Charitable Subsidies and Nonprofit Governance: Comparing the Charitable Deduction with the Exemption for Endowment Income

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I. Introduction

Charitable subsidies are supposed to encourage positive externalities from charity.[1] In principle, the government can pursue this goal by evaluating specific charitable initiatives and deciding how much each should receive. Although the government sometimes makes this sort of fine-grained judgment,[2] this Article focuses on two income tax rules that leave the government essentially no discretion about which charities to fund: the deduction for donations to charity ("the deduction")[3] and the exemption of a charity's investment income ("the ex-

[1] A positive externality is a benefit to a third party. Positive Externalities, http://www.economicsonline.co.uk/market_failures/positive_externalities.html (last visited June 7, 2018).

[2] For instance, various government agencies solicit and evaluate grant proposals. Advance Approval of Grant-Making Procedures, https://www.irs.gov/charities-non-profits/private-foundations/advance-approval-of-grant-making-procedures (last visited June 7, 2018).

[3] The charitable deduction generally allows donors to avoid paying tax on amounts they give to charity. See IRC § 170. For example, if a taxpayer earns $1 million of salary and contributes $100,000 to charity, she pays tax on only $900,000. If her tax rate is 37%, this contribution of $100,000 reduces her tax by $37,000.

emption").[4] With each subsidy, federal dollars flow automatically as long as charities satisfy very general criteria.[5]

As a result, these subsidies are especially important when political institutions are deadlocked. Even if the government is too divided to address an issue, nonprofits can still do so with government money. Indeed, the federal government invests billions of dollars each year in these subsidies.[6]

But although these subsidies loom large today, they could change tomorrow. In 2017, Congress scaled each of them back, to some extent. The charitable deduction is not quite as widely available or as generous as it was.[7] Likewise, the exemption was scaled back for

[4] The exemption spares charities from paying tax on their income from passive investments, such as bonds and publicly-traded stock. IRC § 501(a) (excluding the income of § 501(c)(3) organizations from tax). For example, a charity that earns $100,000 of interest on bonds it holds does not pay tax on this income, thereby avoiding the 21% corporate tax that otherwise would apply. See IRC § 11.

[5] When a tax rule is called a "subsidy," the tax burden differs from what it otherwise would be under a "regular" regime. In describing the exemption as a subsidy, this Article assumes that the baseline regime is an income tax, not a consumption tax. Otherwise, the exemption of a charity's investment income obviously would not be a subsidy, since the investment returns of all taxpayers would be exempt under a consumption tax. Likewise, in describing the deduction as a subsidy, this Article assumes that taxpayers otherwise would be taxed on resources they give away. Compare William D. Andrews, Personal Deductions in an Ideal Income Tax, 86 Harv. L. Rev. 309 (1972) (money a taxpayer gives away should not be considered her income), with Mark G. Kelman, Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World, 31 Stan. L. Rev. 831 (1979) (giving money away is something a taxpayer chooses to do, so this money should be considered her income).

[6] According to the Treasury department's 2017 estimate, the charitable deduction will cost the Treasury $63.14 billion in 2018 (using a 35% rate, instead of a 21% rate, to calculate the revenue loss from corporate contributions). U.S. Dep't of Treasury, Office of Tax Analysis, Tax Expenditures (Oct. 16, 2017), at 23, 24, 34, http://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2019.pdf.

Neither the Treasury nor the Joint Committee on Taxation estimates the revenue loss from the exemption. This Article offers a rough estimate of $48 billion for 2013, using the 35% rate in effect then, which would be approximately $28 billion using the 21% rate in effect now. See text accompanying note 46. Notably, the Congressional Research Service estimated that the revenue loss for 2014 from excluding university endowment income was $16.2 billion. Molly F. Sherlock, College and University Endowments: Overview and Tax Policy Options, Cong. Research Serv. 3 (Dec. 2, 2015), http://fas.org/sgp/crs/misc/R44293.pdf (assuming a 35% corporate rate). This estimate includes only endowments from universities, not from religious institutions, museums, hospitals, cultural institutions, social services organizations, and other nonprofits.

[7] To claim the charitable deduction, taxpayers must itemize. But the number of itemizers is likely to decline because one itemized deduction that was significant for many taxpayers—the deduction for state and local taxes—was capped at $10,000. IRC § 164(b)(6)(B). At the same time, the standard deduction was increased significantly (for example, to $24,000 for married couples). IRC § 63(c)(7). For those who still claim the charitable deduction, its value declined along with the top marginal rate (for example, from 39.6% to 37% for individuals and from 35% to 21% for corporations). See IRC §§ 1, 11.

some universities, which now pay a 1.4% tax on endowment income.[8] The enactment of these modest changes suggests that, for better or worse, more significant changes could also attract political support.

To decide whether changes would be advisable, these subsidies' strengths and weaknesses should be compared. Both rules delegate key decisions to private individuals, but they create very different incentives and effects. As other commentators have emphasized, they vary in their impact on the timing of a charity's spending.[9] In addition, this Article breaks new ground in showing their different effects on the governance of nonprofits. On this dimension, the deduction has three advantages over the exemption.

First, the deduction uses a more reliable test for determining whether a charity should receive government funding: The donor has to give her own money. This "skin in the game" signals confidence in the charity's mission and effectiveness.[10] Admittedly, contributions are not unassailable evidence of a charity's value, since donors sometimes have idiosyncratic preferences or incomplete information. But donations still are a meaningful signal.

In contrast, the exemption is triggered by investment income, not by donations. To benefit from the exemption, a charity needs a surplus to invest. Yet a surplus is not always evidence of social value; for example, it is a positive signal when it derives from a surge in donations, but not when a charity scales back operations because its mission ceases to be relevant.

A second advantage of the deduction is that it empowers donors to monitor nonprofit managers; in contrast, the exemption can undercut this monitoring. The problem is that the exemption offers tax-free returns only to charities, and not to individual donors. To the extent that donors cannot find other ways to earn a tax-free return, the exemption encourages them to turn over assets to charities ("endowment gifts"), instead of keeping these assets and making annual gifts of the investment return ("spendable gifts").

This front-loading of contributions either reduces a donor's influence or imposes other costs. If a donor gives an endowment to an

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[8] IRC § 4968(a) (imposing a 1.4% tax on universities with more than 500 tuition-paying students, whose endowments are more than $500,000 per student).

[9] See, e.g., Daniel Halperin, Is Income Tax Exemption for Charities a Subsidy?, 64 Tax L. Rev. 283, 284 (2011) ("Income tax exemption, in most circumstances, will affect only the relative cost of setting aside funds for the future as compared to providing current benefits."); Brian Galle, Pay It Forward? Law and the Problem of Restricted Spending Philanthropy, 93 Wash. U. L. Rev. 1143, 1153 (2016) ("Restricted-spending policies defer charitable good deeds into the future. How should policy makers compare charity now against the benefit of charity later?").

[10] See, e.g., David M. Schizer, Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals, 62 Tax L. Rev. 221 (2009).

operating charity, such as a university or a museum, she cannot redirect this money to another charity, even if she develops doubts about the charity's mission or management. Alternatively, if a donor gives the endowment to a grant-making charity that she can influence, such as a private foundation or a donor advised fund, she avoids committing to a particular operating charity, but faces other costs, such as taxes, managerial fees, and agency costs (for example, when foundation managers disregard donor preferences in making grants).

In contrast, unlike endowment gifts, spendable gifts allow donors to make fresh judgments about charities every year. Like "staged financing" in venture capital, spendable gifts allow funders to demand results before writing another check.[11] To be clear, spendable gifts are not always better, since endowments offer offsetting advantages, such as stability for multi-year initiatives. But this Article identifies a governance cost when the tax law puts a thumb on the scale for endowments, as the exemption currently does.

Third, in favoring endowments, the exemption exacerbates another governance problem, which is more familiar: cumbersome or stale limits on endowments. Since donors anticipate losing influence after giving an endowment, they often impose contractual restrictions, which can become outdated as circumstances change, and can be difficult (or even impossible) to revise.

Notwithstanding these three governance advantages of the deduction over the exemption, the exemption still has two offsetting advantages, which are well understood. First, it spares charities from making tax-motivated investment decisions. Second, and relatedly, the exemption ensures that the tax law is neutral about whether a charity spends or saves. Because the exemption allows charities to save tax-free, they do not have a tax incentive to spend now, instead of saving for the future.

In my view, these advantages of the exemption need to be balanced against the three governance disadvantages discussed above (use of investment income, instead of donations, as a trigger; less effective donor monitoring; and stale restrictions). There is no perfect way to balance these competing considerations, but two alternative approaches are promising.

First, Congress could repeal the exemption, or at least scale it back. In subsidizing charity, Congress could rely more on the deduction, which avoids the governance disadvantages emphasized in this Article. Admittedly, the deduction is not perfect, especially under current law. For instance, it is more generous to taxpayers in high brackets,

[11] See Ronald J. Gilson & David M. Schizer, Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock, 116 Harv. L. Rev. 874 (2003).

and to those who donate appreciated property. Fortunately, these (and other) familiar flaws under current law are not inherent in subsidizing donations, and could be addressed with responses that I (and others) have addressed elsewhere.[12] For example, the deduction could be replaced with a tax credit, which provides the same government match to both low- and high-income donors,[13] and special tax benefits for contributions of appreciated property could be eliminated.[14] Since these responses are well understood, this Article does not rehash them. Instead, this Article focuses on the general advantages of subsidizing donations, instead of endowment income.

Second, if Congress wishes to preserve the exemption, there is another way to mitigate two of the governance issues emphasized here: weaker donor monitoring and stale restrictions. The core problem is that the exemption creates a tax advantage for endowment gifts over spendable gifts—since charities earn tax-free returns, while donors do not—but endowment gifts limit the ability of donors to adjust to changed circumstances. To claim the tax benefit, donors either have to surrender control over the endowment (if they give it to an operating charity) or incur other costs (if they give it to a private foundation or donor-advised fund). Another way to address these issues, then, is to make it easier for donors to earn tax-free returns for charities on their own, so they feel less pressure to turn over assets to operating charities. For instance, Congress could liberalize the rules for private foundations and donor advised funds. But admittedly, there are risks in this approach. For example, wider use of private foundations could turn control of more assets over to unaccountable foundation managers. In a sense, efforts to mitigate agency costs in operating charities could end up exacerbating agency costs in private foundations. We need to pick our poison, or at least to strike the right balance between these goals.

While others have analyzed the exemption, this Article breaks new ground in three ways. First, this Article focuses on a criterion that has largely been overlooked in the literature on the exemption: the effect on nonprofit governance. Second, this Article is unique in comparing the governance implications of two subsidies: the deduction and the exemption. Although these subsidies are similar in many respects, their effects on nonprofit governance differ in important ways, which are new to the literature. Third, although others have criticized the

[12] See, e.g., Schizer, note 10; Daniel Halperin, A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains, 56 Tax L. Rev. 1 (2002).

[13] Schizer, note 10, at 246.

[14] Halperin, note 12, at 10.

exemption, the criticisms here are markedly different. In some cases, they directly contradict the arguments of other commentators.

For example, in a forthcoming article, Edward Zelinsky also criticizes the exemption, but for very different reasons. He wants to tax endowment income because charities use public services, have the ability to pay, and resemble other institutions that pay tax on investment income, such as for-profit firms.[15] Yet his argument does not address what, in my view, is the main case for exempting a charity's investment income: positive externalities from charity. Zelinsky dismisses this consideration, arguing that other taxpayers also use money for good purposes, "creating jobs, raising families, [and] making investments," but still have to pay tax.[16] Since Zelinsky rejects the idea that charities are different (that is, in systematically generating positive externalities), he does not consider the main question I address: If Congress wishes to subsidize charity, without choosing which specific charities to support, does it matter whether it uses the exemption or the deduction?

Like Zelinsky, Daniel Halperin also does not focus on nonprofit governance. For him, the decisive issue is whether the tax law should influence the timing of a charity's spending.[17] In my view, it is better for the tax law not to influence this choice. Since the exemption accomplishes this neutrality by allowing charities to save tax-free, I consider this neutrality to be the strongest justification for the exemption. But Halperin draws the opposite conclusion. He wants to repeal the exemption in order to encourage current spending.[18] Halperin claims that nonprofit managers have self-interested reasons to save, and he wants the tax law to counter this alleged bias.[19] In response, I argue that the opposite bias—a bias against saving—is just as plausible for nonprofit managers, even though it has been overlooked in the litera-

[15] Edward A. Zelinsky, Section 4968 and Taxing All Charitable Endowments: A Critique and a Proposal, 38 Va. Tax Rev. (forthcoming 2018).

[16] Id. manuscript at 53 ("taxation invariably involves taking from the public fisc money which taxpayers would themselves use for good purposes—creating jobs, raising families, making investments.").

[17] Halperin, note 9, at 286 ("[E]xemption should depend on a value judgement as to whether public policy should favor less accumulation and relatively more current spending by charities.").

[18] Daniel Halperin, Tax Policy and Endowments—Is Excessive Accumulation Subsidized? (Part II), 67 Exempt Org. Tax Rev. 125, 125 (2011) (arguing that endowment accumulation is excessive and discussing ways to discourage accumulation of endowments); see also Galle, note 9, at 1159 ("I show that short-term spending can have long-lasting impact, that future charitable spending is likely to be less valuable because the growing philanthropic sector will have to turn to lower priority projects, and that spreading spending out over time introduces several different forms of agency and information costs.").

[19] Daniel Halperin, Tax Policy and Endowments—Is Excessive Accumulation Subsidized?, 67 Exempt Tax Org. Tax Rev. 17, 20 (2011) ("donors, trustees, and key employees may be biased in favor of accumulation").

ture. Arguably, a manager's reputation is enhanced more by spending (for example, on new initiatives, construction projects, and the like) than by setting aside resources for successors to spend. In other words, although Halperin and I both express reservations about the exemption, our reservations are very different. His main reason to repeal the exemption is, in my view, the best argument for keeping it.

Part II of this Article emphasizes a key similarity between the charitable deduction and exemption: The government plays essentially no role in deciding how much each charity receives. Parts III and IV highlight governance advantages of the deduction over the exemption, while Part V analyzes what, as noted above, I consider the best justification for the exemption: neutrality about whether charities should spend or save. Part VI discusses distribution and deadweight loss, showing that these factors generally do not favor either subsidy. Part VII sums up this Article's policy implications: Either the exemption should be scaled back, or donors should have a greater ability to earn tax-free returns for charities on their own.

