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## Solving Charity Failures

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## Solving Charity Failures

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## INTRODUCTION

On February 7, 2011, an anonymous Massachusetts resident tweeted<sup>1</sup> Detroit Mayor David Bing: “Philadelphia has a statue of Rocky & Robocop would kick Rocky’s butt. He’s a GREAT ambassador for Detroit.”<sup>2</sup> Mayor Bing responded that “[t]here are not any plans to erect a statue to Robocop. Thank you for the suggestion.”<sup>3</sup>

While Mayor Bing did not think Detroit needed a statue of its fictional cybernetic guardian, the Internet disagreed. On February 9, 2011, the Detroit nonprofit The Imagination Station<sup>4</sup> created the

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<sup>1</sup> A “tweet” is a 140-character-maximum message posted on the Twitter website. *See The Story of a Tweet*, TWITTER, <https://about.twitter.com/what-is-twitter/story-of-a-tweet> (last visited Aug. 2, 2014).

<sup>2</sup> *Detroit Needs a Statue of Robocop!*, KICKSTARTER, <http://www.kickstarter.com/projects/imaginationstation/detroit-needs-a-statue-of-robocop?ref=category> (last visited Aug. 2, 2014). *RoboCop* is a 1987 science-fiction/action film about a Detroit police officer who is murdered by a street gang and reincarnated as RoboCop, a crime-fighting cyborg. *See* ROBOCOP (Orion Pictures Corporation 1987); *RoboCop*, IMDB, <http://www.imdb.com/title/tt0093870/> (last visited Aug. 2, 2014).

<sup>3</sup> *Detroit Needs a Statue of Robocop!*, *supra* note 2.

<sup>4</sup> The Imagination Station of Roosevelt Park is a Michigan nonprofit corporation. *Corporate Entity Details, Department of Licensing and Regulatory Affairs*, MICHIGAN.GOV, [http://www.dleg.state.mi.us/bcs\\_corp/dt\\_corp.asp?id\\_nbr=70712P&name\\_entity=THE%20IMAGINATION%20STATION%20OF%20ROOSEVELT%20PARK](http://www.dleg.state.mi.us/bcs_corp/dt_corp.asp?id_nbr=70712P&name_entity=THE%20IMAGINATION%20STATION%20OF%20ROOSEVELT%20PARK) (last visited Aug. 2, 2014). It is either not eligible for or has not applied for federal tax-exempt status under 26 U.S.C. § 501(c) (2012). *See Exempt Organizations Select Check*,

Kickstarter project “Detroit Needs A Statue of Robocop!”<sup>5</sup> The goal of the project was to raise \$50,000 to construct a RoboCop statue in Detroit.<sup>6</sup> Less than two months later, 2718 people had pledged to contribute a total of \$67,436 to the project in exchange for various rewards.<sup>7</sup> Three years later, the statue is almost complete.<sup>8</sup>

The RoboCop statue was an early crowdfunding success. “Crowdfunding” is a way of using the Internet to raise money by asking the public to contribute to a project.<sup>9</sup> In the past, asking a large number of people to contribute small amounts of money to a project was expensive and inefficient for most organizations and individuals. By greatly reducing transaction costs,<sup>10</sup> crowdfunding enables anyone to inexpensively and efficiently seek small contributions to a project.

While crowdfunding is a new model of fundraising, it has already transformed funding for the arts. For example, the crowdfunding platform Kickstarter distributed more than forty million dollars to the creators of almost seventy-five hundred projects within two years of Kickstarter’s launch.<sup>11</sup> On March 3, 2014, Kickstarter announced that it had received more than one billion dollars in pledges from 5.7 million backers.<sup>12</sup> By comparison, the 2014 budget for the National

IRS, <http://apps.irs.gov/app/eos/pub78Search.do?searchChoice=ePostcard&dispatchMethod=selectSearch> (Select: “Were automatically revoked”; Search: “27-3164734” “The Imagination Station of Roosevelt,” “Detroit,” “MI”) (last visited Aug. 2, 2014).

<sup>5</sup> *Detroit Needs a Statue of Robocop!*, *supra* note 2. Kickstarter is an online fundraising tool that focuses on funding creative projects. See generally *Seven Things to Know About Kickstarter*, KICKSTARTER, <https://www.kickstarter.com/hello?ref=footer> (last visited May 28, 2014).

<sup>6</sup> *Detroit Needs a Statue of Robocop!*, *supra* note 2.

<sup>7</sup> *Id.* Rewards included opportunities to visit the statue “in style” and meet-and-greet events with “other cool Detroit peoples.” *Id.*

<sup>8</sup> See Julie Hinds, *RoboCop Statue in Hands of a Master from Venus Bronze Works in Detroit*, DETROIT FREE PRESS (Feb. 17, 2014, 2:47 PM), <http://www.freep.com/article/20140217/ENT01/302170017/RoboCop-statue-Giorgio-Gikas-Detroit>; Lee DeVito, *Take a Look at Detroit’s RoboCop Statue*, METROTIMES (Feb. 5, 2014), <http://metrotimes.com/news/take-a-look-at-detroit-s-robocop-statue-1.1629190>.

<sup>9</sup> Tanya Prive, *What Is Crowdfunding and How Does It Benefit the Economy*, FORBES (Nov. 27, 2012, 10:50 AM), <http://www.forbes.com/sites/tanyaprive/2012/11/27/what-is-crowdfunding-and-how-does-it-benefit-the-economy/>.

<sup>10</sup> A “transaction cost” is “a cost incurred in making an economic exchange.” *Transaction Cost*, WIKIPEDIA, [http://en.wikipedia.org/wiki/Transaction\\_cost](http://en.wikipedia.org/wiki/Transaction_cost) (last visited June 3, 2014). Transaction costs include search and information costs. *Id.*

<sup>11</sup> See Yancey Strickler, *Happy Birthday Kickstarter!*, in *Kickstarter Blog*, KICKSTARTER (Apr. 28, 2011), <http://www.kickstarter.com/blog/happy-birthday-kickstarter>.

<sup>12</sup> *OMG*, KICKSTARTER, <https://www.kickstarter.com/1billion> (last visited Aug. 2, 2014). For current data on Kickstarter, see *Stats*, KICKSTARTER, <http://www.kickstarter.com/help/stats> (last updated Aug. 2, 2014, 2:17 PM).

Endowment for the Arts was \$146 million.<sup>13</sup> Kickstarter is only one of many crowdfunding platforms, which have collectively distributed billions of dollars to creative and charitable projects.<sup>14</sup>

This Article argues that crowdfunding has succeeded, at least in part, because it makes charitable giving more efficient by solving certain “charity failures,” or inefficiencies created by the inability of the charitable contribution deduction to subsidize the charitable giving from low-income donors. The economic subsidy theory of the charitable contribution deduction explains that the deduction is justified because it solves market failures and government failures in charitable goods. According to this theory, free riding causes market failures in charitable goods, and majoritarianism<sup>15</sup> causes government failures in charitable goods. The charitable contribution deduction solves these market and government failures by indirectly subsidizing charitable contributions, thereby compensating for free riding and avoiding majoritarianism.<sup>16</sup>

The economic subsidy theory consists of an empirical hypothesis and a normative claim. The empirical hypothesis is that the charitable contribution deduction solves market failures and government failures; the normative claim is that this increased efficiency justifies the deduction.<sup>17</sup> This Article takes no position on the normative claim, but argues that the remarkable success of crowdfunding helps confirm the empirical hypothesis of the economic subsidy theory.

The empirical hypothesis of the economic subsidy theory implies that the charitable contribution deduction is itself inefficient because it cannot solve market and government failures in contributions by low-income donors. The subsidy provided by the deduction depends on a donor’s marginal tax rate, so the deduction provides a large subsidy to most high-income donors, and little or no subsidy to most

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<sup>13</sup> See *Appropriations History*, NAT’L ENDOWMENT FOR THE ARTS, <http://arts.gov/open-government/national-endowment-arts-appropriations-history> (last visited Aug. 2, 2014).

<sup>14</sup> See C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 5.

<sup>15</sup> “Majoritarianism” is “a traditional political philosophy or agenda which asserts that a majority . . . of the population is entitled to a certain degree of primacy in society, and has the right to make decisions that affect the society.” *Majoritarianism*, WIKIPEDIA, <http://en.wikipedia.org/wiki/Majoritarianism> (last visited Aug. 3, 2014).

<sup>16</sup> See JOHN D. COLOMBO & MARK A. HALL, *THE CHARITABLE TAX EXEMPTION* 109, 113 (1995).

<sup>17</sup> See Ilan Benshalom, *The Dual Subsidy Theory of Charitable Deductions*, 84 IND. L.J. 1047, 1058–59, 1077 (2009).

low-income donors.<sup>18</sup> And if the deduction cannot subsidize contributions from low-income donors, the deduction cannot solve market and government failures in those contributions. I will refer to this inefficiency as a “charity failure.”

This Article argues that crowdfunding is successful because it provides a technological solution to some of those charity failures. While the charitable contribution deduction causes charity failures because the deduction cannot subsidize contributions from low-income donors, crowdfunding can subsidize those contributions by offering rewards instead. As a result, crowdfunding should solve at least some of the charity failures caused by the deduction through providing an incentive for low-income donors to contribute. The remarkable success of crowdfunding suggests that the inefficiency associated with charity failures is quite large.

This Article proceeds in four parts. Part I explains the economic subsidy theory of the charitable contribution deduction. Part II shows why the premises of the economic subsidy theory imply that the deduction causes charity failures. Part III argues that crowdfunding can solve at least some of those charity failures. And Part IV suggests that the success of crowdfunding may reflect persistent inefficiency in the market for charitable goods.

## I

### THE ECONOMIC SUBSIDY THEORY OF THE CHARITABLE CONTRIBUTION DEDUCTION

The charitable contribution deduction allows certain taxpayers to deduct specific charitable contributions from their income tax base under limited circumstances.<sup>19</sup> The economic subsidy theory of the charitable contribution deduction argues that the deduction is justified because it solves market failures and government failures in charitable goods.<sup>20</sup> Classical economics<sup>21</sup> predicts that free riding will cause market failures in public goods and majoritarianism will cause

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<sup>18</sup> See *infra* notes 67–83 and accompanying text.

<sup>19</sup> See I.R.C. §§ 170(c), 2055(a), 2522(a) (2012).

<sup>20</sup> See COLOMBO & HALL, *supra* note 16, at 109, 113. For the purpose of this Article, “charitable goods” are goods produced by a charity in furtherance of its charitable mission.

