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## The Role of Charity in a Federal System

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## THE ROLE OF CHARITY IN A FEDERAL SYSTEM

BRIAN GALLE\*

### ABSTRACT

*This Article critiques the prevailing justification for subsidies for the charitable sector and suggests a new alternative. Existing rationales are based on an economic model that assumes a single government whose decisions are guided by a single median voter. I argue that this theory is unpersuasive when translated to federal systems, such as the United States, in which there may instead be thousands of competing local governments.*

*I then attempt to construct a theory of the charitable sector that takes account of interactions between charity, local government, and national government. In this revised account, charity is most important when federalism mechanisms break down. For example,*

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\* Assistant Professor, Boston College Law School. I am grateful for helpful comments from and conversations with Ellen Aprill, Rob Atkinson, Bill Bratton, Evelyn Brody, Mihir Desai, Joe Dodge, Miriam Galston, Mark Gergen, Daniel Halperin, Adam Hirsch, Jill Horwitz, Aziz Huq, Doug Kahn, Louis Kaplow, Don Langevoort, Sarah Lawsky, Leandra Lederman, Ben Leff, Saul Levmore, Ray Madoff, Dan Markel, Gregg Polsky, Diane Ring, David Schizer, Joshua Schwartz, Henry Smith, Linda Sugin, Bob Tuttle, some anonymous reviewers, and audiences at presentations at the American Association of Law Schools Scholarly Paper Competition Winners Panel, Boston College, Florida State, Georgetown, George Washington University, Harvard, Indiana-Bloomington, and Loyola-L.A. law schools. Rob Stevenson provided outstanding research assistance.

*frictions on exit produce too little jurisdictional competition, and excessively easy exit produces too much competition—a race to the bottom. In both these cases, the quality of the resulting government services is predictably low, so that charity can be expected to outperform rival governments. Even if not, the threat of the charitable alternative may supply competition that is otherwise missing from the market for government services. These conclusions also have implications for the law of charitable organizations, as I detail.*

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## INTRODUCTION

Our contemporary theory of charity is simple and widely accepted, but incomplete. According to the dominant account, charity exists to provide goods and services that could not readily be produced in the for-profit sector.<sup>1</sup> Typically, in this story, the market fails because the products are public goods—their use by one person does not preclude their use by many others, so that no one person has any reason to pay for them herself.<sup>2</sup> Subsidies, such as the deduction for contributions to charity offered by § 170 of the Tax Code,<sup>3</sup> help to prop up the charitable production of these public goods.<sup>4</sup> This same story of market failure is traditionally the basis of the economic rationale for government.<sup>5</sup> Theorists distinguish charity from government by arguing that government meets only the needs of the majority, whereas charity can offer a diverse array of services for all segments of society.<sup>6</sup>

But as I will argue here, this supposed advantage of charity assumes that we have only one government, one majority. To the contrary, our federal system is designed to offer precisely the pluralism, flexibility, and responsiveness that charity theorists call

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1. Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 505 (1990); Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419, 439 (1998); Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1397 (1988); Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307, 391 (1991); Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 68 (1981); David Pozen, *Remapping the Charitable Deduction*, 39 CONN. L. REV. 531, 558, 560 (2006).

2. JOHN D. COLOMBO & MARK A. HALL, *THE CHARITABLE TAX EXEMPTION* 100-13 (1995); Gergen, *supra* note 1, at 1397-98; Hansmann, *supra* note 1, at 68; Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 848-49 (1980).

3. I.R.C. § 170 (2006).

4. COLOMBO & HALL, *supra* note 2, at 104-08; Harold M. Hochman & James D. Rogers, *The Optimal Tax Treatment of Charitable Contributions*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS* 224, 228-32 (Susan Rose-Ackerman ed., 1986); Susan Rose-Ackerman, *Altruism, Nonprofits, and Economic Theory*, 34 J. ECON. LITERATURE 701, 715 (1996).

5. *E.g.*, RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 5-8 (5th ed. 1989).

6. *E.g.*, Gergen, *supra* note 1, at 1399.

for.<sup>7</sup> Thus, in this Article, I argue that we must reconsider charity from the ground up: in a world where both local governments and charities can provide public goods, and government has massive advantages in scale and fundraising, what role is there for charity? Put in terms of tax policy, if the goal is to subsidize production of public goods by actors other than the federal government, why should we grant a deduction for contributions to charity when there is already a deduction for taxes paid to state and local governments?<sup>8</sup>

My goal here is not to undermine support either for charity or local government but instead to establish both sectors on firmer intellectual footing. As it turns out, federalism often fails in its goals. Each sector—the charitable and the governmental—has distinctive strengths and weaknesses that better suit it for some tasks than others. The law of nonprofits should emphasize the sector's strengths while leaving largely to government tasks for which charities are poorly suited.

But that is the end of the story. Let me begin at the beginning. The father of the modern market-failure theory of the deduction is Henry Hansmann of Yale Law School, who set it out in a series of articles in the early 1980s.<sup>9</sup> Hansmann admitted that he had no particular explanation for why charity, rather than government, might be the best place to produce public goods.<sup>10</sup> That piece of the theory was filled in by several other commentators. Some said that government could not itself capture the diversity, pluralism, and experimental energy of society as a whole.<sup>11</sup> The economist Burton Weisbrod, arguing from a purely welfarist perspective, suggested instead that government services can meet only the needs of the median voter, so that charity is necessary to satisfy demand for public goods in excess of the level that the median voter is willing to vote for.<sup>12</sup> Weisbrod acknowledged that there could be more than

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7. *E.g.*, *Gregory v. Ashcroft*, 501 U.S. 452, 457-58 (1991) (explaining the advantages of dual sovereignty between federal and state government).

8. I.R.C. § 164 (2006).

9. Hansmann, *supra* note 1, at 55; Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 500, 623 (1981); Hansmann, *supra* note 2, at 843-45.

10. Hansmann, *supra* note 2, at 896.

11. *See infra* text accompanying notes 39-44.

12. Burton A. Weisbrod, *Toward a Theory of the Voluntary Non-Profit Sector in a Three-*

one government but dismissed the significance of that fact in a single sentence.<sup>13</sup> And there have been only two brief mentions of federalism in the literature since.<sup>14</sup>

As a result, existing discussions of why we ought to choose subsidies for charity over direct government provision of public goods are, to put it mildly, incomplete. Again, the central problem for charity is that state and local governments provide alternatives to monolithic central government decisions about the kind and quantity of public goods to provide, just as charity is said to do. To be sure, there are limits on the variety that local governments will offer, and limits, too, on citizens' ability to move between those jurisdictions or reshape them to get the services they prefer. But the very possibility of such an array of options reduces the need for charity to fill in. Moreover, the legal and economic literatures have until now failed to note inefficiencies that arise when supports for charity are mixed with a federated system of government. These inefficiencies pose the danger that subsidies intended to increase overall social welfare may actually on net drag it below the level we would obtain through federalism alone.

These overlaps and losses might be justified, though, if nonprofits can produce better-quality goods and services.<sup>15</sup> A system that

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*Sector Economy*, in ALTRUISM, MORALITY, AND ECONOMIC THEORY 171, 175-83 (Edmund S. Phelps ed., 1975).

13. *Id.* at 178.

14. Bruce R. Kingma, *Public Good Theories of the Non-Profit Sector: Weisbrod Revisited*, 8 VOLUNTAS 135, 145 (1997); Michael Krashinsky, *Transaction Costs and a Theory of the Nonprofit Organization*, in THE ECONOMICS OF NON-PROFIT INSTITUTIONS, *supra* note 4, at 114, 124-25.

15. There is a rich literature extolling the virtues of privatization—that is, of shifting even the production of public goods away from government to private firms and voluntary associations. For example, Saul Levmore and David Schizer have argued that charity is typically more effective than government, mostly because of supposed advantages in the information and skill of its stakeholders. Saul Levmore, *Taxes as Ballots*, 65 U. CHI. L. REV. 387, 406-07 (1998); David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals*, 62 TAX L. REV. 221, 262 (2009). Many other commentators have urged more generally that any private entity is preferable to bureaucracy. *E.g.*, GUIDO PINCIONE & FERNANDO TESÓN, RATIONAL CHOICE AND DEMOCRATIC DELIBERATION: A THEORY OF DISCOURSE FAILURE 228-42 (2006); E.S. SAVAS, PRIVATIZATION: THE KEY TO BETTER GOVERNMENT 109 (1987).

I find these generic arguments against government unpersuasive. In brief, privatization proponents overlook the possibility that many of government's putative flaws are equally true of charity. More importantly, they misunderstand the significance of the fact that government



includes charity outperforms others in those cases where the inherent limitations of local government diminish the public sector's effectiveness. For instance, residents' costs of moving and gathering information about rival jurisdictions can reduce competition between localities, allowing government to be relatively slack and inefficient.<sup>16</sup> In other situations, there is excess competition, as where the mobility of wealthy taxpayers puts fiscal pressure on local jurisdictions that wish to regulate the mobile or redistribute wealth from them. Charity has a role to play in these scenarios, although, as I explain, it is a narrower role than the expansive one currently envisioned by federal and state law.

With this new, clearer purpose in mind, we have a better sense of how best to resolve many of the persistent puzzles of charitable law. Among the important issues my analysis here helps resolve are the question of whether the deduction should be prohibited for charities that violate "public policy," the debate over political participation by charities, and the extent to which a charity's managers can deviate from the wishes of donors. My refinement also suggests reasons to doubt Malani's, Posner's, and Henderson's arguments for for-profit charity,<sup>17</sup> as I have set out in more detail elsewhere.<sup>18</sup>

In addition to solidifying and clarifying the law of charity, my analysis also makes a case for government. By identifying where each sector has comparative advantages, I show that the privatization advocates are mistaken. Charity and government work best side-by-side, not with one or the other on the sideline. This conclusion somewhat rationalizes the current practice of allowing deductions for both charitable contributions and local taxes.

The Article proceeds in four parts. Part I offers those new to the literature a short overview of why others have claimed we should

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decisions are the product of deliberative processes open to all, whereas charity can be an instrument for the unreflective interests of a few. This single-minded approach can lead charities to neglect the impact of their decisions on others, and research on decision making suggests that any deliberations that do occur may be of lower quality than would happen in an environment with more diverse ideas. For space reasons, however, I leave discussion of these points for future work.

16. See *infra* text accompanying notes 188-92.

17. See M. Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571, 576 (2009); Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2021, 2031 (2007).

18. Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213, 1218-33 (2010).

subsidize charity. Part II explains the inadequacy of these existing justifications in light of federalism and public choice theory. Part III develops a contextual explanation for charity, in which charity becomes an appealing option when there is too much or too little competition between local governments. Part IV sets out my view of the basics of a new law of charity, based on the rationale offered in Part III. The Article concludes with preliminary suggestions for other legal changes that would follow from my arguments here.

### I. THEORIES OF THE SUBSIDY FOR CHARITY

Section 501(c)(3) of the Tax Code exempts qualifying nonprofit entities from the federal tax on the income of corporations.<sup>19</sup> Section 170 of the Code also allows individuals who make contributions to those organizations to deduct some or all of their contribution on their federal income tax return.<sup>20</sup> It is this eligibility to receive deductible contributions that distinguishes 501(c)(3) nonprofits from so-called “noncharitable” nonprofit organizations, many of which also are exempt from federal corporate income tax.<sup>21</sup> Qualifying as a 501(c)(3) also often results in additional state tax benefits.<sup>22</sup>

Although the rationales for these three separate forms of tax benefit are somewhat interrelated, in this Article I focus on § 170, the federal deduction for donations to qualifying charities (the deduction),<sup>23</sup> and on parallel state law deductions.<sup>24</sup> Explanations

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19. I.R.C. § 501(c)(3) (2006). *See generally* DARRYLL K. JONES ET AL., *THE TAX LAW OF CHARITIES AND OTHER EXEMPT ORGANIZATIONS* 11-505 (2003) (setting out requirements of exemption for various forms of charitable organization). This Part is derived from Galle, *supra* note 18, at 1217.

In this Article I generally use “charity” and “nonprofit” interchangeably, but the reader should be aware that in legal terms a charity is a subset of the general class of nonprofits; charities are those nonprofits eligible for the preferential treatment of § 501(c)(3).

20. I.R.C. § 170 (2006). *See generally* JONES ET AL., *supra* note 19, at 1048-76 (describing rules applicable to charitable contributions).

21. *See* JONES ET AL., *supra* note 19, at 728-53.

22. *See* John D. Colombo, *Federal and State Tax Exemption Policy, Medical Debt and Healthcare for the Poor*, 51 ST. LOUIS U. L.J. 433, 436, 439 (2007) (describing the history of property tax exemptions for charitable hospitals).

23. I will refer to the § 170 deduction as simply “the deduction.”

24. The possibility of support for charity at the subnational level also raises an additional set of questions about which tier of government should be assigned that supporting role. I defer consideration of those issues for later work.

for why it may or may not be appropriate to tax the incomes of nonprofit corporations are clouded by more general confusion over why our system imposes a separate tax on entities.<sup>25</sup> Thus, my discussion is conceptually cleaner if it is limited to provisions affecting the taxation of individuals who donate.

There is now widespread agreement that the deduction subsidizes the organizations eligible to receive it.<sup>26</sup> The deduction allows taxpayers who itemize to reduce their taxable income by the amount of their donation, so that on net each dollar of donation reduces the amount of tax paid by \$1 times the marginal tax rate.<sup>27</sup> Because these deductions reduce the total amount of government money available for other projects, the deduction is in effect a government matching grant to the recipients of deductible donations.<sup>28</sup>

Some commentators have argued that the deduction is not intended as a subsidy and need not be defended on that basis, but that view has overwhelmingly been rejected.<sup>29</sup> These claims turn on technical arguments about the normative definition of “income” under an ideal income tax.<sup>30</sup>

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25. For a thorough analysis of exemption issues in a related context, see Daniel Halperin, *Income Taxation of Mutual Nonprofits*, 59 TAX L. REV. 133 (2006).

26. Atkinson, *supra* note 1, at 505 (describing this view as “[t]he emerging orthodox account”).

27. For example, if I earn \$1,000,000, so that I pay \$0.35 in tax on each dollar earned above about \$350,000, a \$1,000 donation reduces my taxable income to \$999,000 and therefore reduces the amount of tax I pay by \$350.

28. Jeff Strnad, *The Charitable Contributions Deduction: A Politico-Economic Analysis*, in *THE ECONOMICS OF NON-PROFIT INSTITUTIONS*, *supra* note 4, at 265, 273.

29. See John D. Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 WAKE FOREST L. REV. 657, 661 (2001) (noting literature’s rejection of these arguments); Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U. L. REV. 505, 517 (2010) (same); Dana Brakman Reiser, *Dismembering Civil Society: The Social Cost of Internally Undemocratic Nonprofits*, 82 OR. L. REV. 829, 882-83 & n.199 (2003) (same).

30. I refer interested readers to the fine analyses by Gergen, *supra* note 1, at 1414-33, and Hansmann, *supra* note 1, at 58-64. Johnny Rex Buckles’s argument that charitable donations are actually a form of “community income” that should be untaxed would also fall in this category. Johnny Rex Buckles, *The Community Income Theory of the Charitable Contributions Deduction*, 80 IND. L.J. 947, 952 (2005). Buckles notes that tax law generally does not treat as income money that is earned by an agent on behalf of a principal. *Id.* at 977-78. He then claims that because charities often serve the community, donors can be thought of as agents collecting money on behalf of the community. *Id.* But Buckles’s analogy is untenable. Agents are not taxed separately because they have no legal claim on their earnings; it is never within

Most commentators instead embrace the idea that the deduction is a subsidy and argue that the subsidy is justified as a tool for encouraging the production of goods that would otherwise be underproduced by the private market.<sup>31</sup> Mostly these consist of public goods—goods whose use can be shared by many consumers and from which it would be relatively difficult for the producer to exclude users.<sup>32</sup> Because of these features, there is a private market failure in the production of public goods.<sup>33</sup> Because every potential consumer gets the good for free once anyone pays for it, individuals have a strong incentive to free ride on others' consumption, making it difficult for any producer to turn a profit.<sup>34</sup> Even if some goods can be sold, the market will probably produce less than the socially optimal amount of the good.<sup>35</sup> Subsidies can remedy this market failure by paying consumers to buy more of the underproduced good.<sup>36</sup>

In practice, pure public goods are rare. More common are private goods that also create spillover benefits, or positive externalities, for people other than the purchaser. For instance, education is a private good—schools can limit their services solely to the admitted. But an educated population can be good for others, too. Again, though, purchasers of education might buy too little education from a social perspective because they will not pay for the benefits to the public. Thus, although I refer throughout this Article to “public goods,” the

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their control. In contrast, a charitable donor has a legal claim over her earnings and chooses to spend them on charity. Even if she has some *moral* compulsion to donate or tithe, the money is still *legally* hers. Further, to the extent that Buckles's argument depends on the existence of a moral compulsion to donate, it is indistinguishable from Andrews's (now discredited) argument that donations are not consumption and therefore should not be taxed. William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 344-75 (1972).

31. See OFFICE OF MGMT. & BUDGET, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 2008, at 257-59 (2007); Ilan Benshalom, *The Dual Subsidy Theory of Charitable Deductions*, 84 IND. L.J. 1047, 1055-62 (2009); Colombo, *supra* note 29, at 698; Gergen, *supra* note 1, at 1397-98; Hansmann, *supra* note 1, at 68, 71-72; Pozen, *supra* note 1, at 547, 552-53.

32. On the general theory of public goods, see MUSGRAVE & MUSGRAVE, *supra* note 5, at 41-48.

33. *Id.* at 44-45; Gergen, *supra* note 1, at 1397-98; Hansmann, *supra* note 1, at 74.

34. COLOMBO & HALL, *supra* note 2, at 101.

35. *E.g.*, JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 184-85 (2d ed. 2006).

36. See COLOMBO & HALL, *supra* note 2, at 107.

reader should understand that the discussion also applies more generally to any private good with a significant positive externality attached.<sup>37</sup>

Henry Hansmann's theory of the nonprofit firm helps to explain why, under this theory of the deduction, only nonprofits should be eligible to receive deductible contributions.<sup>38</sup> Hansmann defines nonprofit firms as those subject to the "nondistribution constraint": they can earn profits, but must use these profits for internal development, rather than distributing them to investors or managers.<sup>39</sup> Entrepreneurs voluntarily accept the nondistribution constraint, Hansmann argues, so that donors will know that their giving will not be wasted.<sup>40</sup> The logic is that donors cannot easily judge the quality of public goods, especially where those goods are delivered to someone other than the donor.<sup>41</sup> Without the nondistribution constraint, managers of the firm could easily divert donations for their own profit, making donors unlikely to give.<sup>42</sup>

Besides spurring the production of public goods, the deduction also might inspire other desirable ends. In one line of commentary, the charitable sector is hailed as a source of diversity and pluralism.<sup>43</sup> In this view, charities are sites for citizens to come

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37. For fuller explication of the points in this paragraph, see GRUBER, *supra* note 35, at 179 ("It is helpful to think about a public good as one with a large positive externality."); MUSGRAVE & MUSGRAVE, *supra* note 5, at 49-50 (explaining equivalency of public goods and private goods with positive externalities, but noting that a smaller subsidy is needed to produce the private goods). Similarly, in some cases, what I refer to as public goods might more precisely be described as "club goods," because in theory they could be "fenced" and made accessible only to "members." Some club goods may also produce externalities for nonmembers, such as a park with historic social significance. The club will underprovide the nonprivate aspects of consumption; for example, the club will not necessarily use the park in a way that is consistent with historic preservation. For a survey of other arguments for government production of potential club goods, see Amnon Lehari, *Property Rights and Local Public Goods: Toward a Better Future for Urban Communities*, 36 URB. LAW. 1, 16-24 (2004).