II. Two Nondiscretionary Subsidies: Private Allocation of Public Funds

At one level, the rationale for subsidizing charities is straightforward: their activities produce positive externalities. To keep these social benefits from being undersupplied, the marginal subsidy should equal the marginal positive externalities from the subsidized activity.

In a world of perfect information and no transaction costs, the mechanism for delivering the subsidy would not matter. The subsidy should be $1,000 if the relevant activity generated $1,000, but it would not matter whether this $1,000 was offered as a grant, a match for donations from third parties, or an exemption of the charity's investment income. Yet the very fact that a subsidy is needed—so externalities are not reflected in market prices—means that information is imperfect and transaction costs are positive. Just as information and incentive problems create the need for a subsidy, they also lend significance to how it is delivered.

An important threshold question, which this Part analyzes, is how active the government should be in deciding which causes to fund. In most government programs, Congress chooses how money is spent.[20]

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[20] In addition to setting the budgets of government agencies, Congress chooses which charities to fund when making grants (which represented 8% of public charities' revenue in 2013) and paying fees (which represented another 8%). Brice McKeever, The Nonprofit Sector in Brief, 2015, Urb. Inst. 4-5 (Oct. 2015), http://www.urban.org/sites/default/files/alfresco/publication-pdfs/2000497-The-Nonprofit-Sector-in-Brief-2015-Public-Charities-Giving-and-Volunteering.pdf.

In contrast, with the deduction and exclusion, the government plays a much more modest role. These subsidies leave key decisions to private parties. This Article's principal claim is that they do so in different ways, which have divergent effects on the governance of nonprofits.

Yet before turning to these differences—a discussion that begins in Part III—this Part offers a more precise account of why and how the deduction and exemption delegate these choices under current law. First, why should any of these decisions be delegated, instead of made by government officials? What are the advantages and costs of doing so? Second, which choices are delegated and who makes these choices? Third, how do the deduction and exemption accomplish these delegations? These issues are considered in turn.

A. Advantages and Disadvantages of Delegating Allocations to Private Parties

Why does Congress rely on private parties, instead of government officials, to allocate the deduction and exemption? The government's limited role is a feature, not a bug, which has familiar advantages and disadvantages.

1. Advantages of Not Relying on Government Officials to Allocate Subsidy

Four advantages are commonly invoked. First, the lack of government control allows operating charities to be more flexible and nimble. They can be launched quickly. If conditions change, charities do not need government approval to adjust priorities and strategies.

Second, for the same reason, operating charities are independent politically. Even if there is no political consensus for its mission, the nonprofit is still able to tap government funds.[21] Unlike legislatures, nonprofits can advance causes that are "cutting edge" and have not (yet) attracted the median voter's support. It is no accident that civil rights, women's rights, and environmentalism all began in nonprofits. The government did not embrace these causes until popular support became more widespread.[22]

Third, the independence of nonprofits allows them to fill gaps when direct government involvement would compromise important values.

[21] Burton A. Weisbrod, Toward a Theory of the Voluntary Nonprofit Sector in a Three Sector Economy, in The Economics of Nonprofit Institutions 21, 30-31 (Susan Rose-Ackerman ed., 1986) (defending charitable deduction as empowering minorities to pursue public goals that majoritarian political processes would not endorse).

[22] Schizer, note 10, at 229.

For instance, the government should not choose which religions to support. The same is true of newspapers, since they are supposed to monitor (and criticize) the government.[23] For these institutions, charitable subsidies offer government funding without government control.

Fourth, since operating charities do not depend on the good will of government officials, they are freer to compete with the government—and each other—to develop the best solutions. In promoting competition, nonprofits function like for-profit firms, enhancing quality, imposing discipline, and promoting innovation. Admittedly, the government can simulate this competition on their own, at least to an extent, by tasking different agencies or levels of government to act independently. For this reason, Brian Galle argues that charitable subsidies are more useful for missions that state and local governments cannot undertake.[24] Yet even when there is some competition already, the charitable sector can add more.

2. *Disadvantages of Not Relying on Government Officials to Allocate Subsidy*

Although the lack of substantive government oversight offers these advantages, it has four familiar downsides as well. First, the government provides no coordination. When separate operating charities pursue overlapping missions, they might duplicate effort and forgo economies of scale. Likewise, each donor decides what to support without full information about what others are supporting.[25]

Second, the government does not provide quality control. Rather, donors are free to support—and direct public money to—misguided causes and poorly run organizations.

Third, some commentators question the legitimacy of relying on private individuals to allocate public money, instead of democratically elected representatives.[26] Yet although Congress does not allocate these funds itself, it has authorized the way they are allocated by en-

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23 David M. Schizer, Subsidizing the Press, 3 J. Legal Anal. 1 (2011).

24 Brian Galle, The Role of Charity in a Federal System, 53 Wm. & Mary L. Rev. 777 (2012). Likewise, Eric Posner and Anup Malani have argued that for-profit corporations should also be tasked with pursuing public goals, and arguably should be subsidized when they do so, since they have the advantages of equity capital and the discipline associated with the profit motive. Anup Malani & Eric A. Posner, The Case for For-Profit Charity, 93 Va. L. Rev. 2017 (2007). In fact, a charitable subsidy for for-profit firms is more feasible than Posner and Malani seem to suggest. For instance, foundations can make grants to for-profit firms as long as the grant has "expenditure responsibility" language requiring the for-profit to use the funding solely for a specified charitable purpose and to account for the way it uses the funds.

25 Saul Levmore, Taxes as Ballots, 65 U. Chi. L. Rev. 387 (1998).

26 Ilan Benshalom, The Dual Subsidy Theory of Charitable Deductions, 84 Ind. L.J. 1047 (2009).

acting the relevant subsidies. Delegating the allocation of funds is not an unusual step for Congress. Agencies have some discretion over their budgets, panels of experts allocate some grants, and the like. A related process-based concern is that wealthy people exert disproportionate control over charitable subsidies, since they have the capacity to make larger contributions.[27] Yet more modest donors still have influence in the aggregate—since large numbers of small gifts add up to significant dollars, and thus meaningful influence. Therefore, a nonprofit manager would be reluctant to alienate large numbers of small donors merely to placate a single large donor. In any event, although large donors still wield disproportionate influence, this issue is not unique to charity. For instance, through campaign contributions, wealthy people also have added influence with elected officials.

Fourth, the influence of wealthy donors raises concerns about outcomes, as well as process. If these donors have idiosyncratic preferences, they may route public money to causes that lack mainstream appeal. For instance, wealthy donors give less to religious organizations than other Americans, and more to cultural and educational institutions.[28] Even so, wealthy people are not monolithic in supporting particular causes. George Soros funds some causes that the Koch brothers oppose, and vice versa. Wealthy people have values and preferences as diverse as the public at large.

Needless to say, commentators weigh these competing costs and benefits differently. Some are enthusiastic about delegating key decisions to private decisionmakers,[29] while others are skeptical.[30] Likewise, commentators also disagree about the effectiveness of the main alternative—relying on government officials—since the government is influenced by interest groups and has limited information and expertise.[31]

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[27] Id. at 1068 (critiquing deduction for "delegating to well-off donors an almost exclusive privileged-patrician status to allocate public finds").

[28] James Andreoni, Philanthropy 50-51 (2004), http://econweb.ucsd.edu/~jandreon/WorkingPapers/Philanthropy.pdf.

[29] See, e.g., Weisbrod, note 6, at 30-31 (praising charitable deduction for funding preferences and innovative ideas of non-median voter).

[30] See Galle, note 24, at 812 (arguing that state and local governments often are a better mechanism than nonprofits to implement preferences of non-median voter).

[31] Compare, e.g., Joseph Stiglitz, The Great Divide: Unequal Societies and What We Can Do About Them (2015) (advocating robust role for government to address inequality), and Paul Krugman, End This Depression Now! (2012) (urging government spending to stimulate economy), with Mancur Olson, Jr., The Logic of Collective Action: Public Goods and the Theory of Groups (1971) (cautioning about influence of concentrated interest groups on government policy), and Gary S. Becker, A Theory of Competition Among Pressure Groups for Political Influence, 98 Q.J. Econ. 371 (1983) (analyzing deadweight loss caused by interest group influence on policy, and dynamics involved in countering it).

Even so, skeptics and enthusiasts should agree that if the government is going to rely on private individuals instead of government officials to make key decisions about these subsidies, this delegation should be implemented in ways that promote better private decisionmaking. In other words, in addition to routing money to nonprofits, these subsidies ideally should also promote better nonprofit governance by empowering decisionmakers with the right incentives and information.

B. Which Decisions Are Delegated and Who Makes Them?

To compare the deduction and exemption on this dimension, the first step is to specify which choices are made by private parties, and who those private parties are. For both subsidies, the delegated choices are the same, as are the private decisionmakers: beneficiaries, donors, the board, and managers. Yet the influence of these groups varies under each subsidy, as Part IV considers.

1. Which Decisions Are Delegated?: Priorities, Monitoring, and Timing

In both the deduction and the exclusion, the government delegates three key choices to private decisionmakers. First, which charitable missions and programs should the government subsidize? Since there are over 1.5 million registered nonprofits in the United States, virtually every cause is represented, and nonprofits with similar missions pursue them with different strategies and programs. As new social problems arise, new organizations are launched to address them. Yet instead of picking which organizations should benefit from the deduction and the exclusion, the government leaves this choice to private individuals.

Second, these subsidies do not rely on the government to monitor the quality of a charity's work. Government officials do not review whether funded initiatives are succeeding, or whether the professional staff is competent and motivated.

Third, government officials do not decide whether a charity should spend money now or later. They do not determine whether a charity's mission will become more important or easier to pursue effectively in the future.

2. *Which Private Parties Determine Priorities, Quality, and Timing?*

Since the government does not choose the cause, monitor quality, or determine the timing of a charity's spending, who makes these choices? With both the deduction and the exemption, four constituencies influence these choices: beneficiaries, donors, the board, and the professional staff. This Subsection briefly surveys their roles, describing the roles they actually play under current law, not the roles they should play. The latter (and other normative issues) are considered in Parts III through VI.

a. Beneficiaries

The first group is the charity's beneficiaries. They cover a larger share of the budget in some charities than in others, and their influence grows as they fund more of the budget. For instance, symphonies and museums sell tickets, so their professional staffs choose performances and exhibits that attract an audience. Fee-paying beneficiaries wield more influence not only because nonprofits depend on their fees, but also because this "programmatic revenue" is likely to induce more than one operating charity to serve them. In a competitive market, beneficiaries have a louder voice, as when universities compete for students.

In addition to influencing priorities, beneficiaries often are well-positioned to assess quality, since they participate in the charity's programs. Some charities are more active than others in seeking feedback from beneficiaries. Again, this feedback is more likely to be influential when beneficiaries generate significant revenue for the nonprofit.

Similarly, beneficiaries also can influence whether an operating charity spends now or later. For example, in a competitive environment, paying beneficiaries may push a charity to focus on them, instead of on (as yet unidentified) future beneficiaries.

b. Donors

The second group of private decisionmakers is donors. They choose which causes and programs to support, and also can restrict the way charities use contributions.

Yet although donors have significant sway over the way charities spend money, their influence is not infinite. The limits in some gift agreements are very general (for example, "to support science" or "to help underprivileged children"), leaving nonprofit managers meaningful discretion.

Since money is fungible, even tight restrictions matter only if they induce a charity to increase its support for the targeted initiative. For example, assume a donor requires a university to use her gift—which represents 0.5% of the university's budget—to fund financial aid, while other donors give unrestricted gifts. As long as the university would otherwise commit at least 0.5% of its budget to financial aid, this restriction has no effect; the gift merely funds what the university would spend anyway.

Moreover, donors do not all want to influence charities in this way. Some give unrestricted gifts, allowing managers to decide how to use them. Others do not even choose a cause; by supporting umbrella charities, such as the United Way or Jewish federations, they rely on the charity's professionals (and in some cases committees of lay leaders) to allocate money to various operating charities.

Just as donors vary in how actively they direct their giving, they also vary in their interest and ability to monitor quality. This role is more feasible for large donors, since small donors—like small shareholders in for-profit firms—have little influence (on their own) with management. To determine the quality of a charity's work, donors can rely on media coverage and rating services (such as Charity Navigator).[32] They can favor charities that measure their own performance and share these evaluations with donors. In addition, they can volunteer time, as well as money, so they can form first-hand judgments about the charity's impact and competence. Donors also can depend on professional advisors or intermediaries, such as managers of foundations or of umbrella charities.

Three limits should be noted on a donor's ability and willingness to monitor quality. First, quality is not always easy to define. For instance, although in theory donors could use contractual conditions to require a stated level of quality, these conditions often would be hard to specify and enforce. Second, experts who are supposed to monitor quality, such as advisors or the managers of umbrella charities, may have self-interested reasons not to do so. They are supposed to monitor the managers of operating charities, but who is monitoring them? Third, donors themselves may also have self-interested motives in supporting charities (for example, networking, prestige, special access to the charity's services, and the like). Even so, this sort of conflict should not be overstated, since most donors presumably are trying to advance a cause they value and want their gift to be used effectively.

Donors also influence whether operating charities should spend money now or later. If donors want to support current work, they can give "spendable" gifts, which the charity is free to spend currently or

[32] Charity Navigator, http://www.charitynavigator.org (last visited June 7, 2018).

to "bank" for later. Alternatively, if donors wish to support work in the future, they can do so in two ways. First, they can create an endowment. To do so, donors enter into a contract with the charity (a so-called "gift agreement"), which requires the charity to invest the gift and allows the charity to spend only the income, not the principal. Second, instead of turning the principal over to the charity, donors can invest the money themselves. They can then use future income from this investment to make spendable gifts to the charity every year.

c. Board of Directors

A charity's board of directors also wields significant influence. Since members of the board usually are donors, they have the various levers described above.

In addition, they also can use the board's formal powers to influence how a charity spends money. The board sets broad policy goals, reviewing budgets, and approving special expenditures and initiatives. The board also chooses the CEO and can look for leaders with a particular vision.

Charitable boards usually also are self-perpetuating. In choosing successors, they can look for candidates who share their priorities. A caveat, though, is that the board is a group, and individuals on the board may have competing views. The more divided they are, the less influence the board is likely to have.

