

**TOWARDS AN IMPROVED ECONOMICS OF  
PHILANTHROPIC ENDEAVOR**

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## **The Philanthropic Enterprise**

The Philanthropic Enterprise seeks to improve understanding of the roles of voluntary action and philanthropy in a free society.

To this end, we engage scholars and philanthropic practitioners in exploring how voluntary action and philanthropy promote human excellence, prosperity, and social cooperation.

We believe that philanthropy and volunteerism—voluntary gift-making and social action not tied to any commercial interest, nor advancing any political agenda—are natural and essential forms of human interaction. We are committed to promoting a dynamic climate for philanthropy and social entrepreneurship, one which strikes a balance between funders’ perceived purposes and the necessity of fostering creative, individualized, and community-based responses to specific needs and circumstances.

Our goals include:

- advancing the state of interdisciplinary scholarship and conversation concerning philanthropic and voluntary action;
- exploring promising developments in philanthropic practice;
- articulating a compelling and cohesive rationale for philanthropic and voluntary action; and
- identifying tools and resources that can improve the effectiveness of giving.

The Philanthropic Enterprise Working Papers Series was established to provide a vehicle for disseminating current research on philanthropy and voluntary association. We will post completed Working Papers on our website, in addition to offering such for publication to appropriate academic and policy journals.

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Benjamin A. Rogge, the late economist, used to talk of “Rogge’s World”, that ideal arrangement of institutions which he would have established if he had been in charge (not that he would have agreed to be put in charge had he been asked). This was a sort of thought experiment he used to consider the implications of better social configurations from a free market perspective. Rogge, I think, was aware of how difficult and even dangerous it is to approach social reform in a constructivist mode because of unintended consequences and secondary effects. Institutions have been built up over long periods of time and countless individuals have made life choices on the basis of existing arrangements. For many, radical changes will bring unexpected and undesired difficulties that will not be obviously balanced by the improved institutional setting. Nevertheless, thought experiments into ideal worlds can demonstrate interesting possibilities and help guide more incremental change.

With this in mind, let us look into the institutional setting of tax exempt philanthropy with improvements in mind. Remember though this is a thought experiment into an ideal world. It is not a plea to increase taxes on non profits. Indeed, this writer believes that all of America is vastly over taxed. What is needed, however, at whatever level of taxation we settle on, is a new consideration of the effect of tax-exemption on the status of American philanthropy.

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The tax-exempt status of philanthropic organizations and other non profits sets them off from other institutions of the civil society, most notably businesses and families. From the point of view of the philanthropies this suggests that they have some superior status, (and too often a “do-gooder complex”) that separates them from the world of getting and spending which produces the wealth off of which they live, and endowed by law with lofty public purpose unsullied by crass materialism. This status in recent years has encouraged many philanthropies to identify closely with the actions of government, because government, whatever its real purposes, always boasts of its special devotion to serving the public good. Many philanthropic leaders now boast that the main purpose of their organizations is to develop a case for the further expansion of governmental programs. Yet as modern scholarship has shown, government on net is an insatiable consumer of personal wealth far beyond what its positive effects on the public good can possibly justify. Furthermore, government actions, more often than not, actually further explicit and identifiable private interests in opposition to the public good. This is one aspect of the problem of faction, famously discussed by Madison in the *Federalist Papers*.

This philanthropy/government alliance is unfortunate, for we should view our diverse non profit organizations as constituting just one aspect of the vast civil society, outside the realm of government, where work, savings, and private endeavor provide the great bulk of resources necessary for personal and social well being, and economic and cultural progress. It is civil society, not government that provides most of the heavy lifting that produces public good. From this perspective, government, when confined to its proper

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role, should be viewed as a limited purpose agent of the larger civil society, a true servant of the people, and not the dominant force in social life. When seen in this manner, tax exemption for private philanthropy helps sustain a false sense of separateness that distracts from a proper understanding of the true place of philanthropy in a free society.