38. Hansmann, *supra* note 9, at 605; *see also* Atkinson, *supra* note 1, at 617-18 (explaining this implication of Hansmann's analysis).

39. Hansmann, *supra* note 9, at 501; *see also* Hansmann, *supra* note 2, at 848-51.

40. *See* Hansmann, *supra* note 9, at 507; *see also* Rose-Ackerman, *supra* note 4, at 716.

41. Hansmann, *supra* note 9, at 506; *see also* Atkinson, *supra* note 1, at 572.

42. Hansmann, *supra* note 1, at 69-70.

43. LESTER M. SALAMON, AMERICA'S NONPROFIT SECTOR: A PRIMER 8-9 (1992); David A. Brennan, *A Diversity Theory of Charitable Tax Exemption—Beyond Efficiency, Through Critical Race Theory, Toward Diversity*, 4 PITT. TAX REV. 1, 15 (2006); Barbara K. Bucholtz, *Reflections on the Role of Nonprofit Associations in a Representative Democracy*, 7 CORNELL J.L. & PUB. POL'Y 555, 556 (1998); John G. Simon, *Charity and Dynasty Under the Federal Tax*

together to pursue common goals.<sup>44</sup> They give voice to interests or communities that otherwise would be unnoticed or unfunded, and they help participants develop the capacity to be more fully rounded citizens.<sup>45</sup> This way, new ideas can slowly “bubble up” from the individual level until they are more generally accepted by the public.<sup>46</sup>

Even if ideas never reach critical mass, these theorists say, the opportunity to pursue and discuss them in a nonprofit setting offers a chance for participants who otherwise would be shut out of government or the market to take part in deliberative self-determination, a fundamental part of what it means to be human.<sup>47</sup> And these deliberations are said to be more valuable than comparable experiences in government or boardrooms, because members are more closely involved with the decision process and the effectuation of organizational goals.<sup>48</sup> Similarly, Levmore emphasizes the way in which the diverse array of donors’ individual choices regarding charities can enhance overall social welfare, a process he calls “taxes as ballots.”<sup>49</sup>

Finally, some supporters of the deduction emphasize its possible role in fostering social justice, particularly in the form of redistribution of wealth from rich to poor.<sup>50</sup> Although these scholars have

*System*, in THE ECONOMICS OF NONPROFIT INSTITUTIONS, *supra* note 4, at 246, 253-54. Alternately, charity is said to offer a nonbureaucratic alternative to government provision, which in turn permits greater diversity of ideas. Schizer, *supra* note 15, at 228, 243-44.

44. See Simon, *supra* note 43, at 254-55.

45. See ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA 513-14 (J.P. Mayer ed., George Lawrence trans., Anchor Books 1969) (1835); ROBERT D. PUTNAM, BOWLING ALONE: THE COLLAPSE AND REVIVAL OF AMERICAN COMMUNITY 288-89 (2000) [hereinafter PUTNAM, BOWLING ALONE]; ROBERT D. PUTNAM WITH ROBERT LEONARDI & RAFFAELLA Y. NANETTI, MAKING DEMOCRACY WORK: CIVIC TRADITIONS IN MODERN ITALY 89-90 (1993); Benschalom, *supra* note 31, at 1077-79; Simon, *supra* note 43, at 254-57.

46. See ROBERT DAHL, A PREFACE TO DEMOCRATIC THEORY 133 (1956); MICHAEL WALZER, ON TOLERATION 107 (1997); Brennen, *supra* note 43, at 24.

47. PUTNAM, BOWLING ALONE, *supra* note 45, at 288-89; Jürgen Habermas, *Justice and Solidarity: On the Discussion Concerning “Stage 6”*, in HERMENEUTICS AND CRITICAL THEORY IN ETHICS AND POLITICS 32, 44-45 (Michael Kelly ed., 1990); Kathleen Sullivan, *Rainbow Republicanism*, 97 YALE L.J. 1713, 1719-21 (1988).

48. See PETER L. BERGER & RICHARD JOHN NEUHAUS, TO EMPOWER PEOPLE: THE ROLE OF MEDIATING STRUCTURES IN PUBLIC POLICY 2-3 (1977).

49. Levmore, *supra* note 15, at 404-06.

50. Anthony B. Atkinson, *The Income Tax Treatment of Charitable Contributions*, in PUBLIC AND URBAN ECONOMICS: ESSAYS IN HONOR OF WILLIAM S. VICKEY 13, 13 (Ronald E.

offered arguments for why there should be some additional benefits for redistributive charity, they have not explained why the deduction should be withdrawn from other goals, such as research, teaching, or art. Thus, I do not view redistribution as a comprehensive theory of the deduction, but instead only as an additional benefit that might be wrung from it.

## II. INADEQUACY OF CURRENT THEORIES OF THE DEDUCTION

Though the subsidy theories of the deduction now are dominant, they have papered over a sizable hole in their rationales. Market failures explain why there must be a government intervention, but they do not explain why that intervention should be in the form of a subsidy for charity, rather than direct government provision of the goods the market fails to offer. Some of the subsidy theorists, such as Henry Hansmann, have been candid in admitting that they can offer no clear reason to prefer charity to government.<sup>51</sup> Others, however, maintain that government fails to satisfy minority preferences or that government provision alone would not be sufficiently diverse or pluralistic.<sup>52</sup> As I will show in this Part, these claims fail to account adequately for the governance possibilities federalism offers. Parts II.A through II.D sketch out flaws in the prevailing approaches, and Part II.E summarizes what remains of the argument for subsidized charity after these limitations are accounted for.

### A. Government Failure and Multiple Jurisdictions

Burton Weisbrod's median voter theory is by far the most common explanation for why there should be a charitable subsidy in addition to governmental provision of public goods.<sup>53</sup> According to Weisbrod,

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Grieson ed., 1976); Perry Fleischer, *supra* note 29, at 509-11; Oliver A. Houck, *With Charity for All*, 93 YALE L.J. 1415, 1423 (1984). *But see* Strnad, *supra* note 28, at 283 (arguing that charity is a poor mechanism for redistribution).

51. Hansmann, *supra* note 2, at 896.

52. *See supra* note 43.

53. COLOMBO & HALL, *supra* note 2, at 100-08; Atkinson, *supra* note 1, at 576-77; John D. Colombo, *The Role of Access in Charitable Tax Exemption*, 82 WASH. U. L.Q. 343, 366 (2004); Crimm, *supra* note 1, at 442 & n.91; Perry Fleischer, *supra* note 29, at 520; Gergen, *supra*

governmental provision of public goods by majority rule will disappoint some minority voters, assuming that voters vary in their preferences.<sup>54</sup> In Weisbrod's model, officials behave according to the standard political science assumption that they should enact the preferences of the median voter.<sup>55</sup> Government succeeds in providing public goods where the median voter is willing to pay for at least some of a given good, because government can tax would-be free riders. But the median voter will not reelect an official who imposes a tax for more goods than she prefers to pay for. Voters who would demand even more of the good therefore cannot use the government's taxing power to overcome the free rider problem.<sup>56</sup> As a result, just as in the private market, democratic government fails to meet all of society's preferences for the consumption of public goods. Subsidies for charity thus allow voters who want more of the good to surmount the free rider barrier.<sup>57</sup>

### *1. Tiebout and Inframarginal Donors*

One glaring problem with this account, albeit one almost totally absent from the nonprofit literature, is that it assumes that disappointed voters who prefer more services have no choice of governments with taxing authority.<sup>58</sup> But in a competing model, first suggested by the economist Charles Tiebout voters have a choice between many rival local governments.<sup>59</sup> Thus, rather than having

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note 1, at 1399; Kingma, *supra* note 14, at 135; Strnad, *supra* note 28, at 285; Avner Ben-Ner, *Who Benefits from the Nonprofit Sector? Reforming Law and Public Policy Towards Nonprofit Organizations*, 104 YALE L.J. 731, 749 & n.84 (1994) (reviewing WHO BENEFITS FROM THE NONPROFIT SECTOR? (Charles T. Clotfelter ed., 1992)).

54. Weisbrod, *supra* note 12, at 175-77.

55. *Id.* at 176. In the simplified two-party universe of the median voter model, rational officials obey the median voter because appealing to anyone else means losing the next election. MUSGRAVE & MUSGRAVE, *supra* note 5, at 89.

56. As Weisbrod notes, this account assumes that taxes are a "nonbenefit"—that is, that each voter cannot individually choose the exact level of tax she pays and benefit she receives, as might be the case with a system of tolls or user fees. Weisbrod, *supra* note 12, at 175.

57. *Id.* at 188-89; *see also* Strnad, *supra* note 28, at 270-72 (describing charities as a mechanism for revealing preferences for public goods not expressed through government or private market). *But see id.* at 285 (suggesting that add-on theory fails if government reduces its own expenditures in response to charitable spending).

58. Weisbrod, *supra* note 12, at 178.

59. Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 418



to rely on subsidies, a voter who preferred more services than her local median voter would simply move to a jurisdiction where the median preference was closer to her own. The reverse would be true for voters with submedian preferences: they would move to a jurisdiction that imposed a lower tax. At equilibrium, assuming that there were enough jurisdictions to choose from and moving were costless, voters in each jurisdiction would actually have identical preferences for public goods, negating the basic assumption of Weisbrod's model.<sup>60</sup>

Weisbrod acknowledges that voter mobility is a challenge for his argument, but dismisses it in one sentence. "[S]ince moving is not costless," he avers, "and since locational decisions reflect many considerations other than governmental outputs and taxes, we can think of [the model] as portray[ing] ... the likely [type of] situation even after migration adjustments."<sup>61</sup> That is, the claim appears to be that citizens will not sort themselves perfectly according to their preferences, so that there will always be some residual, unmet demand for public goods, even at the local level.<sup>62</sup>

While Weisbrod is correct that the "market" for local government is imperfect, he fails to recognize that in a federal system, subsidies for charity contribute to two other inefficiencies. First, any significant amount of mobility increases the waste inherent in the subsidy and reduces its cost-effectiveness. Like most subsidy systems, the charitable contribution deduction is wasteful because it gives money even to donors who would have contributed without encouragement—"inframarginal" donors.<sup>63</sup> For example, consumers with the

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(1956). For elaborations, see Robert P. Inman & Daniel L. Rubinfeld, *The Political Economy of Federalism*, in PERSPECTIVES ON PUBLIC CHOICE 73, 83-85 (Dennis C. Mueller ed., 1997); Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LITERATURE 1120, 1124 (1999) [hereinafter Oates, *Fiscal Federalism*]; Wallace E. Oates, *On Local Finance and the Tiebout Model*, 71 AM. ECON. REV. 93, 93, 95-97 (1981).

60. Weisbrod, *supra* note 12, at 175.

61. *Id.* at 178.

62. Empirical measures of Tiebout sorting are mixed, but in general they find that at the margins people do respond to their local mix of taxes and government services. For empirical surveys, see Vicki Been, "Exit" as a Constraint on Land Use Exactions: Rethinking the Unconstitutional Conditions Doctrine, 91 COLUM. L. REV. 473, 520-22 (1991); William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201, 239-43 (1997); Richard Schragger, *Consuming Government*, 101 MICH. L. REV. 1824, 1830 (2003) (book review).

63. See Schizer, *supra* note 15, at 239-40.

highest demand for a public good cannot free ride on anyone else, and so will buy at least some of the good without subsidization.<sup>64</sup> But they, too, can claim the deduction, meaning that the government spends more on high-demand consumers without obtaining more of the good.<sup>65</sup> By definition, top demanders spend more and get a bigger matching grant than anyone else. Moreover, donors have no incentive to turn down unneeded subsidies, because the fiscal cost of subsidies is largely an externality for any one person: only a tiny fraction of the tax dollars needed to pay for the subsidy comes from his pocket. Thus, unless government can set a different subsidy rate for each donor, which is unlikely,<sup>66</sup> a portion of the subsidy claimed by inframarginal donors is wasted.

Mobility exacerbates the waste problem in two different ways. For one, the possibility of relocation implies that donors could obtain the services they want without a subsidy. That is, as long as there exists another jurisdiction offering additional units of the good, and the cost of moving is less than the cost to the donor of paying for new units of that good in her home jurisdiction, the donor can be satisfied without any subsidy simply by moving. Moving does eliminate the externalities that additional units of the good would produce in the home jurisdiction, but, as I later detail, it is unclear whether that is a bad result.

Relocation also heightens inframarginality by increasing the proportion of inframarginal donors in the donor pool. Again, those with the highest demand for a good in any given jurisdiction are almost always inframarginal. Each person who moves to obtain more of the good elsewhere reduces the number of potential donors who fall in between median demand and highest demand.<sup>67</sup> But

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64. Peter Diamond, *Optimal Tax Treatment of Private Contributions for Public Goods with and Without Warm Glow Preferences*, 90 J. PUB. ECON. 897, 898 (2006). The income effects of a deduction may increase donations even by inframarginal donors, however.

65. MOLLY F. SHERLOCK & JANE G. GRAVELLE, CONG. RESEARCH SERV., R 40919, AN OVERVIEW OF THE NONPROFIT AND CHARITABLE SECTOR 49 (2009), available at <http://pppnet.org/pdf/R40919.pdf>.

66. See Louis Kaplow, *A Note on Subsidizing Gifts*, 58 J. PUB. ECON. 469, 471-72 (1995) (explaining that if subsidy is determined by observed donor behavior, donors may act strategically to increase subsidy).

67. This is true even if the highest demanders leave, because once they depart, the next-highest demander becomes the new highest demander. Also, note that the mobility I focus on here is not random relocation but instead moves by those who desire more of the good. This

these are the donors for whom a subsidy is useful, so that mobility reduces the proportion of deductions claimed by people who will increase giving as a result. If Tiebout sorting were extensive enough, there could be no supermedian voters in a jurisdiction except for the top demanders.

So Weisbrod's argument that there will always be residual demand for a public good misses the point. Demand may remain, but the need for a subsidy might not. Even if some whose giving would be increased by subsidies do not move, a significant portion of each dollar spent on the subsidy could be wasted.

## *2. Distortionary Effects of Subsidized Charity in Federal Systems*

A second inefficiency of the subsidy in a multijurisdictional world arises if it distorts donors' choices of where to live or do business. Of course, the subsidy is supposed to change behavior: it encourages us to give to charity rather than free ride. But this traditional analysis overlooks that there are actually three options, not two: (1) do nothing; (2) give to charity; or (3) move to a jurisdiction where more goods are produced. While the shift from (1) to (2) may be socially desirable, the deduction also induces a shift from (3) to (2). That shift may reduce welfare.

As I model more formally elsewhere,<sup>68</sup> shifts from (3) to (2) reduce welfare when moving is better for society than forming another charity. In addition to generating positive externalities, charities can also produce negative externalities, including the tax cost of subsidizing them.<sup>69</sup> Some of these externalities would disappear if the would-be consumer of the charitable good relocates to a jurisdiction where that good is already being produced rather than founding a new organization in her existing home. The deduction reduces the appeal of relocation for the consumer, though, which

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form of relocation disproportionately reduces the number of supermedian voters without changing the number of others, which is why the usefulness of the charitable subsidy declines.

68. Brian Galle, *The Distortionary Effects of Subsidies for Charity in a Federal System* (Bos. Coll. Law Sch. Legal Studies Research Paper Series, Research Paper No. 229, 2011), available at <http://ssrn.com/abstract=1865975>.

69. Benschalom, *supra* note 31, at 1073-74.

means that in some cases welfare-increasing relocations will not happen.

The idea that charity can produce negative as well as positive externalities is not new. Louis Kaplow argues that charity might reduce incentives for individuals to work, thus slowing the economy.<sup>70</sup> For example, redistributive charities, such as soup kitchens and free health care, make it less painful to have a lower income.<sup>71</sup> More generally, any government subsidy imposes a negative fiscal externality on taxpayers who value the benefits of the subsidized charity less than their payment. Shannon McCormack also notes that individuals can have personal or ideological objections to the production of some public goods.<sup>72</sup>

I would add to Kaplow's and McCormack's accounts by noting that, crucially, negative externalities that would arise if the good were produced in one jurisdiction may not arise at all if the good were instead produced in another. Consider a homeless shelter, which might give material succor or emotional satisfaction to some, but also annoy NIMBY-minded neighbors. Those who view a town with an additional shelter as fairer might be willing to, but prefer not to, move in order to effect justice. If they relocated to a like-minded town, those who objected would no longer suffer the disutility of living near a shelter. But the shelter-builders have no reason to depart; they do not bear any of the unhappiness of their neighbors.

More prosaically, suppose that the median voter, after applying cost-benefit analysis, determines that the current level of wildlife-protection enforcement is optimal; any greater amounts, she deems, will not be worth the cost of deterring possible business investments. Now suppose some citizens place a higher value on additional increments of wildlife protection and form a "save the whales" charity to identify and picket offending local business. Even if damage to business is small, the cost of supporting the wildlife charity may exceed any subjective gains for those who love animals

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70. LOUIS KAPLOW, *THE THEORY OF TAXATION AND PUBLIC ECONOMICS* 253-54, 271-72 (2008).

71. *Id.* at 254-55 & n.13.

72. Shannon Weeks McCormack, *Taking the Good with the Bad: Recognizing the Negative Externalities Created by Charities and Their Implications for the Charitable Deduction*, 52 ARIZ. L. REV. 977, 998, 1010-11 (2010).

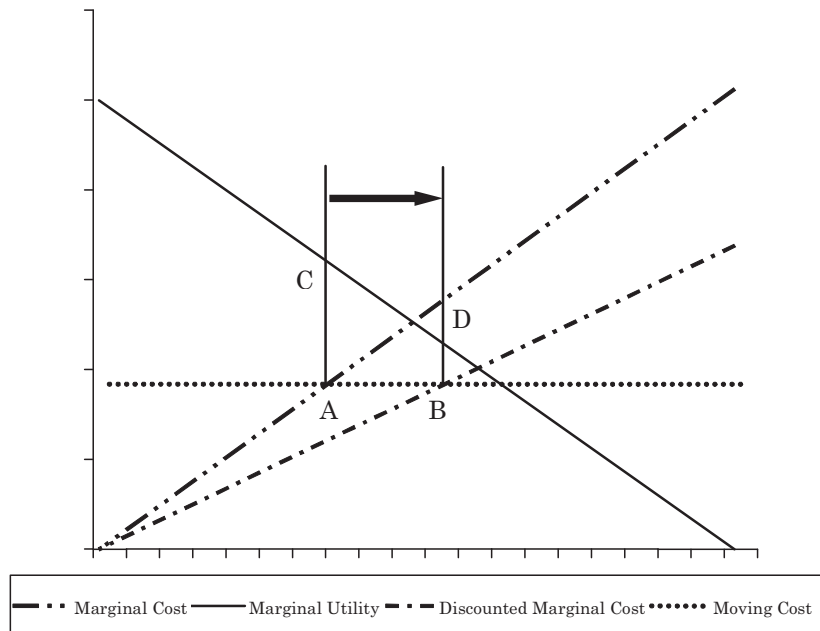
less. Here again, the ideal result in terms of social welfare would be for those who favor greater wildlife protection to relocate to a region with more stringent wildlife-protection laws. Because they are indifferent to the negative effects of their charitable works on other voters, however, they do not go.