<sup>21</sup> “Classical economics” refers to the economic theories written between 1776 through the early 1930s. KEYNES AND THE CLASSICAL ECONOMISTS: THE EARLY DEBATE ON POLICY ACTIVISM 1, available at [http://wps.aw.com/wps/media/objects/11/11640/rohlf\\_keynes\\_and\\_classical.pdf](http://wps.aw.com/wps/media/objects/11/11640/rohlf_keynes_and_classical.pdf) (last visited Aug. 3, 2014). “[T]he most important element of classical economic thought was the belief that a market economy would automatically tend toward full employment.” *Id.* at 1-2.

government failures in public goods.<sup>22</sup> The economic subsidy theory predicts that free riding and majoritarianism will also cause market failures and government failures in charitable goods because they often resemble public goods.<sup>23</sup> It also argues that the charitable contribution deduction eliminates the inefficiency caused by those market failures and government failures by indirectly subsidizing charitable contributions.<sup>24</sup>

### A. *Nonprofits and Charities*

A nonprofit organization (“nonprofit”) is an organization that is subject to the nondistribution constraint, which provides that a nonprofit cannot distribute its assets to its controlling persons and must use its assets to advance the nonprofit’s social purpose.<sup>25</sup> A charity is a nonprofit organization with a charitable purpose.<sup>26</sup> All charities are nonprofit organizations, but not all nonprofit organizations are charities. Some nonprofits benefit their members, which is a non-charitable purpose, but many nonprofits benefit the public, which may be a charitable purpose.<sup>27</sup>

Under federal law, an organization is a charity only if the Internal Revenue Service (IRS) determines that it is exempt from taxation under 26 U.S.C. § 501(c)(3), which effectively defines a charity as a nonprofit organization that is “organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes,” among other things.<sup>28</sup> However, many nonprofit organizations that satisfy the criteria set forth in § 501(c)(3) do not apply for tax-exempt status.<sup>29</sup> Moreover, the criteria set forth

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<sup>22</sup> See COLOMBO & HALL, *supra* note 16, at 109, 113; Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 67–69 (1982).

<sup>23</sup> See COLOMBO & HALL, *supra* note 16, at 109, 113.

<sup>24</sup> See, e.g., *id.* In theory, the deduction “solves” market failures and government failures by enabling charities to provide the optimal amount of charitable goods. See *id.*

<sup>25</sup> Hansmann, *supra* note 22, at 56–57.

<sup>26</sup> See generally *Charitable Organization*, WIKIPEDIA, [http://en.wikipedia.org/wiki/Charitable\\_organization](http://en.wikipedia.org/wiki/Charitable_organization) (last visited Aug. 3, 2014).

<sup>27</sup> See *Frequently Asked Questions*, NAT’L CTR. FOR CHARITABLE STATISTICS, <http://nccs.urban.org/resources/faq.cfm> (last visited Aug. 3, 2014).

<sup>28</sup> See I.R.C. § 501(c)(3) (2012).

<sup>29</sup> For example, organizations with less than fifty thousand dollars in annual gross receipts are only required to file a 990-N, but many do not. *Instructions for Form 990-EZ - Notices*, IRS, <http://www.irs.gov/instructions/i990ez/ar02.html#d0e5162> (last visited Aug. 3, 2014); *Scope of the Nonprofit Sector*, INDEPENDENT SECTOR, [http://www.independentsector.org/scope\\_of\\_the\\_sector](http://www.independentsector.org/scope_of_the_sector) (last visited Aug. 3, 2014).



in § 501(c)(3), as interpreted by the IRS, may not exhaust the scope of charitable purposes.

The customary definition of charity may include purposes and organizations excluded by the federal statutory definition. “Charity” is generally defined as “[t]he voluntary giving of help, typically in the form of money, to those in need,” and a “charity” is generally defined as “[a]n organization set up to provide help and raise money for those in need.”<sup>30</sup>

Accordingly, purposes and organizations that are not defined as charities under federal law may still be charitable in a colloquial sense. More specifically, while an organization is not a charity under federal law unless the IRS determines that it is exempt from taxation in accordance with § 501(c)(3), most people would agree that an organization is a charity if it has a charitable purpose, whether or not it has registered with the IRS or can qualify for federal tax-exempt status.

### B. Charitable Contributions

Federal law defines a charitable contribution as a donation to a charity, and most charitable contributions are potentially tax deductible.<sup>31</sup> In other words, taxpayers may be able to deduct charitable contributions from their taxable income.<sup>32</sup> Taxpayers deduct a substantial amount of charitable contributions. For example, in 2010, taxpayers claimed about \$291 billion in charitable contribution deductions.<sup>33</sup>

However, many donations that satisfy the popular definition of a “charitable contribution” do not satisfy the federal definition. Either the organization that receives the donation has not applied for tax-

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<sup>30</sup> *Charity*, OXFORD DICTIONARIES, [http://www.oxforddictionaries.com/us/definition/american\\_english/charity](http://www.oxforddictionaries.com/us/definition/american_english/charity) (last visited Aug. 3, 2014).

<sup>31</sup> See I.R.C. §§ 170(c), 2055(a), 2522(a).

<sup>32</sup> Tax income is defined as gross income less any deductions. See *What Is Taxable and Nontaxable Income?*, IRS, <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/What-is-Taxable-and-Nontaxable-Income> (last visited July 15, 2014).

<sup>33</sup> JOINT COMM. ON TAXATION, PRESENT LAW AND BACKGROUND RELATING TO THE FEDERAL TAX TREATMENT OF CHARITABLE CONTRIBUTIONS 1 (2011) [hereinafter PRESENT LAW AND BACKGROUND], available at <https://www.jct.gov/publications.html?func=select&id=50> (click “JCX 55-11”).

exempt status, or the recipient of the donation does not qualify as a charity under § 501(c)(3).<sup>34</sup>

### C. *The Economic Subsidy Theory*

The charitable contribution deduction indirectly subsidizes the production of charitable goods by reducing the cost of charitable contributions.<sup>35</sup> When taxpayers deduct charitable contributions from their taxable income, they reduce their tax burden and the government receives less tax revenue. Effectively, the deduction provides a government subsidy to the charities chosen by the taxpayers who make deductible charitable contributions. Every year, the deduction results in an indirect government subsidy of about \$25 billion to charities.<sup>36</sup>

Scholars disagree about the purpose of the charitable contribution deduction. Some argue that it rewards altruism.<sup>37</sup> Others argue that it provides a more accurate measurement of the income of a charitable donor.<sup>38</sup> And still others argue that the deduction is ineffective or improper, and that it should be eliminated.<sup>39</sup>

The prevailing theory of the charitable contribution deduction holds that the deduction is an economic subsidy intended to mitigate market failures and government failures in charitable goods.<sup>40</sup>

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<sup>34</sup> For example, giving alms to a panhandler satisfies the popular definition of charity but not the federal definition because a donation to an individual cannot be a charitable contribution. I.R.C. § 501(c)(3).

<sup>35</sup> See PRESENT LAW AND BACKGROUND, *supra* note 33, at 2–3.

<sup>36</sup> See OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT OF THE U.S., ANALYTICAL PERSPECTIVES, FISCAL YEAR 2001 at 117 tbl.5-3 (2000), available at <http://fraser.stlouisfed.org/docs/publications/usbanalytical/BUDGET-2001-PER.pdf>; JOINT COMM. ON TAXATION, HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS 45 (2005), available at <http://www.jct.gov/x-29-05.pdf>.

<sup>37</sup> TERESA ODENDAHL, CHARITY BEGINS AT HOME 236 (1990) (“Charitable policy is currently enacted through a tax code premised on the notion that individual philanthropy is altruistic and should be rewarded.”); Boris I. Bittker, *Charitable Contributions: Tax Deductions or Matching Grants?*, 28 TAX L. REV. 37, 60–61 (1972).

<sup>38</sup> William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 314–15 (1972); Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1414–15 (1988).

<sup>39</sup> Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an “Ideal” Income Tax and Why They Fit Worse in a Far from Ideal World*, 31 STAN. L. REV. 831, 880 (1979); Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 TAX L. REV. 377, 379 (1972).

<sup>40</sup> See, e.g., Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213, 1215 (2010) (“Modern commentators view the deduction for charitable contributions as a federal subsidy to the recipient firms and argue that the subsidy is justified as a tool for

According to this economic subsidy theory, free riding creates market failures by causing the market to undersupply charitable goods, and majoritarianism creates government failures by causing the government to undersupply charitable goods. The charitable contribution deduction solves these market and government failures by subsidizing the production of charitable goods.<sup>41</sup>

#### D. Market Failures in Public Goods

Classical economics predicts that free riding will cause market failures in public goods.<sup>42</sup> A market failure exists when the market allocation of a good is inefficient.<sup>43</sup> Efficient markets are “Pareto optimal,” meaning that no one’s welfare can be increased without decreasing someone else’s welfare.<sup>44</sup> A market failure exists when someone’s welfare could be increased without decreasing anyone’s welfare.<sup>45</sup>

A public good is a good that is non-rival and non-excludable.<sup>46</sup> A good is non-rival if its consumption does not reduce its availability and is non-excludable if its consumption cannot be prevented.<sup>47</sup> For example, in the absence of intellectual property laws, ideas and expressions are public goods because they can be consumed an infinite number of times, and their consumption cannot be prevented.

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encouraging the production of goods that would otherwise be underproduced by the private market.”).

<sup>41</sup> See, e.g., 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, 698 (2001) [hereinafter *The Marketing of Philanthropy*]; Gergen, *supra* note 38, at 1394; Hansmann, *supra* note 22, at 68, 71; David E. Pozen, *Remapping the Charitable Deduction*, 39 CONN. L. REV. 531, 547 (2006); Daniel Shaviro, *Assessing the “Contract Failure” Explanation for Nonprofit Organizations and Their Tax-Exempt Status*, 41 N.Y.L. SCH. L. REV. 1001, 1007 (1997).

<sup>42</sup> See COLOMBO & HALL, *supra* note 16, at 109, 113; Hansmann, *supra* note 22, at 67–69.

<sup>43</sup> See *Market Failures, Public Goods, and Externalities*, LIBR. OF ECON. & LIBERTY, <http://www.econlib.org/library/Topics/College/marketfailures.html> (last visited Aug. 4, 2014).

<sup>44</sup> See *Pareto Efficiency*, INVESTOPEDIA, <http://www.investopedia.com/terms/p/pareto-efficiency.asp> (last visited Aug. 4, 2014); *Vilfredo Pareto*, Biography in *The Concise Encyclopedia of Economics*, LIBR. OF ECON. & LIBERTY, <http://www.econlib.org/library/Enc/bios/Pareto.html> (last visited Aug. 4, 2014).

<sup>45</sup> See *Market Failures, Public Goods, and Externalities*, *supra* note 43; *Pareto Efficiency*, *supra* note 44; *Vilfredo Pareto*, *supra* note 44.

<sup>46</sup> Tyler Cowen, *Public Goods*, *The Concise Encyclopedia of Economics*, LIBR. OF ECON. & LIBERTY, <http://www.econlib.org/library/Enc/PublicGoods.html> (last visited Aug. 4, 2014).

<sup>47</sup> See *id.*

Common examples of public goods include fresh air, lighthouses, national defense, flood control systems, and street lighting.