The board also is supposed to monitor quality, ensuring that the organization has competent and motivated managers. A key lever is the ability to replace the CEO (and thus to give guidance and feedback, which a CEO will take seriously). Boards also can require the charity to implement systems that measure outcomes and can acquire more information through personal involvement in the organization. Yet boards (and individual board members) vary in their level of engagement. In addition, although they are supposed to monitor the managers, there is always the question of who monitors them.

Boards also influence whether charities spend now or later. They usually approve the nonprofit's budget. In addition, they also decide how the endowment should be invested, as well as how much income should be distributed. In addition, if a charity has an operating surplus, the board can decide to invest it, and can choose to spend this surplus later.

d. Managers

The fourth group of decisionmakers is the nonprofit's managers. Their professional expertise usually commands some deference, while their day-to-day control of operations enables them to make any decisions that donors and the board have not made. As a practical matter, they have residual authority.

Managers are centrally involved in deciding how charities spend money. They choose and implement programs. When charities have programmatic revenue (for example, from tuition, ticket sales, fees from patients), managers allocate it. The same is true of unrestricted donations, whether from spendable gifts or unrestricted endowments.

Although managers have somewhat less control over restricted donations, they still have some influence for two reasons. First, if a restriction is very general, managers have leeway in the way they spend it; for example, a gift for financial aid can be used for needs-based aid, merit-based aid, or loan repayment assistance. Second, even if the restriction is more specific, the fungibility of money leaves a manager unconstrained, as noted above, as long as the manager wants to spend some money on the designated purpose and does not already have enough restricted funds to cover what she wants to spend.

While managers are also supposed to ensure that the nonprofit's work is of high quality, agency costs are a serious concern. An operating charity's success often is hard to measure, the staff controls key information, and there are no owners to look over their shoulders. Without meaningful monitoring, managers are free to define their mission and workload in self-interested ways. Incompetence also becomes harder to detect. The staff also may be committed to a misguided or an out-of-date vision of how to help beneficiaries. Or they may be overly risk-averse, putting their own reputations ahead of the well-being of beneficiaries.

One mitigating factor, mentioned above, is competition. Beneficiaries have more influence—and thus can demand quality—if more than one operating charity is competing to be their service provider. Likewise, competition for philanthropic support can also motivate managers to excel.

Another mitigating factor is that nonprofit managers usually are committed to the cause, and thus may be less interested in taking personal advantage of their position.[33] Yet even idealists sometimes add less value (and are less competent) than they realize.

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[33] If beneficiaries cannot effectively measure quality, they may worry the organization is taking advantage of them. Henry Hansmann has argued that the nonprofit form—and, in particular, the inability to distribute profits—can build trust by eliminating a key incentive to skimp on quality. Henry B. Hansmann, The Role of Nonprofit Enterprise, 89 Yale L.J. 835 (1980). Yet the nondistribution constraint is only a partial solution. Even though managers cannot distribute profits, they can access the surplus in other self-interested ways. For instance, they can claim excessive pay, exert insufficient effort, or pursue pet projects.

Managers play a central role in deciding not only what to fund, but also when to do so. They control whether to spend or save programmatic revenue, as well as unrestricted gifts and endowment income (although boards can weigh in on these issues as well). While managers do not have the ability to spend the principal of an endowment gift, they may be able to borrow against its value.

e. *Indirect Government Influence*

Even though the government delegates key choices to these groups of private individuals, the government still exerts some influence. For instance, when the government disagrees with the way charities are allocating funds, it can threaten to intervene. In some cases, the threat alone can change a charity's behavior. For example, Congress periodically has held hearings urging universities to spend more of their endowment, and some have done so in response.[34]

In addition, Congress can offset the choices of donors and managers, at least to an extent, when it allocates direct grants to charities. For instance, if Congress believes that elite cultural organizations derive too much benefit from the deduction and exemption, it can reduce the grant-making budget of the National Endowment for the Arts. This adjustment enables Congress to retain some control over the overall level of government funding for cultural organizations (although Congress would still not dictate how much goes to each museum or symphony). Of course, the extent to which Congress uses this lever to offset donor choices is an empirical question, which is not considered here.

C. *How Do the Deduction and Exemption Delegate These Decisions?*

With both the deduction and the exemption, government officials delegate choices about priorities, quality, and timing, and they rely on the same group of private parties to do so. But how specifically do the deduction and exemption provide funding without allocating it?

Both subsidies rely on very general criteria to determine eligibility. For example, charities that qualify under § 501(c)(3) are eligible for both subsidies. The standard is quite expansive, asking whether chari-

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[34] Michael Stratford, Billion Dollar Targets, Inside Higher Ed (Feb. 16, 2016), https://www.insidehighered.com/news/2016/02/16/congress-returns-scrutiny-wealthy-university-endowments ("Grassley floated the idea of requiring universities to spend a certain amount of their endowments each year. Although his plans were dropped, the scrutiny is widely credited with spurring more generous, no-loan financial aid packages for low- and middle-income students at the wealthiest institutions.")

ties are "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes."[35] To confirm that they qualify, charities seek a letter from the IRS. In their application, they share their bylaws and articles of incorporation, and also describe their mission, projected budget, and sources of funding. Yet although the application process can be burdensome and does not always yield a successful outcome, the government is not supposed to assess the merits of the cause or the charity's competence to advance it. Rather, as long as charities satisfy very general requirements, the deduction and exemption are automatically available when private individuals take the relevant steps.

1. *The Charitable Deduction*

For the deduction, the relevant step is a contribution to charity. Since contributions reduce a donor's taxable income, and thus her tax bill, the government is a silent partner in this contribution. Significant dollars are at stake. In 2014, Americans gave $358.38 billion to charity.[36] Donations represented 13.3% of the revenues of public charities.[37] The deduction is expected to cost the federal government $63 billion in 2018.[38]

In committing these funds, government officials obviously do not have discretion to adjust the size of the subsidy, regardless of what they think of the cause, the quality of the management team, or the timing of when the charity will pursue the relevant goals. Instead, the subsidy rate is based on the donor's marginal tax rate.

2. *Tax Exemption for Income*

For the exemption, by contrast, the subsidy is triggered when a charity earns income. Since this revenue is not taxed, the subsidy is the marginal rate that otherwise would apply to the charity (the 21% corporate tax rate). Once again, government officials have no discretion to adjust the size of the subsidy, regardless of their view of the particular charity.

Operating charities can earn three types of exempt income, and this Article focuses only on the third. First, charities are not taxed on do-

[35] IRC § 501(c)(3). In general, the deduction is available only for contributions to organizations that qualify under § 501(c)(3), but the exemption is somewhat more widely available. For example, some organizations can earn exempt income, even though contributions to them are not deductible. This is the case for social welfare organizations that engage in lobbying, labor unions, and trade associations. IRC § 501(c)(4), (5).

[36] See McKeever, note 20, at 9.

[37] Id. at 5.

[38] See note 6.

nations. Yet this treatment is consistent with the general rule for gifts, which spares recipients from tax, and thus is not a subsidy.[39]

Second, charities pay no tax on revenue earned in pursuing their mission. In 2013, operating revenue (such as tuition for universities and fees to hospitals) represented 47.5% of U.S. public charities' receipts.[40] Yet even if the exemption is repealed, charities still would not be taxed on operating revenue as long as they have enough deductions to shelter it. In other words, a charity is treated more favorably than for profit-firms—rendering the exclusion a subsidy—only when its revenue funds nondeductible expenses.[41]

A third source of exempt income, which is the focus of this Article, is income from passive investments, such stocks, bonds, and commodities. (For simplicity's sake, this Article uses the phrase "investment income" or "endowment income" to describe this passive income.)[42] In 2013, public charities earned $83 billion of investment income,[43] and private foundations made over $55 billion in grants, which can serve as a rough estimate of the foundations' income.[44] If this estimate is correct, exempting this investment income costs the federal

[39] Halperin, note 9, at 285; Branch Ministries v. Rossotti, 211 F.3d. 137, 143 (D.C. Cir. 2000) (IRS represented that church whose tax exemption was revoked for engaging in political activities could still receive gifts tax-free).

[40] McKeever, note 20, at 5 fig.2.

[41] For example, excluding tuition revenue is a subsidy when it funds a new building (which would be capitalized), but not faculty salaries (which would be deducted). Halperin, note 9, at 285 ("if an expenditure would be deductible when made, tax exemption for amounts set aside for such expenditures does not reduce the present value of tax payments even if these expenditures are deferred"); Boris I. Bittker & George K. Rahdert, The Exemption of Nonprofit Organizations from Federal Income Tax, 85 Yale L.J. 299, 311-12 (1976) ("[P]ermit[ting] nonprofit institutions to deduct all amounts expended to advance their charitable . . . objectives . . . would achieve substantially the same result as tax exemption, save for amounts earned in one year and either accumulated for future expenditure or spent on buildings and equipment.").

[42] An important exception is that investment income is taxable (as "unrelated business taxable income") if a charity finances passive investments with debt or invests in an active business. IRC § 511. For instance, if an art museum sells science books and city souvenirs in its gift shop, this revenue is taxable. Rev. Rul. 73-105, 1973-1 C.B. 264.

[43] The total revenue of public charities in 2013 was $1.73 trillion, see McKeever, note 20, at 3 tbl.1, and 4.8% of this revenue—or $83 billion—came from investments, see id. at 5 fig.2.

[44] Found. Ctr, Aggregate Fiscal Data of Foundations in the U.S., 2013, http:// http://data .foundationcenter.org/#/foundations/all/nationwide/total/list/2013 (last visited Oct. 13, 2018).

government approximately $48 billion,[45] which is about as much as the Treasury's estimate for the cost of the charitable deduction in 2013.[46]

A common rationale for the exemption is that a charity "stands in" for its low-income beneficiaries, and thus should be taxed at the same rate that applies to them. For instance, if a soup kitchen's clients pay a zero rate, investment income earned on their behalf also should bear this rate.[47] Yet this theory justifies an exemption—and treats it as a product of progressive rates, instead of as a subsidy—only if beneficiaries are in the zero bracket. This is not necessarily the case for many charities, including museums, symphonies, universities, environmental organizations, and churches.

For these charities, the exemption is a subsidy, since charities do not pay tax on investment returns, but other taxpayers (generally) do. As a result, the exemption creates an important inconsistency: If donors keep an investment, their return (generally) is taxable. But if they donate the investment to charity, the return is no longer taxed.[48]

The value of the exemption to a charity depends on the size of its endowment,[49] and charities vary markedly on this dimension. Although the charitable sector had $5.17 trillion of net assets in 2013,[50] most charities have little or no endowment. Only 14% of charities

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[45] The 35% corporate rate in effect then would have generated $29 billion of tax on the $83 billion of investment income of public charities. Since private foundations already pay a 1% or 2% tax, an additional 34% would have yielded almost $19 billion of tax (assuming their income was $55 billion). Applying the 21% rate corporate in effect in 2018 to these 2013 numbers, the revenue cost would be approximately $28 billion. These numbers would be overstated if some of this investment income is taxed as unrelated business taxable income (or is taxed to taxable "blocker" corporations that charities use to invest in active businesses).

[46] U.S. Treasury Dep't, Office of Tax Analysis, Tax Expenditures 251 (2017) (estimating $48.87 billion), http://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2013.pdf.

[47] Bittker & Rahdert, note 41, at 315 (arguing that nonprofits should be taxed at the personal rate of their beneficiaries, and defending use of zero as a rough estimate in order to avoid "overtax[ing] the most needy beneficiaries").

[48] Since a consumption tax differs from an income tax in not taxing investment returns, another way to describe the exemption is that it applies a consumption tax to charities, while retaining the income tax as the general rule.

[49] Operating charities can accumulate investment assets in three ways. First, donors can require the charity to invest their gift, allowing the charity to keep the principal and spend only the income. Second, the charity itself can create the endowment, inviting donors to contribute to it and committing to spend only the income. Third, a charity that earns more than it spends can choose to invest this surplus. Technically, the term "endowment" refers only to the first and second of these choices, and the third is usually called a "quasi-endowment." However, this Article uses the term "endowment" to describe all three (that is, a portfolio of passive investments).

[50] McKeever, note 20, at 3 tbl.1. Some of these assets presumably are not passive (such as buildings that house the nonprofits). This total includes the assets of all reporting nonprofits, including public charities and private foundations.

registered with the IRS in 2015 have $500,000 or more of assets.[51] Half of private foundations have less than $500,000, and only 12% have more than $5 million.[52] Among public charities, the largest 10% hold 87% of the assets.[53]

III. Donations and Investible Surplus as Proxies for Social Value

The last Part emphasized the government's limited role in the deduction and exemption. Government officials do not choose which causes to support, monitor the effectiveness of management, or decide whether charities should spend or save. Instead, the government relies on private decisionmakers. To do so, the government makes funding available automatically, as long as charities satisfy the relevant criteria.

Since the government is not directly vetting the charity, the criteria the charity has to satisfy should correlate, as much as possible, with a cause's social value. In other words, the conditions a charity has to meet should be easier for a charity with an important mission and a strong track record of performance.

Notably, the deduction and the exemption use different criteria. To benefit from the deduction, a charity has to attract donations. Government money flows only if donors value a charity enough to support it themselves, and thus have "skin in the game." The deduction does not help charities that receive no gifts and are funded solely with income from operations or endowment.[54]

In contrast, the exemption for investment returns has a different precondition: Operating charities benefit only if they have money to invest.[55] Admittedly, this money could come from a donor—for instance, in the form of an endowment gift—but it does not have to do so. Instead, the charity can fund the investment by running an operating surplus (for example, through extra operating revenue or stringent

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[51] Guidestar, Nine Things You Might Not Know About U.S. Nonprofits 4-5 (2015), https://trust.guidestar.org/what-does-the-nonprofit-sector-really-look-like

[52] Id.

[53] Id. at 5.

[54] The deduction may have helped the charity acquire the endowment, if it comes from a gift instead of from operating surpluses, but the deduction does not affect the charity's ability to live off the return from the endowment.

[55] In theory, the charity can generate resources to invest by borrowing, but debt-financed investments are generally not able to earn tax-free returns; instead their returns generally are taxed as unrelated business taxable income. See IRC § 514.

cost-control).[56] This Part argues that attracting contributions is a better proxy for a charity's social value than having an investible surplus.

