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Criteria for Granting and Withdrawing Charitable Tax Status:

Exploring the Appropriate Analytic Framework

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I. **Introduction**

The recent Senate Finance Committee minority staff discussion draft is the latest installment in a decades-long discussion about the possible need for fundamental change in the tax-exemption standards for nonprofit hospitals. The staying power of this issue reflects several factors: the size of the nonprofit hospital sector, the continuing national debate about providing health care to the more than 40 million Americans who are uninsured or under-insured, and persistent questions about whether nonprofit hospitals are sufficiently different from for-profit hospitals to justify the tax and other benefits attached to charitable tax exemption.

Many proponents of more demanding requirements for section 501(c)(3) status for nonprofit hospitals have focused heavily on the issue of charity care. For example, the Minority Staff Discussion Draft proposes that section 501(c)(3) hospitals be required to provide charity care equal to at least 5% of the greater of gross patient revenues or expenditures. By contrast, nonprofit hospital groups, by and large, have resisted such a quantitative charity care requirement, arguing that nonprofit hospitals should continue to be able to qualify for charitable tax status based on a range of community benefit behaviors rather than being evaluated primarily based on charity care.

This continuing debate raises, in a very important practical context, the broader question of how Congress should approach the task of determining when, and on what terms, to grant charitable tax status. Imbedded in this broad question is a series of interesting and important sub-questions. Is there a single rationale for granting charitable tax status, or are their multiple rationales? Is the concept of market failure a productive starting point for analysis? Is it useful to think about charitable tax status as one option among a range of government market intervention strategies? If so, what criteria should Congress consider to determine whether a grant of charitable tax status is the best option? Should an explicit cost-benefit analysis be part of the overall Congressional decision-making process? If so, what are the principal components of cost and benefit? To what extent can these be quantified? How should Congress weigh quantifiable costs and benefits against other non-quantifiable, but arguably equally important, costs and benefits?

This paper examines these questions in the context of presenting a proposed decision tree for Congressional analysis of decisions to grant or withdraw charitable tax status. A copy of the decision tree is attached as Appendix 1. The proposed decision tree views granting charitable tax status as one of a range of market intervention options available to government. Accordingly, it begins by posing the question of whether, in the case at hand, there is a need for any form of market intervention by government to increase the quantity and/or quality of a particular good or service, or to increase the ability of the poor to obtain that good or service. The decision tree proposes that without a finding of such market failure, no government intervention – and, *a fortiori,* no grant of charitable tax status -- is appropriate.

The decision tree next posits that if market failure is present, it is important to determine the cause and nature of that market failure. The decision tree identifies, and considers the implications of, three distinct types of market failure: under-production of public goods, inadequate quality due to contract failure, and inequitable constraints on the poor's ability to purchase the good or service. It may be important to consider other types of market failure; if so, they could easily be integrated into the analysis.

Where the market failure reflects under-production of public goods or inequitable constraints on the poor's ability to obtain a good or service, the decision tree then focuses on whether government or nonprofits can produce the particular good or service more efficiently than business. The decision tree proposes that if not, the optimum market intervention will be a strategy that seeks to increase business output of the good or service or to increase the poor's ability to purchase that business output. On the other hand, a finding that government or nonprofits are the most efficient producer points to a different menu of potential market interventions, including direct supply by government or direct or indirect subsidies to increase nonprofit output of the good or service. The latter set of strategies includes granting charitable tax status.

If the form of the market failure is inadequate quality due to contract failure, the decision tree considers two types of market intervention, direct government regulation and, if nonprofits produce a significantly higher quality version of the good or service, one or more interventions to increase nonprofit providers' market share. These latter interventions could take the form of direct or indirect subsidies (including, perhaps, charitable tax status) to the nonprofit providers, and/or a regulatory preference for nonprofits.

Finally, if the foregoing analysis suggests that a grant of charitable tax status may be the optimum market intervention strategy, the decision tree proposes that Congress undertake a rigorous cost-benefit analysis to determine whether a grant of charitable tax status would produce a sufficient increase in public welfare to justify the cost.

On the cost side, the decision tree identifies tax expenditures and the opportunity cost of capital as the principal cost components. This list may be incomplete. More specifically, the decision tree proposes that given the reasonably strong linkage between federal tax status and state and local tax exemptions, and to avoid a double-counting of benefits, Congress should consider the tax expenditure cost to state and local governments as well as to the federal government.

On the benefit side, the decision tree underscores that, conceptually, the appropriate measure of benefit is the increase in the valued behavior induced by the grant of tax exemption rather than the overall level of that valued behavior existing after the grant of exemption. For example, if nonprofit hospitals would provide a certain level of charity care even without tax-exemption, only the exemption-induced increase in charity care can be treated as a benefit to be offset against the cost of exemption. On the other hand, the commentary acknowledges that in many cases, determining a useful estimate of even the overall quantum of community benefit – much less separating out the portion attributable to charitable tax status – will not be possible.

Further, the decision tree proposes that in determining the total benefit of granting tax exemption, Congress consider not only alleviation of the specific market failure that is the immediate object of a particular market intervention, but also potential contributions to social capital and healthy pluralism – benefits that the analysis labels "systemic public goods" – likely to result from an increase in nonprofit production of the good or service in question. Many advocates of the nonprofit sector argue that these less direct benefits – for example, increasing civic engagement and community cohesion, or reducing inter-group conflict -- are quite large, and, therefore, are an important part of the overall justification for charitable tax status. This is an important assertion that deserves close scrutiny. Recent research in various disciplines could likely shed considerable light on this question, if appropriately analyzed. Of particular interest in relation to decisions on charitable tax status is the imbedded question of whether some types of nonprofits make significantly greater contributions social capital and/or pluralism than others.

Stepping back from the details, the decision tree analysis brings two broader observations into focus. First, a rational legislative decision to grant or withhold tax exempt status is necessarily deeply rooted in the state of the world at the time of the decision. Reflecting this fact, legislatures and courts have long recognized the dynamic nature of the concept of charity. Charity proponents frequently invoke this principle in support of the need to confer charitable tax status on newly-emerged public benefit activities. But this sword cuts both ways. In a rapidly changing world, not only will new classes of charitable activity emerge, but once compelling rationales for charitable tax status will also recede. Prudence suggests that long-standing charitable tax status should not be lightly withdrawn. On the other hand, it also seems appropriate that in the legislative arena the burden should always be on the charity to demonstrate that the increment to public welfare resulting from its charitable tax status exceeds the cost.