Free riding is the consumption of a good without paying the marginal cost of production.<sup>48</sup> Public goods are vulnerable to free riding because they are non-rival and non-excludable; everyone who wants to consume a public good can consume it, and the producer of the good cannot stop them from consuming it. Free riding causes market failures in public goods because no one is willing to pay the marginal cost of production.

### *E. Government Failures in Public Goods*

Public choice theory predicts that majoritarianism will cause government failures in public goods.<sup>49</sup> Government failures are inefficiencies in government regulation of the market allocation of a good.<sup>50</sup> In theory, governments can solve market failures in public goods by subsidizing their production and taxing their consumption, thereby forcing the consumers of a good to pay its marginal cost of production. In other words, government can compensate for free riding on public goods and ensure that the optimal quantity of a public good is produced; when government fails to do this, a government failure exists.<sup>51</sup>

Majoritarianism creates government failures in public goods because it causes governments to satisfy the preferences of the median voter.<sup>52</sup> Majoritarian governments have an incentive to solve market failures if they affect the median voter but do not have an incentive to solve market failures that only affect political minorities.<sup>53</sup> As a result, a majoritarian government's ability to solve market failures in a public good depends on the uniformity of demand for that good.

Majoritarian governments can solve market failures in a public good when demand is uniform because the supply of the good

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<sup>48</sup> See generally *id.* (providing the example of people watching fireworks from their backyards without paying for the show).

<sup>49</sup> See, e.g., *The Marketing of Philanthropy*, *supra* note 41, at 698; Hansmann, *supra* note 22, at 68, 71.

<sup>50</sup> See *The Marketing of Philanthropy*, *supra* note 41, at 698.

<sup>51</sup> *Id.*

<sup>52</sup> "Median voter" refers to someone who is not at either extreme of public opinion but who instead "sits squarely in the middle of public opinion." Tyler Cowen, *Why Politics Is Stuck in the Middle*, N.Y. TIMES (Feb. 6, 2010), [http://www.nytimes.com/2010/02/07/business/economy/07view.html?\\_r=0](http://www.nytimes.com/2010/02/07/business/economy/07view.html?_r=0) [hereinafter *Why Politics Is Stuck*].

<sup>53</sup> *Id.*

demanded by the median voter will compensate for free riding. For example, the demand for drinking water is relatively uniform, so governments can often solve market failures in drinking water by building waterworks or subsidizing their private construction.

But majoritarian governments cannot solve market failures involving a public good when demand is not uniform because the median voter demand will not compensate for free riding. If the median voter's demand for a public good is low but a political minority's demand is high, a majoritarian government will only subsidize production of the good until the median voter's demand is satisfied.<sup>54</sup> In other words, majoritarian governments can compensate for free riding by the median voter but cannot compensate for free riding by political minorities. As a result, majoritarianism causes government failures in public goods disproportionately demanded by political minorities.

#### *F. Charitable Goods Resemble Public Goods*

The economic subsidy theory argues that charitable goods are vulnerable to free riding and majoritarianism because they resemble public goods.<sup>55</sup> Many charitable goods resemble public goods because they are effectively non-rival or non-excludable. For example, public art is practically non-rival because it can be consumed by an indefinite number of people, and it is practically non-excludable because it is available for public consumption. It follows that free riding should cause market failures in charitable goods to the extent that they resemble public goods.

Demand for charitable goods is rarely uniform. Often, the median voter's demand for a charitable good is low, but a political minority's demand is high for the charitable good.<sup>56</sup> For example, the median voter's demand for a homeless shelter is low, but a homeless person's demand is high. Thus, majoritarianism should cause government failures in charitable goods disproportionately demanded by political minorities.<sup>57</sup>

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<sup>54</sup> See, e.g., *id.*

<sup>55</sup> See COLOMBO & HALL, *supra* note 16, at 109, 113.

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

## II

## THE ECONOMIC SUBSIDY THEORY OF CHARITY LAW

A. *Charity Law Solves Market and Government Failures in Charitable Goods*1. *The Economic Subsidy Theory*

The economic subsidy theory argues that the charitable contribution deduction is justified because it solves market failures and government failures in charitable goods.<sup>58</sup> If free riding causes market failures in charitable goods that resemble public goods and majoritarianism causes government failures in charitable goods demanded by political minorities, then we should expect an inefficient market in charitable goods demanded by political minorities. The economic subsidy theory argues that the deduction solves these market and government failures by indirectly subsidizing the production of charitable goods.

In theory, political minorities can solve market and government failures in charitable goods they demand by subsidizing the production of those goods themselves. In other words, members of a political minority may form a charity to produce the goods they demand and make contributions to that charity.

2. *The Problem of Free Riding*

Charitable contributions are vulnerable to free riding. The people who demand a charitable good benefit when others contribute to charities that produce that good—regardless of whether the demanding person makes a contribution. While altruism will motivate some members of a political minority to make charitable contributions,<sup>59</sup> it may not fully compensate for free riding on charitable contributions. As a consequence, a charity may receive insufficient contributions to offset market failures and government failures in a charitable good, resulting in a shortage of the charitable good.

The economic subsidy theory argues that the charitable contribution deduction is justified because it solves market failures and government failures in charitable goods by subsidizing charitable

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<sup>58</sup> *Id.*

<sup>59</sup> See PRESENT LAW AND BACKGROUND, *supra* note 33, at 36.

contributions, thereby compensating for free riding.<sup>60</sup> The deduction indirectly subsidizes charitable contributions by allowing taxpayers to deduct their contributions from their taxable income.<sup>61</sup> For example, if the income tax rate is 25%, taxpayers with \$100 of taxable income ordinarily pay \$25 in taxes on that income (assuming the taxpayer has other income). But the charitable contribution deduction allows taxpayers with \$100 of taxable income who donate that entire amount to a charity to deduct their contribution from their taxable income. Thus, when the taxpayers donate \$100, they have no taxable income remaining and thereby avoid \$25 in taxes. As a result, the net cost to taxpayers of the \$100 charitable contribution is only \$75. Even if the taxpayer had not donated \$100, they still would have lost \$25 to income tax. The deduction enables the taxpayers to avoid paying \$25 in income tax. Effectively, \$100 donation to the charity consists of \$75 donated directly by the taxpayer and \$25 in uncollected tax revenue donated indirectly by the government.

### *3. How the Deduction Solves Market Failures and Government Failures*

In theory, the deduction can solve market failures in charitable goods by providing a subsidy that compensates for free riding on charitable contributions. For example, if a charity needs \$100 to satisfy the demand for a charitable good but free riding results in only \$75 in contributions, the charitable contribution deduction can compensate for free riding by providing a subsidy of \$25.

The deduction can also solve government failures in charitable goods by subsidizing the production of charitable goods indirectly. Direct subsidies of charitable goods are vulnerable to majoritarianism because majoritarian governments will only subsidize the production of charitable goods when the median voter's demand is not satisfied.<sup>62</sup> This scenario causes government failures in charitable goods demanded by political minorities. The indirect subsidy provided by the deduction can solve some of those government failures by enabling political minorities to determine which charitable goods receive a subsidy.

Moreover, the deduction is likely to subsidize the production of charitable goods affected by market failures and government failures.

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<sup>60</sup> See COLOMBO & HALL, *supra* note 16, at 109, 113.

<sup>61</sup> See I.R.C. §§ 170(c), 2055(a), 2522(a) (2012).

<sup>62</sup> See *supra* notes 49–54 and accompanying text.

Charitable contributions are motivated at least in part by altruism, or concern for the welfare of others.<sup>63</sup> One form of altruism is paying for a public good instead of free riding. Accordingly, altruistic charitable contributions are likely to pay for charitable goods that are vulnerable to free riding and thereby help solve market failures. Another form of altruism is giving to those in need. While majoritarian governments tend to satisfy the preferences of the median voter, they tend not to satisfy the preferences of political minorities,<sup>64</sup> so those in need tend to be political minorities. Altruistic charitable contributions are likely to pay for charitable goods that are vulnerable to majoritarianism and thereby help solve government failures. If altruistic charitable contributions tend to solve actual market failures and government failures, it follows that the subsidy provided by the contributions' tax deductions will also tend to solve actual market failures and government failures.

#### *4. Limits to Solving Market Failures and Government Failures*

Of course, the charitable contribution deduction does not and cannot actually solve all market and government failures in charitable goods. To begin with, the deduction can only compensate for free riding on charitable contributions that are made. Some taxpayers may choose not to contribute and others may lack the resources.

In addition, the deduction is inherently inefficient. The subsidy it provides is not correlated to the actual amount of free riding on a charitable donation. Instead, the subsidy provided by the deduction is determined by a taxpayer's marginal tax rate. As a result, there is no reason to believe that the subsidy provided by the deduction is equivalent to the positive externalities produced by the contribution because the two are unrelated to each other.<sup>65</sup>

Nevertheless, perhaps something is better than nothing. While there is no reason to believe that the charitable contribution deduction efficiently solves market and government failures in charitable goods, presumably it solves or aids at least some of them.

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<sup>63</sup> *Altruism*, OXFORD DICTIONARIES, [http://www.oxforddictionaries.com/us/definition/american\\_english/altruism](http://www.oxforddictionaries.com/us/definition/american_english/altruism) (last visited Aug. 5, 2014); *see* PRESENT LAW AND BACKGROUND, *supra* note 33, at 36.

<sup>64</sup> *Why Politics Is Stuck*, *supra* note 52.

<sup>65</sup> A positive externality occurs when "the consumption or production of a good causes a benefit to a third party." *Positive Externalities*, ECONOMICS HELP, <http://www.economicshelp.org/micro-economic-essays/marketfailure/positive-externality/> (last visited May 29, 2014). For example, education results in a positive externality; the individual receives a benefit, but society as a whole also benefits. *Id.*



### B. Vertical Equity and Distributive Justice

While the economic subsidy theory argues that the charitable contribution deduction solves market and government failures in charitable goods, critics respond that it lacks vertical equity and reduces distributive justice.<sup>66</sup> Specifically, they argue that the deduction lacks vertical equity because it benefits high-income taxpayers more than low-income taxpayers, and that it reduces distributive justice because it benefits rich people more than poor people.<sup>67</sup> Critics argue that the deduction benefits high-income taxpayers more than low-income taxpayers by providing a larger subsidy to high-income taxpayers.<sup>68</sup> As explained above, the subsidy provided by the charitable contribution deduction is determined by the donor's marginal income tax rate: the higher the rate, the larger the subsidy and the lower the rate, the smaller the subsidy.<sup>69</sup>

The federal income tax rate is graduated, meaning that a taxpayer's marginal income tax rate increases as the taxpayer's taxable income increases.<sup>70</sup> There are currently seven income tax brackets for single taxpayers, ranging from 10% on taxable income less than \$9,075 to 39.6% on taxable income more than \$406,750.<sup>71</sup> As a result, the charitable contribution deduction provides a larger subsidy to high-income taxpayers than it does to low-income taxpayers. To illustrate, a taxpayer in the 10% tax bracket who makes a \$100 charitable contribution receives a \$10 subsidy, but a taxpayer in the 39.6% tax bracket who makes a \$100 charitable contribution receives a \$39.60 subsidy.