A. Contributions as Evidence of Social Value

Giving charity means forgoing consumption, so donors have to prioritize the cause over marginal dollars for themselves. Donors also have to prefer their cause to other charities. The range of options is vast, including religious organizations, poverty and disaster relief, education, public policy, civil and human rights, the environment, cultural organizations, and much more. For each cause, several organizations usually compete for donations. Therefore, a charity has to make a strong case.

In evaluating charities, donors have access to significant information, so it is feasible to make informed judgments. Organizations have websites and printed materials, and also sponsor events to publicize their activities. For sufficiently large gifts, a charity's managers spend time with potential donors. In many cases, donors give time as well as money, and this volunteer work educates them about the charity's strengths and weaknesses. The media also covers nonprofits, and various websites evaluate their work. Donors also can get input from professional advisers, as noted above.

This is not to say that every charitable donation is based on rigorous analysis, rich information, and deep insight. Coworkers, neighbors, and family members ask each other to buy raffle tickets or cookies for their causes. Some donors buy tickets to a charity's dinner because a friend is being honored, not because they personally value the cause. Some contributions are given to satisfy a social or professional obligation, or to avoid the awkwardness of saying "no."[57]

Even when donors take these decisions seriously, their choices will not appeal to everyone. Donors have heterogeneous preferences, so causes that resonate with some are unpersuasive—or even unappealing—to others. But charitable subsidies are supposed to support causes outside the mainstream, as noted above. Admittedly, some donations—and, thus, some uses of government money—are misguided.

In some cases, nonprofit managers block poor choices by asking the donor to support something else. If this effort fails, the manager may

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[56] See Halperin, note 9, at 300-01 (noting that exemption becomes relevant when revenue exceeds deductible costs).

[57] Even casual gifts can be a positive signal in some cases. Donors may support their friends' causes with the expectation that friends will reciprocate; if so, these gifts really are indirect support for the donors' own causes. Donors may support a family member or friend's cause because they respect her judgment. In any event, these uninformed choices are more likely for small gifts. For larger gifts, donors are likely to invest more time and thought.

refuse the gift, for instance, if the charity would have to devote matching money, or if the manager worries that the initiative would undermine the charity's (and her personal) reputation.

Even if the nonprofit takes the gift—for instance, because the nonprofit manager also has flawed judgment—this problem is hardly unique to charity. Unwise choices also occur in the for-profit sector, skewing resource allocation and shrinking the tax base, since tax losses are deductible. Likewise, unwise votes and campaign contributions distort government policy. It is not obvious why this problem is worse in charities than anywhere else.

The bottom line, then, is that a charity's ability to raise money should correlate, to an extent, with its social value. Although this correlation is by no means perfect, it should be meaningful. Since donors have skin in the game, the government can be more comfortable piggybacking on their judgments.

B. *Investible Surplus: Less Reliable Evidence of Social Value*

In contrast, a charity must satisfy different conditions to claim the subsidy for investment returns: The charity needs a surplus to invest,[58] and the investment has to yield a positive return.

In some cases, an investible surplus is evidence of social value for an operating charity. For example, if a surplus derives from increasing revenue—whether from donations or from fees for the charity's services—it shows that donors and beneficiaries value the charity's work. A caveat, though, is that an endowment donated long ago reveals more about the charity's value in the past than today.

Surpluses can arise not only from increased revenue, but also from reduced costs. Obviously, intelligent cost-cutting is a positive step. But sometimes an operating charity cuts its expenditures for problematic reasons. For example, when the mission becomes less relevant, there are fewer opportunities to spend money effectively. To make matters worse, managers might hoard cash to protect their jobs, so the payroll is still covered if disillusioned donors end their support.

Even when a surplus is evidence of social value, investing it successfully is not. After all, why would a charity's ability to choose the right stocks and bonds correlate with the value of its mission? Earning robust investment returns is not as dependable a proxy for social value as attracting donations.[59]

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[58] See note 55.

[59] While an endowment is not necessarily evidence of a charity's social value, it offers another mechanism to pursue the organization's goals: the opportunity to choose investments that advance (or at least are consistent with) the charity's mission. For example, an environmental organization may choose not to invest in polluting firms. Assuming this

IV. Tax Preference for Endowments: Stale Allocations and Agency Costs

Not only is the exemption triggered by less reliable evidence of social value, but it also has a second disadvantage: Unlike the charitable deduction, it favors endowment gifts over spendable gifts. While endowments are appropriate in many circumstances, the choice to support an operating charity with an endowment, instead of spendable gifts, turns on context-specific trade-offs. This Part argues that the tax law should not favor one, as opposed to the other. The downside of favoring endowments is that the charity, instead of the donor, controls the assets. As a result, donors become less free to update judgments about the cause or to monitor management. More generally, this tax preference enhances the influence of nonprofit managers, and correspondingly erodes the influence of donors.

A. *Tax Preference for Endowments Instead of Spendable Gifts*

Since charities do not pay tax on their investment returns, but donors generally do (except when they can take advantage of special rules offering favorable treatment), the same investment earns a better after-tax return if owned by a charity.[60] As a result, to the extent that donors are not able to avoid tax on their investment returns, they have a tax incentive to transfer assets to charities. If they give the assets to an operating charity, they lose control over them.

1. *An Illustrative Example*

To see this effect, assume a donor is considering either (1) contributing an endowment to an operating charity, or (2) investing the money herself and contributing the investment income to the charity each year. Assume the donor and charity each earn a 7% pretax return on investments. Is one option more tax-efficient than the other?

a. *First Scenario: Charity and Donor Are Taxed at the Same Rate on Investments*

First, assume that contributions are deductible and the same tax rate applies to the donor and the charity, which is assumed to be the

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investment philosophy reduces its endowment return, the nonprofit should consider whether this use of resources advances its mission more or less cost-effectively than alternatives.

[60] This effect is analogous to the familiar tax advantage of retaining earnings when a corporation's tax rate is lower than the tax rate available outside the corporation, as well as the tax advantage of a multinational corporation in keeping earnings in a low-tax foreign subsidiary.

top rate for individuals under current law (37%).[61] On one hand, if the donor contributes a $100,000 endowment, the charitable deduction reduces her after-tax cost to $63,000 (since she avoids $37,000 of tax). The charity earns a 7% pretax return of $7000 per year. Since the charity is assumed to pay tax on this endowment return, the charity pays a 37% tax of $2590, and has $4410 to spend each year.

On the other hand, the donor can invest the money herself. Since she is no longer contributing $100,000 to charity, she has to pay $37,000 in tax, and can invest only $63,000. At 7%, this investment generates $4410 per year. Since the donor contributes this $4410 to the charity, the charitable deduction shelters it from tax, allowing the charity to spend the same $4410 each year. Therefore, a system that offers only a charitable deduction—with no exemption for a charity's investment income—does not favor endowment gifts over spendable support.

b. Second Scenario: Charity and Donor Are Not Taxed on Investment

For the tax law to be even-handed between spendable and endowment gifts, the key is to tax donors and charities the same way on investments. This condition is satisfied not only by taxing both at the same rate, as illustrated above, but also by exempting both.

Assume the donor and the charity can both earn a tax-free return, for instance, because the income tax is replaced by a cash flow consumption tax.[62] If the donor contributes a $100,000 endowment, the charitable deduction allows her to contribute pretax dollars—that is, the full $100,000, without having to pay a $37,000 tax. The charity earns a 7% return of $7000 per year, but this return is now assumed to be exempt, so the charity can spend $7000 each year.

Alternatively, instead of making an endowment gift of $100,000, the donor can invest the money herself. Yet unlike in the prior example, she can now invest pretax dollars. Under a cash flow consumption tax, she can deduct the $100,000 she invests. This means she can invest the full $100,000, instead of only $63,000. Like the charity, then, the donor can generate a 7% return of $7000 each year. Under a cash flow consumption tax, this amount would ordinarily be taxed, if it is not reinvested. But the donor can shelter this $7000 from tax by contributing it to charity. As a result, the charity has the same $7000 to

[61] In 2018, the top rate for individuals generally is 37%, though the top rate for long-term capital gain generally is 20%, and investment income may be subject to an additional 3.8% tax.

[62] A cash flow consumption tax functions like an unlimited deductible IRA. Taxpayers deduct amounts they invest and are taxed when they spend this money.

spend each year.[63] The bottom line, then, is that endowment gifts also lose their advantage over spendable gifts if investment returns are exempt for both the charity and the donor.

c. *Third Scenario: Donor Is Taxed, But Charity Is Not*

This neutrality is eliminated if a charity's investments are tax-exempt, but a donor's investments are taxed, as generally is the case under current law. Since the charity has an edge in investing the money, donors can support an operating charity more cost-effectively by donating an endowment to the charity, instead of investing money themselves and donating the return.[64]

If the donor contributes an endowment of $100,000 (which, again, is assumed to be deductible), the charity can earn 7% per year after tax, and thus has $7000 to spend. In contrast, if the donor keeps this $100,000, she can invest only $63,000 after paying a 37% tax. Assuming this investment yields the same 7%—but on a base of $63,000, instead of $100,000—the donor earns $4410 each year. By making a tax-deductible contribution of this $4410 to the charity, she avoids tax on these investment earnings. Even so, the charity has only $4410 per year to spend, instead of $7000. In other words, the charity has more money to spend if the donor makes an endowment gift, instead of keeping the principal and contributing the income each year.[65]

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[63] Notably, this treatment can be replicated—or, at least, approximated—under current law, as long as the donor's investment can earn a tax-free return. For instance, the donor can fund charitable gifts with an IRA or with appreciated stock (although, with appreciated stock, the donor is "locked in" to the investment and cannot switch to another without triggering tax). For a discussion, see Subsection IV.A.2.

[64] Halperin, note 9, at 305 (because other future consumption by the donor is affected by the income tax on investment earnings accumulated for this purpose, "when the charity is exempt, the price reduction for charitable spending, as compared to other deferred consumption, is relatively greater the longer consumption is deferred").

[65] Notably, endowment gifts retain this advantage over spendable gifts even if the charitable deduction is repealed. Returning to the recurring example, if the donor wants to use $100,000 of pretax income to contribute an endowment, she can contribute only $63,000 if the contribution is no longer deductible. The charity earns a 7% return of $4410 each year and can keep it all (since endowment returns are assumed to be exempt). In contrast, if the donor invests this $63,000 herself, she earns a pretax return of $4410. But if charitable contributions are not deductible, she has to pay a 37% tax on this income and has only $2778 to contribute. So if the donor keeps the investment, the charity has 37% less to spend each year ($2778, instead of $4410). In other words, the exemption favors endowment gifts over spendable gifts, regardless of whether contributions are deductible.

2. *Caveat: Access of Donors to Tax-Free Investments on Their Own*

In concluding that the exemption favors endowments over spendable gifts, the analysis so far has assumed that donors are taxed on their investment returns. In contrast, if donors had the same ability as charities to earn tax-free returns, there would no longer be a tax advantage in shifting assets to charity. Although donors usually are taxed on investment returns, there are three ways they can replicate the tax-free return of operating charities, at least to an extent, while keeping the assets, or at least maintaining some control over them.

First, donors can invest in growth stocks. After all, when donors contribute appreciated shares to charity, they never pay tax on the appreciation.[66] Even so, some of a charity's tax advantages as an investor are still beyond a donor's reach: Unlike a charity, donors have to pay tax on dividends, and also are taxed if they sell appreciated assets to rebalance their portfolios.[67]

Second, instead of donating an endowment to an operating charity, a donor can give it to a private foundation. While this is still an endowment gift to a charity, the donor retains significant control over the endowment. Every year, the donor is free to allocate endowment income to whatever charities she chooses, as if she still owned these investments, but the tax on this income is much lower than if the donor still owned them.

Even so, these advantages come at a cost. Holding the endowment in a private foundation, instead of giving it to an operating charity, adds a layer of administrative costs, including recordkeeping and filing obligations. If the donor does not make allocation decisions herself, she also incurs direct costs in hiring someone else, as well as agency costs if the foundation manager is incompetent, self-interested, or has different preferences.

In addition, endowment gifts to private foundations are not taxed as favorably as endowment gifts to public charities. Both the exemption and the deduction are less generous for private foundations than for public charities. A private foundation's investment income is not completely exempt; instead, its investment income is subject to a modest tax (of 1% or 2%) as long as the foundation spends enough of it each year.[68] This tax becomes much higher, moreover, if the founda-

[66] The corporation still has to pay tax at the corporate level, but this is true when tax-exempts own shares as well.

[67] Donors also can invest tax-free in IRAs, 401(k)s, 529 plans, and other special vehicles, but these vehicles are subject to various limitations. IRC §§ 401(k), 529.

[68] IRC § 4940(e). (The tax is reduced from 2% to 1% if the foundation makes a minimum distribution and satisfies other requirements).

tion does not distribute enough income.[69] There are also draconian penalties for self-dealing,[70] funding impermissible purposes (such as political activity, nonqualifying travel or study grants for individuals),[71] having a controlling position in a private business,[72] and violating other restrictions as well.[73]

In addition, deductions are more limited when donors contribute to private foundations, instead of public charities.[74] For instance, when donors contribute appreciated property to charity, they would like to deduct the property's fair market value, instead of its basis. This favorable treatment is more widely available for donors who support public charities, instead of private foundations.[75] In addition, when donors contribute a large percentage of their income to charity, they can deduct more of it when contributing to public charities, instead of private foundations. For example, for cash contributions, donors generally can deduct up to 50% of their adjusted gross income when contributing to public charities, but only 30% when contributing to private foundations.[76]

Third, instead of donating assets to a private foundation, a donor can contribute them instead to a donor-advised fund. Since these funds are structured to qualify as public charities, they avoid the extra tax and administrative costs described above. But unlike with a gift to

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[69] IRC § 4942 (an initial tax of 30%, and a subsequent tax of 100% if the foundation does not correct the problem by making a sufficient distribution).

[70] IRC § 4941.

[71] IRC § 4945.

[72] IRC § 4943 (an initial tax of 10% and a subsequent tax of 200% if the foundation does not divest itself of the excess business holdings).