Subsidies for charity exacerbate these potential negative effects by discouraging individuals from relocating. All else equal, a person will move when the costs of relocation are lower than the costs of paying for charitable production of a good in her existing hometown.<sup>73</sup> Subsidies for charity make charity relatively cheaper, reducing the appeal of a move. The larger the subsidy, the less likely an individual will relocate, as Figure 1 suggests.

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73. I emphasize “all else equal.” My analysis here is intended as a partial equilibrium, in which I isolate the interaction of two parts of a complex federalism mechanism. It is possible that this interaction would prompt yet other, and potentially offsetting, reactions by other actors. Even if so, these counterreactions may themselves represent costs that would not be incurred but for the deduction.

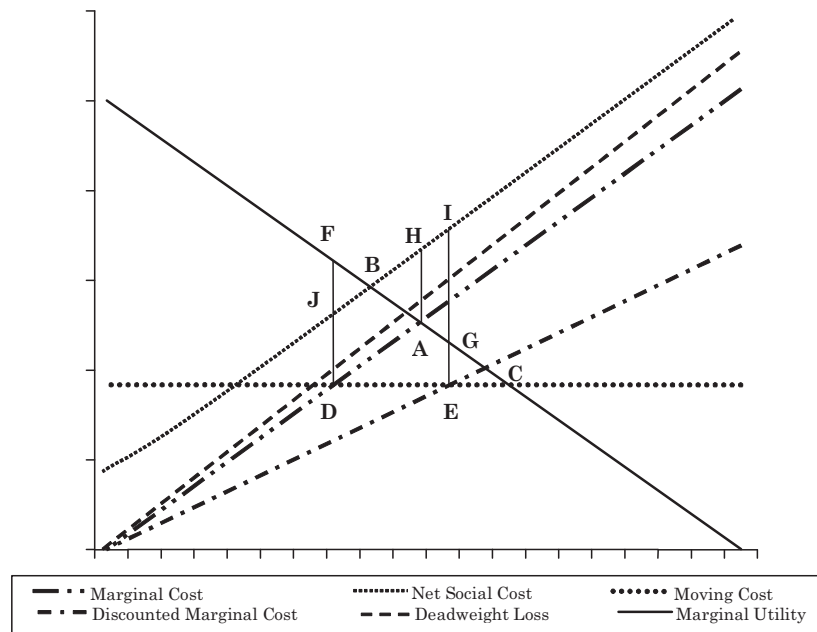
Figure 1: Effects of Charitable Subsidies on Moving Decisions



In the absence of a subsidy, an individual  $i$  relocates when her moving costs intersect the marginal cost line, at A, which corresponds to point C on her marginal utility curve, well before equilibrium. In the presence of the subsidy, however, the moving cost curve does not intersect marginal cost until point B, corresponding to point D on the marginal utility curve, well past the original, unsubsidized equilibrium. So subsidies shift the moving point, in effect increasing the amount of the public good produced in the home jurisdiction.

This change is the key distortive effect of the subsidy, as illustrated in Figure 2.

Figure 2: Net Welfare Effects of Charitable Subsidies



In Figure 2, social surplus from production of the good is represented by the rough triangle formed by the marginal utility and net social cost curves, with its vertex at point B and extending left to the y-axis; social loss from excess production of the good is represented by the triangle BAH. In the absence of a subsidy, *i* moves when her marginal utility is at F, where moving costs intersect her marginal cost curve. Because she moves, no additional units of the good are produced in jurisdiction one, resulting in the loss of the surplus represented by the triangle BFJ. But the relocation also prevents *i* from consuming the incremental units between B and A on her marginal utility curve, avoiding the social overproduction, with welfare consequences represented by the similarly sized triangle BAH. So on net, the welfare effects of the move are unclear. In

contrast, under a subsidy,  $i$  does not relocate until her marginal utility reaches  $G$ , the point on her marginal utility curve directly above the point at which moving and discounted marginal costs are equal. This permits additional overproduction, resulting in the loss triangle  $BGI$ . That triangle is obviously much larger than the surplus  $BFJ$ , so on net the subsidy is clearly welfare-reducing: it has permitted more losses than gains.

More generally, the welfare effects of a subsidy depend on the consequences of a rightward shift in the region affected by a move. If the line running upwards from point  $E$ , the moving point under a subsidy, intersects the marginal utility curve in a region where there is still net social surplus, then the subsidy increases welfare: it allows additional production of welfare-increasing public goods. If instead (as in Figure 2) point  $E$  corresponds to a region in which social welfare is decreasing, then the subsidy is likely to reduce welfare: it allows additional production of welfare-reducing public goods. This effect may be counterbalanced by any surplus that was also created as a result of the rightward shift.

Put more simply, subsidies for charity may well reduce national welfare. Where the welfare from a person's decision to stay is negative, society would be better off if she moved. But the subsidy discourages her from moving, and the larger the subsidy, the more likely she will stay.

One final consideration to keep in mind is that public goods that create significant externalities for other jurisdictions may be impossible to obtain by moving. Municipalities might underproduce many public goods benefitting a wide geographical area, because each individual town has incentives to free ride on others' efforts.<sup>74</sup> It would be surprising, for example, to see one city try to save the world's whales.<sup>75</sup> The deduction is less likely to reduce social welfare for these kinds of national-scope projects, because charities are less likely to have any subnational government competition. So, in that scenario, the world looks more like Weisbrod's model in which there

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74. Robert C. Ellickson, *Cities and Homeowners Associations*, 130 U. PA. L. REV. 1519, 1554 (1982). Whether localities in fact free ride on production of any particular public goods with interjurisdictional spillovers is a complex and difficult question. See Brian Galle & Joseph Leahy, *Laboratories of Democracy? Policy Innovation in Decentralized Governments*, 58 EMORY L.J. 1333, 1341-98 (2009).

75. I am grateful to Louis Kaplow for this point.



are only two possible sources of a public good: government and charity.

Taking all these factors into account, some justification for a charitable deduction remains, but it is rather more limited than Weisbrod, and those who rely on him, suggest. Charity has benefits, but also countervailing costs. All else being equal, subsidies for charity are efficient not simply when there are some citizens with preferences different from the median voter, but rather only when the social cost of relocation exceeds the social cost of charity, including the cost of raising taxes to provide the subsidy. Thus, there is a significant possibility that granting the deduction will reduce overall social welfare.

### *B. Government Failure and Multiple Tiers of Government*

Another factor limiting the usefulness of the charitable deduction under Weisbrod's government-failure model is the possibility of vertical competition between tiers of government. Again, Weisbrod defends his assumption that even multiple governments will leave some voters unhappy with the low level of public goods by suggesting that voters cannot easily move to a rival jurisdiction.<sup>76</sup> Thus, he claims that there will always be some additional policy-making space to be filled by a subsidy for charity.<sup>77</sup>

This account assumes that voters must actually move in order to obtain services from a different government. But in a multitiered government, such as the U.S. system of federalism, there is policy competition not only horizontally between local governments but also vertically, between local governments, states, and the national government.<sup>78</sup> In other words, even if the median voter at the national level has preferences that are too low for some voters, it may be the case that the median voter at the state or local level would prefer more services, or vice versa. In some cases there can be multiple tiers of local government. A single voter could be within

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76. Weisbrod, *supra* note 12, at 178.

77. *Id.*

78. THE FEDERALIST NO. 51, at 291 (James Madison) (Clinton Rossiter ed., 1999); Akhil Reed Amar, *Of Sovereignty and Federalism*, 96 YALE L.J. 1425, 1449-50 (1987) (citing THE FEDERALIST NO. 46, at 294 (James Madison)); Todd E. Pettys, *Competing for the People's Affection: Federalism's Forgotten Marketplace*, 56 VAND. L. REV. 329, 338-53 (2003).

a county, a municipality, and one or more “special-purpose” governments such as school or water districts.<sup>79</sup> All of these represent opportunities to get more public goods than the nation or state provides without incurring any moving costs at all.

As with relocation, Weisbrod considers this possibility but dismisses it out of hand.<sup>80</sup> I concede that there are some plausible arguments that special-purpose governments may fail to maximize social welfare. But the story is more nuanced, and leaves less room for charity, than Weisbrod suggests.

Weisbrod argues that it is costly to establish new governmental entities, so that there may be practical limitations on the citizenry’s ability to create additional layers of government in response to added demands for public goods.<sup>81</sup> Yet it is also costly to establish charitable organizations. It is unclear why we should prefer a subsidized charitable organization to a special-purpose governmental entity. Financing cannot be the answer, because we could easily design the special-purpose government to operate on subsidized user fees, which would be largely identical to the charitable funding model.<sup>82</sup>

Nonetheless, I agree that even endless tiers of special-purpose governments could fail to account for all preferences. One possible “failure” story along these lines is that special-purpose governments are not practical for some kinds of public goods. “Save-the-whales” organizations and their kin—entities with missions that could benefit the whole country—are likely examples here. Where benefits are widely dispersed, only very high demanders of the good are likely to contribute to its production.<sup>83</sup> Because any special-purpose government would have to be drawn to include mostly those who favor production of the good, the district’s borders would have to

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79. On the various forms of special-purpose districts, see Richard Briffault, *A Government for Our Time? Business Improvement Districts and Urban Governance*, 99 COLUM. L. REV. 365, 377-413 (1999); Janice C. Griffith, *Special Tax Districts To Finance Residential Infrastructure*, 39 URB. LAW. 959, 959-72 (2007).

80. Weisbrod, *supra* note 12, at 178.

81. *Id.*

82. See Krashinsky, *supra* note 14, at 125 (offering user fees as fiscal equivalent of charitable contributions).

83. See Susan Rose-Ackerman, *Risk Taking and Reelection: Does Federalism Promote Innovation?*, 9 J. LEGAL STUD. 593, 608 (1980). Again, this is because all others would simply free ride on the efforts of those with the strongest preferences. *Id.*

match the geographic distribution of those who favor production. Yet it is likely prohibitively difficult to gerrymander a special save-the-whales district across, say, seven coastal states. Charity might be a more viable mechanism for bringing together supporters.

Another possible failure story is that increasing the number of layers of local government lowers the desirability of any further proliferation. Voters are usually fairly inattentive to political decisions, because they rationally free ride on the efforts of others to monitor government.<sup>84</sup> A thicket of local governments would likely add considerably to the costs of monitoring, compounding the rational ignorance problem.<sup>85</sup> This, in turn, poses the danger that some politicians could either escape accountability or instead be blamed for the misdeeds of others inside the thicket.<sup>86</sup> Adding extra layers of government could reduce the quality not only of the added special-purpose unit but also of government more generally. That would leave us with a trade-off between the welfare gained by satisfying supra-median voters and the welfare lost by muddying government.

Finally, there may be some policy that cannot costlessly be shifted between different levels of government. The choice of where to locate regulatory authority within a federated system involves a series of trade-offs.<sup>87</sup> Some policies may have either economies or diseconomies of scale; that is, they are cheaper or more expensive, respectively, to operate for larger groups of people.<sup>88</sup> And bundles of policies can have economies of scope, in which it is more efficient to have the same group of experts work on several related problems simultaneously.<sup>89</sup> In short, at times there is already an optimal level

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84. ANTHONY DOWNS, AN ECONOMIC THEORY OF DEMOCRACY 240-59 (1957); see Stephen Earl Bennett, *Trends in Americans' Political Information, 1967-1987*, 17 AM. POL. Q. 422, 423 (1989) (finding that voter knowledge was consistently low for the twenty years studied).

85. Nicole Stelle Garnett, *Suburbs as Exit, Suburbs as Entrance*, 106 MICH. L. REV. 277, 296-97 (2007).

86. *New York v. United States*, 505 U.S. 144, 168-69 (1992); see Ernest A. Young, *Two Cheers for Process Federalism*, 46 VILL. L. REV. 1349, 1360-69 (2001) (making this argument about joint federal-state projects).

87. See Oates, *Fiscal Federalism*, *supra* note 59, at 1120.

88. See Alberto Alesina et al., *What Does the European Union Do?*, 123 PUB. CHOICE 275, 276 (2005); Robert P. Inman & Daniel L. Rubinfeld, *Rethinking Federalism*, 11 J. ECON. PERSP. 43, 45-46 (1997).

89. See FRANCESCO PARISI & VINCY FON, *THE ECONOMICS OF LAWMAKING* 51-54 (2009).

of government for producing a particular public good, so that redirecting some of its production to another level requires sacrificing the benefits of its initial location.

Overall, the opportunity to choose between multiple layers of government thus appears to further narrow, but not to eliminate, a role for charitable subsidies. In some cases, voters can get the extra services they want just by asking for them from a different level of government.

### *C. Government Failure and Public Choice*

Another fundamental problem of Weisbrod's government-failure theory is that it is premised on the idea that officials will meet the preferences of the electorate's median voter.<sup>90</sup> Public choice theory<sup>91</sup> teaches, however, that officials are motivated not merely by votes but also by other rewards that they can collect from interest groups.<sup>92</sup> Even purely public-minded elected officials lack perfect information about voters' preferences—indeed, those preferences may be unsettled in the minds of voters.<sup>93</sup> Nonetheless, the average voter will prefer to free ride on the efforts of others in offering rewards or information to politicians.<sup>94</sup> As a result, political outcomes depend more on intensity of preferences than on their raw numbers.<sup>95</sup> Voters who have limited opportunities to free ride—those who are few in number or feel especially strongly about their positions—will be able to command disproportionate influence on government.<sup>96</sup>

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90. See Weisbrod, *supra* note 12, at 175-76.

91. For overviews, see JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY* (1962); DANIEL A. FARBER & PHILIP P. FRICKEY, *LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION* (1991).

92. FRED S. MCCHESENEY, *MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION, AND POLITICAL EXTORTION*, at x (1997).

93. See MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 20-21, 31, 35 (1971).

94. *Id.* at 34-35.

95. *Id.* at 35.

96. Barry R. Weingast et al., *The Political Economy of Benefits and Costs: A Neoclassical Approach to Distributive Politics*, 89 J. POL. ECON. 642, 649 (1981).

### 1. *The Public Choice Critique*

Public choice theory predicts that Weisbrod's public-goods shortfall can be filled not by subsidized charity but instead simply by lobbying.<sup>97</sup> Voters with the strongest preferences for public goods will, by definition, comprise a coalition of less than half the electorate, and possibly much less. And, again by definition, these interests will have stronger-than-average preferences. Thus, in a typical legislative contest between those who prefer the median amount of a public good and those who prefer more, those who prefer more should prevail. The only cost to those who prefer less of the good is a tax increase. But this tax increase is distributed across the entire population, while the benefits of the additional spending are concentrated among the high-demanders. So in the lobbying contest that ensues, the opposition is rather more likely to free ride on one another than the spending supporters, leading to spending on projects that command only minority support. Thus, a "save-the-whales" charity could acquire federal funding without a subsidy, because whale lovers will lobby intensely while other voters are fairly inattentive to the costs. This point about the tragedy of the budget commons is familiar in other contexts, but it has not generally been applied to the need for a charitable deduction.<sup>98</sup>

Mixed goods, such as those provided by schools and universities, are especially apt to benefit from public choice factors. The mixed good is private but provides a positive externality to others. Lobbying for private goods is more intense because, by definition, the group of beneficiaries is limited.<sup>99</sup> So even if no one would lobby for education generally at the national level, local activists who would benefit from aid to *their* university will all push for targeted funds, resulting in more education overall.

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97. Kingma, *supra* note 14, at 145; Krashinsky, *supra* note 14, at 124-25; *cf.* Levmore, *supra* note 15, at 404 n.54 (claiming that the pluralist argument for deduction fails to take account of public choice theory).

98. *E.g.*, Ilya Somin, *Closing the Pandora's Box of Federalism: The Case for Judicial Restriction of Federal Subsidies to State Governments*, 90 GEO. L.J. 461, 465-66 (2002); Weingast et al., *supra* note 96, at 648-49.

99. OLSON, *supra* note 93, at 132-33.

## 2. *Exceptions to the Critique*

As with my other critiques of Weisbrod's argument, the public-choice approach still admits of some role for charitable organizations, but on a somewhat different basis than has been recognized by others. In some cases, lobbying is likely to fail. Where the extra service is controversial or ideologically charged, there may be an energized and concentrated interest group opposed to its public provision. Even when there is no opposition, those who prefer more services may have comparatively scarce resources to expend on lobbying.<sup>100</sup> Each of these scenarios arguably imply some role for charitable supplements to government spending. For example, a homeless shelter might face tough opposition from NIMBY neighbors, and supporters may be relatively poor. As a result, lobbying for a new shelter might be futile, leaving charity as the more viable option.

In similar fashion, the nonprofit sector might be a meaningful addition to government when public choice factors suppress spending below the level preferred by the median voter. To take one familiar example, in a progressive tax system, a disproportionate share of the government's budget is borne by the wealthy.<sup>101</sup> Where wealthy voters perceive themselves as receiving little benefit from some programs, such as transfer payments or other forms of social insurance, they are capable of and likely to block such programs, even if most voters would have voted in favor of them.<sup>102</sup> This is the scenario envisioned by a number of commentators, who have argued that charities are useful mostly as a vehicle for wealth redistribution.<sup>103</sup>

Lastly, subsidizing charity may be more efficient than lobbying because it requires a smaller subsidy to induce some entrepreneurs

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100. See Stephen Loffredo, *Poverty, Democracy and Constitutional Law*, 141 U. PA. L. REV. 1277, 1327-28 (1993) (arguing that voting power does not necessarily overcome other impediments to political power for the poor, such as lack of resources and difficulty organizing).

101. JONATHAN GRUBER, *PUBLIC FINANCE AND PUBLIC POLICY* 523 (2d ed. 2007). That is, there is a strong correlation between annual income and total wealth. Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993, 1012-21 (2004).

102. Elizabeth Garrett, *Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process*, 65 U. CHI. L. REV. 501, 518-19 (1998).

103. See sources cited *supra* note 50.

to provide it.<sup>104</sup> Lobbying requires entrepreneurs to divide “rents,” or the rewards from producing public goods, between themselves and politicians, while charity might allow the entrepreneur to keep all of it.<sup>105</sup> Existing legal rules, such as the number of seats in the legislature, make officials’ time and attention scarce resources.<sup>106</sup> Competing lobbying efforts to get on the agenda bid up the price of rents needed to secure government action.<sup>107</sup> In contrast, the pool of policy entrepreneurs is not likely to be as limited; entrepreneurs will enter the field as long as there are rents available.<sup>108</sup> This condition will bid down the rent premium needed to attract charitable entrepreneurs.

Overall, public choice theory undermines Weisbrod’s claims but does suggest that lobbying will leave some gaps. As a result, some controversial or redistributive organizations, such as homeless shelters, remain likely candidates for the deduction. Additionally, to the extent that charity is more efficient, charities might be preferable to lobbying, even if lobbying were likely to succeed.

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104. Cf. Krashinsky, *supra* note 14, at 124-25 (suggesting that obtaining public good through charity is preferable to government if transaction costs of forming the nonprofit are lower than lobbying). For descriptions of the role of “entrepreneurs” in mobilizing political groups, see Christopher Schroeder, *Rational Choice Versus Republican Moment—Explanations for Environmental Laws, 1969-73*, 9 DUKE ENVTL. L. & POL’Y F. 29, 49-56 (1998); Richard Wagner, *Pressure Groups and Political Entrepreneurs: A Review Article*, 1 PAPERS ON NON-MARKET DECISION MAKING 161, 161-70 (1966) (reviewing MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* (1965)).