Second, the decision tree analysis highlights a fundamental difference between legislative and judicial decision making with respect to tax exemption. In deciding an exemption case, a court has far less room for maneuver than a legislature. A court may grant or withhold exemption, but it lacks the legislature's ability to redeploy the tax expenditure to fund an alternative market intervention. For example, in the hospital context, a court lacks the power to redeploy the tax expenditure dollars to fund government health care programs for the poor or to pay for tax incentives to increase the private purchase of health insurance. The court may rightly conclude that the same tax expenditure dollars spent differently could expand substantially the poor's access to health care. But the court also faces the reality that the only sure result of a judicial decision to withdraw exemption will be the immediate and certain loss to the poor of whatever incremental charity care hospitals are induced to provide in order to retain their charitable tax status.

II. The Rationale for a Market Failure Framework for Analysis of the Decision to Award Charitable Tax Status

A. Clarifying Terminology

1. Market Failure

With some trepidation, this analysis proposes to use the term "market failure" with a broader meaning than its original technical meaning in microeconomics. The term was first introduced to refer exclusively to circumstances in which free markets fail to achieve the most efficient allocation of resources. In this original meaning, the sole focus was on whether the market had maximized consumer satisfaction, taking the original distribution of wealth as a given. In other words, in its original meaning the term was concerned strictly with allocative efficiency, and not at all with questions of distributional equity.

Only later did welfare economics – a branch of economics that, unlike microeconomics, addresses distributional equity as well as allocative efficiency – borrow the term and give it the broader meaning adopted by this analysis. For welfare economics, market failure encompasses not only circumstances in which free markets fail to achieve allocative efficiency, but also circumstances in which they produce an inequitable distribution of income and wealth. In this broader meaning, market failure thus becomes a normative as well as a descriptive concept. A market has failed not only when it fails to optimize consumer satisfaction given an initial distribution of wealth, but also when it fails to produce an equitable allocation of resources independent of the initial distribution of wealth.

Significantly, adding the normative dimension adds a corresponding element of subjectivity to the concept of market failure. Within American society, individuals hold a wide range of views on what constitutes an equitable distribution of income and wealth, and will therefore have correspondingly varied views on the degree, if any, to which the unfettered free market would produce an inequitable distribution. However, for decades there has been a broad working consensus that the income distribution produced by a free market would involve unacceptable distributional inequities. This consensus underlies a range of long-standing redistributional market interventions by government.

2. Charitable Tax Status

Rather than speaking of "charitable tax exemption," this analysis will use the term "charitable tax status" to underscore that qualification as a charity under section 501(c)(3) confers not only exemption from federal income tax, but also eligibility to receive tax deductible charitable contributions and to use tax-exempt financing. Thus, for purposes of the cost-benefit analysis discussed in Section VIII, the tax expenditure cost to the federal treasury of conferring section 501(c)(3) status is the aggregate tax expenditure cost of all three of these tax benefits, not just the cost of the income tax exemption.

3. Public Benefit Nonprofit Organizations

To avoid confusion, this analysis will reserve the term "charity" to refer only to organizations that have been recognized as qualifying for charitable tax status. While the term, and the organizations it is commonly understood to describe, obviously long predate not only section 501(c)(3) but even the much older legal definition of charity, in contemporary discussions we have come to understand "charity" as describing not only an organization's functional characteristics, but also its legal and tax status. Since this analysis is concerned with defining the criteria for conferring charitable tax status, it will be useful to use a label for these organizations that does not have the conclusion with regard to tax status embedded in the name itself. Accordingly, this analysis will use the term "public benefit nonprofit organization." This term is meant to encompass organizations that are nonprofit in legal form, that are understood by their supporters to be pursuing a public benefit objective, and whose operations do not involve private inurement or private benefit of the sort proscribed by section 501(c)(3). In other words, these are organizations that, under current federal tax law, would qualify for charitable tax status if the purpose for which they are operating is held to constitute a charitable purpose.

B. Market Failure, Market Intervention, and Charitable Tax Status

This analysis proposes market failure as the point of entry for determining whether to award or withdraw charitable tax status. The grounds for adopting this approach are that: (i) market failure is a necessary condition for justifying government intervention to alter the mix of goods and services and/or the distribution of income produced by the free market, and (ii) tax-exemption is most usefully viewed as one option on a menu of economic intervention options available to the federal government.

Embedded in the choice of this analytic starting point is the view that the award of charitable tax status is best understood as the award by the federal government of an economic subsidy with the intent of altering market outcomes by encouraging increased output by the organizations qualifying for charitable tax status. This subsidy perspective, in turn, entails a complex, multi-step analysis to:

- Determine whether a market failure exists,
- Determine the cause of the market failure,
- Identify the range of market intervention options through which government might rationally attempt to alleviate the market failure,
- Identify from among these options the most efficient potential intervention or set of interventions, and
- Determine whether that increment to public welfare is sufficient to justify the cost of the intervention.

A decision to award charitable tax status to a particular set of nonprofit organizations is only one of many possible end points for this analysis. The balance of this paper examines each step in the analytic chain to identify the conditions that must be present to make charitable tax status an appropriate market intervention.

III. Types of Market Failure

While economists have catalogued numerous types of market failure, review of the literature on rationales for tax exemption suggests that only three have been viewed as providing plausible justification for a governmental decision to confer charitable tax status. These three are: (i) the underproduction of public goods, (ii) failure to meet acceptable quality standards due to contract failure, and (iii) inequitable limitations on the poor's access to essential goods or services. If a particular market failure is due to some other cause – for example, the existence of a natural monopoly or the presence of substantial negative externalities, as in the case of environmental pollution – government intervention may well be appropriate, but neither historical practice nor theoretical analysis suggests that that intervention should take the form of a grant of charitable tax status. Thus, the presence of at least one of these three types of market failure would appear to be a necessary, though not sufficient, condition for granting charitable tax status. It is appropriate, therefore, to take a closer look at each.

A. The Under Supply of Public Goods

For economists, a public good is a good or service that is both "non-rival" and "non-exclusive". Non-rival means that, once produced, the good or service can be enjoyed by an unlimited number of people without diminishing the amount of enjoyment received by each. Non-exclusive means that, given existing levels of technology and market conditions, once the good is produced it is not economically feasible to prevent free use of the good by all. National defense is often cited as a paradigmatic public good. It is non-rival in that the military force and foreign policies required to achieve a given level of security is independent of the number of citizens being defended. It is non-exclusive in that once the nation's military force and international alliances are in place, it is not feasible to exclude particular citizens from their protection.

Economists agree that a free market will systematically under-produce public goods for two reasons. First, each individual consumer will be willing to pay only an amount proportionate to the benefit he or she derives from the good or service, notwithstanding the fact that his or her purchase would confer a comparable benefit on every other individual. Second, every potential purchaser has a strong incentive to be a "free rider," enjoying whatever level of the good or service that is purchased by others, while saving his or her own resources for private consumption goods.