[73] To avoid these limits on private foundations, taxpayers can use a grant-making vehicle that qualifies as a social welfare organization under § 501(c)(4). Like private foundations, social welfare organizations are not taxed on income and, if they receive a contribution of appreciated assets, built-in gain is never taxed. Yet there is a downside to using a social welfare organization, instead of a private foundation: Contributions to this entity are not deductible. So compared with a private foundation, a social welfare organization offers a better exemption, but no deduction. See generally David S. Miller, Advice for Jeff Bezos: Social Welfare Organizations as Grantmakers, NYU J. Leg. & Pub. Pol'y (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3198759.

[74] See Wealth of Knowledge—Spring 2012—A Primer on Private Foundations (Apr. 15, 2012), http://www.eisneramper.com/private-foundation-0412/ ("Although a private foundation does provide the donor with maximum control over the entity's eventual charitable distributions, the trade-off is that the charitable income tax deduction for contributions to a private foundation is far less generous than for contributions to a public charity; in addition, stringent rules must be observed to make sure that the foundation—and its founder—comply with the law.").

[75] IRC § 170(e)(1)(B)(ii) (disallowing deduction of built-in gain for contributions to certain private foundations).

[76] See IRC § 170(b)(1)(A), (B). The limits on contributions of appreciated stock, moreover, generally are 30% for public charities and 20% for private foundations. IRC § 170(b)(1)(C), (D). Notably, contributions to certain types of private foundations (such as "operating" foundations) are treated more generously. IRC § 170(b)(1)(F).

an operating charity, the donor retains some control, helping to choose which charities receive the income every year. Donors pay a fee for this privilege (of approximately .6% per year).[77] Another downside of donor-advised funds is that, in theory, the donor's role is limited to giving advice, so donors have less control than in private foundations. But as a practical matter, donor-advised funds generally follow this advice, even though they are not obligated to do so.

The bottom line, then, is that donors can replicate at least some of the tax advantages of endowment gifts without committing their assets to a particular operating charity. But there still are costs in doing so, including fees, administrative costs, extra tax costs, and legal uncertainty (for example, about how much control a donor can exert in a donor advised fund).

B. Governance Problems with the Tax Bias for Endowments

As a result, the cheapest and most straightforward way to support an operating charity with tax-free returns is to give it an endowment gift, allowing the charity to control the assets. Yet this tax advantage of endowment gifts over spendable gifts can distort behavior, exacerbating governance problems at nonprofits.

To be clear, the point is not that endowments are always undesirable. On the contrary, they offer familiar advantages, assuring a program's permanence, enabling operating charities to undertake long-term projects, easing fundraising burdens on the staff, signaling confidence in a way that may attract other donors, and allowing donors to support a charity beyond their lifetimes. To an extent, though, multi-year commitments of spendable gifts can replicate these advantages, while allowing donors more flexibility.

Since the right balance between spendable and endowment gifts is a subtle question, involving a number of context-specific trade-offs, it is hard to see why the tax law should put a thumb on the scale. As this Section shows, the tax bias for endowments under current law can have two unfortunate effects: It can erode the motivation and ability of charities to change with the times, and also can impede the ability of donors to monitor the performance of managers.

1. Stale Allocations

Operating charities that live off endowments may become complacent, addressing dated problems with stale solutions. In contrast, op-

[77] John R. Brooks, The Missing Tax Benefit of Donor-Advised Funds, 150 Tax Notes 1013-24, 1014 (Feb. 29, 2016).

erating charities that depend on spendable donations and operating income are forced to remain relevant. Like start-ups that depend on "staged financing" from venture capitalists,[78] these charities are constantly being evaluated, and must keep proving themselves.

Admittedly, a charity that receives an endowment gift must have impressed the donor who gave it. But the donors who gave this money are not offering a current judgment. In some cases, these donors—and the managers who secured their support—passed away decades ago. While endowments are permanent, a charity's value can change. Yet once donors have given an endowment to an operating charity, they can no longer re-evaluate it and redirect their support.

In addition to undercutting an operating charity's motivation to change, endowments can undercut its ability to do so by limiting the way it can spend money. This issue obviously does not arise with a so-called "unrestricted" endowment, but it can be important when donors enter into a contract with the charity to specify how the money will (or will not) be used. Restrictions can become outdated as the cause becomes less relevant, or the right strategies for advancing it change. Admittedly, spendable gifts can also be restricted, but these limits are imposed currently, and thus are less likely to become stale. Donors can tailor them to current circumstances and can change them later. These steps are less feasible for endowments—and sometimes are impossible—especially when the relevant donors have passed away.

2. *Managerial Agency Costs*

Charitable subsidies should flow not only to the right causes, but also to the right organizations, favoring those that run efficiently. Yet just as government officials do not choose which causes to fund, they also do not monitor the performance of nonprofit managers. Instead, this responsibility is delegated to a charity's donors and board of directors.

Yet endowments can undercut this monitoring by insulating managers from the need to produce results. Admittedly, donors evaluate managers before giving an endowment gift. But this due diligence is conducted ex ante, as emphasized above.[79] Once donors have given an endowment gift to an operating charity, they forgo the right to re-evaluate the charity over time. Of course, donors can still retain some influence by giving an endowment over time, and thus motivating

[78] Gilson & Schizer, note 11.

[79] Testamentary gifts—and, thus, the charitable deduction in the estate tax—also front-load monitoring in this way.

managers to impress them in order to receive future payments. But as donors approach the completion of their giving, their leverage wanes. They may still wield influence in other ways, such as by serving on the nonprofit's board, but they lose the ability to redirect their giving.

In contrast, if donors invest the assets themselves and donate the return each year, they can withhold support if managers underperform. Just as the need for spendable gifts pressures managers to change with the times, as noted above, it also motivates them to run organizations more efficiently and to take less for themselves. For example, Brian Galle and David Walker have found that university presidents earn less "at institutions that are more highly dependent on current donations as a source of revenue (versus tuition, grants, etc.)."[80] This may seem counterintuitive, since the president presumably should be rewarded for effective fundraising. But Galle and Walker believe this finding shows that spendable donations constrain agency costs.[81]

Donors have to balance these governance advantages of annual spendable gifts against the tax cost of keeping the assets themselves. Of course, there are intermediate solutions as well. As noted above, donors can give the endowment to a private foundation, instead of an operating charity.[82] This choice involves higher tax and administrative costs than an endowment gift to an operating charity, but offers the donor more control, as long as the donor runs the foundation herself.[83]

Yet the analysis is somewhat different when the foundation is run by a professional manager. This manager is supposed to monitor the operating charities who receive grants from the foundation, but who is monitoring her? After all, a foundation manager might define her responsibilities and compensation in self-interested ways. In addition, she might substitute her own preferences for the donor's, especially after the donor's death. It is commonly observed, for instance, that the grants and missions of prominent foundations no longer reflect the preferences of their founders.[84] Therefore, private foundations can

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80 Brian Galle & David I. Walker, Nonprofit Executive Pay as an Agency Problem: Evidence from U.S. Colleges and Universities, 94 B.U. L. Rev. 1881, 1887 (2014).

81 Id. ("The fact that more powerful donors are able to drive down pay levels implies that presidents at schools with less-influential donors are extracting more pay than donors would want.")

82 See Subsection IV.A.2.

83 Alternatively, the donor can give to a donor-advised fund. This option involves fewer tax and administrative costs than the foundation, but (at least in theory) offers the donor less control, as noted above.

84 For example, when Henry Ford II resigned from the board of the Ford Foundation, which his grandfather created, he wrote: "[T]he foundation is a creature of capitalism. . . . It is hard to discern recognition of this fact in anything the foundation does." See Fred

mitigate some agency costs, while exacerbating others, depending on the context.

In any event, even though funding charities with spendable gifts has advantages, it has costs as well. Managers are likely to spend more time raising money, leaving less time for other responsibilities. Moreover, when managers are more informed than donors, and thus make better judgments, donor influence can lead to inferior decisions (if managers are unable to persuade donors when they disagree). Donors can only serve as effective monitors during their lifetimes, and generally cannot do so through testamentary gifts (unless they arrange for an agent, such as a foundation manager, to do so).

Obviously, not all forms of donor influence are constructive. For instance, donors sometimes seek to help themselves, instead of the cause. In these cases, donors are a source of agency costs, instead of a constraint on them. In response, charitable subsidies have familiar rules to police donor self-interest, such as the "private benefit" doctrine. Although not a complete solution, these limits are helpful.[85]

Given these trade-offs, the right balance is likely to vary with the context. But again, it is not clear why the tax law should favor endowment gifts over spendable gifts. Since spendable gifts are preferable at least some of the time, current law's tilt toward endowments is problematic.

3. *The Relative Influence of Managers and Donors*

In addition to these specific effects, the tax law's tilt toward endowments has a more general implication: It enhances the influence of nonprofit managers, and correspondingly diminishes the influence of donors.

After all, if a donor keeps an investment, and uses the income it generates to fund annual spendable gifts, she retains control over these resources. The donor can use this authority to set expectations for the charity. If she believes these expectations have not been met, she can redirect the income to a different charity.

In contrast, once a donor turns assets over to an operating charity, she surrenders control of them to the charity's professional managers. Admittedly, managers still have to abide by any restrictions that the donor has imposed on the endowment, but they have some discretion

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Smith, Rolling Over in the Grave, The Gathering, May 22, 2014, https://thegathering.com/rolling-over/ (quoting Henry Ford II).

[85] The dynamic here is like the one associated with large shareholders of private firms, who can discipline management but also may seek private benefits of control. See Zohar Goshen & Assaf Hamdani, Corporate Control and Idiosyncratic Vision, 125 Yale L.J. 560 (2016).

in doing so. More fundamentally, they no longer are under as much pressure to accommodate donor preferences.

This is relevant because donors and managers sometimes compete for influence. As explained above, they may have different preferences about programmatic priorities and the timing of the charity's spending.[86] In addition, donors and managers monitor each other to deter self-interested behavior.

There is a parallel dynamic among grant-making charities. A donor who makes a gift to a private foundation, and hires a manager to manage the foundation's work, has to monitor the manager. Depending on the context, the donor probably has more direct ways to control the manager, who effectively is the donor's employee. But if the donor does not remain personally involved in the foundation, the manager may prioritize her own preferences over those of the donor.

To sum up, subsidies can alter the balance of power among key decisionmakers: The exemption for endowment income strengthens the hand of professional managers in ways that the charitable deduction does not.

4. *Caveat: Addressing Governance Issues in Other Ways*

This Part has identified governance costs of the exemption. Changing the tax law is one way to address this issue, but it is not the only way. Changes in nonprofit law, the governing documents of nonprofits, and gift agreements could give other players more authority and motivation to police these issues, including nonprofit boards, the state attorney general, the IRS, courts, and others. Some of these adjustments could preserve the overall approach described here—in which private individuals play the leading role in these choices—while others would involve government institutions to a greater extent. Nevertheless, since this Article focuses on the tax law, an exploration of other options is beyond this Article's scope.

V. Timing of Charitable Activities

The last Part showed that governance problems arise when a donor is taxed on investment returns, but a charity is not. This differential encourages donors to give endowment gifts, instead of spendable gifts. Yet once operating charities gain control of assets, donors cannot redirect them, and thus cannot monitor management as effectively or reevaluate the cause when conditions change. Likewise, donors who give to private foundations and donor-advised funds face added costs,

[86] See Subsection II.B.2.

as well as the potential for agency costs involving the managers of these grant-making vehicles.

Although the exemption imposes these governance costs, it offers an offsetting advantage, which is considered in this Part: When charities decide whether to spend on current initiatives or save for future ones, the tax law does not distort this choice. Although other commentators favor a bias toward current spending,[87] an even-handed posture has three advantages, which are analyzed in turn. First, charities sometimes have good reasons to save. Second, nonprofit managers may have a bias toward current spending, which the tax law should not reinforce. (Notably, other commentators attribute the opposite bias to managers.[88]) Third, taxing a charity's endowment, but not its operations, would distort its investment choices.

Ultimately, these advantages have to be balanced against the governance issues discussed above. In my view, these advantages are not sufficient to outweigh the governance problems. Nevertheless, this Part shows why repealing or scaling back the exemption is not a cost-free choice.

A. Incentive of Charities to Save

While prior Parts have focused on how the exemption affects the time preferences of donors—favoring endowment gifts over spendable gifts, as noted above—the exemption also influences the time preferences of charities.

Like any taxpayer, a charity's motivation to save is affected by a tax on investment returns. There is both an income and a substitution effect, which cut in opposite directions. On one hand, if charities have to accumulate a particular amount—for instance, to buy a building—they have to save more to reach this target. On the other hand, since a tax on endowment returns increases the cost of saving—but not the cost of spending now—it favors current activities over future ones. Exempting endowment returns from tax eliminates these distortions.[89]

Do we want the tax law to influence whether charities spend or save? If a charity's current activities are inherently more valuable than its future ones, this would be a reason to discourage saving, and

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[87] Galle, note 9, at 1159 ("future charitable spending is likely to be less valuable because the growing philanthropic sector will have to turn to lower priority projects"); Halperin, note 19, at 20 ("Because the trade-off between current and future spending is obviously both complex and fact-specific, it is perhaps best left to the organization to determine. However, as explained next, there are factors that suggest that endowments may exceed optimal amounts.").

[88] See note 19.

[89] Halperin, note 9, at 309 ("an exemption for investment income may be necessary to make the charity neutral . . . as between current and future spending.").

thus to tax endowment returns. But if charities sometimes have good reasons to save, a tax bias discouraging this choice is potentially costly. This Section canvasses four justifications for charities to save.

1. Future Cash Flow Will Be Volatile

First, a charity's future revenue can be volatile. For instance, operating revenue and donations usually decline in economic downturns. This is especially problematic if, at the same time, the charity's mission becomes more important, as when a soup kitchen has more people to feed during a recession. To plan for this contingency, the soup kitchen should set money aside.

Yet a familiar challenge in relying on savings is that endowments tend to decline when they are needed the most. As Halperin has emphasized, universities faced this challenge in 2008, when spendable donations and endowment values plummeted at the same time.[90] Even so, the answer is not to write off saving as a solution, but to save more intelligently. For instance, one option is to reduce the riskiness of the charity's portfolio. Another is to spend less endowment income in good times, and to spend correspondingly more income (and even principal) in bad times.

2. Future Charitable Initiatives Will Be More Effective

Charities also should save if their work will be more effective in the future. They may need to wait for better technology. For instance, significant money has been raised to treat ALS ("Lou Gehrig's Disease"). At the moment, only one drug has been approved by the FDA, which is expensive but not very effective.[91] Instead of distributing this drug, a charity arguably should fund research, while maintaining a reserve to distribute a better drug, once it is developed.

