossible or lead to an outcome which is unsatisfactory to all parties. At this stage some form of collective action, private or public, may be unanimously preferred.

The distinguishing characteristic of private collective action is that donors surrender control over the allocation of resources (and to some extent the type of service offered as well) by channelling funds through an intermediary (the charity firm) rather than directly to recipients, while still retaining the power to determine cost shares through voluntary donations. Collective action of this kind involves both costs and benefits: costs in terms of lost sovereignty over the allocation of resources, and benefits in the form of a reduction in bargaining costs achieved by delegating decision-making to a third party or intermediary. Given the imperfections associated with this form of market mechanism, it is clear that the outcome of private collective provision cannot be expected to conform to the characteristics of the optimal solution as defined in Figure 1. Nonetheless, this may still represent the most preferred outcome, given the imperfections and costs associated with any alternative mechanism, including full government provision.

The major problem which remains is the possibility of undersupply resulting from the incomplete revelation of preferences and from free-riding behavior. Free riding is a problem which no voluntary (noncoercive) solution can fully overcome. However, the severance of the direct link between donor and recipient may introduce a further imperfection in the form of reduced information which actually increases the level of provision above that obtained with a bargaining solution. The implication of this possibility, discussed more fully later, is that charitable activity financed through a collective intermediary (public good characteristics notwithstanding) may lead to superoptimal rather than suboptimal provision, as is usually assumed.

Public collective action, specifically government involvement in the provision of public goods, provides a significant advantage over private action in that the government alone can exercise the coercive power of taxation. One of the primary problems of private provision will be the difficulty of excluding nondonors from the benefits of charitable activity undertaken by others. Although this problem will by no means necessarily imply that the resulting level of provision is suboptimal (much less zero), when the free-rider problem is acute and externalities pervasive all individuals may agree to "enforced giving," via taxation, in order to ensure an acceptable level of provision.

It is important to note, however, that market failure does not automatically dictate the need for government involvement. The optimal solution cannot be achieved by government any more readily than it can by individual action because of the problem of nonrevelation of preferences inherent in any system of provision and because of the additional imperfections of the voting system in transmitting information about preferences to decision-makers. Coercion itself imposes significant costs as long as taxation diverges from the strict principle of contributions according to benefits received. The choice between private and public collective action is therefore a choice between two imperfect alternatives. The latter will be chosen only if it proves to be a least-cost mechanism for the achievement of individual preferences.

In this vein the case for fiscal subsidy to charity emerges from the preferences of individuals like B who, while perhaps not willing to donate, are willing to contribute toward the level of output provided by voluntary donors such as A. If the number of individuals like B is large--that is, if the output of charitable activity produces Pareto-relevant externalities at the margin of voluntary provision for a significant proportion of the population--it may prove to be more efficient (least cost) for subsidies to be administered via the tax-transfer system rather than by the private action of the B's.

This justification of fiscal support for philanthropy, based as it is on the preferences of individuals, carries with it specific implications for the optimal subsidy system--namely, the optimal subsidy will be one which (1) conforms most closely with the preferences of those who finance the subsidy (taxpayers), and (2) achieves the desired outcome at least cost.

In defining an optimal subsidy there clearly may be a tradeoff between these two objectives. The least-cost solution will not necessarily be the one which most closely reflects taxpayer preferences and vice versa.

<u>The possibility of oversupply in the private provision of charitable activity.</u> The benefits of some intangible public goods may be made excludable by withholding information about the extent of their provision. In the case of donations to charity, a donor will benefit from the gifts of others only insofar as he is aware of them. Typically, the information provided by fund-raising charities related to the extent of a particular problem rather than to the extent of its solution. Many donors giving in ignorance of each other may produce a level of output which is greater than that dictated by the equality of summed marginal valuations with marginal cost.

Consider two donors, A and B, both of whom exhibit a Pareto-relevant concern at the margin of C's consumption. If full information is available each will take the existing level of provision (including the gifts of others) as exogenously determined and a private equilibrium will typically be achieved where $MV_{a,b} = MC$ and $\sum_{a,b} MV > MC$. This is illustrated in Figure 2.

Assume for simplicity that B donates first and provides a level of consumption for C of q_b. A then takes q_b as given and donates an additional amount $q_a - q_b$, giving a total level of provision of q_a.[27] This represents an undersupply equilibrium in which $\sum_{a,b} MV > MC$.

However, suppose that A is not aware of B's donation. A will then supply the whole amount q_a giving a total supply of $q_a + q_b = Q'$. Since it is possible that $Q' > \bar{Q}$, it follows that private equilibrium in the absence of perfect information could lead to a situation in which $\sum_{a,b} MV < MC$.

A further source of information which is relevant to donors is the marginal cost of providing additional units of the good χ_1 to C. The marginal cost depends on two variables, the market price of χ_1 and

