



## The Nonprofit Sector's Stealthy Subsidy March 15, 2003

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Political and legal controversies often surround direct government subsidies to nonprofit activities. Consider the following example.

In 1988, the Southeastern Center for Contemporary Art, in Winston-Salem, NC, awarded artist Andres Serrano \$15,000 for his photograph *Piss Christ*, which featured a crucifix immersed in the artist's urine. The work caught the attention of the media and ignited a political scandal, because the award came from a grant to the Center from the National Endowment for the Arts (NEA). Former-Senator Jesse Helms complained that "Americans for the most part are moral, decent people and they have a right not to be denigrated, offended, or mocked with their own tax dollars." On the basis of this example, and many others like it, Senator Helms proposed that the NEA be dismantled.

It seems fair to assume that, in contrast to this controversy, no one would object—on political or legal grounds—to a private donor's gift to a private art museum. If a donor gives to an organization that denigrates, mocks, or offends others' beliefs, most Americans would consider this to be—at worst—a case of bad judgment in conjunction with the exercise of First Amendment rights.

This distinction between public and private funding, however, is based on a common misunderstanding surrounding the government's true role in nonprofit finances. While discussions of government funding to nonprofits typically focus on direct government subsidies to organizations, a large portion of public-sector funding is indirect, in the form of tax revenues *not collected* on tax-deductible private contributions to nonprofits.

### **How much does the government *really* give arts nonprofits?**

While the NEA's annual budget currently sits at about \$115m, private philanthropy to the arts greatly exceeds this amount: According to 2001 Independent Sector data, 11.5 percent of American households made private contributions to the arts in 1999, adding up to approximately \$11 billion. Thirty-six percent of nonprofit arts revenues are donated, while just five percent come directly from various levels of government.

This private giving induces the greater part of the government's subsidies to the arts. For example, imagine that a contributor to a nonprofit arts organization faces an income tax rate of 24 percent, and itemizes deductions for charitable contributions on his or her income tax return. Each dollar in income donated results in a deduction of 24 cents. Hence, if the taxpayer donates \$1,000 in income to the organization, the Federal government indirectly pays \$240 of this donation.

To estimate the total indirect federal subsidy to the arts, we need to apportion giving to the arts by income percentile, comparing the average Federal tax rate for each group and the percentage that itemizes its deductions, with the percentage of total gifts to the arts that each group makes. Using data from the Survey of Income and the General Social Survey to make these calculations, the Federal granted indirect aid to the arts was approximately \$1.42 billion in 1999. Comparing indirect Federal aid with the NEA appropriation in the 1999, the ratio of indirect to direct funding was about \$14-to-\$1. Combining direct and indirect subsidies, the true Federal arts support in 1999 was \$5.55 per American, about \$5.19 of which was indirect.

These principles are not limited to the nonprofit arts. Indeed, they may be even more meaningful in areas such as religious activity, in which direct government aid is not allowed, and private donations make up more than 80 percent of total revenues.

### **Are taxpayers getting their money's worth?**

There are practical reasons why policymakers, nonprofit managers, and other concerned citizens should care about indirect subsidies to nonprofits. To illustrate, let's look at indirect support for an individual arts nonprofit: the New York Philharmonic, one of America's greatest and richest cultural organizations.

In 2001, the Philharmonic had an annual budget of \$70m. It received private donations in the amount of \$42,273,582, and direct government grants worth \$390,700. Making the conservative assumption that the orchestra's donors come mostly from the upper half of the income distribution, we can estimate an average income tax rate of about 12.6 percent. (In reality, the rate faced by donors is probably much higher, because the bulk of donors undoubtedly come from the very top of the income distribution, and the appropriate tax rate to use is actually the marginal rate, or the rate paid on the *last* dollar of income. Thus, the estimates I make here probably fall on the low side.)

This simple analysis suggests that the indirect subsidy from the Federal government to the Philharmonic was more than \$5.3m in 2001, ignoring all indirect state and local subsidies and the lost capital gains taxes on the orchestra's savings. In other words, the Federal government foregoes tax revenues for this *one* organization that are equivalent in magnitude to nearly five percent of the *entire* NEA budget.

From the standpoint of efficiency, public policies are judged by comparing the costs they represent with the benefits they elicit. In other words, we ask whether particular

government outlays are “worth the money.” For practically every policy, reasonable people are bound to disagree, because many benefits are not denominated in dollars; rather, they rely on personal ethics and values. Hence, the question of whether the government *should* subsidize the arts—or any other nonprofit activity, for that matter—involves philosophy as much as it does economics. But neither philosophy nor economics will be well-informed when the cost figures are dramatically off, as is the case when indirect subsidies are ignored. In the case of the Philharmonic, the question is *not* whether taxpayers are getting their \$390,700’s-worth, it is whether they are getting their \$5.7m’s-worth.

The stakes may seem low for a non-controversial organization such as the Philharmonic. Think of the Serrano photograph mentioned earlier, however. While the NEA grant for the work was a paltry \$15,000, the Southeastern Center for Contemporary Art, which commissioned and displayed the work, received at least \$125,000 in indirect subsidies in 2001.

### **Indirect subsidies can be an effective fundraising tool**

None of this discussion is intended to suggest that the concept of indirect subsidies necessarily works against nonprofits. On the contrary, it can be thought of as a valuable fundraising tool. The American system of tax-deductibility represents, in essence, a massive matching-grant program, in which the government pledges to subsidize the donor’s favorite charity, at his or her tax rate. The system should be viewed by managers the same way as they would any other matching grant program: as a means to leverage higher donations. The government makes a donation “worth more” to both donors and recipients than its (tax-deducted) dollar value, and this is particularly true for donors with high tax rates.

Managers can also introduce the concept of indirect subsidies in explicitly political terms, arguing that donors are in the driver’s seat regarding the government’s commitment to their cause. Imagine an arts fundraising pitch that goes something like this: “Do you believe the government should spend more on the arts? Then make a donation, and *force* the government to give.”

### **Conclusion**

An understanding of government aid to nonprofits in America is simply not complete without consideration of indirect aid from taxes foregone. This “stealthy” funding mechanism is the primary vehicle by which the government aids certain activities, such as the arts. Even in sectors such as human services, in which direct aid outweighs indirect aid, it is crucial to overall support. Comprehension of indirect aid gives us the ability to gauge the government’s real financial commitment to a sector and to judge the legitimacy of the true public subsidy to individual organizations. It also represents a useful fundraising handle for organizations themselves.