Moreover, the charitable contribution deduction cannot subsidize the charitable contributions made by most low-income taxpayers because they generally do not itemize their deductions.<sup>72</sup> Taxable

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<sup>66</sup> See Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U. L. REV. 505, 508–09 (2010).

<sup>67</sup> See *id.* at 549–50.

<sup>68</sup> See *id.*; Benschalom, *supra* note 17, at 1057.

<sup>69</sup> See *Charitable Contribution Deductions*, IRS, <http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Charitable-Contribution-Deductions> (last updated Nov. 1, 2013) [hereinafter *Charitable Contribution Deductions*].

<sup>70</sup> See generally *2013 Tax Table*, IRS 74–85, <http://www.irs.gov/pub/irs-pdf/i1040tt.pdf> (last visited May 29, 2014) [hereinafter *2013 Tax Table*].

<sup>71</sup> INTERNAL REVENUE SERV., TAX WITHHOLDING AND ESTIMATED TAX 19 (Mar. 16, 2014), available at <http://www.irs.gov/pub/irs-pdf/p505.pdf>.

<sup>72</sup> Benjamin H. Harris & Daniel Baneman, *Who Itemizes Deductions?*, TAX POL'Y CTR. (Jan. 17, 2011), <http://www.urban.org/uploadedpdf/1001486-Who-Itemizes-Deductions.pdf>.

income is defined as gross income less any deductions.<sup>73</sup> Taxpayers may claim either a standard deduction or the sum of their itemized deductions.<sup>74</sup> The charitable contribution deduction is an itemized deduction.<sup>75</sup> Therefore, taxpayers can deduct their charitable contributions only if they claim itemized deductions; they cannot deduct their charitable contributions if they claim a standard deduction. Most low-income taxpayers claim a standard deduction rather than itemized deductions because the standard deduction is larger than the sum of their itemized deductions.<sup>76</sup> Accordingly, most low-income taxpayers cannot deduct their charitable contributions, and the charitable contribution deduction cannot subsidize their charitable contributions.<sup>77</sup>

Critics of the charitable contribution deduction also argue that it benefits the rich more than the poor because it tends to subsidize charitable goods consumed by the rich rather than charitable goods consumed by the poor.<sup>78</sup> For example, the rich tend to consume charitable goods produced by museums and universities, while the poor tend to consume charitable goods produced by food banks and homeless shelters.<sup>79</sup> Donors tend to contribute to charities that produce charitable goods that they personally consume.<sup>80</sup>

Because rich people make more charitable contributions,<sup>81</sup> it follows that the charitable contribution deduction tends to subsidize charitable goods consumed by the rich rather than charitable goods consumed by the poor. Obviously, the rich are capable of making larger charitable contributions than the poor, simply because they have more wealth to contribute. And increasing income and wealth inequality may have increased this disparity regarding the capacity to make charitable contributions.<sup>82</sup>

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<sup>73</sup> See *What Is Taxable and Nontaxable Income?*, *supra* note 32.

<sup>74</sup> Harris & Baneman, *supra* note 72.

<sup>75</sup> INTERNAL REVENUE SERV., ITEMIZED DEDUCTIONS, SCHEDULE A (2013), available at <http://www.irs.gov/pub/irs-pdf/f1040sa.pdf>.

<sup>76</sup> See PRESENT LAW AND BACKGROUND, *supra* note 33, at 37.

<sup>77</sup> *Id.*

<sup>78</sup> See ODENDAHL, *supra* note 37, at 3.

<sup>79</sup> See Fleischer, *supra* note 66, at 549.

<sup>80</sup> See *id.* (citing Rob Reich, *Philanthropy and Its Uneasy Relation to Equality*, in *TAKING PHILANTHROPY SERIOUSLY: BEYOND NOBLE INTENTIONS TO RESPONSIBLE GIVING* 27–49 (William Damon & Susan Verducci eds., 2007)); ODENDAHL, *supra* note 37, at 3).

<sup>81</sup> See ODENDAHL, *supra* note 37, at 3.

<sup>82</sup> Thomas Piketty & Gabriel Zucman, *Wealth and Inheritance in the Long Run* 1, 17–18 (Apr. 6, 2014), <http://gabriel-zucman.eu/files/PikettyZucman2014HID.pdf>.

Moreover, the rich have a larger incentive to make charitable contributions compared to the poor based on the fact that the rich tend to receive a larger subsidy. Wealthy people often earn large incomes, and poor people tend to have low incomes, so the structure of the charitable contribution deduction amplifies the subsidy of charitable goods consumed by the rich. However, these important normative criticisms of the charitable contribution deduction do not address the empirical claim that it solves market and government failures in at least some charitable goods.

### *C. Charity Failures*

While critics of the charitable contribution deduction argue that the deduction reduces distributive justice and lacks vertical equity, the deduction is also vulnerable to criticism on efficiency grounds. In fact, the economic subsidy theory of the deduction implies that it causes “charity failures,” or failures to solve market failures and government failures in charitable goods consumed by low-income taxpayers.

#### *1. What Is a Charity Failure?*

According to the economic subsidy theory, the charitable contribution deduction solves market and government failures for charitable goods by subsidizing charitable contributions, thereby compensating for free riding and encouraging more people to donate.<sup>83</sup> This subsidy compensates for free riding on charitable goods by creating an incentive for marginal donors to contribute to the charities that produce those goods: the larger the subsidy, the stronger the incentive; the smaller the subsidy, the weaker the incentive.<sup>84</sup> But the charitable contribution deduction can compensate for free riding only to the extent that it can subsidize charitable contributions. If it cannot subsidize a donor’s contributions, it cannot create an incentive for that donor to make contributions. And if the deduction cannot subsidize certain contributions, it cannot compensate for market and government failures associated with those contributions, causing “charity failures,” or inefficiencies in the charitable subsidy.

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<sup>83</sup> See COLOMBO & HALL, *supra* note 16, at 109, 113.

<sup>84</sup> See *id.*

## 2. *Who Is Affected by Charity Failures?*

The economic subsidy theory also implies that charity failures are more likely to affect low-income taxpayers than high-income taxpayers because the charitable contribution deduction provides a larger subsidy to high-income taxpayers than to low-income taxpayers and cannot provide any subsidy to most low-income taxpayers.

First, charity failures are more likely to affect low-income taxpayers than high-income taxpayers because high-income taxpayers receive a much larger subsidy from the charitable contribution deduction.<sup>85</sup> In theory, the size of the subsidy provided by the charitable contribution deduction should affect the number and value of charitable contributions. Empirical studies of the effect of the charitable contribution deduction lend qualified support to this hypothesis. Some studies have found that changing the size of the subsidy causes a disproportionately larger change in the number and value of charitable contributions.<sup>86</sup> Other studies have found a weaker or more qualified response, suggesting that changes in the size of the subsidy may have a limited effect on the number and value of charitable contributions.<sup>87</sup>

It follows that high-income taxpayers should respond in a more correlative fashion to changes in the subsidy than low-income taxpayers, as high-income taxpayers tend to receive a larger subsidy than low-income taxpayers. In fact, many low-income taxpayers receive no subsidy at all.<sup>88</sup> Several studies have shown that changes in the charitable deduction subsidy cause a larger change in the charitable contributions of high-income taxpayers compared to low-income taxpayers.<sup>89</sup>

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<sup>85</sup> See *Charitable Contribution Deductions*, *supra* note 69; *2013 Tax Table*, *supra* note 70.

<sup>86</sup> See generally CHARLES T. CLOTFELTER, *FEDERAL TAX POLICY AND CHARITABLE GIVING* (1985) (presenting econometric analysis of the relationship between federal taxes and charitable giving); Daniel Feenberg, *Are Tax Price Models Really Identified: The Case of Charitable Giving*, 40 NAT'L TAX J. 629, 632 (1987).

<sup>87</sup> Gerald E. Auten, Holger Sieg & Charles T. Clotfelter, *Charitable Giving, Income, and Taxes: An Analysis of Panel Data*, 92 AM. ECON. REV. 371, 380–81 (2002); 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, 692 (2011); William C. Randolph, *Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions*, 103 J. POL. ECON. 709, 735 (1995).

<sup>88</sup> See *supra* notes 75–76 and accompanying text.

<sup>89</sup> Bakija & Heim, *supra* note 87, at 642; Charles T. Clotfelter, *The Impact of Tax Reform on Charitable Giving: A 1989 Perspective*, 7 (NBER Working Paper No. 3273,

Of course, many low-income taxpayers make charitable contributions despite the fact they receive only a small subsidy. In 2011, the Joint Committee on Taxation projected that 216,000 taxpayers filed itemized tax returns reporting \$10,000 or less with a \$1250 average of charitable contributions per return but only a \$72 average subsidy.<sup>90</sup> By contrast, a taxpayer in the 39.6% tax bracket would have received a \$495 subsidy for the same contribution of \$1250.

Furthermore, many taxpayers contribute to a charity even though they receive no subsidy at all. In 2008, charitable organizations reported \$229.28 billion in individual contributions, but individual itemized tax returns claimed only \$172.9 billion in charitable contributions.<sup>91</sup> This suggests that individual taxpayers give nearly \$56.4 billion in charitable contributions for which they received no subsidy whatsoever.<sup>92</sup> Presumably, some taxpayers who filed itemized returns failed to claim some of their charitable contributions, and some charities may have claimed more contributions than they actually received. But taxpayers who did not file itemized returns made many of these unclaimed charitable contributions, and they thereby missed out on subsidies they would have received.

“Hypersalience,” or the mistaken belief that a deduction applies, may compensate for free riding on some unsubsidized charitable contributions.<sup>93</sup> A deduction is “salient” when it creates an incentive for the taxpayers it affects, and is “hypersalient” when it creates an incentive for taxpayers it does not affect but who believe they are affected.<sup>94</sup> The charitable contribution deduction may be hypersalient because it appears to create an incentive for some non-itemizing taxpayers to make contributions even though they cannot claim the deduction. In other words, some non-itemizing taxpayers appear to make charitable contributions because they believe that the contributions will be deductible even though they are not.<sup>95</sup>

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1990), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=226702](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=226702) (click on “Download This Paper”).

<sup>90</sup> PRESENT LAW AND BACKGROUND, *supra* note 33, at 37 tbl.2.

<sup>91</sup> *Id.* at 39 tbls.2, 3.

<sup>92</sup> *Id.* at 37–38.

<sup>93</sup> Lilian V. Faulhaber, *The Hidden Limits of the Charitable Deduction: An Introduction to Hypersalience*, 92 B.U. L. REV. 1307, 1309 (2012).

<sup>94</sup> *Id.* at 1309, 1311.

<sup>95</sup> *Id.* at 1340.