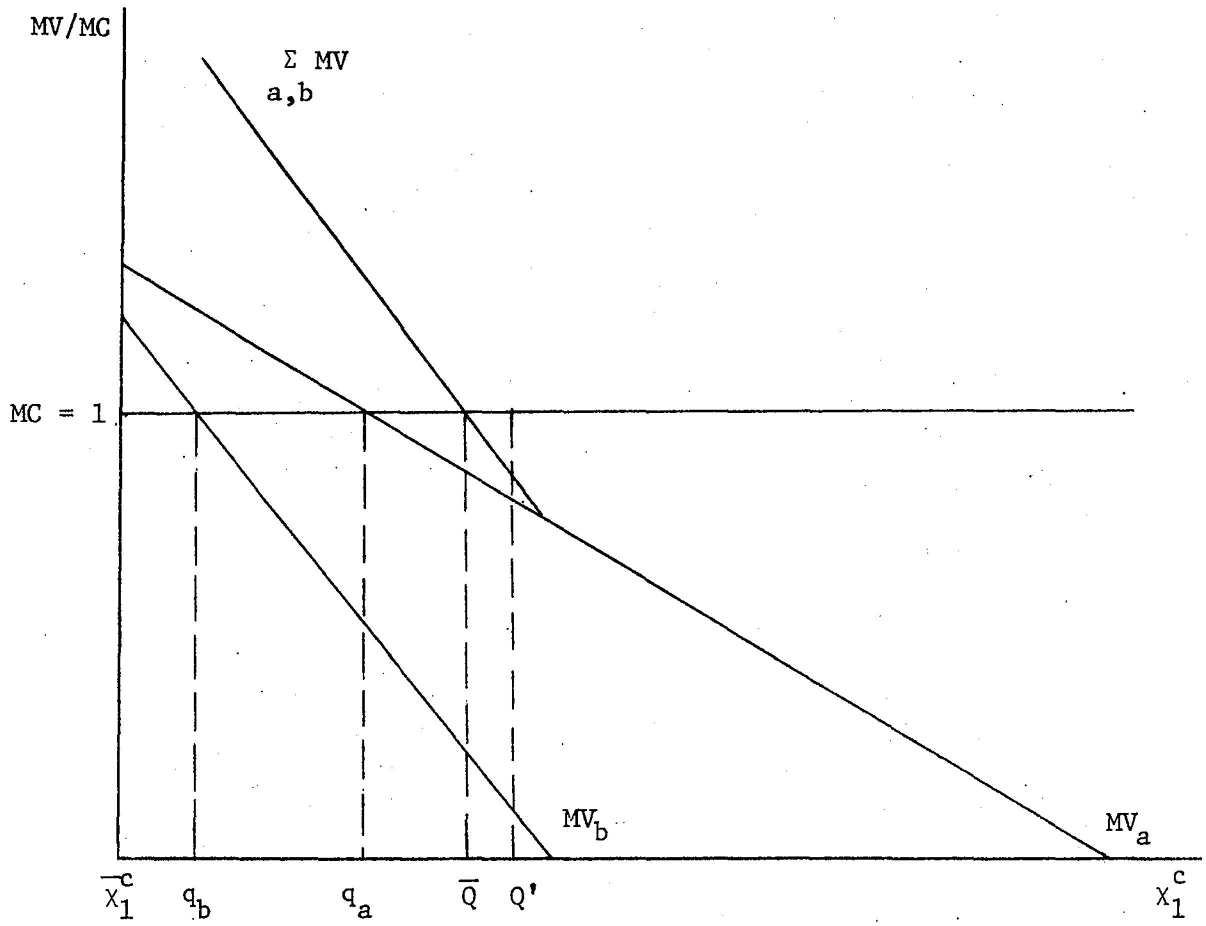


Figure 2. <u>Oversupply Resulting from Imperfect Information</u>

the administrative and transfer costs incurred by the charity. In some cases, depending on the price elasticity of demand for donations, a charity which advertises a price higher than the actual marginal cost may induce a higher level of total donations and thus be able to supply a larger quantity of output than donors expect. Donors are led to oversubscribe in terms of their own preferences regarding C's consumption at the advertised price.

This is illustrated in Figure 3. MC is the "true" marginal cost facing the charity and MC' is the advertised price. At this price the total level of donation is sufficient to finance a level of output q_a'. Assuming that the elasticity of demand with respect to price is less than unity, a rectangular hyperbola (rr) constructed through the point Z and showing all the possible levels of output corresponding to the given level of donations at various prices will lie everywhere above point N. Facing a true marginal cost of MC, the charity could actually supply Q' units of χ_1 to C, which is more than the socially optimal amount $\overline{Q}$.

Finally, consider the case in which the level of voluntary output corresponds to the socially preferred level despite the presence of nondonors who enjoy external benefits from the activity.

Given his preferences, A makes a donation sufficient to provide a level of output corresponding to q_a (Figure 4). At this level $\partial u^b/\partial \chi_1^c < 0$, indicating that B is satiated with respect to C's consumption, although since $MV_b > 0$ at levels of consumption below q_b it follows that B does care about C in the sense that χ_1^c enters as a positive element in B's utility function. The socially optimal level of provision in this case corresponds to the existing voluntary level. Thus although external benefits exist, they are not Pareto-relevant at the margin. To say that