In some cases, moreover, immediate action is less effective than a multi-year effort. For instance, assume an elementary school receives funding to offer a one-semester course to all its students, but the subject requires a minimum level of maturity, such as genocide studies or sex education. Obviously, one option is to give the course now to all students, regardless of their age. But if younger students will benefit

[90] Halperin, note 19, at 25 (2011) ("a larger endowment in relation to the level of spending surprisingly made the institution more vulnerable").

[91] S. Zoccolella, E. Beghi, G. Palagano, A. Fraddosio, V. Guerra, V. Samarelli, V. Lepore, I.L. Simone, P. Lamberti, L. Serlenga, G. Logroscino, Riluzole and Amyotrophic Lateral Sclerosis Survival: A Population-Based Study in Southern Italy, 14 Eur. J. Neurol. 262 (2007) (noting that Riluzole is only treatment for ALS but its efficacy is unclear).

more from the course when they are older, the school should set money aside to offer it to them later.

Of course, this trade-off between present and future activities is less stark if current work makes future efforts easier or more successful. For example, curtailing carbon emissions now can ease climate costs later. Yet although these "prepayment" discounts can be important, they are not universal. For instance, how does providing hospice care or meals in soup kitchens today help terminally ill or poor people in the future? Some commentators suggest that charities always learn from experience, so their work today inherently leads to better results in the future.[92] Yet this seems overly optimistic. In any event, charities are aware of these benefits of learning. They should not need a tax preference to account for them.

3. *Future Harms Will Be More Serious*

Saving is appealing not only if a charity's future work will be more effective, but also if it will be more necessary. This is especially true when the demand for a charity's services correlates with macroeconomic cycles, as with a soup kitchen.

The other side of the coin is that charities should save less if they expect fundraising to become easier or social problems to become less severe. Because some commentators believe economic growth and technological advances will make future generations better off, they would repeal the exemption in order to favor current charitable activities over future ones.[93]

Yet although social conditions might well improve, there is no guarantee. The last two centuries are an encouraging precedent, but growth rates have been zero or negative for much of human history.[94] A number of looming challenges, such as climate change, nuclear proliferation, and exploding fiscal deficits, could make the future more challenging than the recent past. Given this uncertainty, charities are likely to make somewhat different predictions about the future, and to adjust them over time. In my view, it is not obvious why a tax thumb on the scale would improve these choices.

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92 Galle, note 9, at 1160 ("Foundation advocates claim repeatedly that foundations are almost unique in society in their power to use their grant-making ability to experiment, measure outcomes, and derive lessons for the future. If so, though, delays in grant-making also deny the world the opportunity to benefit from those lessons.").

93 See, e.g., id. ("future generations could be wealthier than ours, on average. That implies that, if anything, we should borrow money from the future and spend it today.").

94 Panagiotis Limnios, When Did Medieval Europe's Economy and Standard of Living Catch Up with What It Was During the Roman Empire?, Quora (Aug. 21, 2013), https://www.quora.com/When-did-Medieval-Europes-economy-and-standard-of-living-catch-up-with-what-it-was-during-the-Roman-Empire.

4. *Financial Investment Today Finances More Charitable Spending Tomorrow*

Another reason to save is that, if charities earn a positive return, they can spend more tomorrow than they could today. But this argument proves too much. It suggests a charity should never spend, since saving will always allow it to spend more later.[95] In principle, this argument applies equally to individuals, but we do not consider their current consumption to be inherently inferior to future consumption. In both contexts, the flaw in this argument is that spending generates current benefits, which are deferred when spending is delayed.[96]

By saving, charities give up a social return (the benefits of current spending) to earn a financial return (income on the endowment). These returns should be compared.[97] Saving is better if the financial return exceeds the social return, but spending is better if the opposite is true. This analysis simply brings us back to the issues discussed above, including whether future spending will be more effective or more urgently needed.

B. *Biases of Self-Interested Managers*

To sum up, the last Section rejected one rationale for taxing endowment returns: The idea that current activities are inherently more worthwhile than future ones. This Section considers a different rationale, which Halperin has offered: If nonprofit managers are biased in favor of future activities, the tax law should counter this bias by favoring current ones.[98] While this Section considers reasons why self-interested managers might favor future spending, as Halperin suggests, the opposite bias is also plausible: Self-interested managers may prefer to spend while they run the nonprofit, instead of conserving resources for successors.

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[95] Michael Klausner, When Time Isn't Money: Foundation Payouts and the Time Value of Money, 41 Exempt Org. Tax Rev. 421 (2003); Halperin, note 19, at 20 ("There would always be more resources tomorrow. Obviously, this makes no sense.").

[96] Halperin, note 19, at 21 ("In some cases, current spending can have a future benefit greater than the return on a financial investment").

[97] Galle, note 9, at 1158 ("foundations' decisions to restrict their spending should be measured against the lost opportunities this decision presents. Doing otherwise would cheat future generations as much as it would cheat present-day taxpayers.")

[98] Halperin, note 9, at 280 ("it is likely that trustees, donors, and key employees have a bias in favor of accumulating funds, as opposed to current spending, which does not necessarily reflect the interest of the institution, let alone the public").

1. *Appeal of Endowments to Managers and Other Key Constituents*

Since this Section focuses on agency costs, the question is whether endowments or spendable gifts are more likely to advance managers' personal interests. Endowments offer four advantages. First, they can enhance job security by giving managers permanent funding for their salaries.

Second, endowments shield managers from pressure to accommodate donors and allow them to spend less time raising money. Compared with spendable gifts, endowments give donors less ability to monitor management, as emphasized above. While weaker monitoring is bad for society, it obviously is appealing to self-interested managers.

Third, managers can use endowment restrictions to constrain successors. A leader of a nonprofit who especially values a particular initiative can ask donors to support it with restricted endowments. The restrictions will prevent a successor with different priorities from redirecting this money, assuring at least some permanent funding for the initiative.

Finally, managers (and the nonprofit's board) may regard the endowment's size as a measure of their effectiveness. To enhance their reputations, they may channel money into endowment, even if spendable gifts would otherwise be better.[99]

2. *Appeal of Spendable Money to Managers and Other Key Constituents*

On the other side of the ledger, a self-interested manager has an important reason to prefer spendable gifts: In the near-term, these gifts expand the budget much more than endowment gifts. Admittedly, a $1 million endowment gift has the same present value as a $1 million spendable gift, as long as the endowment is invested at a market rate. Yet the spendable gift allows a manager to spend $1 million right away. In contrast, a $1 million endowment gift increases the budget by only $50,000 each year, assuming a 5% distribution rule. Therefore, the spendable gift permits twenty times as much spending in the first year. Even if the manager remains in office for ten years, and thus can spend endowment income for ten years, the gap still is wide.[100]

[99] Galle, note 9, at 1163 ("Studies report that foundation managers are often motivated in significant part by the amount of the assets under their control, rather than by what those assets can accomplish—a classic example of 'empire building.'")

[100] Spending $50,000 per year for ten years consumes $500,000. Since $450,000 of this money is spent after the first year, the present value is lower, making the gap even wider.

This timing difference matters because self-interested managers may well prefer to spend money on their watch, instead of leaving it for successors. A manager may expect her personal reputation to be enhanced more by her own initiatives than by her successors' accomplishments. In addition, a manager also does not know if her successors will share her priorities; as a result, she may worry that money she leaves for them could fund initiatives she does not favor. Spendable gifts also can enable a manager to avoid trade-offs between competing priorities, work less hard, earn higher pay, and be more generous with colleagues.

This is not to say that self-interested managers always want to spend everything now. One constraint is that they do not want to be remembered as spendthrifts who burdened their successors with unsound finances. Even so, self-interested managers may discount this reputational cost, if only because it is deferred until they retire or leave for another job, and thus has less impact on them. This sort of discounting is familiar in other settings. For example, some Wall Street traders inflate their bonuses with questionable transactions, knowing the reputational costs will not arise until after they leave. Likewise, political leaders often prefer lower taxes and more spending now, funded with higher taxes and less spending after they leave office.

Of course, even if self-interested managers are not worried about their future reputations, they still have other reasons to prefer endowment in some cases, as noted above. They also may not know exactly how long their tenure will be. If their term ends unexpectedly, they may leave a larger surplus for their successor than they intended.[101] Managers also would certainly rather work at an organization that already has a large endowment. Their life is easier in many ways, as noted above. But even though managers are always happy to inherit a large endowment from predecessors, they have less reason to build the endowment themselves.

At the same time, other stakeholders could have different biases. For instance, the board is responsible for the long-term viability of a nonprofit. Through spending rules, scrutiny of budgets, and other forms of oversight, they are supposed to reign in managers who focus excessively on the near term. While this is an important role, trustees may have self-interested reasons to pursue it too zealously, since they worry about reputational costs of failing at this mission. Agency costs, then, can cause trustees to favor the future over the present.

Donors also influence the timing of gifts, and their self-interest can point in different directions. On one hand, spendable gifts enhance

[101] In a sense, this is analogous to bequests motivated by "precautionary saving."

their continuing influence, as noted above, and also offer immediate impact. On the other hand, endowment gifts are permanent, and thus offer more lasting impact and recognition. Heterogeneous donors are likely to weigh these effects differently, so it is hard to generalize about whether donor self-interest favors current spending or endowment.

Given these competing dynamics, there is no universal answer to the question of whether self-interested managers prefer endowments or spendable gifts. Depending on the context, they could have reason to favor one or the other. Therefore, although some commentators believe there is an agency cost bias for endowments[102]—and would repeal the exemption as a response—this claim is unsatisfying. At least some of the time, agency costs can push managers to spend now, instead of saving. In these circumstances, taxing endowment returns reinforces this bias, instead of countering it.

C. Distorted Investment Choices

So far, this Part has analyzed two potential advantages of exempting endowment returns: First a charity's choices about whether to spend or save are not distorted; and second, the biases of self-interested managers to spend on their watch are not reinforced. A third is that a charity's choices about how to invest capital are not distorted.

1. Investment Distortions

If operating charities were taxed on investment income, they would begin making tax-motivated investment choices, just as taxable investors do. For example, charities would be "locked in" to appreciated assets. If they were taxed on investment income, but not operating income, they would game this distinction. For instance, by prepaying expenses, they would earn a return that is economically equivalent to interest income, but is classified as tax-free income from operations.[103]

For similar reasons, charities would prefer to invest in assets used in their mission (which generate tax-free income), instead of passive investments (which would not). For instance, a charity that receives a $10 million donation would be better off acquiring a building to house its operations, instead of an endowment to fund future expenses. No-

[102] See, e.g., Halperin, note 18, at 125; Galle, note 9, at 1159.

[103] For example, a nonprofit might receive a discount for prepaying rent. Instead of paying $105,000 of rent next year, they might be able to pay only $100,000 now. This $5,000 discount is akin to interest. Yet absent a special rule, this discount would inflate their (tax-free) operating income. As a result, the charity would not pay tax on this "disguised" interest, even if it has to pay tax on its endowment income.

tably, the charitable deduction (on its own) does not favor one of these choices over the other. After all, donors receive the same deduction, whether their gift finances a building or a portfolio.

At first blush, the preference for business assets might seem justified in encouraging charities to use capital to pursue their mission.[104] But the resulting inconsistencies are hard to justify. For instance, why should a charity that owns office space pay less tax than one that uses endowment income to rent space? Likewise, should a school that invests capital in laboratory equipment have a tax advantage over one that uses endowment income to fund faculty salaries?

2. *Fixing Investment Distortions: Should Nonprofits Be a Priority?*

While a tax on endowment returns can distort investment choices, this is true of any tax on investments. One way to eliminate these distortions is to stop taxing investment returns across the board. Notably, this step would eliminate the governance concerns discussed above: If donors also can earn tax-free returns, there no longer is a tax reason to contribute an endowment. Donors can invest on their own, donating the return, and thus can redirect giving if the charity underperforms.

But if we fix investment distortions for only a subset of taxpayers, it is not clear why operating charities should be singled out for this privilege. If the goal is to promote more efficient capital allocation, they are not an obvious place to start, since their institutional missions have little to do with investing. Effective investors are more likely to work at hedge funds and investment banks than at museums and soup kitchens. Admittedly, some operating charities are extremely sophisticated investors (such as university endowments), but they are outliers. Indeed, they possess this expertise in part because of the tax preference for endowment gifts, which has helped them to accumulate endowments that are large enough to justify hiring a team of in-house managers. Setting these outliers aside, most operating charities have no special skill at investing, so empowering them—instead of other taxpayers—to make distortion-free investments is not an obvious way to promote better capital allocation.

[104] For example, Halperin notes that active investments are especially worthy of a subsidy, since they cannot be funded with the equity capital that would be available to for-profit firms. Halperin, note 9, at 285 ("the exemption for [income from related goods and services] is special only when it is used for capital expenditures, which suggests a very direct correlation between Hansmann's justification for the exemption and its actual impact"); Henry Hansmann, The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation, 91 Yale L.J. 54, 72 (1981) (arguing that tax exemption is compensation for capital constraints).

VI. Double Utility, Distribution, and Deadweight Loss

To sum up, this Article has highlighted three problems with subsidizing endowment returns, which do not arise in subsidizing donations. First, investible surpluses are less reliable evidence of a charity's social value than donations. Second, by encouraging donors to front-load their giving to operating charities, subsidies for investment income complicate donors' ability to update philanthropic choices and monitor management; likewise, donors who give endowments to private foundations and donor-advised funds can face parallel issues, including agency costs, administrative costs, and extra tax burdens. Third, and relatedly, front-loaded contributions often are accompanied by unwieldy or stale conditions.

While these are persuasive reasons to limit the exemption, this step would not be cost-free. As Part V showed, the exemption keeps the tax law from interfering with a charity's choices about whether to spend or save, and about how to invest their capital. In my view, the overall assessment of the exemption—and how it compares with subsidies for donations—requires us to weigh these competing effects.

But are there other reasons to favor subsidies for donations instead of endowment returns, or vice versa? Is one more likely to generate satisfaction for donors? Is one more effective at pursuing distributional goals? Do these subsidies have different effects on labor choices? Does one involve more administrative costs? This Part briefly canvasses these issues and concludes that these factors do not favor one type of subsidy over the other.