However, hypersalience probably cannot fully compensate for free riding on all unsubsidized charitable contributions. While the deduction appears to be hypersalient for some non-itemizing taxpayers, it is almost certainly not hypersalient for all non-itemizing taxpayers. At least some non-itemizing taxpayers must realize that they cannot claim the deduction based on information provided by the IRS, professional tax preparers, or their own experience of the IRS denying a claimed deduction. Moreover, while the deduction may be hypersalient to non-itemizers, presumably it is more salient and provides a larger incentive to taxpayers who actually receive a subsidy than taxpayers who do not. Accordingly, while hypersalience probably reduces charity failures, it is unlikely to eliminate them because it cannot fully compensate for the difference between the subsidy provided to low-income and high-income taxpayers.

While the charitable contribution deduction creates a strong incentive for high-income taxpayers to make charitable contributions, it creates, at best, a weak incentive for low-income taxpayers to make charitable contributions. Therefore, the economic subsidy theory implies that the charitable contribution deduction compensates for free riding on high-income taxpayers' charitable contributions more effectively than it compensates for free riding on low-income taxpayers' charitable contributions. The deduction provides a larger incentive to marginal high-income donors than to marginal low-income donors.

The economic subsidy theory additionally implies that the charitable contribution deduction will tend to cause charity failures in charitable goods consumed by low-income taxpayers. If donors contribute to charities that produce the charitable goods they personally consume, this implies that the market of charitable goods consumed by high-income taxpayers is more efficient than the market of charitable goods consumed by low-income taxpayers. It also means that charities that produce goods that high-income taxpayers consume are more likely to receive the optimal amount of contributions. And if the deduction provides a weak incentive for low-income individuals to make charitable contributions, then charities that produce charitable goods consumed by low-income taxpayers are less likely to receive the optimal amount of contributions.

In other words, the economic subsidy theory implies that the charitable contribution deduction is more likely to solve market failures and government failures in charitable goods consumed by high-income taxpayers than low-income taxpayers. As a result, the

economic subsidy theory implies that the charitable contribution deduction will tend to cause charities to supply the optimal amount of charitable goods consumed by high-income taxpayers but undersupply charitable goods consumed by low-income taxpayers.

### III

#### SOLVING CHARITY FAILURES

##### *A. Reforming the Charitable Contribution Deduction*

Charitable contribution deduction critics argue that it is unfair. They have proposed several reforms intended to increase distributional justice and improve vertical equity.<sup>96</sup> The proposed reforms include: reducing the subsidy that the charitable contribution deduction provides to high-income taxpayers, allowing non-itemizing taxpayers to claim the charitable contribution deduction, providing a tax credit to low-income taxpayers who make charitable contributions, and providing direct grants to charities.<sup>97</sup>

These proposed reforms may increase distributional justice and improve vertical equity, but they cannot solve the charity failures caused by the charitable contribution deduction because none of them can efficiently compensate the low-income taxpayers for the free riding on their charitable contributions.

Reducing the subsidy for high-income taxpayers may improve vertical equity, but it cannot solve charity failures because this strategy does nothing to compensate for free riding on charitable contributions. On the contrary, it could increase charity failures while reducing the marginal incentive for high-income taxpayers to make charitable contributions.<sup>98</sup>

##### *1. Solving Charity Failures Through Tax Policy*

In theory, the government could solve charity failures through the tax code by extending the charitable contribution deduction to non-

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<sup>96</sup> See, e.g., *House Tax Reform Proposal Limits Charitable Deduction for All*, PHILANTHROPY NEWS DIG. (Mar. 3, 2014), <http://www.philanthropynewsdigest.org/news/house-tax-reform-proposal-limits-charitable-deduction-for-all> (proposing a reform that limits the charitable deduction for all income levels to only those donations that are in excess of two percent of the taxpayer's gross income).

<sup>97</sup> JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS: CASES AND MATERIALS* 808–27 (4th ed. 2010).

<sup>98</sup> David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals*, 62 *TAX L. REV.* 221, 256 (2009).

itemizers or offering tax credits for charitable contributions to low-income taxpayers. However, tax-based solutions to charity failures are likely to be inefficient and costly.

*a. Extending the Deduction to Non-Itemizers*

Allowing non-itemizing taxpayers to claim the charitable contribution deduction would solve some, but not all, charity failures. The subsidy for low-income taxpayers under this model is not large enough to compensate for free riding.

Several studies have found that low-income taxpayers do not respond strongly to changes in the subsidy provided by the charitable contribution deduction.<sup>99</sup> From 1982 to 1986, non-itemizing taxpayers could deduct an increasing percentage of their charitable contributions.<sup>100</sup> While charitable contributions by non-itemizing taxpayers increased when their maximum charitable contribution deduction increased, the response was smaller than the response of itemizing taxpayers.<sup>101</sup> Moreover, much of the increase in charitable contributions by non-itemizing taxpayers was attributable to taxpayers choosing not to itemize in order to receive a larger deduction, rather than taxpayers choosing to increase their charitable contributions.<sup>102</sup>

*b. Providing Tax Credits for Charitable Contributions to Low-Income Taxpayers*

Providing a tax credit to low-income taxpayers who make charitable contributions cannot solve charity failures because it would be costly, inefficient, and often ineffective. The diminishing marginal utility of consumption<sup>103</sup> makes it more expensive to induce a low-

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<sup>99</sup> See Joseph Cordes, John O'Hare & Eugene Steuerle, *Extending the Charitable Deduction to Nonitemizers: Policy Issues and Options*, 7 URBAN INST. 1, 4 (2000); David H. Eaton, *Charitable Contributions and Tax Price Elasticities for Nonitemizing Taxpayers*, 7 IAER 431, 432 (2001); cf. Christopher M. Duquette, *Is Charitable Giving by Nonitemizers Responsive to Tax Incentives? New Evidence*, 52 NAT'L TAX J. 195, 202 (1999).

<sup>100</sup> In 1982 and 1983, non-itemizing taxpayers could deduct 25% of their first \$100 in charitable contributions; in 1984, they could deduct 25% of their first \$300 in charitable contributions; in 1985, they could deduct half of their charitable contributions; and in 1986 they could deduct all of their charitable contributions. Eaton, *supra* note 99, at 431–32.

<sup>101</sup> Duquette, *supra* note 99, at 203; Eaton, *supra* note 99, at 441.

<sup>102</sup> See Duquette, *supra* note 99, at 196, 199–200.

<sup>103</sup> The “diminishing marginal utility of consumption” refers to the notion that, while consumption of other products remains the same, a consumer experiences “a decline in the marginal utility that person derives from consuming each additional unit of that product.”



income taxpayer to make a charitable contribution than to induce a high-income taxpayer to make a charitable contribution.<sup>104</sup> Presumably, the cost of inducing enough low-income taxpayers to make charitable contributions would soon exceed the amount of those charitable contributions. Moreover, to the extent that the charitable contribution is hypersalient, some low-income taxpayers are making charitable contributions in the mistaken belief that they can deduct those contributions and receive a subsidy.<sup>105</sup> Presumably, providing an actual subsidy via a tax credit will have a limited effect on their charitable contributions.

More importantly, most low-income taxpayers could not receive a tax credit because they do not itemize their deductions. In 2010, only about 30% of taxpayers itemized; the number of low-income taxpayers who itemized was even lower.<sup>106</sup> Fewer than 4% of taxpayers in the 0% tax bracket itemized, and about 16% of taxpayers in the 10% bracket itemized.<sup>107</sup> Many low-income taxpayers have no tax liability and do not bother to file tax returns at all.<sup>108</sup>

## 2. Solving Charity Failures Through Grants

The government could also solve charity failures by providing direct grants to charities, but this approach will be inefficient because majoritarianism makes it vulnerable to government failures. The economic subsidy theory argues that the government can solve market failures in charitable goods demanded by political majorities but cannot solve market failures in goods demanded by political minorities.<sup>109</sup> In other words, the government would likely give direct grants to charities that produce charitable goods demanded by political majorities but would not give direct grants to charities that produce goods demanded by political minorities. As a result, direct

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*Law of Diminishing Marginal Utility*, INVESTOPEDIA, <http://www.investopedia.com/terms/l/lawofdiminishingutility.asp> (last visited May 29, 2014). An example of this concept exists in buffet restaurants: “each additional plate of food provides less utility than the one before.” *Id.*

<sup>104</sup> Schizer, *supra* note 98, at 234.

<sup>105</sup> Faulhaber, *supra* note 93, at 1340.

<sup>106</sup> Harris & Baneman, *supra* note 72.

<sup>107</sup> *Id.*

<sup>108</sup> See, e.g., Scott A. Hodge, *Number of Americans Paying Zero Federal Income Tax Grows to 43.4 Million*, TAX FOUND (Mar. 30, 2006), <http://taxfoundation.org/article/number-americans-paying-zero-federal-income-tax-grows-434-million>. In 2006, about fifteen million individuals and families were not required to file tax returns. *Id.*

<sup>109</sup> See *supra* notes 55–64 and accompanying text.

grants can only solve charity failures in charitable goods demanded by political majorities and cannot solve charity failures in charitable goods demanded by political minorities. For example, if a political minority consisting of low-income taxpayers demands a charitable good, charity failures will cause an undersupply of the good because the charitable contribution deduction cannot subsidize contributions to charities that produce the good. Government failures will also prevent the government from solving those charity failures because the good is not demanded by a political majority.

### *B. Crowdfunding*

If the economic subsidy theory of the charitable contribution deduction is correct, it implies that we should expect it to cause charity failures in charitable goods consumed by political minorities of low-income taxpayers. This Article argues that crowdfunding is successful because it solves at least some of the charity failures caused by the charitable contribution deduction by using rewards, rather than subsidies, to compensate for free riding on donations made by low-income taxpayers.

In other words, the remarkable success of crowdfunding<sup>110</sup> supports the hypothesis of the economic subsidy theory by showing that charity failures exist and that they can be solved. Of course, crowdfunding cannot solve all charity failures. But examining its successes may help identify charity failures that can be solved by other means.

Crowdfunding is a way of using the Internet to ask the public for contributions to fund a project.<sup>111</sup> It is a form of crowdsourcing, or using the Internet to ask the public to help accomplish a task.<sup>112</sup> Crowdfunding makes it efficient to fund a project by asking many people for small amounts of money rather than asking a few people for large amounts of money.<sup>113</sup>

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<sup>110</sup> See *supra* notes 12–14 and accompanying text.

<sup>111</sup> See Paul Belleflamme, Thomas Lambert & Armin Schwienbacher, *Crowdfunding: Tapping the Right Crowd*, SOC. SCI. RES. NETWORK 1, 2 (July 9, 2013), <http://ssrn.com/abstract=1836873> (click “Download This Paper”).

<sup>112</sup> See Jeff Howe, *The Rise of Crowdsourcing*, WIRED (June 2006), <http://www.wired.com/wired/archive/14.06/crowds.html>. Crowdsourcing is a portmanteau of “crowd” and “outsourcing.” See *id.*

<sup>113</sup> Belleflamme, Lambert & Schwienbacher, *supra* note 111, at 2–3.