Except in the realm of economic theory, pure public goods – that is, goods that are perfectly non-rival and non-exclusive – are rare. In the real world, goods and services fall on a continuum between the polar cases of pure private and pure public goods. Thus, economists frequently describe real world goods and services in terms of the extent to which they possess one or both of the attributes of a pure public good. The more salient the public good characteristics of a particular good or service, the more serious the market failure problem, and the greater the short-fall between the amount of the good or service actually produced by a free market and the level of output that would maximize public welfare. Thus, in the real world, there is often ample scope for debate over the extent to which a particular good or service is subject to public goods-induced market failure.

That said, there appears to be broad consensus with respect to where most major categories of goods and services fall on the private goods-public goods continuum. For example, consumer goods (e.g., consumer electronics, furniture, clothing, and automobiles), entertainment and recreation, and financial services are all generally accepted to be private goods. Likewise, education, basic research, environmental protection, and public safety are generally agreed to possess important public goods characteristics.

Because a free market will consistently under-produce public goods, economists broadly agree that it is appropriate for government to intervene in the market to increase the supply of public goods. As discussed in the next section, government has a number of intervention options to achieve this goal.

B. Inadequate Quality Due to Contract Failure

Another common cause of market failure is what economists describe as asymmetry of information between the parties to a market transaction. For example, where a purchaser is not in a position to assess the quality of the good or service being provided by the seller, the purchaser will be less willing to make a purchase than if he were able to confirm that he was "getting what he paid for." In his seminal article, Professor Hansmann described this problem as "contract failure," and suggested that the prevalence of nonprofit organizations in particular industries correlates strongly with the extent to which, due to asymmetry of information, purchasers have difficulty verifying the quality of the goods or services they are providing. His paradigmatic examples are international relief organizations – where it is virtually impossible for the average donor to verify the quantity and quality of the relief services ultimately provided by the donee organizations—and nursing homes, where the patients are often not in a position to assess and report on the quality of their care. Hansmann posits that in such situations, consumers and donors have higher confidence that they will get fair value for money from nonprofit rather than for-profit providers both because of the legal prohibition on profit distributions, and the non-legal fiduciary norms perceived to animate the individuals working for nonprofits.

Independent of the question of whether, and under what circumstances, nonprofit organizations offer consumers an effective solution to the problem of asymmetry of information, economists agree that such contact failure-induced quality problems are an important cause of market failure that at least in certain circumstances justifies government market intervention. The most common form of such intervention is direct regulation of the quality of goods or services, as, for instance provided by the FDA with respect to medications, the Department of Agriculture with respect to food products, and the Consumer Products Safety Commission with respect to consumer product safety.

However, this analysis will return below to the question of whether there may also be situations in which the appropriate governmental response to the problem of contract failure may include granting charitable tax status to nonprofit providers of a good or service in order to increase their market share relative to for-profit providers.

C. Failure to Achieve an Equitable Distribution of Income and Resources

As noted above, welfare economics has usefully broadened the concept of market failure to include cases in which the free market fails to produce an equitable distribution of income and resources. Of course, equity is in the eye of the beholder. One man's vision of the fair and natural order of things is another man's vision of an unjust and exploitive social order. But at least since the New Deal, the working consensus in American politics has held that our collective vision of a just society will not tolerate the degree of economic inequality produced by the free market. This public consensus on the existence of market failure with respect to the equitable distribution of goods and services has provided solid and enduring support for major redistributional government programs such as Social Security, Medicare, Medicaid, and Food Stamps.

This consensus also presumably underlies the equally solid and broad-based support for encouraging public benefit nonprofits – through the grant of charitable tax status – to provide a broad range of goods and services to the poor and disadvantaged. In the context of this analysis, this, in turn, raises the critical question of what standard should apply in determining whether a particular public benefit nonprofit's provision of goods and services to the poor – in combination with its other public benefit activities, if any – is sufficient to justify charitable tax status. This question is considered further below.

IV. Social Capital and Pluralism as Public Goods

A central thesis of this analysis is that building social capital and strengthening pluralism are important public goods, that public benefit nonprofits play an important role in producing these public goods, and that charitable tax status is the optimum market intervention to subsidize nonprofits' production of social capital and healthy pluralism. Some public benefit nonprofits have the production of social capital as a direct mission objective, but a far larger number build social capital and support pluralism as a by-product of pursuing other public benefit objectives.

For purposes of this discussion, it will be useful to have a separate term to distinguish these two over-arching public goods from other, more specific public goods like the advancement of education or the promotion of health. Because of the critical role of social capital and pluralism in supporting our entire system of participatory democracy, this analysis will refer to these two pubic goods as "systemic public goods," as distinguished from "specific public goods."

A. Social Capital

Education is often cited as an example of a public good because, on average, an individual's ability to contribute to the greater good – and, one hopes, in most cases his or her actual contribution – increases as his or her education increases. While less frequently mentioned in the public goods literature, the same is surely true with respect to the development of positive moral values, effective interpersonal skills, and supportive networks of social relationships. When a youth development organization teaches young people "honesty, caring, respect, and responsibility," or to be "trustworthy, loyalty, helpful, thrifty, brave, clean, and reverent," the organization certainly enhances the life prospects of the youth they are instructing. But the organization simultaneously confers a benefit on everyone who, over the course of the youths' lives, will be on the receiving end – directly or indirectly – of the actions that will flow from these positive character traits. This broader benefit is both non-rival and non-exclusive – that is, it is a pure public good.

Scholars now commonly refer to a society's accumulated stock of such pro-social moral values, interpersonal skills, and social networks as the society's "social capital." A growing body of research focuses on the relationship between a society's stock of social capital and the effectiveness of its social and economic institutions and the welfare of its citizens. Common sense predicts a strong positive correlation, and a growing body of research in a range of disciplines seem to point in the same direction.

The concept of social capital as a public good is important at two levels in analyzing the merits of conferring charitable tax status on particular types of nonprofit organizations. First, and most obviously, many nonprofits have the development of positive moral values, effective interpersonal skills, and supportive social networks as central mission objectives. This is true not only of the youth development organizations mentioned above, but also of many social service organizations, religious organizations, and nonprofit primary and secondary schools. Moreover, it is frequently asserted that nonprofit organizations produce these values-based and relationship-based public goods more effectively than either business or government. As discussed in Section VII, this assertion, if true, may provide a strong rationale for conferring charitable tax status on the sorts of nonprofits just described.

At a second level, the production of social capital may have still broader relevance in assessing the social contribution of nonprofit organizations, and thus the strength of the case for conferring charitable tax status. This is because many nonprofits whose missions are not directly focused on the production of social capital nonetheless arguably produce substantial social capital as a byproduct of the pursuit of their core missions. Nonprofits provide one of the primary contexts in which millions of Americans learn how to collaborate voluntarily with fellow citizens to advance the public good. These public benefit initiatives are directed at myriad goals, from animal welfare to environmental preservation, from refugee resettlement to organizing a community theater. But from the perspective of building social capital, the specific public benefit objective may well be secondary to the fact that all of these initiatives provide a context in which individuals learn the skills required for active citizenship and experience the satisfaction of community service.