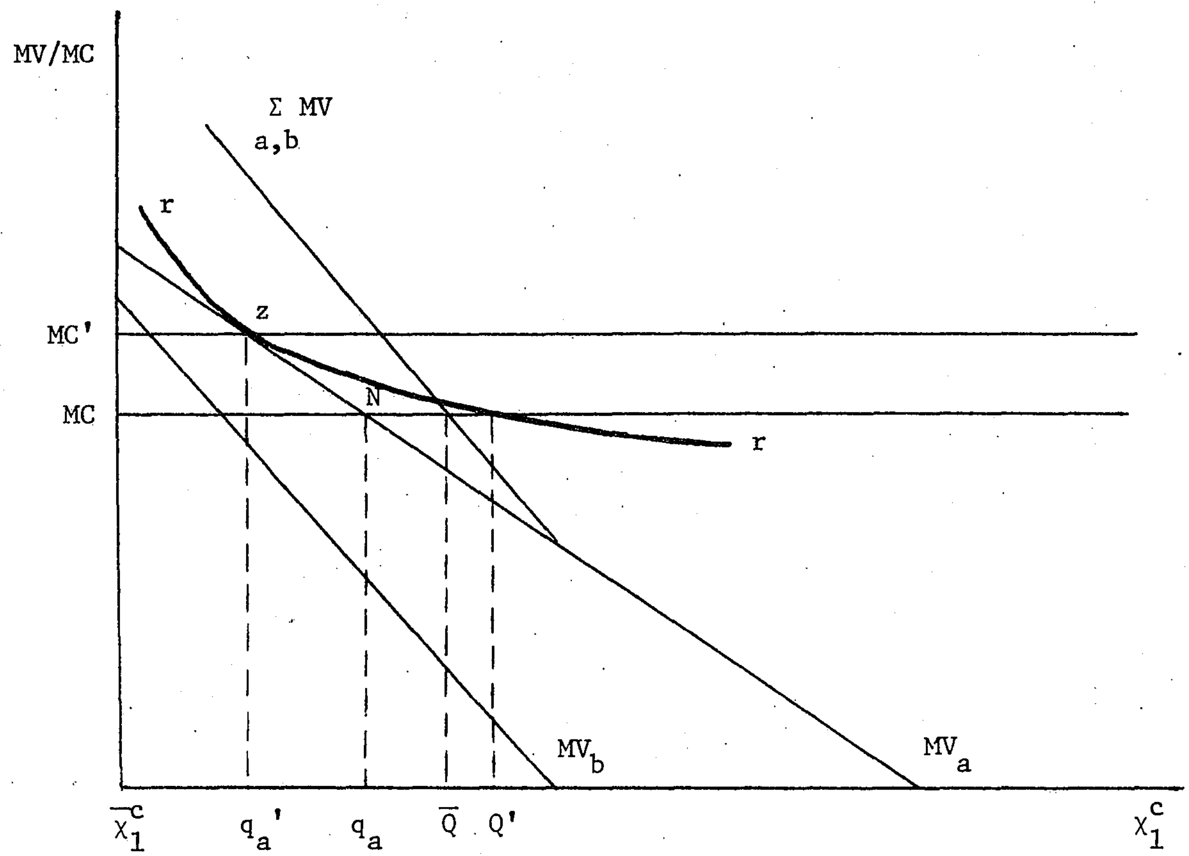


Figure 3. Oversupply Resulting from Incorrect Information

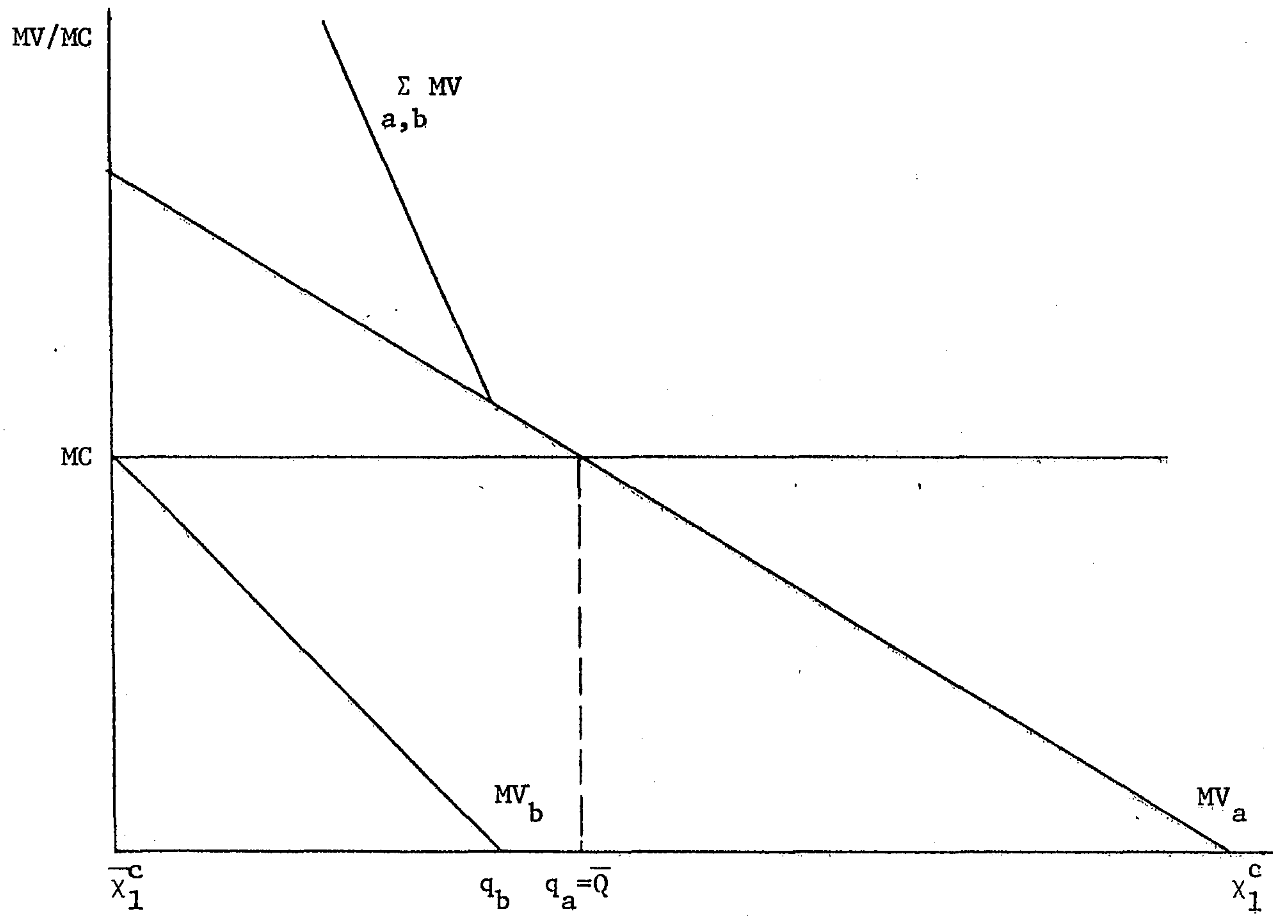


Figure 4. Non-Pareto-Relevant External Benefits

society "cares" about some particular form of charitable activity is not therefore sufficient to make the case that output should be augmented through fiscal subsidy without further information about the existing level of provision.

Obviously one could continue to invent cases in which the standard suboptimality result fails to hold, but these few examples are sufficient to illustrate the most important conclusions, namely: (1) that private collective action by its very nature creates imperfections by breaking the direct link between donor and recipient, which may go some way toward alleviating the otherwise disabling problem of free-riding behavior—thus the charity firm is a viable private market mechanism for the provision of (certain) public goods; and (2) that by no means all forms of activity legally recognized as "charitable" will give rise to the same level of uncaptured external benefits, and indeed some will give rise to no relevant externality. Logically, therefore, all charities will not justify the same level of fiscal support, and some will justify none at all.