105. See Fred McChesney, *Rent Extraction and Interest Group Organization in a Coasean Model of Regulation*, 20 J. LEGAL STUD. 73, 84-89 (1991) (claiming that politicians can better extract value from highly organized groups, leading to lower overall returns from political organizing). Or, similarly, it might be argued that nonprofit organizations have self-serving internal institutional goals that may conflict with the stakeholders’ policy preferences, so that lobbying by those organizations results in some diversion of effort to these ego rents rather than the group’s mission. See Todd J. Zywicki, *Environmental Externalities and Political Externalities: The Political Economy of Environmental Regulation and Reform*, 73 TUL. L. REV. 845, 875-78 (1999) (arguing that environmental advocacy groups choose to lobby for enforcement mechanisms that will increase their own “prominence” rather than those that are maximally effective at reducing pollution).

106. See Krashinsky, *supra* note 14, at 125; Daniel B. Rodriguez, *The Positive Political Dimensions of Regulatory Reform*, 72 WASH. U. L.Q. 1, 111 n.464 (1994). A similar phenomenon occurs when political actors are limited by budget constraints. Nancy C. Staudt, *Constitutional Politics and Balanced Budgets*, 1998 U. ILL. L. REV. 1105, 1132-33.

107. See Krashinsky, *supra* note 14, at 125.

108. See James Q. Wilson, *The Politics of Regulation*, in *THE POLITICS OF REGULATION* 357, 370-71 (James Q. Wilson ed., 1980) (describing how available political rents attract entrepreneurs).

#### *D. Other Rationales for Deduction*

Like Weisbrod's explanation for charity, other theories of the charitable deduction struggle to account for federalism and public choice theory. These other rationales vary in the ultimate goals they ascribe to charity, but they each depend on the existence of policy alternatives to majoritarian government. Most obviously, both pluralism and diversity call for opportunities for new, unpopular, or otherwise unusual views occasionally to produce not just talk but also policy results.<sup>109</sup>

These theories could be satisfied as easily by multiple governments as by charity. Local governments with some degree of independence from the central government can give voice to diverse interests and offer a plurality of views, each of which then has potential to bubble up more widely across the nation. These points are worth explaining in more detail.

##### *1. Federalism*

The diversity and pluralism arguments are even more vulnerable than Weisbrod's theory to the federalism objection because they do not require that *every* jurisdiction offer a full array of policy options. Weisbrod could argue that limitations on relocation leave open a space for charity, because his premise is that citizens in each locality might want additional public goods.<sup>110</sup> But society can be diverse or pluralistic overall, even if some regions are not.

To review, the diversity and pluralism rationales argue that society is better off when some policy outcomes are the result of many different voices and interests. Part of this gain is to society overall: gains from experiments, innovation, and diversification of risk. Another benefit is to individuals, in that their participation in policymaking helps them develop as persons.<sup>111</sup>

Federalism, too, can offer both of these benefits. Given many competing localities, it is likely that at least some of them will, by chance, have a majority willing to enact any given good, ensuring

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109. See sources cited *supra* note 43.

110. Weisbrod, *supra* note 12, at 178.

111. See *supra* text accompanying notes 43-46.



some degree of national diversity. The fact that some citizens face barriers to moving does not matter: as long as each policy option can be produced somewhere, the nation as a whole can still reap the benefits of local experiments.<sup>112</sup> On the participation side, towns and special-purpose governments, like charities, offer a chance for small-scale, intimate roles in policymaking.<sup>113</sup>

## 2. *Public Choice*

Public choice theory casts one final cloud over the alternatives to Weisbrod. As we have seen, minority views will often be better equipped to garner political support than others.<sup>114</sup> Thus, while pluralism and diversity are themselves public goods, such that we should expect few to lobby for them in the abstract, there may often be strong proponents in favor of specific deviations from the majority's preferences.

This dynamic is especially powerful in combination with federalism. Local officials may calculate that those who hold nonstandard preferences for public goods would be willing to deliver political rents in exchange for receiving those goods, particularly if they cannot obtain those goods anywhere else.<sup>115</sup> To obtain the rents, the official might offer financial or other incentives to help overcome barriers to relocation.<sup>116</sup> These incentives cost tax dollars, but that expense can be passed on to all the residents of the jurisdiction, who might well free ride on one another's efforts to resist.<sup>117</sup> Local

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112. Governments can usually copy policies that succeed elsewhere easily. Galle & Leahy, *supra* note 74, at 1347-60.

113. See Lehari, *supra* note 37, at 4-6 (arguing for this role for local governments).

114. See *supra* text accompanying notes 95-96.

115. Cf. Lynn Baker, *Conditional Federal Spending After Lopez*, 95 COLUM. L. REV. 1911, 1971 & n.279 (1995) (arguing that voters place very high value on a policy choice where few other jurisdictions would offer it).

116. Cf. Lynn A. Baker & Mitchell N. Berman, *Getting Off the Dole: Why the Court Should Abandon Its Spending Doctrine, and How a Too-Clever Congress Could Provoke It To Do So*, 78 IND. L.J. 459, 473-74 (2003) (arguing that policies appealing to minority populations may be a competitive tool for states attempting to attract migrants); John O. McGinnis & Ilya Somin, *Federalism vs. States' Rights: A Defense of Judicial Review in a Federal System*, 99 NW. U. L. REV. 89, 108-09 (2004) (suggesting that state officials compete for migrants in order to build influence with powerful local constituencies).

117. See DOWNS, *supra* note 84, at 244-45.

officials may therefore move toward diversity as a strategy for attracting political support.<sup>118</sup>

### *E. An Overview So Far*

Given the complex set of overlapping arguments and counter-arguments I have laid out so far, it is helpful to pause to summarize what remains of the traditional explanations for subsidized charity. Both Weisbrod and proponents of the diversity theories offer important insights, but on closer examination, their claims are subject to major qualifications. The qualifications are nuanced, so that the strength of each critique is weaker or stronger depending on the nature of the particular public good that is to be subsidized. What is true for soup kitchens is not clearly true for universities or efforts to save the whales. How do these nuances relate to one another?

To simplify the analysis, my qualms about the traditional explanations can be boiled down to four basic questions or considerations. First, are the positive externalities from production of the good primarily local, or do they instead spread across many jurisdictions? Nationwide spillovers strengthen the case for subsidies, because they are likely to result in free riding by any one government. They would also be difficult to produce by drawing a special-purpose government.

The second and third factors depend on the political concentration of the benefits and burdens of the good. These are both basic public choice issues: if a good produces large, concentrated benefits, it is more likely that lobbying could convince officials to produce the good without the need for charity. That is especially true of private goods with a positive externality attached to them. On the flip side, goods that burden or annoy a small portion of the population—especially a portion that is already politically powerful—in a significant way are less likely to succeed, even if the median voter prefers them.

Fourth, does the public good in question create negative externalities that are localized, in the sense that they could be reduced or eliminated if production of the good were moved somewhere else? If

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118. Cf. Brian Galle, *Federal Grants, State Decisions*, 88 B.U. L. REV. 875, 912-18 (2008) (describing incentives for officials to adopt policies at variance with the federal government's).

so, I have argued, there is a strong possibility that the deduction is inefficient.<sup>119</sup> If not, there is still a chance the deduction inefficiently distorts interjurisdictional mobility, but it is less likely.

As a very rough first cut on what remains of the argument for subsidized charity, then, I simply plot these factors together side by side, in Table 1.

Form	Geog. Scope of Positive Externalities (S)		Political Concentration of Benefits (B)		Political Concentration of Costs (C)		Geog. Scope of Negative Externalities (E)		Case for Subsidy
	Local ↔	Nat'l ↑	Conc. ↓	Diffuse ↔	Conc. ↑	Diffuse ↔	Local ↓	Nat'l ↔	
1	Local		Conc.		Conc.		Local		weak
2	Local		Conc.		Conc.			Nat'l	neutral
3	Local		Conc.			Diffuse	Local		v. weak
4	Local		Conc.			Diffuse		Nat'l	weak
5	Local			Diffuse	Conc.		Local		neutral
6	Local			Diffuse	Conc.			Nat'l	strong
7	Local			Diffuse		Diffuse	Local		weak
8	Local			Diffuse		Diffuse		Nat'l	neutral
9		Nat'l	Conc.		Conc.		Local		neutral
10		Nat'l	Conc.		Conc.			Nat'l	strong
11		Nat'l	Conc.			Diffuse	Local		weak
12		Nat'l	Conc.			Diffuse		Nat'l	weak
13		Nat'l		Diffuse	Conc.		Local		strong
14		Nat'l		Diffuse	Conc.			Nat'l	strong
15		Nat'l		Diffuse		Diffuse	Local		neutral
16		Nat'l		Diffuse		Diffuse		Nat'l	strong

Table 1: Combinations of Factors Affecting the Strength of the Argument for a Subsidy

Each factor either strengthens (↑), weakens (↓), or has no or an uncertain effect (↔) on the argument for charity. The final right-hand column sums the various factors in each row. In summing these factors, I assume that political concentration of benefits (B) is

119. See *supra* Part II.A.2. Again, these negative externalities can include the tax costs of the subsidy. However, because it is difficult to predict in the abstract when those costs would exceed an individual taxpayer's demand for the charity, I focus here on other forms of negative externality.

somewhat more important than geographical scope of positive externalities (S) on the theory that the political rents from pleasing an activated constituency would overcome any local government inclinations to free ride. “Neutral” results indicate that my analysis does not suggest a different outcome from Weisbrod’s, except to the extent that the waste and geographical distortion of the deduction might reduce welfare even where negative externalities are not localized. “Weak” indicates that the case for charity is weaker than under traditional theories; “strong” indicates the opposite.

Table 2 summarizes these results and offers real-world examples of public goods that correspond to each of the sixteen resulting combinations.

Form	Factors	Examples	Case for Subsidy
1	SL,BC,CC,EL	Opera; Shakespeare in the Park	weak
2	SL,BC,CC,EN	Offensive art; political theater	neutral
3	SL,BC,CD,EL	Fair-housing enforcement	weak
4	SL,BC,CD,EN	Parks; museums	weak
5	SL,BD,CC,EL	Homeless shelters	neutral
6	SL,BD,CC,EN	Local consumer protection enforcement/ better business bureaus	strong
7	SL,BD,CD,EL	Mass transit; fireworks	weak
8	SL,BD,CD,EN	Emergency rooms	weak
9	SN,BC,CC,EL	Wind farms	neutral
10	SN,BC,CC,EN	Endangered species conservation	strong
11	SL,BC,CD,EL	Wetlands preservation	weak
12	SL,BC,CD,EN	Universities	weak
13	SN,BD,CC,EL	Nuclear waste storage	strong
14	SN,BD,CC,EN	Clean air	strong
15	SN,BD,CD,EL	“Star Wars” missile defense	neutral
16	SN,BD,CC,EN	Salvation Army; public health	strong

Table 2: Summary of case for subsidy for representative public goods

Although the results here are only a very rough approximation, they nonetheless are striking. Hospitals, universities, and museums are among the largest of existing charities, and their eligibility for

charitable status under existing law is largely unquestioned.<sup>120</sup> Yet the case for subsidies for all three are remarkably weak under my reappraisal of the traditional rationales. For example, although the nationwide public good of a well-educated populace might be subject to free riding among states, universities provide a private good to enrollees, such that we would expect that lobbying could often produce significant expenditures on higher education. Thus, the gap between median and high-demanding voters suggested by Weisbrod is unlikely to arise.

A number of other charitable forms score as “neutral,” but that should not be read as an unqualified endorsement of the traditional analysis. For nearly all of the “neutrals,” factors that cut against subsidy are balanced against those that favor it. Whether subsidies are appropriate should depend on a more careful analysis of which factors loom larger for a particular good. For instance, homeless shelters might produce relatively concentrated negative externalities among nearby residents unhappy about the effects of the shelter on their neighborhood, which would depress political support and increase the case for charitable production. But at the same time, the negative externality might be eliminated if shelter donors would instead relocate. We do not know whether the welfare losses from that distortion exceed the gains from spurring more charitable assistance for the poor. Consequently, organizations in the “neutral” category are not necessarily good candidates for subsidy.<sup>121</sup>

As a result, to this point it appears that the argument that charity fills in where government cannot has been oversold. There are a handful of situations where some level of government will likely fail to provide all of the public goods the population demands and charitable provision will increase social welfare. But these few scenarios do not justify the vast scale of the current nonprofit sector. Are there other arguments that might?

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120. SHERLOCK & GRAVELLE, *supra* note 65, at 1-11.

121. It is worth noting that my assignment of some organizational forms to particular categories here is certainly open to debate; the examples are supposed to be illustrative, not definitive. For instance, in positing that opera produces negative externalities for its neighbors, I assume that crowds and noise might be unwanted, and in concluding the same about wetlands preservation, I assume unhappy neighboring landowners.

### III. QUALITY OF OUTPUTS

The previous Part showed that, for the most part, the charitable deduction cannot be justified simply by pointing to a failure of the government sector to provide public goods. Yet there may be an argument for charitable provision even in cases where government, too, can provide the good: where the *quality* of what charity would deliver is superior to what we would expect of government. This suggestion seems like an obvious line of attack, but because of the literature's heavy dependency on Weisbrod and other government-failure theories, it has never seriously been undertaken.

Therefore, in this Part, I consider whether there are situations in which the quality of services charity provides is superior to government or, at a minimum, offers something that government provision alone cannot. For example, in some instances, we see either insufficient or too much competition between local governments. Insufficient competition may result from barriers to mobility or political failures, such as oligopolistic or risk-averse behavior among public officials. In these cases, competition with charity can serve as the spur to quality and innovation that competition between governments does not. On the other hand, excess competition, as in the infamous "race to the bottom," may produce an environment where public goods are low quality. In those situations, charities can fill the resulting gap.

Put another way, the analysis of this Part represents a relaxation of the assumptions of the last. Part II argued that in an ideal federalist system Weisbrod's assumptions break down. But few real federalist systems meet those ideals. I consider here how these real-world failures impact the case for charity.

In addition, as many commentators have recognized, some charitable functions are inimical to government provision.<sup>122</sup> Most obvious is the separation of church and state.<sup>123</sup> Thus, under my theory, religious organizations would always be eligible for a subsidy; I leave aside for now any line-drawing issues in differentiating pure worship from other activities in which government might

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122. Pozen, *supra* note 1, at 559 n.131 (collecting sources).

123. *Id.* at 559.

reasonably compete. Accordingly, the discussion that follows addresses only nonchurch charities.

### *A. Imperfect Horizontal Competition*

Where competition between governments is low, government services may also be low quality because of weak incentives for public officials to perform at a high level. A familiar story of federalism is that competitive pressure from other jurisdictions motivates officeholders to outperform rivals.<sup>124</sup> At times, though, this competition breaks down. Charity can perform an important social role by offering a new source of competition for inefficient governments.

#### *1. Charity as a Substitute for Intergovernmental Competition*

Jurisdictional competition improves the quality of local government. Free riding and rational ignorance among the local electorate makes electoral control a relatively loose constraint on slacking and self-dealing by the elected.<sup>125</sup> But a resident deciding whether to relocate to another jurisdiction to obtain higher-quality services cannot free ride on others; only she can move.<sup>126</sup> Thus, migration based on quality is less subject to collective-action problems than voting based on quality.<sup>127</sup> The threat of out-migration impacts officeholders both directly, through a smaller tax base for their pet projects, and indirectly, as a signal to the remaining voters of the officeholder's performance.<sup>128</sup>

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124. PAUL E. PETERSON, *THE PRICE OF FEDERALISM* 17-19, 25-26, 46-47 (1995); Douglass C. North, *A Framework for Analyzing the State in Economic History*, 16 *EXPLORATIONS ECON. HIST.* 249, 255 (1979). *But see* Jonathan Rodden & Susan Rose-Ackerman, *Does Federalism Preserve Markets?*, 83 *VA. L. REV.* 1521, 1530-36 (1997) (arguing that the claim that exit leads to efficient government depends on unrealistic assumptions about local political process).

125. *See, e.g.*, Joseph P. Kalt & Mark A. Zupan, *The Apparent Ideological Behavior of Legislators: Testing for Principal-Agent Slack in Political Institutions*, 33 *J.L. & ECON.* 103, 103-04, 107-08 (1990).

126. *See* Clayton P. Gillette, *Can Public Debt Enhance Democracy?*, 50 *WM. & MARY L. REV.* 937, 965-66 (2008); Ilya Somin, *Foot Voting, Political Ignorance, and Constitutional Design* 28 *SOC. PHIL. & POL'Y* 202, 210-11 (2011).

127. Somin, *supra* note 126, at 212-13.

128. *See* Richard Briffault, *Our Localism: Part II—Localism and Legal Theory*, 90 *COLUM. L. REV.* 346, 400-01 (1990); Lee Anne Fennell, *Beyond Exit and Voice: User Participation in*

Where exit costs are high, competitive federalism breaks down.<sup>129</sup> Frictions on moving limit the extent to which people and firms will relocate to obtain their desired policies.<sup>130</sup> These frictions include the inevitable barriers to moving that everyone faces: moving costs, cognitive costs of recognizing and evaluating new opportunities, and the fact that laws are not the only reason to choose a place to live.<sup>131</sup> Frictions loom even larger when the choice is not between policies, but rather only between gradations in the quality of the policy.

It is worth emphasizing that exit costs are not just the price of a moving van. They can span tangible and intangible costs of all kinds, such as lost connections to family and neighbors, or government services available in the old regime but not the new.<sup>132</sup> Probably one of the more obscure but most important is network effects—the benefits of having many resources in one place.<sup>133</sup> Silicon Valley is what it is in part because of its tremendous concentration of human capital; if the geniuses dispersed, much of their collective energy would be lost.<sup>134</sup> The opportunity to share in those economies of concentration is one of the major factors that keeps people and firms in place, generating locational rents.<sup>135</sup>

The importance of locational rents might suggest that charity is most essential in urban areas, where such concentrations usually arise,<sup>136</sup> but there are exit considerations that favor rural charity as well. For workers in urban areas, there are often many different governments to choose from: rings of suburbs surrounding the urban

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*the Production of Local Public Goods*, 80 TEX. L. REV. 1, 26 (2001).

129. See Jacob T. Levy, *Federalism, Liberalism, and the Separation of Loyalties*, 101 AM. POL. SCI. REV. 459, 461 (2007).

130. Oates, *Fiscal Federalism*, *supra* note 59, at 1122.

131. Brian Galle, *Federal Fairness to State Taxpayers: Irrationality, Unfunded Mandates, and the "SALT" Deduction*, 106 MICH. L. REV. 805, 824-25 (2008).

132. See James M. Buchanan & Charles J. Goetz, *Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model*, 1 J. PUB. ECON. 25 (1972) (noting that the Tiebout model fails to acknowledge locational rents and differing qualities of public goods); Henry W. Herzog & Alan M. Schlottmann, *Labor Force Migration and Allocative Efficiency in the United States: The Roles of Information and Psychic Costs*, 19 ECON. INQUIRY 459, 459-60 (1981).

133. Stefano Breschi & Franco Malerba, *The Geography of Innovation and Economic Clustering: Some Introductory Notes*, 10 J. IND. & CORP. CHANGE 817, 819-20 (2001).

134. *Id.* at 817-18.

135. David Schleicher, *The City as a Law and Economic Subject*, 2010 U. ILL. L. REV. 1507, 1527.

136. *Id.*



core.<sup>137</sup> But for those who work in rural areas to change governments, they likely must also change jobs, or at least face very long commutes.<sup>138</sup> Changing jobs is itself often quite costly.<sup>139</sup> So both urban and rural residents may face high exit costs, although these costs come in different forms.