While it seems likely that the great majority of nonprofit organizations make at least some positive contribution to the stock of social capital, it also seems likely that the magnitude of that contribution varies greatly across different types of organizations. For example, volunteer fire departments, citizen-led neighborhood watch programs, and community foundations all seem likely to generate substantially more social capital per dollar of operating budget than a medical research organization or a public policy think tank. At the cost-benefit stage of assessing the merits of granting charitable tax status, an organization's contribution to social capital should clearly be taken into account. Quantifying the amount of that contribution will be extremely difficult, if not impossible. But an effort should be made, at least qualitatively, to assess the significance of that contribution.

B. Pluralism

In a society as diverse ethnically, regionally, religiously, culturally, and politically as the United States, a robust sector of public benefit nonprofits arguably produces another public good generally discussed – albeit again not frequently in the public goods literature – under the heading of pluralism. If government were the only mechanism through which individuals in this highly diverse society could seek to realize their very different, and often conflicting, visions of the public good, the result would likely be a society of increasingly frustrated and alienated political, religious, cultural, and ethnic minorities. The ability of these minority communities – and on certain dimensions, every citizen is a member of a minority group – to act on their values by forming public benefit nonprofits thus functions as an important safety valve, reducing the pressure on our political institutions and moderating inter-group conflict. There is much evidence to suggest that members of a minority community – be it an ethnic, religious, cultural, or political minority -- feel empowered by the ability to form their own public benefit nonprofits, and that the availability of this outlet for collective action reduces the frustration and isolation otherwise engendered by minority status. Further, each minority's public benefit nonprofits provide a mechanism through which that community can explore opportunities for collaboration, or at least accommodation, with other social groups.

A few examples illustrate the myriad contexts in which public benefit nonprofits play this important role:

- Pro-choice individuals can act on their view by supporting Planned Parenthood, while pro-life individuals can support abstinence and adoption efforts.
- Persons concerned about global warming can support a wide range of nonprofit initiatives during a period in which they are strongly critical of the federal government's policy on the issue.
- AIDS activists can promote safe sex initiatives and needle-exchange programs, while social conservatives can promote traditional family values.
- America's growing Islamic community can establish its own network of social service, educational, and international relief organizations to support its members during a period in which they perceive widespread hostility from the larger society.
- Individuals that support embyonic stem cell research can contribute to nonprofit research organizations that are pursuing this research more aggressively than permitted for federally-funded research.

This list could be multiplied many fold. The resulting increase in citizen empowerment and the reduction in social conflict seems likely, in the aggregate, to be quite substantial.

From a public goods perspective, this benefit to society that is both non-rival and non-exclusive, and thus meets the formal definition of a public good. Thus, as discussed above, public goods theory holds that, like all public goods, it will be under-produced unless government intervenes to support increased production. As will be discussed below, this, in turn, has potentially important implications in determining when it is appropriate to confer charitable tax status.

V. Intervention Options to Address the Various Types of Market Failure

When government considers intervening to alleviate the effects of a market failure, it generally has a broad range of options, depending on the particular type of market failure involved. The following table illustrates the range of market intervention options for the three types of market failure discussed above.

Market Intervention Options to Alleviate Specific Types of Market Failure

	Increasing the Production of Public Goods	**Mitigating Quality Problems Due to Contract Failure**	**Alleviating Distributional Inequities**
Producer-Side Interventions			
1. Direct Govt. Production or Regulation	• National security • Public safety • Public education • Govt. laboratories	• Consumer safety regulation • Quality regulation of health care providers	• Govt. operated health clinics • Job Corps
2. Direct Govt. Subsidy			
a. Business subsidies	• Research contracts • Military procurement	•	•
b. Nonprofit subsidies	•	•	•
3. Tax Incentives	•	•	•
a. Business incentives	•	•	•
b. Nonprofit incentives	• Charitable tax status • Exemption • Contribution deduction • Exempt bonds	• Charitable tax status • Exemption • Contribution deduction • Exempt bonds	• Charitable tax status • Exemption • Contribution deduction • Exempt bonds
Consumer-side Interventions			
A. Direct Transfers	• Pell grants	•	• Food stamps
B. Tax Incentives	• Home energy tax credit	•	• Earned Income Tax Credit

A. Market Intervention Options to Increase the Supply of Public Goods.

As the table indicates, when government considers its options to increase the supply of a public good, the first fork in the road is deciding whether to intervene on the supply side by subsidizing the cost of production or on the demand side by increasing consumer's purchasing power. On the demand side, government has three basic alternatives: to produce the good itself, to subsidize directly production by non-government producers (for-profit, nonprofit, or both), or to establish tax incentives to lower the after-tax cost of production. Tax incentives, in turn, may take numerous forms: they may be targeted on a specific activity or they may alter the tax status of the entity as a whole, and they may be conferred on taxable entities or on particular types of tax-exempt entities.

On the demand side, the basic alternatives are direct transfers to consumers to subsidize their purchase of a public good (e.g. Medicare), or tax incentives to reduce the after-tax cost to consumers of purchasing the public good (e.g., tax credits for expenditures to increase household energy efficiency).

In terms of this taxonomy, all three of the principal federal tax benefits conferred by charitable tax status – tax-exemption, eligibility to receive deductible contributions, and ability to use tax-exempt financing – are entity-level producer-side interventions that are restricted to qualifying public benefit nonprofits. The characteristics of these incentives are discussed in more detail below.

B. Market Intervention Options to Address Inadequate Quality Due to Contract Failure

The most commonly used and straightforward market intervention strategy to address quality problems arising from contract failure is regulation. This regulation is generally performed directly by government, but is sometimes outsourced, as in the case of the regulation of securities dealers by NASDAQ or the regulation of attorneys by state bar associations.

There is once circumstance, however, in which, at least at a conceptual level, it would be rational to consider granting charitable tax status as a potential component of a contract failure-focused market intervention strategy. This is where a good or service is provided by both for-profits and by public benefit nonprofits, and where the nonprofits consistently provide significantly higher quality than the for-profits. In this situation, the presence of the nonprofits in the market will benefit consumers both directly by giving them a higher quality provider, and indirectly by putting competitive pressure on for-profit providers to provide higher quality than would otherwise be the case. Under these conditions, it may be useful for government to grant charitable tax status as a means of increasing the nonprofits' market share, thereby reinforcing both their direct and indirect contributions to quality improvement. Some commentators have suggested that this analysis supports continued charitable tax status for nonprofit hospitals.