The Determinants of Optimal Subsidies

A primary characteristic of the optimal subsidy is that it should accurately reflect the preferences of taxpayers. One of the interesting questions arising from a study of subsidy patterns is the extent to which the characteristics of current subsidies conform to this objective. Without doing undue violence to the variety and complexity of the existing arrangement in the United Kingdom and the United States, the current system may be categorized in two ways: (1) tax relief to donors implies that subsidies are (should be) related both to donor income and to the size of individual gifts, and (2) tax exemption of charitable income implies that subsidies are (should be) positively related to the income of the charity. Both of these points are considered next.

Subsidies and donor income. Assume a world of three groups of individuals, A, B, and C. The A's make positive donations to charity, the B's value the output of charitable activity but are not willing to donate at the market price, and the C's do nto donate but rather receive the benefits of the donations of others.

In such a world the optimal level of charity-financed consumption by C is, as before, where $\sum_{a,b} MV = MC$ at $\overline{Q}$ (Figure 5). This outcome is achieved when A faces a price of p_a per unit and B faces a price p_b per unit. Since A is the donor, all of the net subsidy is financed by B.[28] In addition, since $p_a + p_b = MC$, it follows that the per unit subsidy to A is $(1 - p_a) = p_b$ (assuming $MC = 1$).

Suppose that the income elasticity of A's marginal valuation of χ_1^c is positive, so that MV_a shifts upwards to $MV_a{}'$ as the income of the donor increases. Three changes will result:

(1) The socially optimal level of provision increases from $\overline{Q}$ to Q'.

(2) The price facing A increases to $p_a{}'$. Since MV_b is unchanged, this implies that the per unit subsidy received by A (S/q) declines to $(1 - p_a{}') = p_b{}'$.

(3) The change in the total subsidy, $S' = (1 - p_a{}')Q'$, depends not only on the level of S'/q but also on the level of A's net gift. A higher level of output must be financed by the combined contributions of A and B, but since A donates more (net) the effect on B's contribution is indeterminate. The outcome depends on the price elasticity of MV_b. If $\varepsilon_p < 1 \Longrightarrow S$ declines; if $\varepsilon_p > 1 \Longrightarrow S$ rises.

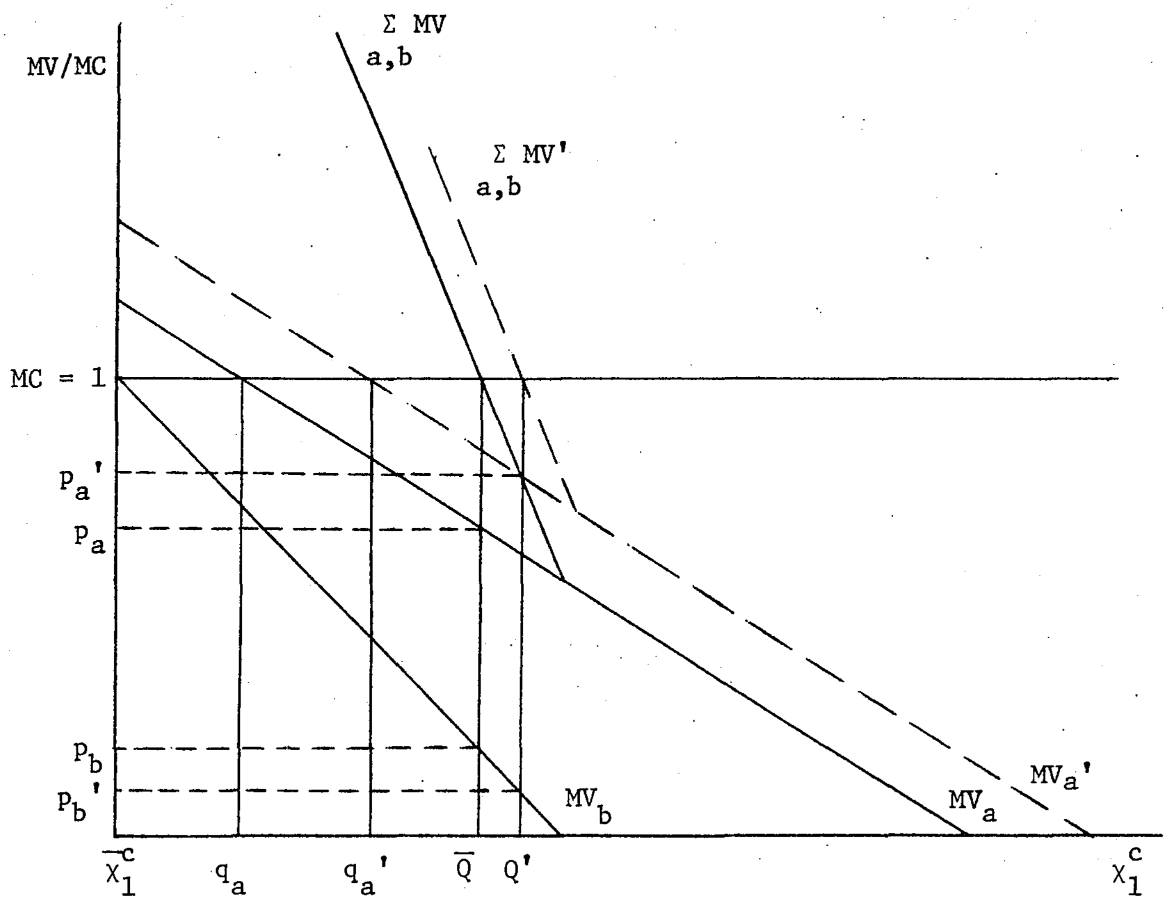


Figure 5. Per Unit Subsidies and Donor Income

The conclusion is that the level of per unit subsidy declines with the income of the donor and with the size of his net contribution, and that while the total subsidy may vary directly with the size of A's gift over some range, this cannot be justified as a basic principle. These results run counter both to the conclusion of Hochman and Rodgers (1977), who suggest that per unit subsidies should be invariant with respect to the income of donors, and to the current tax treatment of charities in the United Kingdom and the United States.