Nonprofit firms can fill the competition gap high exit costs produce.<sup>140</sup> If a donor can obtain services from the charity of her choice without relocating, she acquires a new, low-cost exit option. To protect their tax base, local officials must attempt to outperform any potential charitable competitors. In the case of local governments that themselves subsidize charity, donations automatically reduce the tax base of the local government.<sup>141</sup> Alternatively, the donor may now vote for lower taxes, to reflect the fact that she has shifted some of her consumption of public goods away from her local government.<sup>142</sup>

Skeptics might argue that increased competition does not necessarily equate to higher quality.<sup>143</sup> The quality of public goods

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137. See Garnett, *supra* note 85, at 297 (explaining that fragmented governments surrounding urban cores are fertile ground for Tiebout sorting).

138. Cf. Katherine Porter, *Going Broke the Hard Way: The Economics of Rural Failure*, 2005 WIS. L. REV. 969, 1009-13 (describing the sparsity of rural jobs and the difficulty of selling rural homes to change jobs).

139. A number of factors contribute to the costliness of changing jobs. Employees develop firm-specific capital, or expertise related to their particular employer, which earns them a premium wage. Lorne Carmichael, *Firm-Specific Human Capital and Promotion Ladders*, 4 BELL J. ECON. 251, 252 (1983). Employers also typically structure wages and benefits to encourage development of this capital. *Id.* at 254. For example, employer-based health insurance produces a significant amount of “job lock”: employees cannot leave without giving up affordable health care. Jonathan Gruber & Brigitte C. Madrian, *Health Insurance and Job Mobility: The Effects of Public Policy on Job Lock*, 48 IND. & LAB. REL. REV. 86, 86 (1994).

140. Cf. Somin, *supra* note 126, at 222-23 (noting that privatization may be a lower-cost alternative than physical exit).

141. Most jurisdictions with an income tax also allow the charitable deduction. WISC. LEGISLATIVE FISCAL BUREAU, INFORMATIONAL PAPER NO. 4, INDIVIDUAL INCOME TAX PROVISIONS IN THE STATES 11 tbl.4 (2009). Other jurisdictions grant charities exemptions from property or sales taxes, so that as the scope of local charity increases, tax revenues decline. BRUCE R. HOPKINS, *THE LAW OF TAX EXEMPT ORGANIZATIONS* 54 (9th ed. 2007).

142. See Elizabeth Becker & Cotton M. Lindsay, *Does the Government Free Ride?*, 37 J.L. & ECON. 277, 279-80 (1994). There is some empirical evidence of this behavior. *Id.* at 278 (“[D]onations to public colleges and universities result in dollar-for-dollar reductions in government spending.”).

143. I am grateful to Bill Bratton for this point.

is difficult to assess directly.<sup>144</sup> Comparisons between two entities, especially those with somewhat differing goals, might be incrementally more difficult.<sup>145</sup> Even if direct quality measures are available, we might not want too much to depend on them, since the difficulty of specifying and measuring them might distort the incentives of government and nonprofit managers.<sup>146</sup>

The benefits of charitable alternatives do not depend much, though, on citizens' ability to compare precisely the outputs of the two sectors. "Yardstick" theory suggests that the performance of one entity gives voters information for evaluating the other, although perhaps only on fairly general terms.<sup>147</sup> Even poor competitors help set at least a floor for what it is possible to achieve with a given set of resources. While small disparities in quality may not be observable, extremes of waste and self-serving behavior can be exposed by comparison to an organization less subject to them.<sup>148</sup> Over time, observing one producer can create benchmarks for the performance of others, a benefit that nonprofits provide even if there is healthy intergovernmental competition.<sup>149</sup> Fellow voters can then observe

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144. See John D. Donahue, *Market-Based Governance and the Architecture of Accountability*, in *MARKET-BASED GOVERNANCE: SUPPLY SIDE, DEMAND SIDE, UPSIDE AND DOWNSIDE* 1, 5-6 (John D. Donahue & Joseph S. Nye, Jr. eds., 2002) (describing the difficulties of arriving at universal definitions of success in areas of public interest, such as schools and taxes); Hansmann, *supra* note 2, at 846-47 (noting that separation of donors from beneficiaries increases information costs of monitoring).

145. See Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 508-11 (1996) (arguing that quality comparisons between nonprofits are infeasible).

146. Galle, *supra* note 18, at 1225-29.

147. See Paul Belleflamme & Jean Hindriks, *Yardstick Competition and Political Agency Problems*, 24 SOC. CHOICE & WELFARE 155, 162 (2005) (suggesting that the fact that a rival chooses a policy tells a voter it was more likely that the policy should have been undertaken by the voter's own government). Evidence suggests that voters also use these kinds of ballpark comparisons between governments. *E.g.*, Roger Bivand & Stefan Szymanski, *Spatial Dependence Through Local Yardstick Competition: Theory and Testing*, 55 ECON. LETTERS 257, 257-59, 264 (1997) (finding evidence that citizens use yardstick competition to evaluate trash removal services); Federico Revelli, *Performance Rating and Yardstick Competition in Social Service Provision*, 90 J. PUB. ECON. 459, 461-62, 472-73 (2006) (finding that explicit ratings by national government appeared to crowd out behaviors that theory predicts would follow from informal citizen comparisons).

148. See Andrei Shleifer, *A Theory of Yardstick Competition*, 16 RAND J. ECON. 319, 322-23 (1985) (suggesting that government can evaluate firms with opaque cost structures by comparing them to competitors).

149. See Oguzhan C. Dincer et al., *Corruption, Decentralization, and Yardstick*

which entity attracts more support, giving them a kind of “wisdom of crowds.”<sup>150</sup> Rival public-good producers also have incentives to monitor each other and reveal their competitor’s poor performance to the public, further helping to overcome voters’ rational ignorance.<sup>151</sup>

Although yardstick competition’s results play out only slowly over time, arguably that is a better incentive structure than more vigorous competition would provide. Because the immediate rewards of victory are modest, yardstick competition is a kind of “low-powered” incentive. But, as I mentioned earlier, the risks posed by mismeasurement and externalities make high-powered incentives likely undesirable for producers of public goods.<sup>152</sup>

Many other benefits from competition do not depend on voter comparisons at all. When a local government holds a monopoly on the production of public goods, it can extract monopoly rents from constituents in exchange. Studies of government corruption suggest that political rivals help to bid down the price for these rents.<sup>153</sup> Further, the existence of an alternative gives voters an incentive to monitor their officials more closely, because in the absence of other choices there would be nothing to do with information gained from monitoring. Similarly, the existence of an alternative source of public goods gives more bargaining power to attentive citizens, allowing them to force public officials away from the officials’ policy preferences and closer to their own.<sup>154</sup> For example, if officials attempt to extract high taxes by offering a “take it or leave it” budget with the alternative being an unacceptably low amount of

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*Competition*, 11 *ECON. GOVERNANCE* 269, 271-74 (2010) (modeling the claim that voters can draw inferences about their officials based on simple comparisons to other governments over time).

150. Cf. Marlon G. Boarnet & Amihai Glazer, *Federal Grants and Yardstick Competition*, 52 *J. URBAN ECON.* 53, 63-64 (2002) (reporting evidence that voters use federal grants to judge the quality of their local governments).

151. Donald Wittman, *Why Democracies Produce Efficient Results*, 97 *J. POL. ECON.* 1395, 1400 (1989).

152. For more extended discussion on this point, see Galle, *supra* note 18, at 1225-30.

153. James E. Alt & David Dreyer Lassen, *The Political Economy of Institutions and Corruption in American States*, 15 *J. THEORETICAL POL.* 341, 355, 359-60 (2003); Daniel Lederman et al., *Accountability and Corruption: Political Institutions Matter*, 17 *ECON. & POL.* 1, 1-2, 4 (2005). Of course, comparisons also help to reduce corruption. Dincer et al., *supra* note 149, at 285, 287.

154. JOHN E. ROEMER, *POLITICAL COMPETITION: THEORY AND APPLICATIONS* 5, 52-71 (2006).

services, nonprofit alternatives allow voters to leave the unwanted offer on the table.<sup>155</sup> Lastly, having another organization ready to produce public goods allows a jurisdiction to diversify the risk that the current regime will suffer from total breakdown or take an ideologically extreme position.

## 2. Counterarguments: Irrelevant Exit and Crowd-Out

However, this competition-gap theory raises a number of possible counterarguments. First, the theory assumes that mobility is necessary in order to generate interlocal competition. There are several alternative sources of competitive pressure other than outright exit, each of which could arguably make charity unnecessary. For one, residents can simply *threaten* to exit unless government reforms.<sup>156</sup> Additionally, the benchmarks set by neighbors can put competitive pressure on each government.<sup>157</sup> A third possibility is fluctuations in the value of property affected by the quality of local government. Anup Malani, for instance, argues that local homeowners who observe poor performance by their government will likely lower their reserve price, driving down home values.<sup>158</sup> Mismanagement can also drive up a town's cost of borrowing, diminishing the value of existing bonds.<sup>159</sup> These price variations are signals to close observers of the government's poor performance, as well as possible spurs to anger by those who have lost wealth as a result.<sup>160</sup>

Most of these mechanisms themselves depend on ease of exit, however. Threats to exit are only credible if the government official

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155. See Therese J. McGuire, *Proposition 13 and Its Offspring: For Good or Evil*, 52 NAT'L TAX J. 129, 131-33 (1999) (explaining how low reversion budgets can force the public to accept higher spending than they prefer and noting voter initiatives may reduce this effect by giving voters agenda-setting power).

156. Bratton & McCahery, *supra* note 62, at 264-65.

157. Timothy Besley & Anne Case, *Incumbent Behavior: Vote-Seeking, Tax-Setting, and Yardstick Competition*, 85 AM. ECON. REV. 25, 30 (1995).

158. Anup Malani, *Valuing Laws as Local Amenities*, 121 HARV. L. REV. 1273, 1280-81 (2008).

159. Gillette, *supra* note 126, at 975-76.

160. See PETERSON, *supra* note 124, at 18; Gillette, *supra* note 126, at 952 ("[M]issed payments provide a readily detectable indication of mismanagement."); Ethan Yale & Brian Galle, *Muni Bonds and the Commerce Clause After United Haulers*, 115 TAX NOTES 1037, 1044 (2007).

believes that exit costs are lower than the value of the demands.<sup>161</sup> Yardstick competition, similarly, probably works mostly as an implicit threat of exit.<sup>162</sup> Rationally ignorant voters will not bother to compare their own officials with others. So the only residents who are likely to pay attention to yardsticks are those who might move to the better-performing neighbor. Malani's predicted decline in home prices rests on the assumption that individuals will be less interested in living in the jurisdiction, driving down demand for housing.<sup>163</sup> Although there is no obvious exit story to tell about bondholders, in all likelihood bondholders will free ride on the monitoring efforts of other bondholders, just as voters do.<sup>164</sup> Thus, where exit is difficult, charity remains the most promising source of pressure on local government.

A second potential counter to the competition story is that, just as with Weisbrod's government-failure account, subsidizing charity may be a cure that is worse than the disease. Recall that the subsidy distorts a resident's choice between moving and charity.<sup>165</sup> However, the costs of charity are largely externalities for the resident, so that she may choose charity instead of moving, even where that reduces overall social welfare.<sup>166</sup> It is difficult to predict, as a matter of theory, whether this loss would be larger than the social gains from additional sources of competition for local governments.

When charities are competing with government over quality, though, the potential losses are smaller, due to a phenomenon economists call "crowd-out."<sup>167</sup> This is a key difference between the competition rationale and Weisbrod's supra-median voter story. In Weisbrod's version, there is no government that provides the public good, so that donors who pay for the service shell out only once.<sup>168</sup>

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161. See Saul Levmore, *Interstate Exploitation and Judicial Intervention*, 69 VA. L. REV. 563, 601 (1983) (stating that state officials' opportunities to extract rents from firms are limited by firms' exit costs).

162. Bratton & McCahery, *supra* note 62, at 264-65.

163. See Malani, *supra* note 158, at 1288-90.

164. See Brian Galle & Ethan Yale, *Can Discriminatory State Taxation of Municipal Bonds Be Justified?*, 117 TAX NOTES 153, 155 (2007).

165. See *supra* text accompanying note 63.

166. I assume here that the positive externality resulting from better competition would be similar under either moving or charity.

167. MUSGRAVE & MUSGRAVE, *supra* note 5, at 510.

168. See Weisbrod, *supra* note 12, at 175.

But if the reason the donor gives to charity is simply because she is dissatisfied with the *quality* of the available good, she is in effect paying for it twice: once through her tax dollars, and again through her donation. For instance, if graduates of my local high school can hardly read, and I want an elite institution in the town, I will have to fund a second school.<sup>169</sup> Unless I value superior education very highly, I am unlikely to pay so much for it—the existence of the government program, for which I have no choice but to pay, discourages me from buying additional private education. So government provision of low-quality goods may crowd out charitable provision of superior alternatives.<sup>170</sup>

The double-payment problem enhances the expected value of the deduction.<sup>171</sup> Crowd-out increases the likelihood that the subsidy is “treasury-efficient,” that is, that \$1 of subsidy produces at least \$1 of additional public goods. Recall that subsidies run the risk of some waste because of inframarginal purchasers: money is spent on people who would have bought the good anyway. But where the cost of purchasing the good is increased as a result of the double-payment problem, the amount of waste decreases, since there will be fewer citizens who are inframarginal—fewer who would have been willing to pay the higher price.<sup>172</sup>

Therefore, although in general the exact welfare effects of a subsidy remain hard to predict, the double-payment problem at least makes it more likely that the subsidy is efficient. While charity is likely overproduced in Weisbrod’s scenario, here crowd-out makes charity more likely to be underproduced, so that the deduction has a better chance of bringing total output closer to the social optimum.

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169. See generally Sam Peltzman, *The Effect of Government Subsidies-in-Kind on Private Expenditures: The Case of Higher Education*, 81 J. POL. ECON. 1 (1973) (modeling how free public education may crowd out private schools).

170. For discussion of empirical efforts to measure crowd-out, see *infra* Part III.E. The charitable deduction does not eliminate double payment. A deduction operates to reduce taxable income, not the tax actually due. Suppose I earn \$100,000 and pay a 10 percent local tax, which for simplicity we can assume is spent entirely on the local opera. If I donate \$1,000 to a rival opera, and earn a \$1,000 deduction, I reduce my taxable income to \$99,000. But that only reduces the amount of tax I pay from \$10,000 to \$9,900. So my total opera expenditures now are \$10,900. Only a dollar-for-dollar credit on tax due, which no state has ever adopted or, to my knowledge, even seriously contemplated, would eliminate the double-payment problem.

171. For a mathematical model, see Galle, *supra* note 68, at 13-17.

172. *Id.* at 16-17.

However, this efficiency story is harder to tell when potential donors all reside in the same jurisdiction. In that event, the donors can avoid double payment by the simple expedient of banding together to vote or lobby to cut spending on the low-quality government service.<sup>173</sup> Although they will face the ubiquitous free-rider problem in their efforts, the subsidy greatly aids their cause by forming charities, which allow donors to easily identify others who are similarly situated, transact face-to-face with those others at charity events, and hire staff who can coordinate their efforts.<sup>174</sup>

In short, where consumers live close together, the deduction may again overproduce charity. Colocated donors can much more easily combine their donation with a vote to lower their taxes. For example, there is evidence that charitable giving to education reduces local government education spending.<sup>175</sup> In these instances where charity “crowds out” government, there is no double payment, and so charity is less likely to be cost-effective.

This analysis implies that the amount or availability of the deduction should depend on where its supporters reside. Admittedly, it is hard to imagine how to administer a rule that makes the deduction vary depending on where donors live. I will suggest some practical solutions to this problem in Part IV.A.

### *B. Inadequate Vertical Competition*

Another theme of the federalism literature is that the existence of viable local governments improves the quality of the federal government.<sup>176</sup> James Madison, for example, argued that the states would compete with the national government for the loyalty of the public, with the winner earning the right to deliver services in exchange for political rewards.<sup>177</sup> Here, too, the competitive mechanism may at times break down, leaving a theoretical opportunity

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173. See Becker & Lindsay, *supra* note 142, at 279-80.

174. See Robert D. Tollison, *Rent Seeking: A Survey*, 35 *KYKLOS* 575, 590 (1982); cf. Brakman Reiser, *supra* note 29, at 876-77 (discussing the ways in which membership in nonprofit organization facilitates political action).

175. Becker & Lindsay, *supra* note 142, at 278.

176. See *supra* note 78.

177. THE FEDERALIST NO. 51, *supra* note 78, at 291.

for charities to step in as rivals for the affections of the public.<sup>178</sup> In practice, though, charities likely cannot fill this role.

As we have already seen, localities are often unlikely competitors for national government when the scope of the service is national. Each smaller government has incentives to free ride on any effort others might make.<sup>179</sup> A single national government does not have this problem. Similarly, states may be inadequate competition for the federal government because of economies of scale: it can be far more efficient to provide a particular service across huge expanses of territory or population.<sup>180</sup>

For instance, it may be more efficient to provide clean water at the national level because of spillovers between states.<sup>181</sup> Interstate bargains to guarantee clean water are unlikely to materialize because polluter states can have incentives to be the last to the bargaining table, leading to holdout problems.<sup>182</sup> Compacts can also lead to a “team-production” problem for participating officials: none have incentives to work to ensure the success of the project, because they can free ride on the efforts of others and blame the others for any failures.<sup>183</sup>

Another breakdown arises from the fact that the optimal level of government for the production of a public good may vary over time. Optimality is the result of a set of trade-offs.<sup>184</sup> For example, although there may be economies of scale, larger governments are harder for the public to interact with and control.<sup>185</sup> Not all of these factors are stable over time. Technological changes might make monitoring government officials easier.<sup>186</sup> Or the addition of new

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178. Cf. Barbara K. Bucholtz, *Reflections on the Role of Nonprofit Associations in a Representative Democracy*, 7 CORNELL J.L. & PUB. POL'Y 555, 572 (1998) (noting that the Madisonian idea of divided authority resembles features of the nonprofit sector).

179. See *supra* text accompanying notes 74-75.

180. Inman & Rubinfeld, *supra* note 59, at 84-86. States can “scale up” to solve these problems by forming interstate compacts, but compacts introduce additional bargaining and cross-monitoring costs. See ROBERT D. COOTER, *THE STRATEGIC CONSTITUTION* 108-15 (2000).

181. See Richard B. Stewart, *Pyramids of Sacrifice? Problems of Federalism in Mandating State Implementation of National Environmental Policy*, 86 YALE L.J. 1196, 1215-16 (1977).

182. See COOTER, *supra* note 180, at 113.

183. See Bengt Holmstrom, *Moral Hazard in Teams*, 13 BELL J. ECON. 324, 325 (1982).

184. See Oates, *Fiscal Federalism*, *supra* note 59, at 1120.

185. Ernest A. Young, *The Rehnquist Court's Two Federalisms*, 83 TEX. L. REV. 1, 58-59 (2004).

186. See Jane S. Schacter, *Digitally Democratizing Congress? Technology and Political*



services at one level might create economies or diseconomies of scope with the existing services.<sup>187</sup>

However, even as the optimal level for the delivery of a good is fluid, the actual provision of the good can be “sticky.” Officials accustomed to receiving political rents for delivering a particular service will be unlikely to give up the rents.<sup>188</sup> Winning budget space for the service from officials in the alternative tier of government will be more difficult, as there is not yet any constituency in that government for the service.<sup>189</sup> Bureaucrats who carry out the project might resist reassignment because of connections with patrons or peers in their existing organizational structure.<sup>190</sup> And lobbyists who have purchased relational capital with officials in one government will be reluctant to start over elsewhere.<sup>191</sup>

James Buchanan and his various coauthors have likewise argued that government in general is too sticky. In Buchanan’s argument, increased taxation is a one-way ratchet, so that once we have added to the size of the bureaucracy, we have created a political force that will resist its own downsizing.<sup>192</sup> Buchanan claims that competition between governments can check the forces of expansion, but that collusion between officials at different levels may allow all of them to expand without limit.<sup>193</sup>

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*Accountability*, 89 B.U. L. REV. 641, 648-73 (2009).