C. Market Intervention Options to Alleviate Inequities in the Distribution of Income and Resources

The range of market intervention options to alleviate distributional inequities closely parallels the range of options for increasing the supply of public goods. As with public goods market intervention options:

- Government may intervene on the producer side, the consumer side, or both;
- Potential producer-side interventions include government provision of services to the poor, direct subsidies to for-profit and/or nonprofit providers of goods and services to the poor, and tax incentives to indirectly subsidize for-profit or, more commonly, nonprofit providers of such services; and
- Consumer-side interventions may take the form of either direct transfers to the poor or tax incentives like the earned income tax credit.

To the extent public benefit nonprofits provide subsidized goods and services to the poor, it may be rational for government to confer charitable tax status as a means of increasing the resources available to the nonprofits for this re-distributional activity. The issue of when, and in what ways, the federal government should condition charitable tax status on a given level and/or type of subsidized services to the poor arises frequently, as in the current debate about the tax status of nonprofit hospitals.

D. Use of Multiple Market Intervention Strategies

In closing, it is worth noting that government frequently attacks a particular market failure with a range of market interventions. A good example is the federal government's multi-pronged effort to increase the amount of basic research, which includes a diverse set of producer-side subsidies. Government "produces" this public good directly at government laboratories like those at the National Institutes of Health, Las Alamos, and Livermore; it directly underwrites private research programs through myriad grant and contract programs; and it uses tax incentives like conferring charitable tax status on research universities and providing the research and development tax credit for business. Similarly, the federal government often combines producer and consumer-side subsidies, as when it simultaneously funds research to develop new energy conservation technology while granting consumers a tax credit for expenditures to increase the energy-efficiency of their homes or to purchase more energy-efficient vehicles. This pattern of using multiple intervention strategies may, in part, reflect political compromise and rent-seeking. But it probably also reflects an appropriate judgment that – given the strengths, weaknesses, and uncertainty of each market intervention option -- the use of complementary strategies is likely to be more effective than any single strategy alone.

VI. A Closer Look at Charitable Tax Status as a Market Intervention

A. Charitable Tax Exemption

The economic effect of tax exemption is to subsidize the exempt entity's production costs by an amount equal to the tax it would have paid had it been treated as a taxable entity. The amount of this subsidy, accordingly, will depend on the particular tax rules governing the computation of taxable income, and the rate of tax imposed on that taxable income. If gifts received are excluded from taxable income, donative nonprofits would generally have no net taxable income. For them, therefore, the tax exemption, *per se*, is worthless. By contrast, at least some commercial nonprofits might have significant taxable income, and these nonprofits would benefit proportionately from tax exemption. Alternatively, if donated income were included in taxable income, even donative non-profits might have significant taxable income, and would derive a corresponding benefit from tax exemption.

B. Charitable Contribution Deduction

Eligibility to receive tax deductible contributions subsidizes the donee organization's cost of production by an amount equal to the amount by which the donated income it receives with the charitable deduction rules in place exceeds the amount of donated income it would receive if the charitable deduction were repealed. The mechanism of subsidy is that the charitable deduction lowers the after-tax cost of giving, and this reduction in the after-tax cost of giving induces donors to devote at least some of the tax savings to additional giving. The magnitude of this effect is measured by what economists term the price elasticity of giving: roughly speaking, the percentage by which giving increases in response to a one percent reduction in the after-tax cost of giving. Thus, the value of this subsidy for any given organization will equal the amount of contributions the organization receives from donors qualifying for the income or estate tax charitable deductions, multiplied by the relevant price elasticity of giving.

Notwithstanding decades of analysis, economists are far from consensus on the actual price elasticity with respect to changes in either income or estate tax rates. Recent estimates of the price elasticity for changes in the income tax rates range from __ to __, while recent estimates for changes in estate tax rates range from __ to __. Whatever the absolute price elasticities of giving, the relative importance of the subsidy provided to charities by the contribution deduction will be greater for donative nonprofits than commercial nonprofits, and, among donative nonprofits, it will be greater for those who get a larger proportion of their contributions from donors eligible for the income and/or estate tax deductions.

C. Tax-exempt Financing

Tax-exempt financing subsidizes the cost of production by reducing the interest cost of borrowing by an amount equal to the difference between the interest rate on tax exempt bonds and the higher interest rate on commercial loans. At present, this spread is approximately __%. Thus, for a $10 million loan, the annual interest savings is approximately $____. Because tax-exempt bonds are used to finance capital products, this subsidy is principally of value to capital-intensive public benefit nonprofits like hospitals and universities. The myriad small charities with little or no physical plant receive no benefit from their eligibility to issue tax-exempt bonds.

D. Overall Charactistics

Stepping back and considering the characteristics of three tax incentives attached to charitable tax status, as compared to the federal government's other market intervention options to increase the production of public goods, it is striking how attenuated the government's control is over these charitable tax incentives. As noted above, all three are entity as opposed to activity subsidies; that is, they increase the resources available to the entity without imposing any restrictions, other than those imposed by its charitable tax status. Further, charitable tax exemption and the charitable deduction are the tax expenditure equivalent of an entitlement program, available to any and every organization that qualifies as a charity. Finally, the decision to tap these subsidies rests entirely in private hands.

VII. Conditions Under Which Charitable Tax Status May be Part of the Optimum Market Intervention Strategy

Having canvassed the range of market intervention options available to the federal government to mitigate the effects of the various types of market failure, and having analyzed in more detail the nature of the tax incentives that accompany charitable tax status, the next question is under what circumstances will granting charitable tax status be the optimum, or part of the optimum, market intervention strategy? It is appropriate to analyze this question separately with respect to each type of market failure discussed above.

A. Charitable Tax Status as a Market Intervention to Increase the Production of Public Goods

In considering the efficacy of granting charitable tax status as a market intervention to increase the production of public goods, it will be useful to consider it first in relation to the systemic public goods of social capital and pluralism, and then in relation to specific public goods like advancement of education, promotion of health, preservation of the environment, or promotion positive youth development.