The most powerful implications of this construction are that the optimal subsidy calls for contributions only from those individuals such as A or B who enjoy a Pareto-relevant externality at the margin of private provision, and that as long as the subsidy is financed by B both the total level and the size of the per unit subsidy are determined entirely by the preferences of B, the taxpayer.

The distribution of subsidies between charities. Let us first consider the case in which there exist two charities supporting different causes (Figure 6). Charity one (C_1) supplies the good χ_1 to C, the other (C_2) supplies another good χ_2 also to C. Assume that the marginal cost facing both charities is the same and equal to unity, and that the level of voluntary contributions made by the group of donors (A) is the same in both cases. This implies that at the margin $MV_a' = MV_a''$ and thus $q_a' = q_a''$. Assume further that at the existing level of voluntary provision nondonors (taxpayers) exhibit less concern about the output of C_1 than about the output of C_2. Thus $MV_b' < MV_b''$ at the level of output corresponding to A's donation. The following results emerge.

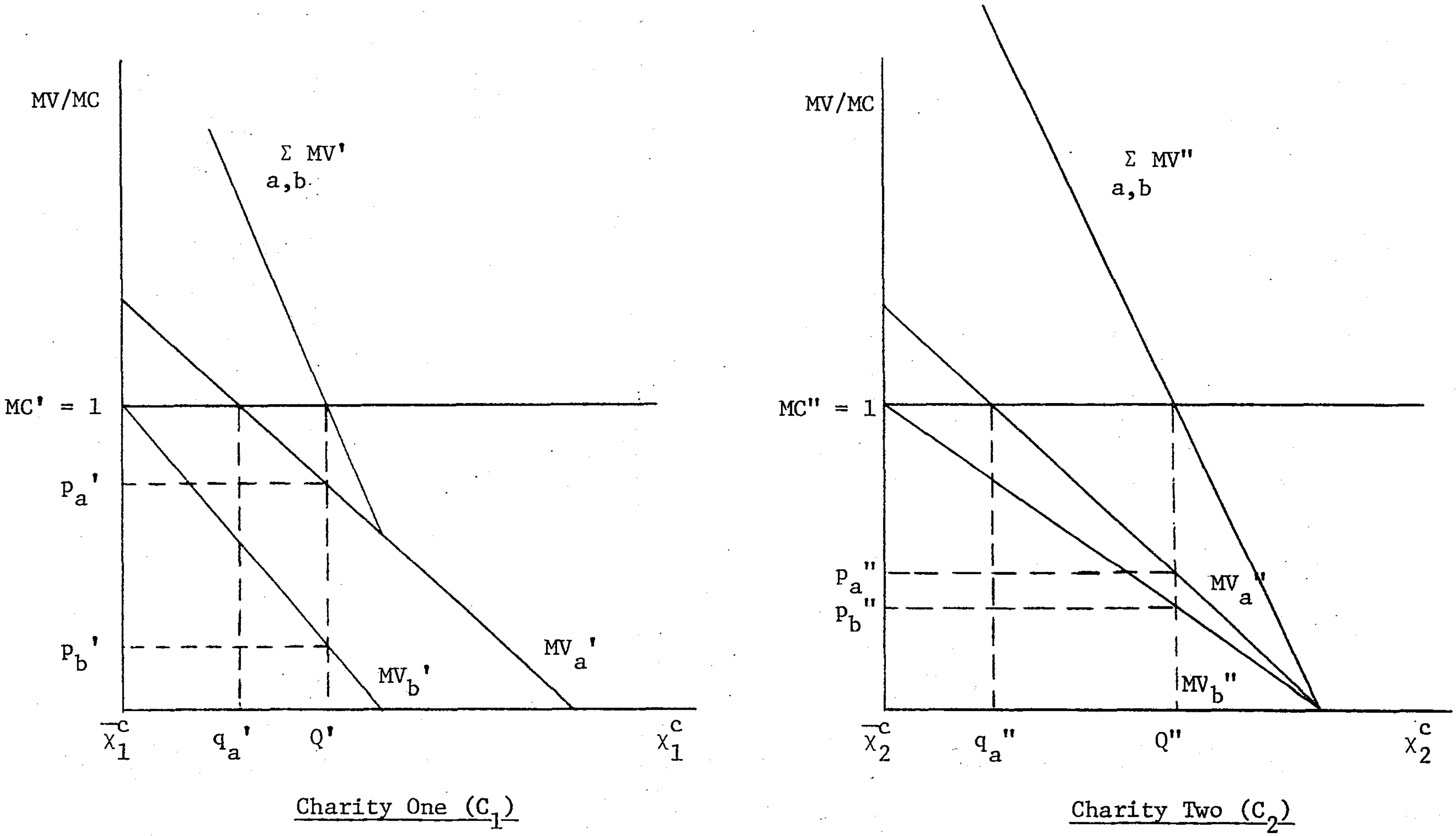


Figure 6. Relative Subsidies Between Charities. The Case of Equal Voluntary Income

(a) The socially desired level of output is lower in C_1 than in C_2. ($Q' < Q''$.)