187. See PARISI & FON, *supra* note 89, at 53-54.

188. See Craig Volden, *Intergovernmental Grants: A Formal Model of Interrelated National and Subnational Political Decisions*, 37 PUBLIUS: J. FEDERALISM 209, 219 (2007).

189. See Roderick M. Hills, Jr., *Against Preemption: How Federalism Can Improve the National Legislative Process*, 82 N.Y.U. L. REV. 1, 11-13 (2007).

190. Cf. Dara Kay Cohen et al., *Crisis Bureaucracy: Homeland Security and the Political Design of Legal Mandates*, 59 STAN. L. REV. 673, 687-88 (2006) (describing bureaucratic resistance to internal restructuring); Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621, 658 (1998) (making this point about privatization).

191. See Jerry L. Mashaw & Susan Rose-Ackerman, *Federalism and Regulation*, in THE REAGAN REGULATORY STRATEGY: AN ASSESSMENT 111, 133-34 (George C. Eads & Michael Fix eds., 1984).

192. GEOFFREY BRENNAN & JAMES M. BUCHANAN, THE POWER TO TAX: ANALYTICAL FOUNDATIONS OF A FISCAL CONSTITUTION 163-67 (1980).

193. *Id.* at 173-91; see also Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, 11 J.L. ECON. & ORG. 1, 3 (1995) (developing the argument that competitive federalism restrains opportunity for governments to appropriate private property).

In theory, charitable provision of public goods can solve all these sets of problems. As spontaneous organizations, charities can be designed to match the ideal geographic distribution of the desired goods.<sup>194</sup> A charitable enterprise can be scaled up to account for the scope of the problem or for economies of size,<sup>195</sup> as with the Gates Foundation's effort to tackle malaria and global poverty.<sup>196</sup> As the appropriate scale changes, charities can either change their operations or wind up their affairs and transfer their assets back to stakeholders for reallocation. And charities could be a sort of temporary government, adding to society's capacity to produce public goods in times of great need—in the aftermath of natural disasters, for example<sup>197</sup>—without raising the danger of Buchanan's one-way ratchet.

In current practice the charitable picture is not quite as promising. Under state laws governing both charitable trusts and corporations, it is extraordinarily difficult to change the charitable purposes of an organization, including the geographic scope of its operations.<sup>198</sup> For instance, in one famous case, a court refused to allow a charity to broaden its mission beyond a single county in California, notwithstanding the charity's huge accumulation of resources and the considerable wealth of that county.<sup>199</sup> State and federal law both sharply limit the use of charitable resources upon

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194. This is the point Clay Gillette makes in favor of residential associations. Clayton P. Gillette, *Courts, Covenants, and Communities*, 61 U. CHI. L. REV. 1375, 1388-89 (1994).

195. See Atkinson, *supra* note 1, at 583-84.

196. Chandler H. Udo, Note, *Nongovernmental Organizations and African Governments: Seeking an Effective International Legal Framework in a New Era of Health and Development Aid*, 31 B.C. INT'L & COMP. L. REV. 371, 376-77 & n.36 (2008).

197. Current law includes disaster relief as one of the permissible goals of a 501(c)(3) organization. For an overview and assessment, see Danshera Cords, *Charitable Contributions for Disaster Relief: Rationalizing Tax Consequences and Victim Benefits*, 57 CATH. U. L. REV. 427, 434-62 (2008).

198. See Marion R. Fremont-Smith, *The Search for Greater Accountability of Nonprofit Organizations: Recent Legal Developments and Proposals for Change*, 76 FORDHAM L. REV. 609, 622-28 (2007) (discussing the *cy pres* doctrine); Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transforming Obedience into Fidelity*, 76 FORDHAM L. REV. 893, 898-901 (2007) (discussing the duty of obedience). Recent reforms in trust law have somewhat loosened standards, but change can still be had only when the original purposes of a restricted gift are impractical. MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 173-75 (2004).

199. Estate of Buck, 35 Cal. Rptr. 2d 442, 442-43 (Ct. App. 1994); see also John G. Simon, *American Philanthropy and the Buck Trust*, 21 U.S.F. L. REV. 641 (1987).

dissolution of the charity.<sup>200</sup> And managers committed and invested in a charitable enterprise can be just as reluctant as bureaucrats to change course.<sup>201</sup> Indeed, if managers self-select based on ideological commitments, and this self-selection is more prevalent in the charitable sector because of the predictable weakness of oversight by those with differing views,<sup>202</sup> managers of charities will be even less flexible than government.

Although of course it is possible to reform the law of charity to move towards greater flexibility, that change would carry some costs. The inflexibility of charity may be an asset to firms. By helping to guarantee that managers cannot easily change the way the firm's resources are used, inflexible rules may lower the "agency costs" of contributing, thus encouraging donations, managerial talent, or the effort of volunteers.<sup>203</sup> Reforming the law of charity to loosen these ties might enable charity to better supplement government, but it would also weaken those charities that do not perform these supplementary functions.

Thus, even though there is a solid theoretical case for charity as a supplement to vertical competition, employing charity for that purpose may ultimately reduce social welfare by undermining the capacity for charity to fulfill other functions. Still, that does leave charity with the narrow function of offering competition for the federal government in cases where the scope of the good crosses state borders.

### *C. Excess Competition*

It is a familiar point that mobility and jurisdictional competition can produce races to the bottom as well as the top.<sup>204</sup> When capital

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200. Treas. Reg. § 1.501(c)(3)-(4) (2009); MARILYN E. PHELAN, *NONPROFIT ENTERPRISES: CORPORATIONS, TRUSTS, AND ASSOCIATIONS* § 15-10 (2000).

201. See Hansmann, *supra* note 9, at 521.

202. See *supra* note 17.

203. See Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 658-63 (2004) (making this point about contributions to trusts in general). What is presently unclear is the marginal value of additional restraints on managers; in other words, we do not know how much additional giving results from changes in agency costs. See Rob Atkinson, *Reforming Cy Pres Reform*, 44 HASTINGS L.J. 1111, 1123 (1993) (noting uncertainty about whether strict application of *cy pres* doctrine is necessary to encourage giving).

204. See William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83

is mobile, local jurisdictions face choices between their regulatory preferences and their ability to attract investment.<sup>205</sup> Similarly, individuals who prefer not to spend money on redistributive programs, or prefer to free ride on the redistributive efforts of others, will put downward pressure on any efforts to redistribute wealth at the local level.<sup>206</sup> Jurisdictions that do offer redistributive benefits may attract migrants who are net consumers of tax dollars, prompting cuts in benefits or the flight of those who must fund the transfers.<sup>207</sup>

It is less well known that frictions on mobility permit some level of local redistribution and regulation, but the need to create frictions reduces the quality of those goods. Clay Gillette and others have noted that the cost of moving gives localities the power to exact “locational rents” from mobile firms and residents: that is, redistribution is possible but is capped by the firm’s exit costs.<sup>208</sup> Roberta Romano adds that to induce investment in the first place, a jurisdiction must also credibly promise not to exact *all* of the value of investment.<sup>209</sup> Since talk is cheap, this promise must, to be credible, be backed by some guarantee that reneging will be costly.<sup>210</sup> As a result, any effort at local redistribution must include some costly mechanism to commit the state to not tax away future gains, leaving less money available for actual redistribution.

Accordingly, if we rely solely on the government sector to produce redistribution, we are left with two choices, both flawed. Although local redistributive programs are more prevalent than basic economic theory predicts, they persist only at substantial cost. The

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YALE L.J. 663, 666 (1974).

205. *E.g.*, Stewart, *supra* note 181, at 1211-12.

206. Michael I. Luger, *Federal Tax Reform and the Interjurisdictional Mobility Impulse*, 23 J. URB. ECON. 235, 236 (1988).

207. MUSGRAVE & MUSGRAVE, *supra* note 5, at 455. For reviews of the empirical evidence on whether localized benefits attract poor migrants, see Jan K. Brueckner, *Welfare Reform and the Race to the Bottom: Theory and Evidence*, 66 S. ECON. J. 505, 514-18 (2000); Robert Moffitt, *Incentive Effects of the U.S. Welfare System: A Review*, 30 J. ECON. LIT. 1, 30-36 (1992).

208. See Clayton P. Gillette, *Local Redistribution, Living Wage Ordinances, and Judicial Intervention*, 101 NW. U. L. REV. 1057, 1082-84 (2007); *cf.* Schleicher, *supra* note 135, at 1515-29 (reviewing scholarship about the relative costs and benefits of urbanization).

209. Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 235-36 (1985).

210. *Id.*

alternative, of course, would be to run these programs at the federal level. But federal production of redistribution, as I have already mentioned, may leave many voters dissatisfied with the level of benefits and will likely lack pluralism and diversity.<sup>211</sup>

Charitable provision can mitigate some of the problems of local redistribution. Obviously, voluntary donors do not flee, so those with a preference for redistributing their own wealth can do so without fear that high tax rates will drive away those who contribute to the cost of redistribution. In the regulatory context, charities are not limited to extracting locational rents and need not offer costly commitments.

In other respects charity can be subject to similar limitations as government, at least when the charity is focused on a narrow geographic area. Redistribution may change the geographic preferences of beneficiaries, and local governments might further reduce their own redistribution to offset that change. For instance, a high-quality homeless shelter might attract new homeless individuals who are costly to the local government in other ways, such as through higher Medicaid costs. The government might respond by cutting those other benefits, or otherwise making itself more unattractive to poor newcomers.<sup>212</sup> If cuts are not possible, some wealthier taxpayers might exit to avoid higher costs. Similarly, charitable efforts to redistribute away other people's money, such as through quasi-regulatory charities, might drive away capital.<sup>213</sup> Here, again, local government might respond by deregulating in other areas, or by granting targeted tax breaks that redistribute wealth back to the "regulated" industry.

Offsetting and distortionary effects might be mitigated if the charity carries out its mission more widely. Distributing benefits in many places means that migrants will be less attracted to any one jurisdiction. And widespread regulation offers "regulated" capital fewer jurisdictions to which it might plausibly flee.

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211. *See supra* text accompanying notes 115-18.

212. For evidence of these kinds of offsetting responses, see generally Nora Gordon, *Do Federal Grants Boost State Spending? Evidence from Title I*, 88 J. PUB. ECON. 1771 (2004).

213. Of course, charities cannot regulate in the sense of exerting the coercive power of the State, but investigation, disclosure, shaming, and boycotts could potentially obtain similar results.

With these geographic caveats in mind, my analysis does generally confirm the long-standing tradition of charity as an aid for the poor. I add to the conventional wisdom by showing that the same logic can also apply to quasi-regulatory public goods. In addition, by attending to the nuances of what makes charity a good vehicle for redistribution, I have revealed the limits of that logic. Contrary to some received wisdom, local jurisdictions can redistribute, but in many instances their efforts will be costlier or of lower quality than charity. In these instances, in particular, charity can make the largest contribution, especially if its focus is not as geographically narrow as that of local governments.

#### *D. Warm Glow*

One final qualitative difference between charity and government, which some commentators suggest may warrant the deduction, is that donations produce a personal satisfaction for donors that dutifully paying taxes does not.<sup>214</sup> For example, David Schizer argues that the act of giving creates some personal satisfaction for the giver, so that public goods funded by donations result in higher overall social welfare than government spending alone.<sup>215</sup> Following the economic literature, he distinguishes this “warm glow” from pure altruism.<sup>216</sup> An altruist cares only about the welfare of the donee and so is indifferent between two equally effective spending programs.<sup>217</sup> In contrast, the warm-glow giver gets rewards from being the agent of change, whether because she is satisfied by thinking of herself as a good person or because she enjoys the social approval and status that may come with being seen by others as generous.<sup>218</sup> In the latter view, warm-glow donations are like Gucci

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214. KAPLOW, *supra* note 70, at 270-71; Schizer, *supra* note 15, at 225-26, 230-31; *see also* Rose-Ackerman, *supra* note 4, at 717 (arguing that charity is better at creating warm glow than government or for-profits). *But see* Gergen, *supra* note 1, at 1409 (noting that self-regarding motives may result in excessive societal investment in giving).

215. Schizer, *supra* note 15, at 225-26.

216. *Id.* at 226. For a review of the warm-glow literature, see B. Douglas Bernheim & Antonio Rangel, *Behavioral Public Economics: Welfare and Policy Analysis with Non-Standard Decision Makers* 56-60 (Nat'l Bureau of Econ. Research, Working Paper No. 11518, 2005).

217. Rose-Ackerman, *supra* note 4, at 713.

218. *Id.* at 712-13; *see also* Bernheim & Rangel, *supra* note 216, at 58. Of course, any given

handbags: they are a status good.<sup>219</sup> Schizer acknowledges, but does not confront head-on, Peter Diamond's critique of the use of warm glow as a normative justification for charity.<sup>220</sup> Diamond argues that even if the warm-glow explanation for why giving occurs is correct as a descriptive matter, it does not follow that warm-glow giving increases welfare.<sup>221</sup> Among other points, he observes that apparent warm-glow advantages of giving over paying taxes may actually result from donor misperception of the efficacy of government or from the framing of donations, taxes, and spending.<sup>222</sup> Thus, to determine whether warm glow should be added to social welfare, we must decide whether to count these forms of misinformed preferences, a subject on which there is currently no agreement in the economic community.<sup>223</sup> Another point of controversy arises over whether a social planner should take account of "relative preferences," that is, a person's desire simply to outdo her neighbor—say, with a Gucci handbag.<sup>224</sup> Some argue that, in the aggregate, these preferences are zero sum, and so we cannot count the feelings of superior status as adding to welfare unless we also count the feelings of inferior status.<sup>225</sup>

Another point mentioned only in passing by Diamond is critical to the trade-off between donations and taxes. As Diamond and others note, it is possible that what is described as a warm glow is actually the relief we feel in satisfying social pressure to be good or

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donation may be offered out of a mix of pure altruism and warm glow.

219. Amihai Glazer & Kai A. Konrad, *A Signaling Explanation for Charity*, 86 AM. ECON. REV. 1019, 1019-21 (1996).

220. Schizer, *supra* note 15, at 226-27 & n.16 (citing Diamond, *supra* note 64, at 909).

221. Diamond, *supra* note 64, at 915-17.

222. *Id.* at 916.

223. For a survey of the disagreement and some suggested solutions see Galle, *supra* note 131, at 818-24, 842-51.

224. For overviews of the relative preferences debate, see ROBERT H. FRANK, CHOOSING THE RIGHT POND: HUMAN BEHAVIOR AND THE QUEST FOR STATUS 5 (1985); Richard H. McAdams, *Relative Preferences*, 102 YALE L.J. 1, 26-69 (1992) (describing generally how individuals measure themselves against one another and the effects of relative references on market equilibriums). For evidence on the empirical significance of relative preferences, see Fredrik Carlsson et al., *Do You Enjoy Having More than Others? Survey Evidence of Positional Goods*, 74 ECONOMICA 586, 587-93 (2007).

225. See McAdams, *supra* note 224, at 4-5. It should be noted that the counting does not necessarily net out to zero if positive and negative feelings are asymmetrical, or if some of the points of comparison are outside the society whose welfare we are trying to maximize.

generous.<sup>226</sup> To the extent that we all feel this pressure, but only some of us can fully satisfy it, the norm may actually reduce welfare overall. On this account, donations are psychologically indistinguishable from paying taxes. A wide literature on tax compliance claims that, given the rarity of tax audits and small size of most sanctions, it is likely that most people pay their taxes because they have internalized a compliance norm and fear psychological discomfort or social ostracization if they fail to comply.<sup>227</sup> Hence, if this picture of warm glow is accurate, charitable giving is no different than paying taxes.

A warm-glow justification for the deduction could also be circular. Warm glow results in some measure from meeting the approval of a social monitor, whether internal or external.<sup>228</sup> But the expectations of the monitors may themselves be a product of the deduction. Perhaps, as Rob Atkinson has argued, the legal regime for charity helps to establish a social norm and practice of altruism.<sup>229</sup> Or perhaps the existence of the deduction and other supports for charity help the charitable sector to spend resources developing its own kind of brand.<sup>230</sup> Thus, while warm glow may be a reason to continue the deduction's existence once it is firmly entrenched, standing alone it is a weak justification for choosing charity over government when we are designing on a blank slate.

### *E. Treasury Efficiency*

A final possible situational argument in favor of charity is that it might be a thriftier use of government dollars than direct spending.

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226. Diamond, *supra* note 64, at 917; *see also* Bernheim & Rangel, *supra* note 216, at 58-59; Amartya K. Sen, *Rational Fools: A Critique of the Behavioral Foundations of Economic Theory*, 6 PHIL. & PUB. AFF. 317, 329 (1977).

227. Michael Doran, *Tax Penalties and Tax Compliance*, 46 HARV. J. ON LEGIS. 111, 112 (2009); Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1468-84 (2003); Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1785-91, 1806-10 (2000).

228. *See* Bernheim & Rangel, *supra* note 216, at 58; Rose-Ackerman, *supra* note 4, at 713 n.10, 714.

229. Atkinson, *supra* note 1, at 632.

230. *Cf.* JOHN KENNETH GALBRAITH, *THE AFFLUENT SOCIETY* 111-12 (40th anniv. ed. 1998) (arguing that decades of private-sector advertising had convinced the public that the quality of government services was lower than the private sector's).



For one thing, it is possible that the subsidy is so effective at triggering private spending that each dollar of subsidy results in more than one dollar of giving.<sup>231</sup> If that were true, then devoting a dollar to the subsidy would result in more public goods, all else equal, than a dollar of direct government provision. In addition, government provision could crowd out some private giving that might have occurred—for example, because of altruism—absent government.<sup>232</sup>

But subsidies for charity also have some fiscal disadvantages. Charities do not spend all of the money they receive on public goods; much is consumed in fundraising, a cost the government does not incur.<sup>233</sup> Moreover, as noted earlier, subsidies given to inframarginal donors are, from a social perspective, wasted.<sup>234</sup> Thus, theory is indeterminate whether subsidies are a more efficient use of government treasury dollars.<sup>235</sup>

Empirical research offers only tenuous evidence for the treasury efficiency hypothesis. Studies of the price elasticity of giving have varied widely; one synthesis found that one dollar of an income tax subsidy produced about \$1.10 in charitable spending,<sup>236</sup> while the

231. CHARLES T. CLOTFELTER, *FEDERAL TAX POLICY AND CHARITABLE GIVING* 280-81 (1985). The responsiveness of giving to the amount of the subsidy is usually known as the “price elasticity of philanthropy.” William Vickrey, *Private Philanthropy and Public Finance*, in *ALTRUISM, MORALITY, AND ECONOMIC THEORY* 149, 153 (Edmund S. Phelps ed., 1975).

232. Russell D. Roberts, *Financing Public Goods*, 95 *J. POL. ECON.* 420, 420-35 (1987).

233. See Pozen, *supra* note 1, at 557-58. Of course, the government must collect taxes, but recall that in order to provide the subsidy, the government must raise taxes. These tax-collection costs are thus present for both subsidies and direct provision.