1. Charitable Tax Status, Social Capital, and Pluralism

The importance to American democracy of the systemic public goods of social capital and pluralism has been considered above. This section will consider the efficacy of granting charitable tax status, relative to other market intervention options, as a means to build social capital and strengthen pluralism. More specifically, this section will argue that granting charitable tax status offers major comparative advantages over all other market intervention options because of the indirect nature of this market intervention and government's very attenuated control over its use.

a. The Comparative Advantage of Public Benefit Nonprofits as Producers of Social Capital

As discussed above, social capital consists largely of moral and social values that stimulate pro-social behavior, interpersonal skills that enable individuals to cooperate effectively in voluntary activities, and social networks that facilitate such cooperative action. Both our democratic system of government and our free enterprise economy are highly dependent on this social capital, but it seems unlikely that either government or business is very efficient in producing that social capital. Reflecting the diversity of our society and deep-seated mistrust of government power, Americans have never been willing for government to be the principal arbiter or inculcator of moral values. Moreover, even in societies that are less diverse and less anti-state, it seems doubtful that government has the necessary tools to function effectively in these roles. Likewise, the business sector seems much more likely to be a net consumer rather than a net producer of social capital. For example, business in our highly decentralized economy is heavily dependent on trust, cooperation, and a commitment to fair dealing. But where do these essential values come from? Almost certainly not from the contemporary business culture that is so dependent on them. On the contrary, the literature on the moral and social development of children strongly suggests that if young people are going to develop these pro-social values, it must happen long before they enter the business world and that it happens primarily in the family, the neighborhood, and in other non-governmental community institutions.

Public benefit nonprofits appear to play a central role both in developing pro-social values and skills in the young, and in providing a principal context (arguably *the* principal context) in which adults act on these values, put into practice and refine the skills essential to effective voluntary action, and build the social networks that knit communities and the country together. While public schools appropriately give priority to promoting academic competence, most American communities have a rich network of religious and secular youth organizations committed to promoting the positive moral and social development of the young. And while local governments offer various opportunities for citizens to serve on community boards or to hold elected office, the great majority of Americans find their chance for civic engagement not through a direct role in local government, but rather by becoming involved in one or more of the many and varied public benefit nonprofits that pervade most aspects of American community life.

If, as this analysis suggests, public benefit nonprofits have a significant comparative advantage over government and business as "producers" of social capital, then it follows that the optimum market intervention option to foster the production of social capital is one that subsidizes the most efficient producers – i.e., public benefit nonprofits. As noted above, this, in turn, leads to the question of whether this subsidy is better provided directly through government grants or contracts to support particular activities of public benefit nonprofits, or indirectly through the tax incentives attached to charitable tax status. This question will be considered further in Section VII.A.1.c, below. But first it is appropriate to consider the comparative advantage of public benefit nonprofits as producers of a healthy pluralistic society.

b. The Comparative Advantage of Public Benefit Nonprofits as Efficient Producers of Pluralism

One is tempted simply to state that the comparative advantage of public benefit nonprofits over government and business as producers of healthy pluralism is self-evident, and leave it at that. But brief comment is appropriate, if only to underscore the strength and importance of public benefit nonprofits as the essential organizational infrastructure for pluralism. Section IV has already briefly described the role that public benefit nonprofits play both in strengthening and supporting minority communities, and in providing the organization framework through which different minority communities can explore opportunities for collaboration or, at least, accommodation. These nonprofits belong to the community, and they often become the guardian of the community's values and heritage, and the champion of its hopes and dreams. It is inconceivable that government or business could effectively perform these roles. Indeed, public benefit nonprofits are so fundamental to a healthy pluralistic society that the idea of pluralism without a rich network of nonprofits approaches logical incoherence. Even if not a logical impossibility, the real world likelihood that American pluralism could continue to flourish without the organizational infrastructure provided by public benefit nonprofits seems vanishingly small.

c. Charitable Tax Status as the Optimum Market Intervention to Subsidize Public Benefit Nonprofits' Production of Social Capital and Pluralism

Assuming that public benefit nonprofits are more efficient producers of social capital and pluralism than government or business, a strong argument can be made that government can much more effectively subsidize the production of these public goods through the indirect tax incentives attached to charitable tax status than through direct financial transfers to nonprofits. On this view, the greater efficacy of charitable tax status derives principally from the interaction of charitable tax exemption and the charitable deduction. The ability to use tax-exempt financing, while reasonably important to some charities, is of distinctly secondary importance for the charitable sector as a whole.

i. Transforming Government Dollars Into Charitable Dollars

Whether government gets its money's worth out of the charitable deduction has been debated for decades. Critics focus principally on the price elasticity of giving, and argue that the deduction is good policy only if the deduction-induced increase in charitable contributions substantially exceeds the deduction's tax expenditure cost to the federal Treasury. Since, in the critics' view, the econometric evidence fails to establish that the deduction satisfies this test, they argue that government would be better off collecting the tax and using it to fund direct government expenditures, particularly since government would have far greater control over how the funds would be used.

However, from the perspective of building social capital and supporting pluralism, a strong argument can be made that these critics have failed to recognize a more fundamental strength of the charitable deduction. As clear from the discussion in the preceding section, public benefit nonprofits' effectiveness in producing social capital and supporting pluralism derives largely from their character as voluntary citizens' organizations staunchly independent of government. Given this fact, a dollar of support freely given by a citizen as an expression of personal commitment to a particular vision of the public good is arguably worth far more than a dollar of funding received from government for government-determined purposes and subject to detailed government accountability rules. The donated dollar increases citizen ownership, reinforces through action the values of altruism and civic engagement, and supports the autonomous social space in which individuals can practice the art of voluntary cooperation for the public good. By contrast, the government dollar is likely to undermine autonomy and encourage citizens to sit back and let government and nonprofits' professional staff worry about community concerns.

From this vantage point, even if the price elasticity of giving is at the lower end of the range indicated by econometric studies, the contribution deduction is still a highly efficient mechanism for transforming government dollars extracted by fiat into charitable dollars freely given by citizens committed to the public good.

The charitable tax exemption and tax-exempt financing produce a similar transformation of government dollars into charitable dollars, albeit without the important ownership effect connected with citizens' decisions to make voluntary charitable contributions. It is difficult to see how government could effectively support nonprofits' production of social capital and pluralism without the alchemy accomplished by the charitable tax incentives.

ii. The Legitimizing Effect of Charitable Tax Status

The impact of charitable tax status in increasing the resources available to public interest nonprofits likely substantially exceeds the subsidies inherent in charitable exemption, the charitable deduction, and tax-exempt financing. By establishing charitable tax status, attaching to it substantial tax benefits, and recognizing particular public benefit nonprofits as qualifying for this favored status, the federal government affirms the value of civic-mindedness and altruism, and legitimizes specific tax-exempt charities as worthy of public support. It is reasonable to hypothesize that this prominent and pervasive federal policy contributes importantly to motivating citizens to engage in altruistic behavior over and above making deductible contributions. This hypothesis deserves careful study. If valid, it provides important independent justification for the relative efficacy of granting charitable tax status relative to other market interventions.