While the concept behind crowdfunding is old, Internet-based crowdfunding is quite new.<sup>114</sup> Nevertheless, the use of crowdfunding has grown very rapidly. Crowdfunding organizations have proliferated and enabled individuals, organizations, and charities to raise substantial amounts of money for a wide range of projects, both domestically and internationally.<sup>115</sup>

As discussed above, many different crowdfunding organizations provide many different crowdfunding platforms. A crowdfunding platform is a website that allows a recipient to describe a project and ask the public for contributions to the project.<sup>116</sup> Depending on the crowdfunding platform, the recipient may also offer something in exchange for contributions.<sup>117</sup> Most crowdfunding platforms require recipients to set a funding goal of a specific amount of money in a specific amount of time.<sup>118</sup> Many crowdfunding platforms provide that contributions are contingent on the satisfaction of that funding goal.<sup>119</sup> Most crowdfunding organizations charge a fee of five to ten percent of the contributions to a project.<sup>120</sup>

Crowdfunding finances many different kinds of projects, but most crowdfunding platforms focus on a particular category of projects. For example, Spot.us focused on journalism;<sup>121</sup> 33needs and StartSomeGood focus on social enterprise;<sup>122</sup> PROfounders, Startup Addict, and peerbackers focus on entrepreneurs;<sup>123</sup> Kickstarter, Indiegogo, RocketHub, Hatchfund, and NewJelly focus on creative

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<sup>114</sup> Bradford, *supra* note 14, at 11 (arguing that Internet-based crowdfunding began in 2005).

<sup>115</sup> *See id.* at 11–14.

<sup>116</sup> Prive, *supra* note 9.

<sup>117</sup> *See, e.g., Seven Things to Know About Kickstarter, supra* note 5.

<sup>118</sup> *See, e.g., id.*

<sup>119</sup> *See, e.g., id.*

<sup>120</sup> *See, e.g., Start Your Project., KICKSTARTER, [https://www.kickstarter.com/learn?ref=what\\_is\\_kickstarter](https://www.kickstarter.com/learn?ref=what_is_kickstarter) (last visited Aug. 7, 2014) (click “What is Kickstarter’s fee?”).*

<sup>121</sup> Marianne McCarthy, *Can You Still Spot.us? Crowdfunding Pioneer Slumps Under APM*, PBS: MEDIASHIFT (Dec. 19, 2012), <http://www.pbs.org/mediashift/2012/12/can-you-still-spot-us-crowdfunding-pioneer-slumps-under-apm354/>.

<sup>122</sup> *How It Works: Criteria*, STARTSOMEGOOD, <http://startsomegood.com/Help/Values> (last visited Aug. 13, 2014); *33needs*, CROWDSOURCING.ORG, <http://www.crowdsourcing.org/site/33needs/33needscom/2487> (last visited Aug. 13, 2014).

<sup>123</sup> *About*, STARTUP ADDICT, <http://www.startupaddict.com/crowdfunding/page/about> (last visited Aug. 13, 2014); *About peerbackers*, PEERBACKERS, <http://peerbackers.com/media-kit/> (last visited Aug. 13, 2014); PROFFOUNDERS CAPITAL, <http://www.profounderscapital.com/> (last visited Aug. 13, 2014).

projects;<sup>124</sup> PledgeMusic focuses on musicians;<sup>125</sup> FirstGiving focuses on charities;<sup>126</sup> DonorsChoose.org focuses on education;<sup>127</sup> ioby focuses on environmental projects;<sup>128</sup> AppsFunder focuses on mobile apps;<sup>129</sup> and Quirky focuses on inventors.<sup>130</sup> The market for crowdfunding platforms is quite volatile. New platforms are constantly appearing. Some are successful, and others disappear.<sup>131</sup>

Crowdfunding is used for commercial or charitable purposes or a mixture of the two.<sup>132</sup> For example, the Imagination Station created a crowdfunding project to create a statue of RoboCop in Detroit.<sup>133</sup> Under federal law, the Imagination Station is not a charity because it has not applied for tax-exempt status,<sup>134</sup> but the project was intended to create a work of public art, which is a charitable purpose. Broadly speaking, one could say that a crowdfunded project has a commercial purpose to the extent that its purpose is to produce a commercial good and has a charitable purpose to the extent that its purpose is to produce a charitable good.

Contributions to a charitable crowdfunded project may or may not be charitable contributions. Individuals, businesses, and charities can all use crowdfunding platforms to solicit contributions to crowdfunded projects.<sup>135</sup> Some charitable crowdfunded projects are

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<sup>124</sup> *About Us*, HATCHFUND, <http://www.hatchfund.org/about/us> (last visited Aug. 13, 2014); *About Us*, INDIEGOGO, <https://www.indiegogo.com/about/our-story>, (last visited Aug. 13, 2014); *About Us*, NEWJELLY, <http://www.newjelly.com/About-us/> (last visited Aug. 13, 2014); *Seven Things to Know About Kickstarter*, *supra* note 5; *see Our Movement*, ROCKETHUB, <http://www.rockethub.com/about> (last visited Aug. 13, 2014).

<sup>125</sup> PLEDGEMUSIC, <http://www.pledgemusic.com/> (last visited Aug. 13, 2014).

<sup>126</sup> FIRSTGIVING, <http://www.firstgiving.com/> (last visited Aug. 13, 2014).

<sup>127</sup> DONORSCHOOSE.ORG, <http://www.donorschoose.org/> (last visited Aug. 13, 2014).

<sup>128</sup> *About ioby*, IOBY, <http://www.ioby.org/about/our-story> (last visited Aug. 13, 2014).

<sup>129</sup> APPSFUNDER, <http://www.appsfinder.com/us> (last visited Aug. 13, 2014).

<sup>130</sup> *About*, QUIRKY, <https://www.quirky.com/about> (last visited Aug. 13, 2014).

<sup>131</sup> For example, MicroPlace, which focused on microfinance, stopped operating on January 14, 2014. *The Future of MicroPlace*, MICROPLACE, [www.microplace.com](http://www.microplace.com) (last visited Aug. 7, 2014).

<sup>132</sup> *See generally* Bradford, *supra* note 14, at 12–15. Among other things, crowdfunding reminds us that charity takes many forms. *See, e.g., Invest in Breasts*, MY FREE IMPLANTS, <http://myfreeimplants.com/> (last visited Aug. 7, 2014).

<sup>133</sup> *Detroit Needs a Statue of Robocop!*, *supra* note 2.

<sup>134</sup> *See Exempt Organizations Select Check*, *supra* note 4.

<sup>135</sup> *See* Bradford, *supra* note 14, at 15–16; *see, e.g., id.* at 25.

created by charities.<sup>136</sup> Others are sponsored by charities but created by individuals or businesses.<sup>137</sup>

If a charitable crowdfunded project is created or sponsored by a charity, contributions to the project are generally charitable contributions. But if it is not created or sponsored by a charity, contributions are not charitable contributions. While many crowdfunded projects have a charitable purpose, contributions to many of those projects are not charitable contributions.

Most crowdfunding platforms are businesses operating for a profit.<sup>138</sup> However, crowdfunding platforms administered by businesses may host projects created by charities, just as businesses may solicit charitable contributions on behalf of charities.<sup>139</sup> And many crowdfunded projects created by individuals and businesses have a charitable purpose in a colloquial sense. For example, GiveForward enables individuals to create crowdfunding projects to raise funds for an individual's medical treatment.<sup>140</sup> While a contribution to an individual is not a charitable contribution under federal law, contributions to a person in need are charitable in a colloquial sense.<sup>141</sup>

### 1. Models of Crowdfunding

There are four distinct crowdfunding models, and they are defined by what recipients offer in exchange for contributions: (1) the donation model, (2) the reward model, (3) the loan model, and (4) the equity model.<sup>142</sup> Many crowdfunding platforms use only one model, but some use multiple models.<sup>143</sup>

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<sup>136</sup> See, e.g., *id.* at 15.

<sup>137</sup> See Gene Takagi, *Fundraising & Charitable Giving: Nonprofit Crowdfunding Risks*, NONPROFIT LAW BLOG (July 8, 2014), <http://www.nonprofitlawblog.com/category/fundraising/>.

<sup>138</sup> See Bradford, *supra* note 14, at 142.

<sup>139</sup> 4.76.51.3 *Professional Fund-Raisers*, IRS (Dec. 13, 2013), [http://www.irs.gov/irm/part4/irm\\_04-076-051.html#d0e331](http://www.irs.gov/irm/part4/irm_04-076-051.html#d0e331).

<sup>140</sup> *About Us—Online Fundraising Websites*, GIVEFORWARD, <http://www.giveforward.com/p/about-us> (last visited Aug. 7, 2014).

<sup>141</sup> See *supra* note 34 and accompanying text.

<sup>142</sup> Bradford, *supra* note 14, at 14–15. Bradford's pre-purchase model is omitted in this analysis because it is duplicative of the reward model. See *id.*

<sup>143</sup> *Id.* at 15.

*a. The Donation Model*

Under the donation model, recipients offer nothing to donors in exchange for contributions.<sup>144</sup> Unsurprisingly, the donation model is used primarily by crowdfunding platforms that focus on charitable projects.<sup>145</sup> In fact, the crowdfunding platforms are often operated by charities and the recipients of the projects are usually charities.<sup>146</sup> As a result, contributions to this model of crowdfunding projects are often deductible, as a contribution to a crowdfunded project is a charitable contribution if the recipient is a charity.<sup>147</sup> Examples of crowdfunding platforms that use the donation model include GlobalGiving and DonorsChoose.org.<sup>148</sup>

The donation model cannot solve the charity failures created by the charitable contribution deduction because it cannot compensate for free riding on charitable contributions made by low-income taxpayers. As explained above, the charitable contribution deduction causes charity failures because the deduction cannot subsidize many types of charitable contributions from low-income taxpayers.<sup>149</sup> But while the donation model cannot solve charity failures by subsidizing contributions, it may mitigate charity failures associated with the charitable contribution deduction by reducing transaction costs. Donors tend to contribute to charities that produce the charitable goods they consume.<sup>150</sup> But charities often produce many different kinds of charitable goods. Donors who only consume some of the charitable goods that a charity produces will have a stronger incentive to make a charitable contribution if the charity uses their contribution to produce the charitable goods they consume rather than the ones they do not.

The donation model enables a charity to determine more efficiently the demand for each of the charitable goods it produces by asking donors to fund specific projects rather than asking for general

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<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> See I.R.C. § 501(c)(3) (2012).

<sup>148</sup> See *About GlobalGiving*, GLOBALGIVING, <http://www.globalgiving.org/aboutus/> (last visited Aug. 7, 2014); *About: How It Works*, DONORSCHOOSE.ORG, <http://www.donorschoose.org/about> (last visited Aug. 7, 2014).

<sup>149</sup> See *supra* notes 83–95 and accompanying text.