234. See *supra* text accompanying notes 63-66. For examples of the forms of wasteful charities that may arise as a result of overincentivization, see ROB REICH ET AL., *STANFORD U. CTR. ON PHILANTHROPY AND CIVIL SOC'Y, ANYTHING GOES: APPROVAL OF NON-PROFIT STATUS BY THE IRS* (2009), available at <http://pacscenter.stanford.edu/practitioners/published-papers>.

235. A bit more formally, suppose that under a subsidy the amount spent on public goods is equal to  $e$ , the price-elasticity of giving, times the subsidy amount  $S$ , plus a voluntary giving amount  $V$ , less the costs of fundraising  $F$ . On the other side of our inequality, we could put  $G$ , the amount of government spending, plus  $V$ , minus  $C$ , the amount of  $V$  that is crowded out by  $G$ . The question then is whether  $e \cdot S + V - F > G + V - C$ , or more simply whether  $e \cdot S - F > G - C$ .

236. John Pelozo & Piers Steel, *The Price Elasticities of Charitable Contributions: A Meta-Analysis*, 24 *J. PUB. POL'Y & MKTG.* 260, 265 & tbl.1 (2005). Probably the most thorough examination to date is Jon Bakija & Bradley T. Heim, *How Does Charitable Giving Respond to Incentives and Income? New Estimates from Panel Data*, 64 *NAT'L TAX J.* 615 (2011). Bakija and Heim report a federal elasticity of about 0.9, and a combined federal-state elasticity of

Congressional Research Service estimated a highly inefficient \$0.50 spent per \$1 in subsidy.<sup>237</sup> Measures of crowd-out are also highly divergent, with one well-known study finding crowd-out of about \$0.19 for every \$1 of government spending.<sup>238</sup> That is almost the precise amount an average charity spends on fundraising.<sup>239</sup> So, at best, charity appears to offer only a small price advantage over government.<sup>240</sup>

### F. Some General Objections

Although I have identified some possible advantages to the charitable form, there remain some possible costs to subsidized charity as well. Changing the justification for the subsidy does not eliminate all of the weaknesses I mentioned earlier. For one, there remains the problem that some goods might actually be overpro-

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about 1.1, meaning that \$1.00 in incentives produces \$1.10 in giving. *Id.* at 639. But they also argue that a combined result of as high as 1.4 is not implausible. *Id.*

237. SHERLOCK & GRAVELLE, *supra* note 65, at 49. Both of these numbers may overestimate the efficacy of subsidies. It is possible that deductibility merely changes the form of income-tax reporting of contributions, rather than increasing donations. See Ellen P. Aprill, *Churches, Politics, and the Charitable Contribution Deduction*, 42 B.C. L. REV. 843, 861 (2001). In addition, existing studies do not distinguish between charities that are subject to crowd-out and those that are not. My theory implies higher treasury efficiency for charities that might be crowded out by government, because those are less likely oversubsidized. See *supra* text accompanying note 171.

238. Bruce R. Kingma & Robert McClelland, *Public Radio Stations Are Really, Really Not Public Goods: Charitable Contributions and Impure Altruism*, 66 ANNALS PUB. & COOPERATIVE ECON. 65, 65-76 (1995) (summarizing other findings and reporting authors' own study). Another study by two well-known economists found crowd-out of 30 percent during the 1930s. Jonathan Gruber & Daniel M. Hungerman, *Faith-Based Charity and Crowd-Out During the Great Depression*, 91 J. PUB. ECON. 1043, 1043 (2007). Two other economists found that it was zero. David C. Ribar & Mark O. Wilhelm, *Altruistic and Joy-of-Giving Motivations in Charitable Behavior*, 110 J. POL. ECON. 425, 425 (2002). Some studies have found divergent results within the same data set. *E.g.*, A. Abigail Payne, *Does the Government Crowd-Out Private Donations? New Evidence from a Sample of Non-Profit Firms*, 69 J. PUB. ECON. 323 (1998) (finding crowd-out of either zero or \$0.50 per dollar, depending on statistical method).

239. James Andreoni & A. Abigail Payne, *Is Crowding Out Due Entirely to Fundraising? Evidence from a Panel of Charities*, 95 J. PUB. ECON. 334, 341 (2011) (finding that fundraising costs were just under 20 percent within their sample).

240. In terms of the earlier inequality, the results are  $\$1.10 - 0.20 > \$1.00 - 0.19$ . That is, one dollar spent on charity produces \$0.90 in spending, while the same dollar produces \$0.81 in public goods if spent on government provision. Furthermore, even the most generous figures assume that the quality of both sectors is comparable, which may well be an unfounded assumption.

duced from society's perspective. As just noted, donors do not internalize the cost of subsidizing their activities. And, again, charitable production of public goods can produce positive and negative externalities, the latter of which might be mitigated if the good were not produced or produced through government instead. For example, if social insurance produces moral hazard, that will be true no matter who offers the insurance.<sup>241</sup> The deadweight losses of the resulting moral hazard will largely be externalities to the charity.<sup>242</sup>

In contrast, governments at least include stakeholders who may be affected by negative externalities. Employers who face a smaller workforce as a result of the labor-reducing effects of social insurance, for example, can vote and lobby. These stakeholders may exert political pressure to reduce moral hazard, keeping social insurance closer to the optimal level. At a minimum, the opportunity for contrary views to enter the policy-making process encourages planners to consider and deliberate the right course of action.<sup>243</sup>

Additionally, complementing government programs through an outside organization sacrifices any economies of scope that society might achieve by integrating the two programs.<sup>244</sup> For instance, it might be much more effective to coordinate education with children's public health than to attempt each separately.

Some of these problems, however, are a product of the current law of charity, rather than an immutable feature of the sector. In the next Part, I offer some suggestions for reforming charity law to render it more deliberative and more receptive to the needs of outsiders.

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241. See Schizer, *supra* note 15, at 226.

242. Cf. Zywicki, *supra* note 105, at 879-81 (arguing that environmental organizations do not fully internalize social costs of environmental protection because their members do not bear many of those costs).

243. See Mark Seidenfeld, *Cognitive Loafing, Social Conformity, and Judicial Review*, 87 CORNELL L. REV. 486, 523-24 (2002); cf. Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey's Kiss-Off*, 108 COLUM. L. REV. 749, 790-814 (2008) (measuring market valuation of agency costs inherent in trust form).

244. Cf. M. Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571, 575, 590-93 (2009) (making this argument for superiority of for-profit firms over charities). Of course, in some cases charities can also experience economies of scope. Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 608-09, 626-33 (1989).

### *G. Summary*

Overall, there is a solid case for subsidies for charity as a way of improving the quality of public goods. The charitable sector is a necessary competitor for government where moving costs to obtain a particular service are high, where the states cannot easily scale up to rival the federal government, or where the public good in question would distort locational decisions. Even if the charity itself does not actually outperform government, the threat of competition may improve the *government's* performance. The subsidy and the structure of charities, however, may themselves create some economic distortions. I attempt to synthesize these strengths and weaknesses in the next Part.

## IV. TOWARDS A NEW FOUNDATION FOR CHARITY

If my argument so far is at all persuasive, it is an argument not only for a theoretical reappraisal of charity, but also a legal one. The traditional conceptions of charity have heavily influenced the shape of current U.S. law.<sup>245</sup> As those rationales evolve, so too should the law. Thus, in this Part, I set out tentative ideas for reforming the system the United States uses for allocating subsidies for charity. I focus on the method for determining what projects qualify as “charitable.” Part IV.A synthesizes the theory so far into a single, more or less coherent definition of what activities should count as “charity” eligible for subsidy. Part IV.B offers a legal regime for making that decision, contrasts it with the current regime, and explains the benefits of my proposed procedure. Part IV.C responds to the view, long-entrenched in the existing law, that government cannot be trusted to pass judgment on the merits of prospective charitable organizations.

### *A. What is “Charity” Under a Comparative-Advantage Rationale?*

Under the comparative-advantage theory I have laid out here, the legal definition of charity is not a single concept but is instead the

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245. See Hall & Colombo, *supra* note 1, at 332-39 (tracing influence of notions of charity on the creation of § 501(c)(3)).

end product of several overlapping policy arguments. Modern U.S. law does have a somewhat unified conception of charity: most entities can qualify for their subsidy by showing that they provide something for which there is a private market failure.<sup>246</sup> As I have shown, however, market failure is only the beginning of the story. Charity also has costs, and it is uncertain whether these costs outweigh the gains to be had from solving the markets' paralysis. Some costs could also be contained or eliminated by providing the good through government instead. I have suggested a number of factors that make it more likely any given charity will leave society better off. Given a market failure, the very strongest case for a charitable over government solution is when donors incur high exit costs, the good in question is provided across a wide geographical region, and it is redistributive in character.

### *1. Exit Costs*

Exit is central to the comparative-advantage rationale. As I have explained, easy mobility from one jurisdiction to another, or the credible threat of it, is vital to high-quality local government. As moving becomes costlier and more difficult, therefore, charity's role as a substitute for horizontal competition rises in importance. Further, when the cost of moving is high, the net social welfare from charity is higher, because charity saves society the costs of the move.

As I described earlier, though, exit costs can be highly subjective. The value of living in one place may depend on personal ties and tastes, not to mention the structure of a worker's employment contract. Given the difficulty of assessing these factors on an individual basis, the role of exit is probably to set a general baseline for the need for charity. In a society where exit costs are high overall, such as one in which there are large disparities in locational rents, the case for all forms of charity is stronger, and society should be more generous with organizations seeking the subsidy. More homogenous societies, or those in which labor mobility is easy, might set the bar higher for obtaining a subsidy. The modern United States likely

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246. See HOPKINS, *supra* note 141, at 103-09 (discussing the process of determining whether an organization operates for a tax-exempt purpose).

falls on the lower end of the exit-cost spectrum for individuals.<sup>247</sup> A more nuanced analysis of exit costs is possible to the extent that costs also correlate with other important factors.

## 2. *Broad-Based Services*

Exit costs, together with several other points I have mentioned, suggest that the subsidy is more defensible when the good to be subsidized is delivered across a wide geographical area.

### a. *Vertical Competition*

For one, wide distribution raises the possibility of vertical competition—that the charity will compete not only with local governments but also with the national government. Again, charities are especially vital when acting as a potential rival to the national government, because state and local governments cannot easily do so and often lack incentives to deliver services that would benefit other, competing jurisdictions.<sup>248</sup>

Subsidies are important in a vertical competition story because of the vast fiscal advantages of the national government. The federal government usually enjoys economies of scale and scope compared to charity; large foundations can turn the tables, but only in those few policy areas where they can concentrate their time and resources.<sup>249</sup> Governments can borrow, giving them huge flexibility in terms of maintaining liquidity, responding to urgent needs, and spreading the costs of a long-lasting capital project across the lifetime of the project.<sup>250</sup> Charities can also borrow, but those seeking to borrow in excess of the value of their assets can borrow

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247. Michael J. Greenwood, *Internal Migration in Developed Countries*, in 1 HANDBOOK OF POPULATION AND FAMILY ECONOMICS 648, 651-55 (Mark R. Rosenzweig & Oded Stark eds., 1997).

248. See *supra* text accompanying notes 180-97.

249. See JOEL L. FLEISHMAN, *THE FOUNDATION: A GREAT AMERICAN SECRET: HOW AMERICAN WEALTH IS CHANGING THE WORLD* 3-11 (2007).

250. See Hansmann, *supra* note 2, at 894-95 (describing advantages of government financing).

against only the uncertainty of future donations or revenues, which leads to higher borrowing costs than government.<sup>251</sup>

*b. Horizontal Competition*

Broad-based services also strengthen the case for subsidy as a support for horizontal competition. Recall that crowd-out makes subsidies more appealing: when a donor must pay twice to get a higher-quality public good, she is rather less likely to do so, increasing the need for a subsidy.<sup>252</sup> Donors who reside close together can vote or lobby to eliminate the government-provided good entirely, and they pay only once. As a result, organizations funded by these donors are more likely inefficient, at least in the case in which there are negative externalities from production of the good that could be eliminated if the organization relocated. These donors may also be over-subsidized. A subsidy that is large enough to overcome free riding when the donor must pay for both charity and similar government service will be too large for other goods.

It is difficult to imagine an administrable system in which an organization's eligibility depends on where its donors reside, but the nature of the good provided by the charity can be an effective proxy. Many public goods, by their nature, can only usefully be consumed locally.<sup>253</sup> Think of trash collection, policing, fire prevention, and public parks. For these forms of services, at least, we can be fairly confident that the consumers are necessarily bunched closely together. Other services are inherently nonlocal, such as theoretical scientific research or endangered-species conservation; in all likelihood the funders of such goods are widely scattered and cannot effectively offset their charitable spending with reductions in local taxes. Yet other services are somewhere in between, combining local benefits with additional spillovers that diffuse more widely, such as

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251. *See id.* at 877; Norman I. Silber, Charitable Debt Calamity: How Nonprofits Fell into the Auction-Rate Trap; and the Problems that Lie Ahead 6-13 (Jan. 10, 2009) (unpublished manuscript) (on file with author) (arguing that bank lending to charities is based largely on expanding value of charitable real estate). Both charities and local governments can offer tax-exempt bonds. I.R.C. § 103 (2006).

252. *See supra* text accompanying notes 165-75.

253. *See* RICHARD CORNES & TODD SANDLER, THE THEORY OF EXTERNALITIES, PUBLIC GOODS, AND CLUB GOODS 32-33 (2d ed. 1996).

churches, schools, and public health providers.<sup>254</sup> Though there is probably no bright line, the horizontal-competition rationale for the deduction is weaker as services become more local by their nature.

Alternatively, the lack of crowd-out among some donors might be an argument not for elimination of the subsidy but instead simply for multiple tiers of subsidy. Government could grant a lower subsidy to those who do not face double payment, avoiding the oversubsidization problem. A lower subsidy amount also mitigates the distortionary impact of the subsidy.

*c. Public vs. Private Goods*

Finally, broad-based services bolster both the horizontal- and vertical-competition stories by making the good purchased look less like a private good. Geographic concentration can be a stand-in for production of mostly private goods, for which no subsidy is necessary. More precisely, a highly concentrated service resembles what economists call a “club good,” which is a good whose benefits are shared among a finite group.<sup>255</sup> Club groups often can overcome free-riding problems, despite pooled benefits, because the small number of players allows for direct negotiations.<sup>256</sup> Social pressure to pay one’s “fair share” is also a more powerful factor in small groups, especially those, such as neighborhoods, that allow for face-to-face interactions.<sup>257</sup>

Thus, locally concentrated goods might not fully satisfy the threshold condition for subsidies: private market failure. It is likely that many localities would build parks with or without a subsidy because of the disproportionate benefit that a park provides to its nearest neighbors. But because of the free riding problem, it is very unlikely that a city would establish a nature preserve to protect an endangered chipmunk whose endearingly fuzzy existence is cherished mostly by conservationists around the world. Subsidies are therefore more necessary for the nationwide benefit of chipmunk conservation than for the local park.

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254. See Fennell, *supra* note 128, at 6-9.

255. CORNES & SANDLER, *supra* note 253, at 33-34.

256. See Lehavi, *supra* note 37, at 14.

257. *Id.* at 25-26, 42-48.



### 3. *Redistribution*

A final factor that weighs strongly in favor of a subsidy for a given organization is if its mission includes a significant amount of wealth redistribution. Race-to-the-bottom dynamics among subnational jurisdictions tend to increase the cost and reduce the efficacy of both pure redistribution and redistributive regulation.<sup>258</sup> That leaves a significant opportunity for charity to outperform government. Note again, though, that highly geographically concentrated redistribution may be problematic, as it may contribute to offsetting redistribution upwards by local governments.

One other caveat to the redistribution factor is that it stands in some tension with the exit costs argument. As I have explained, local governments can redistribute more effectively when the amount of redistribution is less than payers' exit cost. So as exit costs rise, charitable redistribution's comparative advantage diminishes. But this conflict is not inevitable. Exit costs need not be uniform; individual donors could face high costs while regulated firms or other taxpayers might be able to move fairly costlessly. In that situation, the theoretical case for charity would be at its apex.

### 4. *Objections to Weisbrod, Reconsidered*

One additional benefit of these three factors is that they also defeat the objections—federalism, special-purpose governments, and public choice theory—I raised earlier to the government-failure theories. Obviously, the factors are designed to account for federalism's failings. The factors also favor situations that closely resemble instances in which special-purpose governments will struggle: when benefits cover a wide geographic area and when vertical competition is important.<sup>259</sup>

The factors also diminish the bite of public choice theory, which might otherwise weigh against subsidies for higher-quality services.

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258. See *supra* text accompanying notes 205-10.

259. Special-purpose governments are an unpromising source of intergovernmental competition, because higher tiers of government often have both formal authority to limit special-purpose governments and informal fiscal and political tools for reigning them in. See Young, *supra* note 185, at 74-75.

Because only high-demand consumers would be willing to create a second institution just to achieve higher quality, donors would be relatively unlikely to free ride. Unless one accepts my earlier suggestion that charity is generally more efficient than lobbying,<sup>260</sup> this would imply that there should be no subsidy to encourage higher-quality public goods because lobbying alone should suffice.

The public choice critique is weakened, however, when exit costs are high, benefits diffuse, and the good is redistributive. I have already explained the redistribution point: redistributive goods are more likely to generate concentrated and politically powerful opposition.<sup>261</sup> I have also shown that consumers of geographically dispersed services have less political influence because of the increased coordination costs of assembling and enforcing a coalition.<sup>262</sup> High exit costs, too, reduce the power of lobbying by diminishing the political influence of those who could otherwise have threatened exit.<sup>263</sup>

I should also note that the addition of a comparative-advantage rationale does not undermine the government-failure justification for those narrow categories of charity that survived my earlier critique. The two can be cumulative. But there are few, if any, organizations that would be justified by government failure and not by comparative advantage,<sup>264</sup> so I will omit a separate analysis of government failure going forward.

### *5. A Summary, and Two Examples*

Taken together, the comparative-advantage rationale for charity suggests a fairly coherent legal ideal. As with any subsidy, would-be producers should first show that market production alone would be inadequate. The question then is whether the best corrective to the private market lies in government or in subsidized charity. Although no one factor seems dispositive, a charity can make its

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260. *See supra* text accompanying notes 104-08.

261. *See supra* text accompanying notes 100-03.

262. *See supra* text accompanying notes 173-75.

263. *See* Bratton & McCahery, *supra* note 62, at 264-65 (explaining relationship between exit threats and voice).

264. For example, all of the services with “strong” support under the government-failure rationale are nationwide, redistributive, or both. *See supra* Table 2.

strongest argument when government is at its weakest—as when there are high exit costs, few possible government competitors, or the good is redistributive—or when charity’s potential downsides are mitigated, such as when the good is shared widely across many jurisdictions and negative externalities are minimal. Part IV.B details how this test could be administered. First, though, it may be helpful to have an example or two of what my proposed legal norm would look like in practice.

Let us reconsider, then, the case for a subsidy for educational institutions. Government failure does not provide a persuasive justification for subsidizing education, since consumers of education at any given institution receive a private good, implying a strong political constituency for funding their school. There is a robust local market for education. At the same time, schools create localized negative externalities by increasing noise and traffic and eliminating alternative uses for large land parcels.

In contrast, national universities can make a strong argument for subsidy as potential competitors for government. A school that draws its student body from across the country, and sends its alumni out across the globe, will tend to have donors who cannot easily offset their gifts with lower spending on their various state universities.<sup>265</sup> This mitigates the waste of money given to infamarginal donors. The donors also could not easily band together to lobby for higher quality from any one state university.