Pending further research, two data points consistent with, though certainly not proof of, this hypothesis bear noting. The first is the rate at which Americans contribute volunteer services in support of charities. In 20__ -- the most recent year for which data are available -- an estimated __ million Americans provided volunteer services in support of charities. The estimated value of this volunteer service has been conservatively estimated at $__ billion, an amount equal to __% of total financial contributions in the same year -- a level of volunteerism that substantially exceeds that in other developed nations. This American penchant for volunteer service is, no doubt, rooted in values and history that long pre-date charitable tax status under federal tax law. But the federal government's strong endorsement of voluntary support of charities may well be a significant factor in the inter-generational transmission of this cultural norm.

Essentially the same observations can be made with respect to the substantial charitable giving by taxpayers that derive no tax benefits from their contributions. The majority of Americans, because they do not itemize deductions for income tax purposes and have estates below the threshold for estate tax liability, fall into this category. In 200_, these donors made total contributions of $__ billion. Again, it is plausible that the federal government's strong stand in support of charitable giving makes a material contribution to encouraging this level of giving even by donors who do not benefit directly from the charitable deduction.

2. Charitable Tax Status as a Market Intervention to Increase Production of Specific Public Goods

If public benefit nonprofits are at least as efficient as government and/or business in the production of a specific public good, then government subsidy of the nonprofit producers may reasonably constitute, or be part of, government's optimum market intervention strategy. A public good is likely to fall into this category if its production benefits significantly from inputs that public benefit nonprofits are best able to secure. For example, any public good whose production is enhanced by the use of volunteers is likely to be more efficiently produced by nonprofits than by business or government. The same is likely true of public goods whose production is enhanced by an organization embodying strong moral or religious commitment, as proponents claim to be the case for faith-based social service programs.

When, for these or other reasons, the optimum market intervention to increase production of a specific public good involves subsidizing public interest nonprofits, the next issue is whether this subsidy is best provided directly through government funding, indirectly through tax incentives, or through a combination of both. For several reasons, it seems likely that in the preponderance of cases the market intervention should include granting charitable tax status. First, as just noted, if nonprofits have a comparative advantage in the production of a particular public good, that advantage will likely derive from attributes of the nonprofit that are more effectively reinforced by charitable tax status than by direct government funding. Further, granting charitable tax status will subsidize production not only of the specific public good that is the immediate object of the intervention, but also the systemic public goods of social capital and pluralism. Finally, if, as suggested above, charitable tax status helps stimulate increased volunteerism and charitable contributions even from donors who receive no tax benefit, then each dollar of tax expenditure is likely leveraged into substantially more than a dollar of resources available to support expansion of the nonprofits' activities.

B. Charitable Tax Status as a Market Intervention to Address Quality Problems Due to Contract Failure

As noted above, subsidizing nonprofits is likely to be part of the optimum intervention to address contract failure only where it can be demonstrated that nonprofits consistently provide a significantly higher quality good or service than provided by for-profits. If this is the case, the optimum market intervention strategy will again likely include a grant of charitable tax status, since the nonprofits' quality advantage will probably be attributable principally to attributes directly related to, and reinforced by, charitable tax status.

C. Charitable Tax Status as a Market Intervention to Address Distributional Inequities

For many public benefit nonprofits, aid to the poor and disadvantaged is a central mission objective. Moreover, to the extent that charities have a comparative advantage over business or government with respect to some types of aid to the poor, this advantage derives from attributes such as a strong mission-focused and values-based organizational culture, and because of nonprofits' ability to leverage financial resources with committed volunteers. As noted repeatedly above, granting charitable tax status is almost certainly more effective than providing direct funding as a means for government to augment the resources available to these charities.

* * *

To recapitulate the analysis presented in this section:

- Public benefit nonprofits have a strong comparative advantage over government and business in producing the systemic public goods of social capital and pluralism, as well as in producing a range of specific public goods whose production is enhanced by the use of volunteers, a values-based or faith-based organizational culture, or other inputs more readily available to nonprofits than to government or business.
- Charitable tax status will generally be an efficient means to enable charities to leverage the inputs from which their comparative advantage with respect to these public goods derives.
- Considering all of these factors, when government decides to intervene to increase the supply of a specific public good, if the public good is produced as efficiently

or more efficiently by public interest nonprofits than by government or business, the optimum market intervention strategy will generally include granting charitable tax status to the nonprofit producers.

- Granting charitable tax status may also be part of the optimum intervention strategy in cases where government seeks to alleviate contract failure-induced quality of service problems in industries in which nonprofits provide significantly higher quality services than for-profits.
- Public benefit nonprofits also have a comparative advantage in alleviating distributional inequities through programs that rely heavily on volunteers, that require a strong values-based or faith-based organizational culture, and/or that are enhanced by strong organic ties to the community. If government seeks to address distributional inequities through such strategies, granting charitable tax status will be part of the optimum intervention strategy.

VIII. Cost-Benefit Analysis of Granting Charitable Tax Status

Even if granting charitable tax status is the optimum intervention strategy to alleviate a given market failure, this strategy must compete with all other claims on the federal government's finite resources. Thus, the final step in the analysis of whether to grant charitable tax status should be as rigorous a cost-benefit analysis as our current state of knowledge allows. As discussed below, any effort to quantify the costs of charitable tax status will be at best a very rough estimate. Many of the benefits will be still more difficult to quantify. But nonetheless, going through the cost-benefit analysis should have multiple salutary effects. First, it will help clarify conceptually the principal elements of cost and benefit. Second, it will focus attention on whatever data and analysis are available with respect to the magnitude of each component of cost and benefit. And third, it will force a considered qualitative judgment where, as will generally be the case, the data and analysis end far short of definitive answers.

A. Analyzing the Costs of Granting Charitable Tax Status

1. Federal Tax Expenditure Cost

The overall cost to the federal Treasury of charitable tax status is the total of the tax expenditure costs of charitable tax exemption, the charitable contribution deduction, and charity's use of tax-exempt bonds. Even for the charitable sector as a whole, considerable further analytic work is required to produce a reasonably solid and comprehensive estimate. The annual tax expenditure estimates produced by the Joint Committee on Taxation and the Treasury Department exclude the charitable tax exemption entirely on the ground that it is not a tax expenditure. This position seems questionable even in relation to the principal purposes for which these estimates are produced. It is clearly inappropriate for providing Congress a comprehensive estimate of the revenue loss attributable to charitable tax status. Further, there is a major "black box" problem with respect even to the aggregate estimates of the tax expenditure costs of the charitable deduction and charities' use of tax-exempt bonds, since neither the Joint

Committee nor Treasury routinely makes public a comprehensive explanation of the methodology used to make these estimates.