(b) The shortfall (or externality) is therefore less in C_1 than in C_2 and as a result, both per unit and total subsidies will be lower.

$$S/q = (1 - p_a) = p_b$$

since $\quad p_a' > p_a'' \implies S/q' < S/q''$.

$$S = (1 - p_a)Q$$

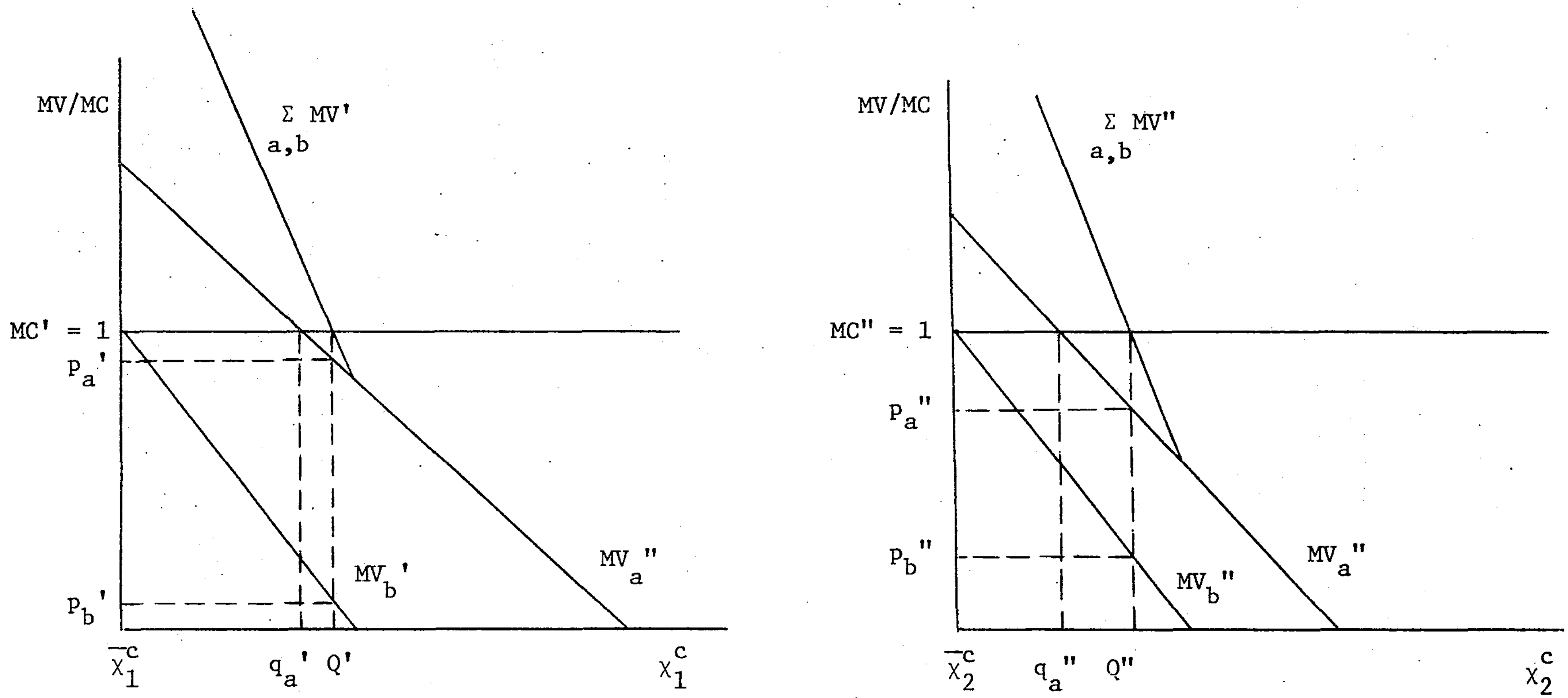
since $\quad (1 - p_a') < (1 - p_a'')$ and $Q' < Q'' \implies S' < S''$.

The implication of these results is that the optimal level of both per unit and total subsidies differs between the two charities despite the fact that their incomes are the same. This follows directly from the fact that the optimal subsidy is determined by the preferences of nondonors. The charity creating the greatest level of external benefits at the existing level of voluntary provision will, ceteris paribus, receive the greatest support.

As a second example, consider the case illustrated in Figure 7 in which the level of voluntary donations (or total income) differs between two charities serving different causes ($MV_a' > MV_a''$ at $MC' = MC''$), and nondonors are indifferent between the output of the two charities at all levels ($MV_b' = MV_b''$ for all q).

(a) Since $MV_a' > MV_a''$ it follows that $q_a' > q_a''$. The income of C_1 will be higher than the income of C_2 and the level of output greater.

(b) Since $MV_b' = MV_b''$ for all q it follows that the socially desired level of output of C_1 is greater than that of C_2. ($Q' > Q''$.)



Charity One (C_1)   Charity Two (C_2)

Figure 7. Relative Subsidies Between Charities. The Case of Unequal Voluntary Income

(c) $S/q' < S/q''$ since $p_a' > p_a''$. Per unit subsidies decline with the total income of the charity.

(d) Total subsidies vary with S/q and Q. In this case since $S/q' < S/q''$ but $Q' > Q''$, the size of the total subsidy for the charity with the largest income depends on the price elasticity of MV_b. If $\varepsilon_p > 1 \Longrightarrow S' > S''$; if $\varepsilon_p < 1 \Longrightarrow S' < S''$.

It follows, therefore, that the optimal subsidy system will be one in which per unit subsidies decline with the income of the charity. Given nondonor preferences, the level of externality varies inversely with total income, and so therefore does the price facing nondonors. Total subsidies may either increase or decrease with total income, depending on the elasticity of nondonor preferences with respect to changes in price.

Conclusions

The conclusion drawn from this analysis is that the appropriate type and level of fiscal support to charitable activity is not necessarily determined by the income of donors, the size of gifts, or the income of charities. Rather it is determined by the preferences of taxpayers with respect to the optimal level of provision and the shortfall created by voluntary (unsubsidized) activity. The subsidy to any organization varies directly with the level of Pareto-relevant marginal externalities or the extent to which its activities are valued by society as a whole. If the valuation of society may be expected to depend primarily on the particular causes (or objectives) which a charity supports, then it follows that subsidies should vary according to the objectives of charities. It is clear that the present system of subsidies in the United Kingdom and the United States cannot meet this requirement.[29]

Two main alternatives to tax deductibility in the fiscal treatment of charitable contributions have been proposed in the literature, namely a tax credit and a matching grant (Hochman and Rodgers, 1977; Atkinson, 1976; McNees, 1973; and McDaniel, 1972). The major benefit of these proposals, from the viewpoint of efficiency in resource allocation, is that the level of per unit subsidies could be varied between broad groups of charities defined in terms of objectives in a way that is not possible at present. Thus a variable tax credit or variable matching grant could adjust the rate of credit or percentage "match" to reflect different social valuations about alternative charitable outputs. The main disadvantage of both of these proposals, and indeed of any form of direct relief on donations, is that once subsidy rates are set the size of the total subsidy is still determined entirely by the level of contributions. Even if a ceiling is placed on total relief, up to the limit subsidies are still a positive function of contributions.