The case is not as clear for some secondary schools and local community colleges. When parents and alumni are clustered closely together in a single political community, they are less likely to free ride, enabling those who choose private school to reduce public spending on schools.<sup>266</sup> Those who seek to create public competitors to existing schools are also more likely to do so, as the charter-school

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265. University donors are overwhelmingly graduates of the school or parents of would-be students. See R.G. Ehrenberg & C.L. Smith, *The Sources and Uses of Annual Giving at Selective Private Research Universities and Liberal Arts Colleges*, 22 *ECON. EDUC. REV.* 223 (2003).

266. WILLIAM A. FISCHER, *THE HOMEVOTER HYPOTHESIS* 73-76 (2001); see Becker & Lindsay, *supra* note 142, at 278, 294 (explaining that governments reduce spending on schools when schools are privately financed); see also Lehavi, *supra* note 37, at 14, 25-26, 42-48 (describing why local governments have less free riding).

movement suggests.<sup>267</sup> On the other hand, these predictions may fail in larger or more diverse jurisdictions, such as states, rural counties, suburbs that welcome many new migrants, or large cities.<sup>268</sup> Local private schools in those areas could plausibly argue that they offer necessary competition that would not otherwise arise.

In either case, schools can strengthen their argument by also serving as agents for social justice. Education can be a powerful leveler if it is available to those of modest means. Thus, private schools offering need-based scholarships, or schools collecting only modest tuition, such as most community colleges, could also make a strong argument for exemption regardless of their geographical focus.

In sum, these kinds of practical questions of politics and geography form the bedrock of my proposed standard. Admittedly, the test may turn on relatively nuanced facts. But to the extent this is a problem, it can be mitigated with a procedure that softens the need for most organizations to summon so much detail.

### *B. Establishing Charitable Status*

Although I have proposed a fairly detailed legal standard, it is possible to design the test for eligibility so that it would be mostly procedural, rather than substantive. The largest problems of the charitable sector derive from the weak incentives of organizations' principals to account for negative externalities.<sup>269</sup> The application process itself can shape these incentives, screening out many of the worst applicants. Many others—those within the core of the three factors I detailed—could be granted virtually automatic approval, leaving regulators to focus their resources on the relatively small number of borderline cases.

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267. Christiana Stoddard & Sean P. Corcoran, *The Political Economy of School Choice: Support for Charter Schools Across States and School Districts*, 62 J. URB. ECON. 27, 47 (2007).

268. See Briffault, *supra* note 128, at 399-422 (contrasting these situations with dynamics in small suburbs).

269. See *supra* text accompanying notes 68-73.

The first way for the application process to shape applicant incentives is if it establishes a “costly screen.”<sup>270</sup> Costly screens are a regulatory sorting tool in which applicants for some benefit must incur a modest cost to qualify.<sup>271</sup> The tool is most useful in situations in which the benefit grantor would prefer to limit availability of the benefit to those who value it highly—for example, because it is costly to provide—but the grantor lacks full information about the applicant’s preferences.<sup>272</sup> If the process of obtaining the benefit is costly in some way to the applicant, then only applicants who value the benefit at more than the cost of the screen will obtain it. Thus the screen obliges applicants to internalize some of the costs of providing the benefit and to reveal the strength of their preference.<sup>273</sup> Ideally, the screen will have differentiated costs, so that those who value the benefit less will perceive the screen as more costly, but that is not always achievable.<sup>274</sup>

The second way in which the process can shape incentives is by fostering internal deliberation. Scholars of administrative law have shown that when planners know that their decisions will be reviewed by someone who may disagree with their views, and the process of planning is costly, the planners have strong incentives to consider the views of the later reviewers.<sup>275</sup> Therefore, requirements to justify internal decisions to outsiders encourage insiders to take account of others’ views. Just as agencies have become more democratic and deliberative as a result of the need to survive review by

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270. See, e.g., Jonathan S. Masur, *Costly Screens and Patent Examination*, 2 J. LEGAL ANALYSIS 687, 688-90 (2010) (describing costly screens in patent examinations); see also Matthew C. Stephenson, *The Price of Public Action: Constitutional Doctrine and the Judicial Manipulation of Legislative Enactment Costs*, 118 YALE L.J. 2, 4-6, 16-17 (2008) (describing “screening” concept as a technique of judicial review).

271. See Masur, *supra* note 270, at 688-90.

272. See Stephenson, *supra* note 270, at 11-15 (describing use of screen as solution to information asymmetry).

273. *Id.* at 15.

274. That is, because the screen imposes some deadweight loss even on those whom the government wishes to obtain the benefit, *id.* at 22-23, it would be preferable to be able to differentiate the degree of effort required of different applicants.

275. Seidenfeld, *supra* note 243, at 523-24; see also Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 35, 38-41, 50-54 (2002) (describing social science literature on impact of external accountability but arguing that such accountability is undesirable if it undermines norms of board cohesion).

potentially disagreeable judges,<sup>276</sup> so too might charities become less insular and less subject to confirmation bias and groupthink.

Putting these two design features together, would-be charities could be obliged to explain why their organization deserves a subsidy, taking into account opportunity costs, moral hazard, and other possible harms to others.<sup>277</sup> Treasury officials would be empowered to consider these arguments and reject the application of organizations that lack merit, albeit while subject to careful oversight by layers of administrative and judicial review. At least in difficult or borderline cases, outsiders would also be welcome to comment on the officials' own deliberations. Treasury officials would apply a sliding scale of scrutiny, with organizations that meet most of the key factors I have outlined able to obtain approval with cursory explanation and little scrutiny.<sup>278</sup> Those that appear to offer minimal benefits, produce mostly private goods, or create serious negative externalities would instead have a significant burden to explain why they deserve subsidy. Periodic recertification might ensure that organizations do not get slack after approval.

This framework could open charitable governance to outside views and influences with concomitant benefits to the quality of the organizations' deliberations. The weaker the benefits the charity would offer, or the larger its harms, the heavier the burden of explanation, and so the higher the costs of application for entrepreneurs—and the supporters who must pay them.<sup>279</sup> In all likelihood, many organizations with dubious benefits would not bother to apply at all.

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276. Seidenfeld, *supra* note 243, at 516-17.

277. One design question on which I take no firm position is whether a would-be charity need consider purely ideological, or even racist, objections. My tentative view is that it should not: if one goal of charity is to foster heterodox views, the mere unpopularity of the organization's views should not be a strike against it. See McCormack, *supra* note 72, at 995, 1013-14 (arguing that displeasure of racists and majority groups should not be a reason to reject charity). But, admittedly, the line between ideological and other objections is likely hard to draw.

278. Organizations carrying out inherently nongovernmental activities, such as religious entities, would also probably be automatically exempt.

279. In this way, entrepreneurs whose enterprises would create large social value, but small private value for the entrepreneur, may still be willing to undergo the screening process. See Masur, *supra* note 270, at 690 (noting that screening will fail to increase welfare if there are significant numbers of applicants who would create large social value but assign low private value to applying).

The procedure would likely need at least two important exceptions. First, small charities for whom the application or recertification process would be a major administrative burden could be exempted. In their case, the costly screen is too costly, because it would eat up a disproportionate share of organizational resources, and the cost to society of granting eligibility is small in any event. Additionally, to preserve charities' flexibility in the face of sudden new needs, there could be an exception or expedited process for emergency responses, such as earthquake or tsunami relief.<sup>280</sup>

One other important feature worth consideration is to make available multiple tiers of subsidy for applicants to choose from. For instance, there might be two or three subcategories of § 501(c)(3), with contributions deductible at different multiples of the amount donated—say, 50 percent, 100 percent, and 125 percent.<sup>281</sup> As noted earlier, a lower but nonzero subsidy may be the best solution to the problem that some, but not all, donors face double payment. Allowing a partial subsidy also gives Treasury officials an intermediate option if they find an organization has a plausible but not overwhelming case for subsidy; borderline organizations could reapply for higher subsidies after they have built up a track record of service. Furthermore, putting aside the mechanics of the application process, having flexible subsidy amounts allows a more efficient rate of subsidization. Subsidies should be set at the amount that induces the optimal amount of charity,<sup>282</sup> but currently the size of the subsidy depends almost entirely on the donor's marginal tax rate, which has no obvious relation to optimal giving.<sup>283</sup> If the Treasury can adjust the multiplier for each tier of subsidy, the subsidy rate can be decoupled from the marginal tax rate.

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280. I note, however, that current law allows organizations to obtain 501(c)(3) status retroactively, which might make an emergency exception unnecessary. See HOPKINS, *supra* note 141, at 855-56.

281. I am grateful to Kirk Stark for this suggestion.

282. James R. Hines, Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179, 1214 (2010).

283. Gergen, *supra* note 1, at 1402-03.

*C. Dangers of Discretion?*

I must acknowledge at this point that my suggestion of significant government scrutiny of the purposes of charities is contrary to existing law and to the views of nearly every other commentator.<sup>284</sup> Pluralists, for instance, claim that allowing the government to decide which charities may receive the subsidy would leave novel, unpopular, or minority viewpoints unfunded.<sup>285</sup> Welfarists suggest that majority control would fail to reveal preferences of voters with supramajority tastes for public goods.<sup>286</sup>

Based on this logic, it could be further argued that government must grant the deduction equally to all charities that produce public goods, irrespective of their quality. It may be challenging to design a system capable of making fine distinctions between different organizational goals without permitting space for government judgment about the desirability of those goals.<sup>287</sup> For instance, we may think that the comparative-advantage rationale for the deduction is persuasive for producers of opera but not rock music. But granting government the ability to choose which production companies receive the deduction raises the danger that head-banging aria haters at the IRS will do the opposite.

Current law appears to reflect this thinking. In deciding what is charitable, officials cannot deny an organization charitable status because they dislike its goals, but instead can determine only whether the entity performs a function that the for-profit market

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284. An exception is Roger Colinvaux, *Charity in the 21st Century: Trending Toward Decay*, 11 FLA. TAX REV. 1, 45 (2011).

285. See FLEISHMAN, *supra* note 249, at 22-24; Atkinson, *supra* note 1, at 636-37; Iris J. Goodwin, *Donor Standing to Enforce Charitable Gifts: Civil Society vs. Donor Empowerment*, 58 VAND. L. REV. 1093, 1118-19 (2005); see also Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 342 (1976).

286. Hall & Colombo, *supra* note 1, at 404; Pozen, *supra* note 1, at 558-59; cf. Schizer, *supra* note 15, at 251-52 (arguing that in this scenario, charities would be forced to lobby for benefits).

287. Atkinson, *supra* note 1, at 636-37; Perry Fleischer, *supra* note 29, at 532-34 (raising and responding to this argument); see NORMAN I. SILBER, A CORPORATE FORM OF FREEDOM: THE EMERGENCE OF THE MODERN NONPROFIT SECTOR 5-6, 42-81 (2001) (tracing the history of judicial evaluation of charity in an effort to show that judicial decisions reflect the judiciary's policy preferences).



does not.<sup>288</sup> For example, rules for distinguishing permissible “educational” activity from prohibited lobbying at least purport to test only how the organization spreads its message, not the message’s content.<sup>289</sup> Although there is an exception to the definition of charity for violations of “public policy,” the Supreme Court has interpreted that exception to refer only to policies on which there is near-uniform social agreement.<sup>290</sup> Thus far, the only disqualifying policies that the Court has identified are invidious racial discrimination and criminal enterprises; even charities that discriminate based on gender remain in the clear.<sup>291</sup> The Court has suggested that the reason the public policy exception must remain narrow is because government officials cannot be trusted to decide which charitable endeavors are good policy.<sup>292</sup>

This vision of charity law fails, however, because concerns about government bias are overblown. The harm of excluding the occasional borderline group does not obviously outweigh the benefits of curtailing wasteful subsidies. Furthermore, governmental review improves, rather than threatens, charity. Excluding harmful and marginal charities is likely to boost the willingness of the public and government officials to support the sector. Approval by officials who are accountable to the public at large helps to ensure that charitable goals are balanced against the possibility of externalities or consumption of scarce resources that might be better devoted to other charities. Surviving a formal review can also help the organization

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288. See HOPKINS, *supra* note 141, at 158-63.

289. *Id.* at 261-67.

290. See *Bob Jones Univ. v. United States*, 461 U.S. 574, 593-96 (1983). For an insightful discussion of the uncertainties behind the “illegal activity” prohibition, see Johnny Rex Buckles, *Reforming the Public Policy Doctrine*, 53 U. KAN. L. REV. 397, 409-37 (2005).

291. David A. Brennan, *The Power of the Treasury: Racial Discrimination, Public Policy, and “Charity” in Contemporary Society*, 33 U.C. DAVIS L. REV. 389, 391 & n.2 (2000); Nicholas A. Mirkay, *Is It Charitable To Discriminate? The Necessary Transformation of Section 501(c)(3) into the Gold Standard for Charities*, 2007 WIS. L. REV. 45, 72-74.

292. Although the Court is not explicit on this point, Justice Powell forcefully argued this position in his *Bob Jones* concurrence, and the majority’s response was that public policy violations could be found only when there was widespread social and political agreement. See *Bob Jones*, 461 U.S. at 593-98 & n.23; *id.* at 611 (Powell, J., concurring). For scholarly assertions of this point, see Buckles, *supra* note 290, at 457-59; Daniel P. Tokaji, *First Amendment Equal Protection: On Discretion, Inequality, and Participation*, 101 MICH. L. REV. 2409, 2429-30, 2497-99 (2003) (discussing general tradeoffs between official discretion and potential for discriminatory application).

to cement its case to a skeptical public. Plus, the need to justify charity to such officials may in itself lead to more internal deliberation within the charitable organization about the place of its goals within the larger society. For instance, an organization that excludes women should be made to justify its decision against the expressive harms that even its private decision may have on others. The very act of considering and offering an explanation that could be plausible to outsiders may begin to change the discriminatory attitudes of the organization's members.<sup>293</sup>

These forms of balancing by officials can themselves be subject to review in ways that limit the role of the officials' subjective preferences. For instance, as I have mentioned, that is one goal of administrative law: to oblige the executive to justify its decisions based on public reasons, taking into account all reasonable competing viewpoints.<sup>294</sup> To be sure, the effectiveness of judicial or other forms of review depend on the reviewers. Administrators may blatantly discriminate against some charitable enterprises, and courts at times may let them. But *stare decisis* and norms of duty to follow it will help constrain judges who might be tempted to give a pass to harsh administrative treatment of organizations of which they disapprove.<sup>295</sup> And an agency that is unable *ex ante* to predict the attitudes of its reviewing judges and is reluctant to waste resources

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293. See Seidenfeld, *supra* note 243, at 524.

294. See *supra* text accompanying notes 275-76.

295. See Michael Abramowicz & Maxwell Stearns, *Defining Dicta*, 57 STAN. L. REV. 953, 956 (2005). Admittedly, there is debate over evidence of the extent to which precedent limits judicial behavior. Compare FORREST MALTZMAN ET AL., CRAFTING LAW ON THE SUPREME COURT: THE COLLEGIAL GAME 32-56 (2000) (discussing the Chief Justice's power to assign majority opinions in order to set an agenda), and JEFFREY A. SEGAL & HAROLD J. SPAETH, THE SUPREME COURT AND THE ATTITUDINAL MODEL REVISITED 80, 298-300 (2002) (finding that judges pick and choose precedents in line with their policy preferences), with Jack Knight & Lee Epstein, *The Norm of Stare Decisis*, 40 AM. J. POL. SCI. 1018, 1029 (1996) (noting that Justices act out of a belief that following precedent is necessary to maintain legitimacy), and Keith E. Whittington, *Once More unto the Breach: Post Behavioralist Approaches to Judicial Politics*, 25 LAW & SOC. INQUIRY 601, 617-18 (2000) (arguing that the pool of cases available to the Court limits its ability to change precedent). Given the difficulties of interpreting the empirical evidence, however, Michael J. Gerhardt, *The Limited Path Dependency of Precedent*, 7 U. PA. J. CONST. L. 903, 909-22 (2005), I am persuaded by the model constructed by Abramowicz and Stearns.

on a decision that will be nullified on review is more likely to act *as though* judges will hold them to the letter of their obligations.<sup>296</sup>

In any event, any politicization of charity would not doom unpopular projects. In fact, an extremist charity that fails to win a subsidy is still quite likely to continue its mission precisely because of the extremity of its positions.<sup>297</sup> Recall that distant outliers know that they cannot free ride on the efforts of others; thus, each member is likely to contribute, regardless of subsidy. Each member will lobby more vigorously for political approval. Even if approval is not forthcoming, the government's refusal further marks the charity as an outsider, confirming to its members their inability to rely on other contributors and strengthening their own resolve to contribute.<sup>298</sup>

On balance, then, it is both plausible and appropriate for the law of charity to distinguish between worthy and unworthy charities. Indeed, current law overstates the need to curtail official determinations of the merits of a charity's goals. At a minimum, charities that outright discriminate against others should have to justify their exclusionary practices.

#### CONCLUSION

I have offered here a new theoretical foundation for the law of charity, one in which charity steps in when government falters, offering competition when frictions reduce the pressure on governments to outperform local or national rivals. Charity also can supply redistribution from or regulation of mobile taxpayers who otherwise could be targeted only at great expense to local jurisdictions. Both of these functions, however, bring with them some costs, such as the danger that charities will generate burdens for others or allow

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296. Jonathan T. Molot, *The Judicial Perspective in the Administrative State: Reconciling Modern Doctrines of Deference with the Judiciary's Structural Role*, 53 STAN. L. REV. 1, 64-65 (2000).

297. Cf. Bruce A. Ackerman, *Beyond Carolene Products*, 98 HARV. L. REV. 713, 723-31 (1985) (making this argument to show that discrete and insular minorities may not require judicial protection).

298. See *id.* at 730-31 (suggesting that societal prejudice may strengthen political activism of oppressed groups). This is not to deny that government disapprobation may carry a stigma that can both harm the members and, in the long run, undermine their cause.

residents to diminish the tax base for pursuit of their own private goals.

This new formulation of the rationale for charity implies a number of important policy recommendations, such as rules aimed at limiting the possible downside of charitable endeavors. Although it is too early for finely grained details, I have offered the first draft of a new law of charity that attempts to sort more precisely welfare-increasing charities from those that harm others or waste shared resources. The hope is that the process of explaining their goals to outsiders will open charity to a more diverse set of views and perhaps also educate the public of the unique contributions of each new proposal.

My argument also has implications for a number of secondary rules, such as the compensation and duties of officers in charitable organizations, the role of charity in politics, and the nature of the public policy exception to the definition of charity. First, in arguing that more demanding procedures are consistent with the diversity and independence of the charitable sector, I have also shown that current doctrine is likely too timid in dealing with charities that discriminate or otherwise violate public policy.

Further, my analysis bears on the controversial questions of political advocacy by charities and the compensation of their executives. I have already explained elsewhere that the comparative-advantage rationale implies that for-profit charity, and existing Treasury regulations allowing nonprofit executives to be paid compensation “comparable” to executives at equivalent for-profit firms, are wrongheaded and should be revised.<sup>299</sup> Most commentators have struggled to find any normative grounding for existing restrictions on lobbying and electioneering by charities.<sup>300</sup> In my account, however, charity is explicitly justified as an alternative to government, so that allowing charitable dollars to be used for lobbying for government services would defeat the whole point of the subsidy. Both these areas deserve more detailed attention, but space constrains me to defer that consideration to future work.

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299. Treas. Reg. § 53.4958-4(b)(1)(ii) (2011); Galle, *supra* note 18, at 1218-33.

300. See Johnny Rex Buckles, *Does the Constitutional Norm of Separation of Church and State Justify the Denial of Tax Exemption to Churches that Engage in Partisan Political Speech?*, 84 IND. L.J. 447, 452-79 (2009).