Let us look at some other harmful aspects of the favored tax treatment of philanthropic enterprise.

Government views philanthropy with its growing wealth as a potential source of new tax funds. Politicians continually threaten philanthropy with new taxes and regulations unless the philanthropies conform to what the politicians believe to be socially useful projects. Congressional hearings and IRS investigations of philanthropic wealth and expenditure have happened in the past. Political demagogues will surely be tempted to turn again to such tactics one day. The possibility of such threats may encourage philanthropies to be unduly cautious in their programs and to be too complicit with governmental perspectives. Many philanthropies are governed more by unduly cautionary advice from their attorneys than by creative and bold thinking about how to carry out their philanthropic mission.

Philanthropies with their ability to buy and sell securities free of the capital gains tax and the income tax paid by individuals and for profit corporations are able to unfairly compete with private taxable endeavors. This is a growing problem as the business wings of non profits increasingly engage in commerce and the provision of social services,

widely conceived. A reader who buys a book from a non profit, a shopper who purchases holiday gifts from a museum catalog, or a family that attends a symphony concert has fewer resources in their budget to be deployed elsewhere. Non profits that provide social services, education, and consultation compete directly with private, for profit ventures.

The tax exempt status of philanthropies contributes to ill-considered philanthropic investments and institutional arrangements. For instance, a property owner who gives land or buildings to a historical preservation or conservation non profit only to avoid burdensome taxation takes valuable property out of productive enterprise and freezes in place the status quo at the cost of some economic benefit to the society at large. Family fortunes may be turned into hastily conceived foundations run by non family philanthropic professionals with purposes of their own. Minus tax-exempt status and death duties such largely irreversible decisions would be less attractive. These two problems, unfair competition and inflexible institutional arrangements, encourage both government officials and private individuals to view with suspicion the operations of many non profits.

A related question is the problem of perpetuities, a suspect category under common law. Times change, but non profits, in theory at least, can go on for ever. For profit corporations appear also to be immortal. But actually they can be bought and sold, merged with other corporations, go bankrupt, or distribute their assets to their shareholders. Subject to competitive pressures, in practice, no American for profit corporation has the life span of a Harvard University or a Philadelphia Symphony

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Orchestra. Again, without tax exempt status, a philanthropic minded individual might be willing to develop more flexible and less permanent institutional arrangements for his financial legacy.

But if one were to view philanthropies as part of the civil order, engaged in many of the same endeavors as private individuals and businesses, we begin to see that they are not as different from the for profit world and from private families as usually assumed.

Philanthropies as well as business provide jobs and social services (employment bureaus, credit counseling, retirement plans); purchase and sell goods; run medical care and research facilities (hospitals and laboratories) and provide cultural and environmental amenities (fine architecture, art collections, libraries, golf courses, and office parks). Both may charge fees for goods and services, though the non profit may give many of its services away without charge. On the other hand, for profit businesses donate many goods and services to worthy causes and persons, and contribute time and money to non profit entities. The non profit, like the heavily taxed family, may provide most of its goods free of charge, yet the family in the free society is by far the more important social service “agency”, providing most of our education, cultural upbringing, medical care, food, clothing and shelter. We usually think of these as private goods, and truly they are, but the successful delivery of such goods also has profound social implications for the overall health and wellbeing of the social order. Considering the greater contributions to society of the family, why should families bear the brunt of taxation while non profits are exempt? Better to tax both at some low and uniform rate.

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A tax structure that acknowledged this close alliance of the philanthropic sector and the private sector, indeed the overlapping and intertwined functions and duties of the two which constitutes the civil society, would look much different than what we see today. By reforming the tax structure we would bring the activities of the two sectors into harmony, rather than continue to perpetuate rivalry between them, and would serve over time to blend them together into the one sector that they truly constitute, different from government, because they are based on voluntary rather than coerced relationships. Such a harmonization of interests would strengthen the institutions of the free society in general while restraining the tendency of government toward unchecked growth.