Any system, including the comprehensive exemption of charitable income from liability to tax, necessarily discriminates between charities on the basis of total income in a way which cannot be rationalized by recourse to externality arguments.

The objective of the optimal subsidy could be achieved by replacing both the tax exemption of charitable income and the subsidy to donors by a direct grant administered by the government or some independent body constituted for the purpose.[30] Under such a system donors would remain free to direct the use of their own resources but not, as at present, the resources of taxpayers also.

A direct grant system of this kind affords significant advantages, not the least of which is the opportunity to make the logically necessary distinction between the legal and fiscal privileges of charitable status. The legal benefits conferred by the award of charitable status arise as a result of the particular characteristics of certain kinds of philanthropic transactions which give rise to problems of enforcement. The objective of the law in this respect is to ensure that such transactions can take effect and can be enforced. Fiscal privileges, on the other hand, are awarded on the presumption that the outputs of a certain kind of philanthropic activity produce benefits which society wishes to encourage. There can be no presumption that those transactions to which the law may wish to grant privileges in order to ensure their existence will be identified with those which society wishes to support through fiscal means. The law as it currently stands assumes that they are, since charitable status automatically implies fiscal support.

The result is that the legal definition of charity is unnecessarily restrictive, and some forms of activity are denied the benefits necessary to ensure their existence on the grounds that they do not justify fiscal subsidy.[31] The current requirement in the United Kingdom that, to be classified as charitable, an organization must not engage in legislative or political activity in support of its cause is a particularly relevant example of this principle at work.

The replacement of current fiscal exemptions with a direct grant would make a clear distinction between legal and fiscal concessions possible since charitable status would be a necessary but no longer a sufficient condition for fiscal support. This would be not only logically more appealing but would also facilitate a liberalization of the present law, which effectively restricts the range of permissible philanthropic transactions.[32]

The suggestion that charities should receive direct fiscal assistance by no means represents a radical departure from current practice. In 1975 registered charities in England and Wales received approximately £290 million, or 8% of total income, in the form of direct grants from central or local government, compared with around £91 million in tax repaid on covenanted gifts (Austin and Posnett, 1979). For particular types of organizations the proportion is significantly higher. Charities concerned with the provision of housing for the poor, of health services, of education (primarily public schools), and those promoting the arts or culture receive substantial direct support, and this reflects the fact that government is already willing and able to discriminate between charities on the grounds of perceived social benefit. Interestingly, those charities receiving the largest grants were not, in general, either those with the highest level of donations or those with the largest total income. It appears, therefore, that income is not generally a good indicator of social preferences, especially bearing in mind the fact that the income of charities is predominantly derived from fees and sales, or from the returns to capital, which may be more a reflection of past preferences than of present ones.

Finally, although a direct grant may be the most appropriate subsidy in meeting the first condition of optimality--that is, reflecting the preferences of taxpayers--it will not necessarily also be the least costly. If the price elasticity of giving over the relevant range is numerically less than unity, a subsidy on individual contributions will reduce the amount of net gifts, and in this case an equal-cost direct grant will be more efficient in increasing the level of output. If $\varepsilon_p > |1|$, however, the opposite conclusion follows, and a variable tax credit or variable matching grant may increase output by more than an equal-cost direct grant. Even in these circumstances, however, the advantage of the direct grant in bringing the total cost of subsidies within the range of policy variables may offset any potential efficiency loss.

The choice of optimal fiscal treatment therefore involves a tradeoff between the efficiency of a direct grant in meeting taxpayer objectives and the possible cost effectiveness of a subsidy to donors. The outcome will depend both on empirical evidence and on the relative weight attached to the two possibly competing characteristics of optimality.

NOTES

[1]The most comprehensive treatment of this topic is found in Hochman and Rodgers (1977). See also Atkinson (1976), McNees (1973) and Taussig (1967).

[2]In England and Wales in 1975 the proportion was around 23% overall (Austin and Posnett 1979). In the United States in 1973 the figure was 13% (Weisbrod and Long 1977).

[3]Income Tax Act of 1972, Section 110(1)(a). In 1972 the limitation was raised from 10% to 20% of income.

[4]Internal Revenue Code, 1954, Section 170.

[5]Income and Corporation Taxes Act, 1970, Section 434.

[6]Finance Act, 1946, Section 28. The procedure is that a donor pays tax in full on his income without any allowance for charitable contributions but is entitled to deduct tax at the basic rate from any gift before transferring the net sum to the charity. The charity then reclaims the tax paid from the Inland Revenue. In effect this is equivalent to a refundable tax credit at the basic rate of income tax.

[7]Simons also proposed a further definition at page 206: "Personal income, properly, is a kind of measure of the individual's prosperity--or, in the language of Professor Haig, a measure of 'the net accretion of one's economic power between two points in time' (if one includes power exercised in consumption)."

[8]For example, according to Kahn (1960, p. 3), "The refinement of gross income to net income has been construed, broadly speaking, as deduction from the taxpayer's receipts of 'ordinary and necessary' expenses connected with the creation of his income, and of losses that might be incurred in the course of activity directed toward the acquisition of income or gain." Kahn (1960, p. 174) also states that "A deduction may be intended to grant relief from a quasi-involuntary expenditure, and thereby differentiate between taxpayers whose incomes, though apparently equal, are of different sizes in some relevant sense."

