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Is crowding out due entirely to fundraising? Evidence from a panel of charities

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ABSTRACT

When the government gives a grant to a private charitable organization, do the donors to that organization give less? If they do, is it because the grants crowd out donors who feel they gave through taxes (classic crowd out), or is it because the grant crowds out the fundraising of the charities who, after getting the grant, reduce efforts of fundraising (fundraising crowd-out)? This is the first paper to separate these two effects. Using a panel of more than 8000 charities, we find that crowding out is significant, at about 75%. We find this crowding out is due primarily to reduced fundraising. Depending on which types of organizations are included in the analysis, crowding out attributable to classic crowd-out ranges from 30% to a slight crowd-in effect, while fundraising crowd-out ranges from 70% to over 100% of all crowd-out. Such a finding could have important consequences for how governments structure grants to non-profits. Our results indicate, for example, that requirements that charities match a fraction of government grants with increases in private donations might be a feasible policy that could reduce the detrimental effects of crowding out.

1. Introduction

When the government gives a grant to a private charitable organization, how much will this displace private donations? This is known as the crowding out problem and is one of the oldest and most important questions in public economics.[1]

The classic theory of crowding out is that individual donors, who are also often tax payers, will treat their voluntary private contributions as a substitute for their involuntary contributions through taxation and, as a result, reduce giving to a charity by the full amount of the grant. For this explanation to have traction, donors must treat their gift and the government's contribution as substitutes. A growing body of evidence from both experimental and survey data, however, questions this assumption.[2] The theory also requires that donors are aware of the fluctuations in government grants received by the charity and respond accordingly. While such information eventually becomes publicly available through tax filings of the charities, using IRS form 990, it may not be available to the donors at the time of their contributions.

The classic theory also ignores an important aspect of reality, namely fundraising. Fundraising is a significant undertaking. A typical charity will spend from 5 to 25% of its donations on further fundraising activities.[3] While these activities may be profitable for the organizations, managers of nonprofits are forbidden by law from capturing any of this surplus for themselves. Charity managers, therefore, may see fundraising as a "necessary evil" and, given the chance, might prefer to divert fundraising resources to their charitable activities.[4] Moreover, donors and charity watch-dog groups often perceive large fundraising expenses, rightly or wrongly, as indications of a low-quality charity. Charity Navigator, for instance, gives its lowest rating to a food bank or community foundation that raises fewer than $5 for every dollar spent on fundraising.[5] Since both donors and managers seem predisposed to dislike fundraising, a grant to a charity may also crowd out its fundraising activities. This gives a second indirect way that grants could reduce giving—charities may spend less effort on raising money.

This paper is the first to both estimate crowd-out and to decompose it into classic crowding out and indirect crowding out due to reduced fundraising. Why is this endeavor important? First, crowding out is a hidden cost to government grants, and it is

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[1] See Clotfelter (1985) and Andreoni (2006) for reviews and perspectives on crowding out.

[2] Andreoni (1989, 1990) provides some of the early theoretical contributions, recent empirical evidence comes from Ribar and Wilhelm (2002), recent experimental evidence can be found in Andreoni (2007), and neurobiological evidence is found in Harbaugh et al. (2007). Andreoni (2006) reviews this literature.

[3] See Andreoni (1998) for a discussion of fund-raising expenditures by charities in the Unites States.

[4] This hypothesis for why charities may not maximize net revenues was first offered by Weisbrod (1988) and since has been explored by several others. We discuss this in more detail later in the paper.

[5] See the Charity Navigator web site http://www.charitynavigator.org/index.cfm, under "methodology."

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important to understand its magnitude and its causes. Second, our answers may inform behavioral models of both donors (are they warm-glow givers?) and charitable firms (are they net revenue maximizers?). Third, the nature of crowding out can have significant consequences for potential government policies toward charities and fundraising. Suppose, for instance, that in an attempt to mitigate crowding out the government required that spending by the organization go up by the full amount of the grant, that is, it legislated zero crowding out. If crowding out is entirely due to reduced fundraising, then this policy is feasible. If, by contrast, crowding out is purely classic and charities are behaving optimally, then the government may be powerless to stop the ill effects of crowding out. Hence, if we are able to find a significant fraction of crowding out is in fact due to endogenous responses of the charity, it expands the policy tools available to a government wishing to maximize the benefits of the tax dollars spent.

We study crowding out and its causes with a panel of tax returns from charitable organizations. We begin with a sample of more than 40,000 organizations. After excluding organizations that never report private donations, government grants, or fundraising expenditures and/or appear to have extreme values, we analyze a sample of more than 8000 organizations and close to 40,000 observations. Our estimates show significant crowding out of about 73%—every $1000 grant reduces giving by $727. This figure is slightly higher than in prior studies. However, it is robust to a number of different instruments and the inclusion/exclusion of different types of organizations. Most importantly, we find that most of the crowding out is the result of reduced fundraising. In our preferred specification, all of the crowd-out is attributable to fundraising. There is no evidence of classic crowding out—in fact we measure a slight crowding in of donors by government grants. If we exclude some groups of organizations, the results suggest that the crowding out attributable to fundraising is substantial but not complete.