Another benefit of moving the non profit, for profit, and private institutions closer together would be in the mitigation of various troubling social conflicts. For example, one may cite the following questions: By what criteria are 501 (c) 3 applications for tax exempt status to be judged? What institutions deserve 501 (c) 3 status by these criteria? Who determines which organizations these are? Does the IRS harass politically unpopular non profits or do Members of Congress, through threats of their own, attempt to influence non profit giving? How far may non profits go in advocating social change or proposing or opposing particular political agenda without calling their tax exempt status into question? Do political leaders use the IRS to investigate and intimidate their political enemies among the non profits? For taxation purposes, what is a church? What government regulations should be applied to church activities? What revenues of tax exempt entities should be designated “unrelated business activities”? What actions of

foundations should be prohibited as self-dealing? Should the names of donors to non profit organizations be publicly disclosed? All these questions are frequent subjects of public controversy.

When we begin to think about such issues, the usefulness of our thought experiment becomes clear. In the ideal world of the thought experiment there should be no non profits. All income on investments and sales of goods and services by any entity would be taxed at the same low, flat tax rate. Non profits would pay sales and property taxes like any other organization. Groups without endowments, living off annual giving alone would still be largely tax exempt. The main tax revenues they would generate would be on the income of their employees, as is the case today. Churches might have to pay property taxes, if any such existed, but local governments could exempt churches, museums, open space, nature preserves, and historic properties if they cared to do so, on a non discriminatory basis. Better would be to attempt to keep property taxes controlled at some low level through constitutional restraints in order to reduce political meddling and social engineering. There would be no death duties and no capital gains taxes for anyone. In order make this new system of taxation work and to keep rates of taxation on income low enough to encourage productive endeavor and to discourage new reasons for the creation of tax favored entities, deductions on personal income taxes for charitable giving, mortgage interest, medical expenses, and so forth should be abolished also. Only deductions for local and state taxes paid would remain, in order to avoid double and triple taxation of income.

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No doubt experts in tax policy would perceive other issues and difficulties that should be addressed. A serious discussion of such of matters should lead to a more complete understanding of needed reform.

Would such a radical reform mean the death of non profits and the loss of their important contributions to overall public well-being? Not at all. “Non profit” need not be synonymous with “not taxed”. Increased national wealth from a more efficient tax system and the elimination of the huge economic loss created by estate planning, tax avoidance schemes, income tax preparation, and foundation consultant fees to accountants and lawyers would leave both individual donors and non profit organizations with more money to spend on charitable activities. In any event, here in America at least, personal disposable income, not tax avoidance, is the primary determining factor in the amount of charitable giving. Certainly the nature of non profit activity would change in unpredictable ways. Non profits might be more willing to spend down their resources. They might be more adaptable to changing circumstances. Public charities might come to rely more on annual giving and become less concerned with building endowments.

Viewed in this manner, the reform of the tax exempt portions of the tax code becomes one phase of the larger question of reform of American taxation in general. Everyone knows that, whatever the total incidence of taxation should be, our tax code needs radical simplification. Despite this widely held understanding, so far politicians, for the most part, have remained unwilling to do much about this scandalous situation. They appear to believe that one key to their political success is handing out tax advantages to favored

groups. Recently, a few Members of Congress, political candidates, and public intellectuals have questioned this conventional political wisdom and have begun to advocate a major overhaul of the structure of our tax system. Maybe the next election will bring new leaders to the fore who can finally bring about an effective study and reform of taxation.

But perhaps only constitutional reform can ever bring major changes in the structure of our taxes. In the meantime, further research and thought experiments may help over time to influence the course of public discussion of the place of non profits in our society. While we contemplate, as Professor Rogge would have had it, the ideal structure of larger institutional changes, we should be sure to include in this discussion an investigation of the tax status of the non profits as well. Indeed, this would be a good project for a foresightful foundation to fund as part of its own philanthropic reform efforts.