[9]The quote comes from Edward T. Devine, "Social Forces in War Time," The Survey, July 7, 1917.

[10]Referring to tax deductibility, the Commission states "Its immediate result would be a big reduction in the value of subscriptions to charities...."

[11]The Royal Commission defines the tax unit as a family or unattached individual. Thus gifts within the tax unit (family) are not included in the tax base of the recipient since such gifts merely represent sharing of common economic power. A similar argument is made by Goode (1964, pp. 101-102) in relation to gifts between family and friends. "Simons' contention that giving is a form of consumption is not persuasive. It seems more realistic to say that consumption is pooled for members of any one household and that gifts to persons who are not members of the household are voluntary transfers of consumption power.... Consumption is increased if A [the donor] obtains a *quid pro quo*, but to ask whether he does is merely to repeat the question." Apparently, "Transfers at death and large, nonrecurrent gifts or systematic transfers made between living persons over a period of time may be distinguished

from other gifts" (p. 102) and should be subject to separate taxation. Goode does not indicate in which category gifts to charity might fall.

[12]"That definition is consistent with the practical purpose of the tax--to divert some economic resources to public uses in a manner that will reduce disparities in standards of living and saving [Andrews, 1972, p. 356]."

[13]Goode (1964) also seems to define consumption to exclude transactions not involving a quid pro quo, but he does not apparently require that the exchange should take the form of real resources (see note 17). The approach here contrasts with that of Simons, who views consumption as an exercise of power over the allocation of resources without regard to "sensations, services or goods [Simons, 1938, p. 49]."

[14]Andrews does not draw this implication. He argues that the taxation of gifts in the hands of donors may be justified as an alternative to taxing recipients if marginal tax rates between donor and recipient do not differ significantly. Gifts to charity should not be similarly treated, however, because there can be no presumption that this requirement will hold.

[15]Internal Revenue Code, 1954, Section 511. The general exemption is contained in Section 501.

[16]Income and Corporation Taxes Act, 1970, Section 360(1)(c).

[17]Income Tax Act, Section 149.1 (enacted in 1977).

[18]"The income tax is not a tax upon income but a tax upon persons according to their respective incomes; and, subject to the requirement of adherence to simple, general rules, the objective of policy must be fairness among persons, not fairness among kinds of receipts (whatever that might be construed to mean) [Simons, 1938, p. 128]."

[19]In Britain gifts made by covenant are included in the income of the recipient, and such gifts to charity would properly be subject to tax.

[20]Under current U.S. tax legislation, for example, distributions received by shareholders in a medium other than cash are valued at market prices for the purposes of assessing the income of shareholders.

[21]Simons is in no doubt that the treatment of income in kind is one of the most difficult aspects of defining income. "At all events, let it be recognised that one faces here one of the real imponderables of income definition [Simons, 1938, p. 124]."

[22]The current imputation system was introduced in the United Kingdom by the Finance Act of 1972. Canadian legislation is contained in the Income Tax Act of 1972. In Canada a public corporation is distinguished from a private corporation by the fact that its shares are quoted on a Canadian Stock Exchange, and by rules relating to the number of shareholders, ownership of shares, and the size of the corporation. The treatment of a private corporation comes much closer to a full integration of personal and corporate taxation. The business income of a corporation is taxed at the normal rate (46%), but a private corporation may be entitled to a small-business deduction which reduces the effective rate to 25% (equivalent to the tax credit to shareholders). Other income is

also taxed at 46%, but 25% tax is refundable to the corporation if this income is distributed, again yielding an effective tax rate of around 25%.

[23]The first $100 of dividends is excluded from gross income for tax purposes (Internal Revenue Code, Section 116). Any organization may be taxed as a corporation regardless of its legal identity. Thus a trust may be taxed as a corporation if its capital is supplied by the beneficiaries themselves, or if the trustees are managers whose purpose is to provide a profit for beneficiaries, rather than merely to conserve or protect the property.

[24]In Canada the rates of tax are those applied to individuals; in the United States the rates are slightly lower. In Canada a "preferred beneficiary" may elect to have capital gains taxed as personal income whether distributed or not.

[25]See note 2.

[26]It is assumed that χ_1 is a "good" for C--that is, that $\partial u^c/\partial \chi_1^c > 0$. This is not strictly a necessary assumption. It is quite possible that A and B care about something which is distasteful to C, in which case the analysis might justify compulsion by A or B, as is the case with compulsory education.

[27]The final level of total output is not affected by who donates first. If A gives first, he will provide q_a and B will provide nothing.

[28]This assumes that B is the only taxpayer. In a world in which all individuals pay taxes but only some receive subsidy, the relevant group of Bs will include all those for whom net tax payments are positive--that

is, those for whom subsidy minus tax is negative. The results are not affected by this change.

[29]The present system may be understood in terms of the ability of donors to coerce nondonors (and other donors) via the voting system. Donors will prefer subsidies which increase with the size of gifts or with the income of charities since in this way they can maximize the reallocation of tax funds and minimize the costs to themselves of their own preferences for charitable activity.

[30]In the way that the Social Science Research Council or the Medical Research Council allocate research grants in the United Kingdom at present, or indeed in the way the major grant-making trusts and foundations allocate funds to charities.

[31]A bequest designed to benefit philanthropic causes will fail to take effect unless the object can be conclusively presumed to come within the legal definition of charity. For example, in the case of Oppenheim vs. Tobacco Securities Trust Co., Ltd. (1951), a trust set up for the education of the children of employees and ex-employees of the British American Tobacco Company and its subsidiaries failed to gain charitable status on the grounds that a gift for the benefit of persons connected with a particular firm could not justify fiscal support. The result was that the fund reverted to the next-of-kin. At the time the potential beneficiaries numbered in excess of 110,000. (For a general discussion of this case see Keeton and Sheridan 1971, pp. 30-31.)

[32]For a more detailed analysis of the logic of the current legal and fiscal treatment of charities in the United Kingdom see Culyer, Wiseman and Posnett (1976).

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