<sup>150</sup> See Fleischer, *supra* note 66, at 549 (citing Rob Reich, *Philanthropy and Its Uneasy Relation to Equality*, in *TAKING PHILANTHROPY SERIOUSLY: BEYOND NOBLE INTENTIONS TO RESPONSIBLE GIVING* 27–49 (William Damon & Susan Verducci eds., 2007)); ODENDAHL, *supra* note 37, at 3.

donations. Thus, the number and value of charitable contributions to a particular project more accurately reflect the donor demand for the charitable good produced by that project. If a project is funded, the charity knows that demand is high, and it can produce the charitable good in question; if a project is not funded, the charity can reevaluate the demand for that charitable good.

In other words, the donation model of crowdsourcing may mitigate some charity failures by reducing transaction costs. But it cannot solve the charity failures caused by the charitable contribution deduction because the donation model cannot subsidize charitable contributions from low-income taxpayers. Without an alternative subsidy, the donation model cannot compensate for free riding on contributions made by low-income taxpayers.

#### *b. The Reward Model*

Under the reward model, recipients offer rewards to donors in exchange for contributions.<sup>151</sup> The reward model is used by crowdfunding platforms that focus on both charitable and commercial projects.<sup>152</sup> While the reward for contributing to a project can be almost anything, rewards generally relate to the particular project in question and depend on the size of the contribution.<sup>153</sup> A reward may have any value, and the perceived value of a reward often depends on the size of the contribution.<sup>154</sup> Contributors who make small contributions receive low-value rewards; contributors who make large contributions receive high-value rewards.<sup>155</sup> Low-value rewards often include postcards, e-mails, or some form of recognition. High-value rewards are often unique and closely related to the recipient of the contribution.<sup>156</sup> For example, an artist may offer a unique art object in exchange for a large contribution or a filmmaker may offer an executive producer credit.<sup>157</sup>

Historically, large charities and charities that operated a medium of mass communication, like public radio and television stations, have used rewards to provide an incentive for marginal donors to make

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<sup>151</sup> Bradford, *supra* note 14, at 16.

<sup>152</sup> See *An Introduction to Crowdfunding*, NESTA (July 2012), [http://www.em-a.eu/fileadmin/content/REALISE\\_IT\\_2/REALISE\\_IT\\_3/IntroToCrowdfunding.pdf](http://www.em-a.eu/fileadmin/content/REALISE_IT_2/REALISE_IT_3/IntroToCrowdfunding.pdf).

<sup>153</sup> See *id.*

<sup>154</sup> See *id.*

<sup>155</sup> See *id.*

<sup>156</sup> See *generally id.* (describing the general types of rewards donors receive).

<sup>157</sup> Bradford, *supra* note 14, at 16.

small contributions. For example, contributors to the Sierra Club or National Public Radio may receive a reward, like a coffee mug or a tote bag, in exchange for contributing twenty-five or fifty dollars. Smaller charities are much less likely to offer rewards of this kind.

The unlikelihood of smaller charities offering rewards is consistent with the hypothesis that using rewards to incentivize small contributions is efficient only if the marginal cost of charitable solicitation is low. Large charities and charities that operate a medium of mass communication have a low marginal cost of solicitation, so they can afford to offer a reward in exchange for a small contribution. By contrast, small charities have historically had a high marginal cost of solicitation, so they could not afford to offer rewards, and often were forced to hire professional solicitors.<sup>158</sup> Crowdfunding levels the playing field, reducing the marginal cost of solicitation for small charities by providing access to a medium of mass communication and enabling the charities to cheaply and easily reach large numbers of potential donors.

Kickstarter, which focuses on creative projects, is one of the most successful contemporary crowdfunding platforms using the reward model.<sup>159</sup> Kickstarter requires users to specify their fundraising goal and the duration of their fundraising campaign.<sup>160</sup> Contributors pledge to donate.<sup>161</sup> If a Kickstarter project meets or exceeds its goal by the end of the campaign, the creator of the project receives all of the pledges.<sup>162</sup> If it does not, the creator of the project receives nothing.<sup>163</sup> If a Kickstarter project is funded, Kickstarter takes a commission of five percent of the total contributions to the project.<sup>164</sup>

Kickstarter requires recipients to offer rewards in exchange for contributions, but does not specify the nature of the rewards.<sup>165</sup> While Kickstarter rewards can consist of almost anything, they are often the

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<sup>158</sup> See, e.g., *Illinois ex rel. Madigan v. Telemarketing Associates, Inc.*, 538 U.S. 600, 605, 624 (2003) (holding that the First Amendment does not prohibit fraud claims against professional fundraisers hired by charities).

<sup>159</sup> Bradford, *supra* note 14, at 16; *Kickstarter Basics: Kickstarter 101*, KICKSTARTER, <https://www.kickstarter.com/help/faq/kickstarter%20basics> (last visited May 30, 2014) [hereinafter *Kickstarter Basics*].

<sup>160</sup> *Kickstarter Basics*, *supra* note 159.

<sup>161</sup> *Id.*

<sup>162</sup> *Id.*

<sup>163</sup> *Id.*

<sup>164</sup> Dave Roos, *How Kickstarter Works*, HOW STUFF WORKS, <http://money.howstuffworks.com/kickstarter1.htm> (last visited May 30, 2014).

<sup>165</sup> *Kickstarter Basics*, *supra* note 159.



product of the project for which they are a reward.<sup>166</sup> A Kickstarter reward can also have any relationship to the size of the contribution for which it is a reward.<sup>167</sup>

Kickstarter projects that are predominantly commercial tend to offer rewards that are close in value to the amount of the contribution. Of course, the donor will wait some time to receive the product, and there is no guarantee that it will ever be successfully produced. As a result, most Kickstarter projects effectively offer rewards worth less than the amount of the contribution.<sup>168</sup> Kickstarter projects that are predominantly charitable tend to offer rewards that are much less valuable than the amount of the contribution. Kickstarter projects that propose to fund a community art project tend to offer recognition or some other token of appreciation.

In general, successful Kickstarter projects are funded primarily by small contributions.<sup>169</sup> For example, one recent project received 703 contributions totaling \$13,606, including 495 contributions of \$10 or more, and about 83% of its contributions were \$50 or less.<sup>170</sup> This is typical of Kickstarter projects: 83% of funded projects offer backers a reward for a pledge of less than \$20.<sup>171</sup> In addition, projects that offer backers a reward for a pledge of less than \$20 have a 54% success rate, but projects that do not only have a 35% success rate.<sup>172</sup>

The reward model solves charity failures caused by the charitable contribution deduction because rewards can subsidize charitable contributions made by low-income taxpayers and thereby compensate for free riding on their charitable contributions. Under the charitable

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<sup>166</sup> *Creator Handbook: Rewards*, KICKSTARTER, <https://www.kickstarter.com/help/handbook/rewards> (last visited Aug. 9, 2014). Kickstarter prohibits certain kinds of rewards. See *Prohibited Items*, KICKSTARTER, <https://www.kickstarter.com/rules/prohibited> (last visited Aug. 8, 2014). For example, a Kickstarter project cannot offer a chance at a prize (illegal gambling) and cannot offer equity in a project (unregistered securities). See *id.* In addition, Kickstarter appears to disallow some projects and rewards on policy grounds. See *id.*

<sup>167</sup> See *Creator Handbook: Rewards*, *supra* note 166.

<sup>168</sup> See Bradford, *supra* note 14, at 17.

<sup>169</sup> See Dave Roos, *Tips for Funding a Kickstarter Project*, HOW STUFF WORKS, <http://money.howstuffworks.com/kickstarter3.htm> (last visited Aug. 9, 2014).

<sup>170</sup> IronSpike, *Poorcraft: A Comic Book Guide to Frugal Urban Suburban Living*, KICKSTARTER, <http://www.kickstarter.com/projects/ironspike/poorcraft-a-comic-book-guide-to-frugal-urban-and?pos=1> (last visited Aug. 9, 2014); Yancey Strickler, *The Price is Right*, in *Kickstarter Blog*, KICKSTARTER BLOG (Apr. 2, 2010), <http://www.kickstarter.com/blog/the-price-is-right> [hereinafter *The Price is Right*].

<sup>171</sup> *The Price is Right*, *supra* note 170.

<sup>172</sup> *Id.*

contribution deduction, donors receive a tax deduction.<sup>173</sup> Under the reward model of crowdfunding, donors receive rewards instead. While low-income taxpayers receive little or no benefit from a tax deduction, they receive the full benefit of a reward. Moreover, donors who make small contributions receive only a small benefit from a tax deduction but may receive a significant benefit from a reward.

Many charities offer rewards in exchange for contributions. For example, many public radio and television stations use a rewards model to incentivize donations.<sup>174</sup> A donor who makes a small charitable contribution may receive a coffee cup or a tote bag. A donor who makes a large charitable contribution may receive a naming opportunity or board position.

The fact that charities commonly provide rewards for donations suggests that they implicitly recognize that the charitable contribution deduction causes charity failures, some of which can be solved by rewards. However, the charitable contribution deduction discourages rewards because a donor who receives a *quid pro quo* cannot deduct a charitable contribution.<sup>175</sup> Essentially, a charitable contribution is not deductible if the contributor receives something of more than nominal value in exchange for the contribution.<sup>176</sup>

The remarkable success of the rewards model of crowdfunding suggests that rewards can subsidize donations from low-income donors that cannot be subsidized by the charitable contribution deduction. Most Kickstarter projects are not created by charities, so contributions cannot be deducted, and the average Kickstarter pledge is between twenty-five and fifty dollars.<sup>177</sup> In other words, most Kickstarter donors are making relatively small, nondeductible contributions in exchange for rewards.

The hypothesis that rewards can subsidize donations from low-income donors is supported by the fact that the reward model of

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<sup>173</sup> *Charitable Contribution Deductions*, *supra* note 69.

<sup>174</sup> See, e.g., *Support Louisville Public Media*, LOUISVILLE PUBLIC MEDIA, <https://louisvillepublicmedia.webconnex.com/contribute> (last visited Aug. 9, 2014) (allowing a donor to choose to receive a cookbook, a DVD, a CD, or no reward in exchange for a contribution of \$180 to Louisville Public Media).

<sup>175</sup> See *Charitable Contributions—Quid Pro Quo Contributions*, IRS, <http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Charitable-Contributions-Quid-Pro-Quo-Contributions> (last updated Mar. 5, 2014).

<sup>176</sup> See *The Marketing of Philanthropy*, *supra* note 41, at 662–63.

<sup>177</sup> Fred Benenson & Yancey Strickler, *Trends in Pricing and Duration*, in *Kickstarter Blog*, KICKSTARTER BLOG (Sept. 21, 2010), <https://www.kickstarter.com/blog/trends-in-pricing-and-duration>.

crowdfunding has proven particularly effective for creative projects. Studies show that most low-income taxpayers do not contribute to arts organizations.<sup>178</sup> While the charitable contribution deduction can incentivize marginal, high-income donors to make charitable contributions to arts organizations, crowdfunding appears to provide the incentive necessary for low-income taxpayers to contribute to arts organizations.