Another interesting finding of our analysis is that charitable fundraising is highly profitable, with over $5 raised per dollar spent on fundraising. While this number may strike economists used to profit maximization as somewhat high, it is perfectly in line with ideals of best practices promulgated by the charity watchdog groups and fundraising professionals, as we show below. That is, while economists see this finding surprising, industry experts would find this return to fundraising to be just as expected. Below we provide some speculation on the kinds of factors that could explain the effectiveness of fundraising.

The most important implication of our findings is that they open up a broader set of policy alternatives to the government. According to our estimates, a $1000 increase in grants will result in classic direct crowding in of $45, reduced fundraising expenditures of $137, and indirect crowding out due to reduced fundraising of $772. As a result of the $1000 grant, total contributions to the charity fall by $727, and the charity nets $410 including the money it saves on fundraising. If charities were required to maintain current fundraising expenditures and practices, the charity would not only preserve its prior donations but also gain $45 in revenue resulting from a slight crowd-in effect of the grant.

This paper is organized as follows. Next we give a brief background to the literature on crowding out, including the motivation for our approach. Section 3 describes the data. Section 4 discusses the estimation strategy and Section 5 presents the results. Section 6 is a conclusion.

2. Background

The classic model of crowding out, as presented in Warr (1982), Roberts (1984), and Bergstrom et al. (1986), is derived from the assumption that individuals see their own contribution as a perfect substitute for dollars given by the government. Andreoni (1988) showed that this model of "pure altruism" is unable to explain many simple facts about giving, and also leads to extreme predictions, such as that consumption is independent of redistributions of income. A model of impure altruism that assumes individuals experience some joy of giving, or a "warm-glow" (Andreoni, 1989, 1990, Steinberg, 1987, Cornes and Sandler, 1984), naturally leads to incomplete crowding out. Empirical research, as shown by Ribar and Wilhelm (2002), has been more consistent with a model of warm-glow giving than of pure altruism.

There are many empirical studies on crowding out, and most show that crowding is quite small, often near zero, and sometimes even negative (crowding in). Notable studies include Kingma (1989), Okten and Weisbrod (2000), Khanna et al. (1995), Payne (2001), Manzoor and Straub (2005), Hungerman (2005), Borgonovi (2006), and Gruber and Hungerman (2007). Payne (1998) noted that the government officials who approve funding for the grants are elected by the same people who make donations to charities. This means that positive feelings toward a charity will be represented in the preferences of both givers and the government, and that this simultaneity could bias findings against crowding out and could even lead to biased predictions of crowding in. For instance, a hurricane that causes both public and private charity to rise could create this positive bias. Payne (1998), using a panel of charities drawn from IRS 990 forms, addresses this with two-stage least squares analysis. She uses aggregate government transfers to individuals in the state as an instrument for government grants and finds that estimates of crowding out rise from zero in OLS to around 50% in 2SLS.

Andreoni and Payne (2003) ask the simple question: what happens to a charity's fundraising expenses when it gets a government grant? They first provide a theoretical framework that predicts that charities that compete for donors will reduce fundraising efforts in response to a grant, due partly to classical crowding and partly to substituting efforts away from fundraising and into their charitable services. For the empirical analysis, they again looked at IRS 990 filings, this time on a 14-year panel of 233 arts organizations and 534 social services organizations. As with Payne's (1998) earlier observation, charities that are in high demand will likely receive government grants and engage in active fundraising. This again requires an instrumental variables approach. Their results imply that a $1000 increase in grants will reduce fundraising for the arts by $265, and for social services by $54. These effects are significant; grants decrease fundraising by about 52% for arts organizations and 32% for social service organizations.

The next natural step in this research is to measure crowding out and ask what fraction of this is due to reduced fundraising as opposed to classic direct crowding out. We address this question next.

3. The nonprofit data set

The data on nonprofit revenues and expenses come from federal tax returns filed by IRS Section 501(c)(3) organizations for the period 1985 to 2002.[6] Representing the largest part of the nonprofit sector, 501(c)(3) nonprofits are those organizations whose purposes are religious, charitable, educational, scientific, or related to public safety testing.[7] The tax returns identify the amount the nonprofit received in private donations, government grants, and fundraising expenditures for the year for which the return was filed. Private donations may come from individuals, estates, corporations, and/or other nonprofit

[6] The data were obtained from the Urban Institute's National Center for Charitable Statistics. For a given year, the returns are for firms whose accounting period ended between November of that year and October of the following year. We brought together data from two samples. The first sample covers the period from 1982 to 1997, although for this analysis we pulled only the data for 1985 and beyond. The sample is stratified based on the asset size of the non-profits. Most of the returns tracked are for non-profits with assets that exceed $500,000. For each year, IRS randomly sampled the non-profit firms within each asset level. As IRS's budget for this study increased, the number of non-profit organizations tracked for a given year also increased.

[7] An organization is required to file a tax return if its annual gross receipts are greater than $25,000 and it is not a religious organization.