A. Double Utility

So far, the analysis has focused on how charitable dollars are spent. A different issue, which is the focus of this Section, is how these dollars are raised. As Louis Kaplow has observed, a distinctive feature of charity is that it can enhance the welfare not only of the beneficiary, but also of the donor, who finds satisfaction in making a gift.[105] In other words, charity can offer "double utility."

Is the deduction more likely to generate this "double utility" than the exemption? Arguably it is, since the donor is more immediately involved in triggering the subsidy, and thus can derive satisfaction in doing so. But the exemption offers an analogous benefit, so the two subsidies are not especially different in this regard.

105 Louis Kaplow, A Note on Subsidizing Gifts, 58 J. Pub. Econ. 469, 469 (1995).

1. *Externalities from Gifts*

Since charity is voluntary, donors make contributions because they want to do so. This choice shows that these gifts enhance their welfare too.

Charity offers an additional advantage when donors are wealthier than beneficiaries: Resources flow to people who need them more.[106] Obviously, some charities induce more voluntary redistribution than others. For example, a soup kitchen is stronger on this dimension than a symphony.

Yet these advantages of charity are likely to be undersupplied. In deciding how much to give, donors focus on their own welfare, undercounting the beneficiaries' welfare.[107] As Kaplow has observed, the benefit to the beneficiary is a positive externality, which can justify a subsidy.[108] Since the marginal subsidy is supposed to equal the marginal positive externality, the subsidy generally should equal the benefit to the beneficiary.

2. *Double Utility: Contributions Versus Investment Income*

Charities obviously can be funded in various ways. Are some sources more likely to generate "double utility"? Do gifts and endowment income differ on this dimension? If one is more likely to offer this advantage, subsidizing it becomes correspondingly more appealing.

To assess the likelihood of a "double utility" advantage, the first question is whether beneficiaries are likely to care if charity comes from gifts or endowment income. It is possible to imagine reasons why this could matter to them. For instance, if donations are more likely to be spent effectively, as argued above, beneficiaries should prefer this funding source. They may also be concerned if they consider the funding source disreputable or morally compromising, although this issue can arise with either donations or endowment

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[106] Louis Kaplow, The Theory of Taxation and Public Economics 256 (2008) (describing charity as "voluntary redistribution").

[107] For example, assume a \$100 gift would give a donor satisfaction worth \$80, while giving beneficiaries \$100 of value. Even though the social gain from this expenditure (\$180) exceeds the cost (\$100), the donor will not spend this \$100 if she focuses solely on her own welfare (\$80) and does not account for the beneficiary (\$100).

[108] Kaplow, note 106, at 253-54.

income.[109] Aside from these issues, though, the source of a charity's funding seems unlikely to loom large for beneficiaries.[110]

From the funder's perspective, though, charitable contributions and endowment income could well be different. In at least some cases, contributions could provide a somewhat greater double utility advantage. This advantage depends on the donor's motive in supporting charity, and also on the information donors have about how their gifts have been invested.

a. Altruistic Donors

For some donors, there should not be a difference. Their sole motive is for beneficiaries to receive support. These altruistic donors do not care whether this support comes from them personally. Money from other donors or the government is just as good. Since the source of funding is irrelevant to altruistic donors, they do not care whether a charity is funded with spendable gifts or endowment income.

b. Warm Glow Donors

In contrast, other donors do care whether the money comes from them personally. They derive particular satisfaction, which the literature calls "warm glow," from being the source. For donors to experience warm glow, two conditions presumably have to be satisfied: First, they have to be the source of the money; second, they have to know this is the case. For contributions of spendable money, this is straightforward. Donors usually are aware of the contributions they make.

For endowment income, however, these conditions are not always met. A charity that does not receive any gifts—and is funded solely with operating revenue—can still run a surplus. Any income earned from investing this surplus cannot be traced to a donor. As a result, no one experiences warm glow.

Alternatively, if this charity also receives spendable gifts, these gifts can contribute to the surplus, and thus can generate endowment in-

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[109] For instance, universities have committees to consider whether a donor meets their reputational standard. In addition, some members of university communities oppose investing the endowment in particular sectors or countries. For some, these divestment movements are an effort to influence the targeted industry or nation. But for others, they also can be an effort to distance the university from investments they consider morally problematic.

[110] For this reason, they will prefer charitable services to be funded by gifts or endowment income, instead of by operating revenue. For instance, students obviously favor lower tuition, with the gap filled by philanthropic support. But whether the philanthropy comes from spendable gifts or past endowment gifts is of less interest to them.

come. But will the donors who gave these gifts know that their giving helped generate this endowment income? What if the charity does not tell them? Without information connecting their gifts to endowment income, donors do not know they are the source. Unlike gifts themselves, then, income earned from gifts has a more attenuated connection to donors.

In some cases, donors might assume they are the source, even if they were never told that this was the case. In other cases, their connection to investment income is quite clear. For instance, donors who give endowment gifts can experience warm glow not only from the cash contributed, but also from the income this cash is expected to generate. Even if projected returns do not generate warm glow, actual returns can do so, for instance, if the charity periodically updates donors about the endowment's investment performance, as well as the way the income was used. These reports are common among well-run charities. Since the endowment is permanent, the donor's warm glow can be refreshed in this way every year.[111]

In analyzing whether donations or endowment income is more likely to generate warm glow, the assumption here is that warm glow should be encouraged. Yet some commentators consider warm glow too speculative to influence policy choices. They worry that donors do not always enjoy giving. For instance, if someone does not want to give, but feels awkward about saying "no," giving is merely the lesser of two evils.[112]

Yet this concern is overstated. Many donors obviously do enjoy giving. Those who do not can say "no" in ways that minimize awkwardness.[113] Moreover, even when charity is given to avoid negative feelings, it is not unique. Some consumers buy expensive cars and homes to "keep up with the Joneses." They do not want them, but are avoiding the stigma of not having them. Since these choices usually

[111] The social benefit from warm glow is greater if donors feel warm glow not only for money they personally give, but also for government "matching money" triggered by their gift. For instance, if a taxpayer in the 37% tax bracket gives $10,000 to charity, $3700 comes from the government (in the form of a reduced tax bill). It seems plausible that donors would take satisfaction not only in the portion they personally finance, but also in additional resources brought along with their gift.

[112] Andreoni, note 28, at 26 ("Although you cringe when they [fundraisers] approach, you give because saying no would be even more painful than saying yes. Hence, giving has a marginally positive effect on your utility—but it was "the ask" that lowered it in the first place."); see also Peter Diamond, Optimal Tax Treatment of Private Contributions for Public Goods with and Without Warm Glow Preferences, 90 J. Pub Econ. 897, 909, 917 (2006).

[113] For example, donors can express appreciation for the cause, as well as regret that other commitments keep them from supporting it.

are regarded as enhancing welfare, and thus are considered relevant in policy analysis, the same standard should apply to charity.[114]

In any event, the bottom line is that endowment income is sometimes a source of satisfaction to warm glow donors, but not always. As a result, endowment income may be somewhat less effective than contributions at promoting double utility. This difference is another reason to focus subsidies on contributions, instead of endowment income. But the magnitude of this advantage is hard to assess and may well be modest. As a result, this consideration is substantially less important than the governance issues discussed above.

B. Distribution

A familiar advantage of charity, noted above, is voluntary redistribution from wealthy donors to needy beneficiaries. Subsidies can enhance welfare by encouraging this redistribution. Are subsidies for donations more likely to promote redistribution than subsidies for endowment income? The answer is not clear.

1. Type of Charity

Four variables affect the distributional impact of charitable subsidies. The first is the mission of the subsidized charity. Charities with needier beneficiaries are more likely to advance distributional goals. On this dimension, soup kitchens are better than orchestras.

Are charities with endowments systematically more (or less) likely to have needy beneficiaries? Most charities do not have significant endowments,[115] and there is no obvious pattern among those that do. Some are quite likely to help low-income beneficiaries (such as hospitals, the Gates Foundation, and the Red Cross), while others are not (such as cultural institutions), and some have a blended mission (such as universities, which fund both financial aid and research). Therefore, it is hard to generalize.[116]

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114 Donors can be motivated not only by altruism and warm glow, but also by more tangible benefits. Some seek recognition, an enhanced reputation, access to the charity's managers or other donors, or other "exchange" benefits. In contributing either spendable money or endowments, donors can negotiate for exchange benefits.

115 Andreoni, note 28, at 3.

116 Endowments can affect distribution in a different sense. Charities with large endowments are likely to outcompete other charities. For example, some critics argue that this inequality can lead to overconcentration of talent in a small number of universities. Jonathan R. Cole, The Great American University: Its Rise to Preeminence, Its Indispensable National Role, Why It Must Be Protected 486 (2009) ("too much of a good thing").

2. *Economic Incidence*

A second variable affecting the distributional impact of charitable subsidies is its economic incidence. Are charitable subsidies helping beneficiaries or other stakeholders? For example, if a soup kitchen uses extra resources to pay higher salaries, employees benefit more than beneficiaries.[117] As a result, agency costs can divert charities from their redistributive missions. As noted above, subsidies for donations can piggyback on donor monitoring more effectively than subsidies for endowment income. As a result, they may be somewhat less likely to be diverted, but the magnitude of this distributional advantage is hard to assess.

3. *Donor's Income*

Third, the degree of redistribution from charity (and thus from the charitable subsidies that encourage it) depends not only on the beneficiary, but also on the donor. For instance, when very poor people help moderately poor people, the redistribution cuts the wrong way. At the same time, when extremely wealthy donors help upper middle-income beneficiaries, distributional goals are advanced, at least to an extent. To make a reliable judgment about the distributional impact of charity, then, we need to know the source of the funds.

Does endowment income tend to come from wealthier people than donations? Once again, a generalization on this issue is not easy. On one hand, donors who give endowments are likely to be wealthier, on average, than donors who give spendable money. On the other hand, endowments—and thus endowment income—do not come only from endowment gifts. They also can come from an operating surplus. If this is the case, the surplus's source is hard to ascertain, since money is fungible. We know revenue exceeded costs. But if some revenue came from wealthy people, and some did not, how do we know which revenue was invested, and which was spent?

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[117] Likewise, if a subsidy allows a donor to reduce her giving (for example, because she can use the subsidy to get to her "target" contribution), the donor, rather than the beneficiary, is helped by the subsidy. Yet the evidence suggests that subsidies do not usually "crowd out" giving in this way. See, e.g., Julia Bredtman, Does Government Spending Crowd Out Voluntary Labor and Donations?, IZA World of Labor 1 (Sept. 2016), https://wol.iza.org/uploads/articles/299/pdfs/does-government-spending-crowd-out-voluntary-labor-and-donations.pdf ("The empirical evidence investigating whether public spending crowds out private charitable donations is mixed. A number of studies find significant but small crowding-out effects, while others find no effects or even evidence of a crowding-in effect."); James Andreoni, An Experimental Test of the Public Goods Crowding Out Hypothesis, 83 Am. Econ. Rev. 1317 (1993) (experimental test showing that crowding out is incomplete).

4. *Benefits to Donor*

Fourth, in assessing the distributional impact of charity (and charitable subsidies), we should consider the benefits not only to beneficiaries, but also to donors. For example, donors experience warm glow, and also use subsidies to reduce their tax bill. Indeed, the government's distributional analysis of the charitable deduction focuses on who claims it, rather than on who benefits from charitable work that is funded. This focus is unsatisfying, since it misses the main goal of the charitable subsidy, which is to help beneficiaries. But even so, distribution of the tax benefit is part of the picture.

On this dimension, the subsidy for donations under current law does not fare especially well. The charitable deduction is upside down in familiar ways. It is available only to itemizers, is more valuable in high tax brackets, and is especially generous for appreciated securities. Yet these upside down features are not inherent in a subsidy for donations, which could be structured as a credit instead.[118]

To sum up, charitable subsidies are likely to advance distributional goals, but the magnitude of this advantage depends on the type of charity that is subsidized, the incidence of the subsidy, and the source of the charity's funds. On these dimensions, subsidizing donations does not have an obvious distributional advantage over subsidizing endowment returns, and vice versa.

Even if there are differences, we presumably can address them with offsetting adjustments in the tax and transfer system.[119] Therefore, although distribution is part of the case for charitable subsidies, it does not loom large in the comparison between the exemption and deduction.

C. *Deadweight Loss*

In deciding whether to subsidize donations or endowment returns, we should also ask whether one type of subsidy creates less deadweight loss than the other. As with distribution, there is no clear winner on this issue.

1. *Labor and Savings Effects*

In principle, either subsidy can alleviate labor or savings distortions. For example, exempting endowment income mitigates distortions in a charity's investment choices, as noted above.

118 See Schizer, note 10.

119 Kaplow, note 106, at 247 n.40 (discussing distribution-neutral income tax adjustments).

In a somewhat different way, the charitable deduction also can ease labor and savings distortions. For example, taxpayers who donate their last dollars of earnings to charity pay no tax on these earnings, and thus have reason to work and save more.[120] Likewise, taxpayers who contribute their first dollars to charity also have added motivation to work or save, but for a different reason. Their contributions leave them with less money, so they work or save more to fund more consumption.[121]

The other side of the coin, though, is that subsidies are funded with higher taxes, which discourage work and saving.[122] The net of these various effects determines labor and savings distortions. As Kaplow has shown, if a subsidy is implemented in a distribution-neutral way—so its distributional effects are offset, on average, by adjustments in tax rates—the distortions do not change.[123]

For instance, consider the treatment of a taxpayer who gives 1% of her income to charity under two different regimes. In the first, the gift to charity is not deductible and the tax rate is 36.63%. If she earns $1000 and makes a nondeductible $10 gift to charity, she pays $366.30 in tax and has $633.70 for consumption (including $10 for charity).

In the second regime, the gift to charity is deductible, and the rate is increased to 37% to fund this subsidy. As the table below shows, the result is the same. With $1000 of income, she contributes $10 to charity. But since this contribution is deductible, she has only $990 in taxable income, which is taxed at 37%. So once again, her tax bill is $366.30 and she has $633.70 for consumption (including $10 for charity).[124]

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[120] Diamond, note 112, at 900 (noting that higher income workers in his model "are willing to undertake a more arduous job because of the increase in the public good that they perceive from the higher contribution they make when holding a higher paying job. That is, if the workers care enough about the public good it is not necessary to give higher consumption in order to induce employment at a more difficult job").