Because crowdfunded projects can offer a wide range of rewards in exchange for a wide range of contributions, crowdfunding enables projects to better tailor rewards to the preferences of their donors. This makes crowdfunding more efficient than traditional forms of fundraising and enables crowdfunded projects to generate more contributions than direct solicitation.

Indeed, the use of crowdfunding for creative projects illuminates this hypothesis. For quite some time, donors have made charitable contributions to creative projects using “fiscal sponsors.”<sup>179</sup> A donation is deductible only if it is a charitable contribution.<sup>180</sup> Accordingly, a donation to a creative project is deductible only if the creative project is the project of a charity. A donation to an individual is not deductible; in order to deduct donations to individuals, donors contribute to a charity that acts as a “fiscal sponsor” to the individual.<sup>181</sup> The donor then suggests that the charity use the donation to fund the individual’s creative project.<sup>182</sup> The charity receives an administrative fee up to ten percent for this service.<sup>183</sup> The result is that the donor gets a deduction, the charity gets a fee, and the individual gets the money. Fiscal sponsorship appeals to high-income donors because it allows them to utilize the charitable contribution deduction. It also appeals to charitable foundations that have restrictions on making distributions to individuals.

The reward model of crowdfunding operates in much the same way as fiscal sponsorship, with the exception that the donor receives a reward rather than a deduction. Essentially, fiscal sponsorship appeals

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<sup>178</sup> See ODENDAHL, *supra* note 37, at 3.

<sup>179</sup> See George Johnson & David Jones, *K. Community Foundations*, IRS, <http://www.irs.gov/pub/irs-tege/eotopick94.pdf> (last visited Aug. 9, 2014). Forms of fiscal sponsorship date back to the 1940s. See *id.*

<sup>180</sup> *Fiscal Sponsors*, NAT’L COUNCIL OF NONPROFITS, <http://www.councilofnonprofits.org/fiscal-sponsorship> (last visited Aug. 9, 2014).

<sup>181</sup> *Id.*; see Johnson & Jones, *supra* note 179.

<sup>182</sup> See Johnson & Jones, *supra* at 179.

<sup>183</sup> *Id.*

to high-income taxpayers for whom the charitable contribution deduction is valuable, and the reward model of crowdfunding appeals to low-income taxpayers for whom rewards are valuable. Indeed, many crowdfunded projects allow donors to decide whether they wish to donate through the crowdfunding platform and take a reward or donate through a fiscal sponsor and take a deduction. For example, I co-created two Kickstarter projects relating to the film *Our Nixon* (2013), which I co-produced.<sup>184</sup> Both projects informed contributors that they could contribute to our fiscal sponsor if they wanted to take a deduction for their contribution. We found that some donors who contributed one thousand dollars or more chose to use our fiscal sponsor rather than Kickstarter.

### *c. The Lending and Equity Models*

Under the lending model, recipients offer to repay contributions over time, often with interest.<sup>185</sup> Thus, under this model, contributors expect a return on their investment.<sup>186</sup> Under the equity model, recipients offer a share of their profits.<sup>187</sup> The loan and equity models are used primarily by crowdfunding platforms that focus on commercial projects.<sup>188</sup> These models differ from the other types because they ask contributors to invest in a project rather than make a donation or purchase.<sup>189</sup>

## *2. The Legality of the Lending and Equity Models*

Initially, the viability of the lending and equity models was dubious, as they appeared to violate federal securities laws.<sup>190</sup> In fact, crowdfunding platform PROfounders tried to implement the equity model but folded in early 2012, citing “the current regulatory environment.”<sup>191</sup>

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<sup>184</sup> Brian L. Frye & Penny Lane, *Our Nixon*, KICKSTARTER, <https://www.kickstarter.com/projects/1222291754/our-nixon-found-footage-documentary> (last visited Aug. 9, 2014); Brian L. Frye & Penny Lane, *Our Nixon—Premiere at SXSW & Beyond!*, KICKSTARTER, <https://www.kickstarter.com/projects/1222291754/our-nixon-premiere-at-sxsw-and-beyond> (last visited Aug. 9, 2014).

<sup>185</sup> Bradford, *supra* note 14, at 20.

<sup>186</sup> *Id.*

<sup>187</sup> *Id.* at 24.

<sup>188</sup> *Id.* at 21.

<sup>189</sup> *Id.* at 20.

<sup>190</sup> *Id.* at 29.

<sup>191</sup> Joyce M. Rosenberg, *New Crowdfunding Law Helps Small Businesses Find Investors*, HUFFINGTON POST: NEWS AND TRENDS (Apr. 12, 2012, 11:04 AM), <http://www>

But on April 12, 2012, President Barack Obama signed into law the Jumpstart Our Business Startups Act, or JOBS Act, which eased various securities regulations in order to make it easier for small businesses to raise capital.<sup>192</sup> Among other provisions, the JOBS Act includes the CROWDFUND Act, creating an exemption intended to permit the equity model of crowdfunding.<sup>193</sup> This exemption allows companies to fundraise up to one million dollars from unaccredited investors without registering with the Securities and Exchange Commission, provided that the funds are raised through a registered broker or crowdfunding platform.<sup>194</sup> The exemption also limits the amount of money that can be raised from an unaccredited investor based on that investor's income.<sup>195</sup> However, businesses cannot currently take advantage of this exemption because the SEC has not completed the rulemaking process.<sup>196</sup>

### 3. Solving Charity Failures with the Lending and Equity Models

The lending model and the equity model of crowdfunding could solve some charity failures. In particular, they could provide access to capital for individuals and businesses engaged in charitable activities. However, they cannot solve most charity failures because they anticipate a return on investment.

Producing charitable goods is generally not a profitable enterprise. If it were, there would be no need for charity. Indeed, classical economics predicts market failures in charitable goods precisely because they are not profitable to produce.<sup>197</sup>

The donation and reward models of crowdfunding help solve charity failures by making charitable giving easier and providing targeted incentives to marginal, low-income donors. The donation model provides no subsidy, and the reward model provides a subsidy that costs less than the contribution. As a consequence, the donation

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.huffingtonpost.com/2012/04/12/new-crowdfunding-law-help\_n\_1420708.html (internal quotation marks omitted).

<sup>192</sup> See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 301-05, 126 Stat. 306, 315 (codified in 15 U.S.C. (2012)).

<sup>193</sup> *Id.* The Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act (CROWDFUND Act) is one component of the broader JOBS Act. See *id.*

<sup>194</sup> See *id.*

<sup>195</sup> Crowdfunding, 33 Fed. Reg. 9470 (2013), 34 Fed. Reg. 70741 (2013) (to be codified at 17 C.F.R. pts 200, 277, 232, 239, 240, 249).

<sup>196</sup> See *id.*

<sup>197</sup> See *supra* notes 42–48, 55 and accompanying text.

and reward models are useful to individuals and organizations producing unprofitable charitable goods.

By contrast, the lending and equity models of crowdfunding anticipate a return on investment. As a consequence, they are of limited utility to individuals and organizations that produce unprofitable charitable goods because lenders and investors are unlikely to lend to or invest in charitable activities with a projected negative return. As a consequence, the lending and equity models of crowdfunding are unlikely to solve most charity failures.

#### IV

#### CROWDFUNDING SOLVES SOME CHARITY FAILURES

While all of the forms of crowdfunding may help solve charity failures, the reward model of crowdfunding appears to solve charity failures most effectively. Unlike the other models of crowdfunding, the reward model compensates for free riding on charitable contributions, and it does so without requiring that charitable activities generate a profit. Most importantly, the reward model of crowdfunding can provide an incentive for low-income donors to make a contribution by offering a targeted reward rather than a deduction.

The donation model of crowdfunding may solve some charity failures by making charitable giving easier and more efficient. Crowdfunding platforms are generally streamlined and intuitive; they make it easy for charities to create projects and for donors to make contributions. In addition, they enable charities to reach more people more easily, and crowdfunding platforms enable donors to review a broader range of charities. Perhaps more importantly, crowdfunding platforms encourage charities to think about how to pitch projects effectively and to identify charitable goods that are demanded. However, the only incentive that the donation model can provide is a deduction for charitable recipients. Thus, the donation model cannot solve the charity failures caused by the deduction.

The reward model of crowdfunding retains all of the advantages of the donation model. However, it also solves some of the charity failures caused by the deduction. The deduction causes charity failures because it cannot compensate for free riding on charitable contributions made by low-income taxpayers. But the reward model of crowdfunding can compensate for free riding on those contributions by providing a reward rather than a deduction. While low-income taxpayers usually cannot take a deduction, they can

receive a reward. In other words, low-income taxpayers receive no value from the subsidy provided by the deduction, but they receive the full value of a reward from a crowdfunded project.

The reward model of crowdfunding can compensate for free riding more efficiently than the deduction because the value of the reward is adjustable in relation to the project, but the value of the subsidy provided by the deduction is not. The subsidy the deduction provides does not depend on the recipient of the charitable contributions, so some projects will receive a subsidy that is too large, and some will receive a subsidy that is too small. But crowdfunded projects can offer many different rewards calibrated to the incentive necessary for a particular project. Projects that are predominantly charitable may offer rewards with little value, as little additional incentive beyond altruism is necessary to induce contributions. But projects that are predominantly commercial may offer high value rewards as altruism will not motivate sufficient contributions.

While the lending and equity models of crowdfunding may also help solve charity failures by enabling charities to raise capital more efficiently, they cannot directly address the charity failures caused by the deduction. It will be interesting to see how they are used once the IRS completes the rulemaking process.

Essentially, crowdfunding appears to be successful, at least in part, because it provides a technological solution to certain charity failures caused by the deduction. Of course, crowdfunding cannot solve all charity failures caused by the deduction. Many low-income taxpayers lack convenient access to computers or the Internet, and they may not be familiar with crowdfunding platforms.<sup>198</sup> Others may find crowdfunding an unappealing way of making charitable contributions. And the reward model of crowdfunding appears to work more effectively for some kinds of charitable projects than others. In particular, it seems to work well for creative projects but less well for social justice projects.<sup>199</sup> This suggests that it may be necessary to develop alternative ways of solving charity failures in charitable goods that are not suited to crowdfunding.

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<sup>198</sup> Edward Wyatt, *Most of U.S. Is Wired, but Millions Aren't Plugged in*, N.Y. TIMES (Aug. 18, 2013), <http://www.nytimes.com/2013/08/19/technology/a-push-to-connect-millions-who-live-offline-to-the-internet.html>.

<sup>199</sup> For example, Kickstarter is many orders of magnitude more successful than Hatchfund. See *Kickstarter Basics*, *supra* note 159; *How We Work*, HATCHFUND, [http://www.hatchfund.org/get\\_involved/artists](http://www.hatchfund.org/get_involved/artists) (last visited Aug. 10, 2014).

### CONCLUSION

The charitable contribution deduction solves market failures and government failures in charitable goods by subsidizing charitable contributions. But the charitable contribution deduction causes charity failures because it cannot subsidize the charitable contributions made by low-income taxpayers. Crowdfunding provides a technological solution to some of those charity failures by offering rewards rather than subsidies.