But the bigger problem lies in the dearth of solid analysis of the tax expenditure cost of granting charitable tax status to particular types of public benefit nonprofits. For example, even after two decades of reasonably active and continuous debate about the tax treatment of nonprofit hospitals, neither the Joint Committee nor Treasury has produced a rigorous estimate of the federal tax expenditure cost of the current hospital exemption rules, or of how potential changes in those rules would alter that cost. Given that hospitals comprise the largest single component of the charitable sector, and given that Congress is actively considering potentially significant changes in their tax status, the need for such a solid tax expenditure estimate seems clear. But, if the past is prologue, the tax writing committees will ultimately make their decisions informed only by the Joint Committee's usual rough and ready revenue estimates. Even a modest resource commitment the Joint Committee or Treasury, particularly if it were actively supported by academic economists with appropriate expertise, could almost certainly improve substantially, the information available to Congress on the federal tax expenditure cost of granting charitable tax status to various types of nonprofits.

2. State and Local Tax Expenditure Cost

Another cost issue worth some reflection is whether, when Congress considers whether to recognize, withdraw, or modify the charitable tax status of a specific ground of nonprofits, it should consider the likely tax expenditure implications for state and local governments. While recognition or withdraw of charitable tax status at the federal level does not automatically produce the same result for state or local tax purposes, overall the linkage is quite strong. For example, it Congress were to withdraw charitable tax status from a significant percentage of nonprofit hospitals, there would almost certainly be a strong ripple effect resulting in many of these hospitals losing local property tax exemption. Perhaps even more important, unless governments at all levels consider the tax expenditure cost of charitable tax status to all affecting taxing jurisdictions, there is a great risk that each taxing jurisdiction will count only its own tax expenditure cost while giving charities "credit" for the total value of the benefits they confer on the public. This multiple counting of a single quantum of community benefit to justify multiple tax benefits clearly introduces an inappropriate bias in favor of granting charitable tax status.

3. Opportunity Cost of the Deployment of Charitable Capital

Finally, an argument can be made that Congress should also count as a cost of charitable tax status of the charitable capital currently held by the nonprofits whose charitable tax status is under review. A practical example that brings this issue into focus is the formation over the last decade and a half of more than 100 grant-making foundations, some with assets in excess of a $1 billion, created as a result of the sale of nonprofit hospitals and health plans to for-profit firms. A similar result would almost certainly follow if Congress withdrew charitable tax status from a significant number of nonprofit hospitals. If this charitable capital would likely be redeployed to uses that would generate a substantially higher social return, the opportunity cost of forgoing this increased return should arguably be considered as an additional cost of granting charitable tax status. While this is unlikely to be a significant factor for most types of public benefit nonprofits, hospitals may be a significant exception, given their very substantial capital assets.

B. Analyzing the Benefits of Granting Charitable Tax Status

Earlier sections have presented at great length the case for viewing charitable tax status as a market intervention designed to mitigate one or more of three types of market failures: (1) to increase the supply of public goods (both specific and systemic), (2) to mitigate contract failure-induced deficiencies in the quality of particular goods or services, and (3) redress distributional inequities. It follows that Congress should expect proponents of charitable tax status for a particular set of public benefit nonprofits to explain how, and to what extent, these nonprofits advance one or more of these objectives.

Useful quantification of particular benefits will rarely be possible. For example, it seems unlikely that we will any time soon have a methodology capable of estimating the dollar value of particular nonprofit's contributions to social capital or pluralism, or even of their output of specific public goods like education, environmental preservation, or character development in the young. *A fortiori*, we will not have useful quantitative estimates of the value of the portion of this output attributable to charitable tax status.

A more realistic, and still quite useful, goal is to press for conceptual clarity. Where proponents of charitable tax status advance a public goods rationale, they need to explain the specific nature of the alleged market failure, why it is sufficiently serious to justify government intervention, why subsidizing the nonprofits in question is the optimum market intervention, and why it is reasonable to conclude that the benefits of this intervention will justify the costs. Conceptual clarity on these key points should help Congress make a more considered qualitative judgment about whether awarding charitable tax status would produce the claimed benefits to the public.

Where the proponents of charitable tax status advance a contract failure rationale, they need to demonstrate that the public is, in fact, suffering serious harm as a result of their inability to police the quality of the particular good or service, that the nonprofit providers consistently provide significantly higher quality goods or services than the for-profit providers, and that charitable tax status is likely to significantly expand the nonprofits' market share. Again, greater conceptual clarity would assist Congress in reaching a qualitative judgment about whether the benefits of granting charitable tax status are likely to justify the costs.

Finally, where the proponents advance a distributional equity rationale, they need to demonstrate why subsidizing a specific set of public benefit nonprofits through granting charitable tax status will be more effective than other market intervention options, including direct transfers or tax relief to the poor.

IX. Broader Observations on the Nature of the Exemption Decision

A. The Time-Bound Nature of the Exemption Decision

[To be added.]

B. The Differing Character of Legislative and Judicial Decisions on Exempt Status

[To be added.]

X. Conclusion

[To be added.]

Appendix 1

Decision Tree on Granting Charitable Tax Status

1.Does the market fail to supply the socially optimum quantity, quality, or income distribution of the good or service?

1a. No → No government intervention

1b. Yes → May need government intervention to increase quantity or quality of good or service or to increase supply to the poor and disadvantaged.

2. What is the form of the market failure?:

2a. Inadequate supply because good or service is a public good

3. Can government or nonprofits produce good or service more efficiently than business?

3a. No → Producer or consumer subsidies or tax incentives to increase business production

3b. Govt. most efficient producer → Govt. supplies good or service directly

3c. Nonprofits most efficient producer → Direct subsidies or tax incentives to increase nonprofit production

2b. Inadequate quality because of contract failure

4. If the quality problem is serious enough to justify intervention:

4a. If cost effective govt. regulatory program is feasible?: → Direct govt. regulation

4b. If nonprofits provide higher quality than for-profits: → Can govt. cost-effectively increase nonprofit market share?

4b1. Yes

4b2. No

2c. Under-supply to the poor or disadvantaged because of inability to pay

5. Can government or nonprofits produce good or service more efficiently than business?

5a. No → Direct subsidies or tax benefits to increase purchasing power of the poor

5b. Govt. most efficient producer → Govt. supplies good or service directly

5c. Nonprofits most efficient producer → Direct subsidies or tax incentives to increase nonprofit production

6. What is the optimum intervention to increase nonprofit production:

6a. Direct govt. subsidy → Grant or contract program

6b. Tax incentives → Tax-exemption

6c. Restricted consumer subsidy → Restricted voucher program

6d.Regulatory preference → Create preference

7. Does cost-benefit analysis justify c3 status?

<u>Costs of c3 status</u>

7a1. Federal tax expenditure

7a2. State & local tax expenditure

7a3. Opportunity cost of capital

7a4. Other?

< ?

<u>Benefits of c3 status</u>

7b1. Increase in supply of good or service

7b2. Increase in quality of good or service

7b3. Increase in supply to poor and disadvantaged

7b4. Increase in social capital and/or pluralism