[121] Kaplow, note 106, at 255 n.13. Note that the dynamic is somewhat different if people give to charity because they derive unusually little marginal benefit from consumption.

[122] Id.

[123] Id. ("A subsidy on [charitable contributions] would be accompanied by an increase in marginal labor income tax rates, which has the effect of raising the net cost of earning income to spend on [charity] that just offsets the extent to which expenditures on [charity] have a higher marginal utility than before.")

[124] A similar analysis applies to the exemption for endowment returns. It allows donors to support charities more cost-effectively by giving endowment gifts, instead of spendable gifts, as noted above. This possibility might encourage a donor to save or work more, since marginal earnings yield a greater benefit (that is, more income for the charity). But to fund the subsidy, the tax rate needs to be higher. If the package is distribution-neutral, the labor and savings effects for donors (on average) should not change.

TABLE 1

Regime	*Gross Income*	*Charitable Contribution*	*Taxable Income*	*Tax Rate*	*Tax*	*Consumption By Taxpayer*
No Deduction	$1000	$10	$1000	36.63%	$366.30	$623.70
Deduction	$1000	$10	$990	37%	$366.30	$623.70

Of course, these regimes are no longer equivalent for taxpayers whose charitable giving is either more or less than average. For taxpayers who give nothing to charity, the regime with a charitable deduction is less favorable; the deduction does not help them, while the rate is higher.[125] In contrast, for taxpayers who give extra charity, this regime is more favorable, since the deduction more than offsets the higher rate.[126]

Although a distribution-neutral charitable subsidy should not affect labor and savings choices of donors, it can influence beneficiaries. For instance, if a charity funds some of a beneficiary's consumption, she has less incentive to work and save.[127] On the other hand, if a charity enhances a beneficiary's human capital (for example, by funding her education), she may respond by working more.[128] These effects arise because beneficiaries receive more resources. Yet the source of these resources—and, in particular, whether they come from donations or endowment income—should not matter. On this dimension, subsidies for donations and endowment returns have similar effects.

2. *Administrative and Fundraising Costs*

In comparing how these subsidies contribute to deadweight loss, we also should consider administrative costs. For each subsidy, the government has to craft and enforce rules, and taxpayers need to comply with them. In each case, lines need to be drawn. For instance, we have to distinguish between deductible charity and nondeductible private benefits, as well as between tax-exempt income and unrelated business taxable income. These line-drawing costs probably are comparable for both subsidies.

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125 For instance, this taxpayer pays $400 in tax on earning $1000, and has $600 for consumption. But if the rate were only 39.6%, and there was no charitable deduction, she would pay $396 and could consume $604.

126 For instance, consider a taxpayer who contributes 2% to charity. With a charitable deduction, this taxpayer is taxed on only $980 of her $1000 of earnings, and a 40% tax (of $392) leaves her with $588 to consume. Without the charitable deduction, she would pay $396 in tax, while giving $20 in charity, and thus would have only $584 to consume.

127 Kaplow, note 106, at 250.

128 Unsubsidized charity can have these effects, and a subsidy can magnify them by increasing the charity they receive.

Likewise, the underlying behavior also can generate administrative costs. For example, nonprofits hire fundraisers and investment advisors, and nonprofit managers invest time working with them. Again, it is not obvious that one of these subsidies generates more costs than the other.[129]

VII. Policy Implications

This Article has three main policy implications. First, although the deduction for charitable contributions and exemption of a charity's investment income use a similar approach, relying on private parties instead of government officials to allocate funds, they have very different effects.

Second, compared with the deduction, the exemption has an important weakness: By favoring endowment gifts over spendable gifts, it discourages donors to operating charities from redirecting their giving when needs change or management fails to deliver. While these costs are a reason to repeal or scale back the exemption, this solution creates a new problem: The saving and investment choices of charities are distorted.

Third, these distortions can be avoided by addressing the governance issues a different way: allowing donors to earn a tax-free return for charities on their own, without turning assets over to an operating charity. Yet this solution can exacerbate other problems, such as agency costs in private foundations.

A. The Deduction and Exemption: Siblings, But Not Twins

At first blush, the deduction and exemption appear to be quite similar. Each relies on private parties, instead of government officials, to choose which causes to support, monitor quality, and decide whether to spend money now or later. This limited role of government officials contrasts markedly with the way most federal dollars are spent.

Yet notwithstanding these similarities, this Article breaks new ground in showing that the deduction and exemption have quite different effects on the governance of nonprofits. Although both subsidies delegate decisions to private parties—notably, donors, the board, and professional managers—these tax rules affect the balance of power among these groups in different ways. The deduction strengthens the hand of donors (by authorizing them to choose which charities benefit from the subsidy), while the exemption increases the influence

[129] Indeed, there is considerable overlap. For instance, if the charitable deduction is repealed, the exemption would still motivate them to raise money for their endowment, and thus to maintain a fundraising infrastructure to do so.

of managers (by encouraging donors to turn over assets to them). By favoring endowment gifts over spendable gifts, the exemption reduces a donor's ability to monitor and influence managers after she has given her gift.

In addition, another difference between the deduction and exemption already is familiar: the effect on a nonprofit's decision to spend now or later. As other commentators have observed, the exemption eliminates the tax incentive a charity otherwise would have under an income tax to accelerate spending.[130] The exemption also spares charities from making tax-motivated investment decisions.

The bottom line, then, is that if Congress wishes to commit a particular share of its budget to this sort of nondiscretionary funding for charities—and there are good reasons for it to do so—the effects can vary significantly, depending on how much Congress allocates to the deduction, on one hand, and the exemption, on the other. This balance affects the relative influence of managers and donors, as well as the incentives of charities to save.

B. Repealing or Scaling Back the Exemption

The deduction has two advantages over the exemption, which suggest that scarce subsidy dollars should be focused on the deduction, instead of the exemption. First, the charitable deduction uses a more reliable measure of a charity's social value: the willingness of donors to commit their own money. In contrast, the exemption of endowment income uses a less dependable proxy: a surplus that is invested successfully. A surplus is not always a good sign, since managers may horde cash to protect their jobs, and skillful investing does not necessarily correlate with effectiveness at the charity's mission.

A second disadvantage of the exemption is that, unlike the deduction, it favors endowments over spendable gifts. While endowments are appropriate (and even essential) in some cases—for instance, to provide stability for a multi-year charitable initiative—endowments also have disadvantages, which suggest that the tax law should not put a thumb on the scale for them. Specifically, when donors turn assets over to an operating charity, they can no longer redirect these resources if the mission becomes less relevant or managers underperform. In addition, donors usually impose restrictions, which can become dated over time.

Obviously, Congress can eliminate this tax advantage by repealing the exemption. A charity's investment income can be taxed at the

[130] Halperin, note 18, at 125; Galle, note 9, at 1159.

same rate that governs donors.[131] This new tax would mitigate the governance distortions, described above, which arise from favoring endowments over spendable gifts.[132]

Yet even as taxing charities solves some problems, it creates others. Charities would begin making tax-motivated investment decisions. In addition, as other commentators have observed, they would have a tax incentive to spend currently, instead of saving.

In managing this trade-off, Congress does not face the binary choice of either repealing the exemption or preserving it in its current form. An intermediate option is to tax nonprofits at a reduced rate. For instance, if the rate on a donors' investments is 23.8%, a 10% rate for nonprofits could be a viable compromise, reducing (though not eliminating) the tax advantage of endowments, while having only a modest effect on a charity's saving and investment choices.[133] In setting this rate, Congress should consider the severity of the relevant distortion. For instance, if governance issues are a particular concern, the rate for nonprofits should be close to the rate for donors. But if distortions in charities' saving and investment decisions loom especially large, the rate should be closer to zero.

More generally, assuming we continue to use an income tax, the case for exempting endowment income is mixed at best. Allowing charities to make undistorted savings and investment choices is appealing, but favoring endowment gifts—and thus undercutting the ability of donors to monitor managers and reevaluate charities over time—raises concerns. On balance, there is a good argument for scaling back the exemption.

Finally, if Congress chooses to rely less on the exemption in subsidizing charity—and more on the deduction—it should address some of the deduction's familiar limitations under current law. For instance, since the deduction is more generous to taxpayers in high brackets, it could be replaced with a tax credit, which provides the

131 In 2018, use of the corporate rate, which is 21%, would not establish this parity with individuals, whose top rate is 37%.

132 Taxing nonprofits has another advantage as well. As I have argued elsewhere, this step could serve as a useful component of corporate tax reform. The tax on corporate profits is harder to collect from corporations than for shareholders because corporations can use an avoidance strategy—shifting profits abroad—that is not available to shareholders. One way to block this avoidance strategy is to tax shareholders, instead of corporations. But this solution is not available for nonprofit shareholders if the exemption spares them from tax. Repealing (or scaling back) the exemption would unblock this avenue to corporate tax reform. David M. Schizer, Between Scylla and Charybdis: Taxing Corporations or Shareholders (Or Both), 116 Colum. L. Rev. 1849 (2016).

133 In addition, Congress can look for ways of taxing nonprofits that minimize the distortions in their savings and investment decisions. For example, an up-front lump sum tax is less likely to affect how much the charity chooses to save or how it invests those savings. I am grateful to Brian Galle for this observation.

same government match to both low- and high-income donors. Likewise, a uniform tax benefit could be provided, regardless of whether a donor contributes cash or appreciated property. Since these and other limitations of the deduction are well understood, and I have considered them elsewhere,[134] this Article does not focus on them.

C. Extending Tax-Free Treatment to Donors

Instead of repealing or scaling back the deduction, there is another way to address this rule's governance costs. Since the goal is to conform the treatment of endowments and spendable gifts—or, at least to narrow the difference—there are two ways to do so. One is to increase the tax burden on endowment gifts, as discussed above. The other is to reduce the tax burden on spendable gifts.

To ease this burden, Congress could allow a donor to earn tax-free returns for charities on her own, so she would no longer have to turn over assets to operating charities in order to access this tax benefit. This would be the case, for instance, of Congress replaced the income tax with a consumption tax. After this fundamental reform, a donor would pay no tax on investment returns. Since donors and charities would be taxed the same way, endowment gifts would no longer be taxed more favorably than spendable gifts. As a result, donors would no longer have a tax motivation to give endowments and would do so only if they considered this the best way to support a charity.

Yet a consumption tax is a broader response than necessary to eliminate the tax advantage of endowments.[135] A narrower alternative is to preserve the tax on other investment returns, while allowing tax-free returns on investments committed to charity, even if taxpayers have not yet chosen which operating charity will receive these funds. In other words, once taxpayers contribute money to a vehicle that can fund only charities (or administrative expenses of supporting charities), investments in this vehicle would grow tax-free, and thus would be taxed as favorably as the endowment of an operating charity.

Private foundations and donor-advised funds are examples of this sort of vehicle under current law. But as noted above, they are not taxed as favorably as an operating charity's endowment. For instance, a private foundation's investments are subject to a modest tax, as well as to strict requirements about how much must be distributed. Contri-

[134] See generally Schizer, note 10.

[135] A consumption tax offers other advantages, which are beyond this Article's scope. See, e.g., Joseph Bankman & David A. Weisbach, The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax, 58 Stan. L. Rev. 1413 (2006).

butions to private foundations also are taxed less favorably than contributions to public charities.[136]

While donor-advised funds avoid these limits, since they ordinarily qualify as public charities, this benefit comes at a cost: Compared with a private foundation, a donor-advised fund is supposed to offer the donor less control over how funds are allocated. In theory, the donor is not a decisionmaker, and can offer only advice about which charities to support. As a practical matter, this understates the donor's role. But if donors play a more robust role than the tax law allows, they are assuming some tax risk. For instance, if these funds are treated as private foundations that do not satisfy the relevant tax rules, they could be subject to significant penalties.

To eliminate the tax advantage of endowments over spendable gifts, Congress could authorize donor-advised funds to allow donors explicitly to decide which charities receive the funds. Or alternatively, Congress could ease the onerous rules that currently apply to private foundations, so they are treated more like public charities.

In doing so, Congress would eliminate the tax advantage of endowment gifts to operating charities, since the tax treatment would be the same if donors instead contributed to foundations, and then decided every year which charities to support with their investment return. Some donors would prefer this approach, since it allows them the flexibility to redirect giving, while others would still give endowment gifts (for example, if they were persuaded that the operating charity needed the stability associated with permanent funding).

While this would be an improvement, two important caveats are in order. First, broadening the tax-free treatment of endowments in this way would have a revenue cost. As a result, the efficiency gains from doing so must be compared with the efficiency cost of making up this revenue with other taxes (for example, higher rates on wages or on other investments).

Second, although leveling the playing field between endowments and spendable gifts mitigates governance problems within operating charities, it can exacerbate them within private foundations or donor-advised funds. For example, if donors depend on professional managers or philanthropic advisors to allocate grants from their foundations, these professionals might seek to advance their own preferences and interests, instead of those of the donor. As a result, the governance issues might shift from operating charities to foundations. Again, there are no bulletproof solutions.

[136] See Subsection IV.A.2.

VIII. Conclusion

The deduction for charitable contributions and the exemption of endowment returns share a unique feature: Government officials apply very general criteria to determine whether charities are eligible, and do not decide how much each charity should receive. These nondiscretionary allocations safeguard the independence of nonprofits, encouraging them to experiment, compete, and advance causes that do not (yet) command widespread political support.

Although this independence has advantages, it has costs as well. How do we know public money is not being wasted? Is it going to worthwhile causes? Are nonprofits advancing these goals efficiently? Or are managers merely pursuing their own interests? There is a tension between giving nonprofits room to experiment, on one hand, and ensuring that they spend wisely, on the other.

This Article breaks new ground by showing that the deduction resolves this governance trade-off more successfully than the exemption for two reasons. First, the deduction uses a more reliable measure of a charity's social value: the willingness of donors to commit their own money, instead of the ability of a charity to generate a surplus. Second, the deduction empowers donors to monitor nonprofit managers, while the exemption sometimes undercuts this monitoring.

Therefore, if Congress is going to rely on private decisionmakers to choose which charities receive public support, the deduction is a better mechanism than the exemption. Yet eliminating the exemption is not cost-free, since it keeps the tax law from influencing whether charities should spend or save, and how they invest their capital. On balance, there is a good argument for either scaling back the exemption or for allowing donors to invest tax-free on their own in order to support charities.