

THE DILUTION OF NON-PROFIT SIGNALS

THE CASE FOR THE 501(C)(3)/501(C)(4) SEGMENTATION OF CHURCH FINANCES

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## Introduction

The Internal Revenue Service tax code allows non-profit organizations classified under section 501(c)(3) access to specific benefits (namely, tax-exempt status and access to additional government support in the form of discounting the price of donations). This paper does not seek to offer normative arguments for or against the classification of churches as 501(c)(3) non-profit institutions. Instead, it looks to display inherent problems of inefficiency in the status quo and present a feasible alternative.

The proposal is based solely on issues of economic efficiency and upon what would theoretically produce Pareto optimal results. Issues of constitutionality, precedent, and existing religious interests, while relevant, will not be explored further in this paper; such issues will require further addressing.

The first post-introductory section will focus on key sections of literature that undergird existing theories of why, specifically, it is efficient for 501(c)(3) non-profit organizations to receive such benefits from the government. The two requirements for such a classification exist. The organization must be reasonably apolitical and the organization produce a substantial public benefit to justify the reallocation of government resources toward said organization (Samansky 13).

The second section will examine whether or not the two requirements are reasonably met by churches. It is important to note that the allowance of 501(c)(3) status should in theory require proof of public benefit, so simply raising enough doubt about the positive case made *for* such a status for churches to defeat their burden of proof would be sufficient. Thus, it is necessary that church organizations be provably apolitical and produce significant positive

externalities. The first portion of this section will focus on the seeming contradiction in terms of a religious group that is expected to avoid providing substantial moral and value-based (and, therefore, political) guidance to its members or else risk losing its tax-exempt status. This subsection will be broken down further into two planks: non-support of a candidate or party, and abstinence from lobbying efforts (Samansky 13). The second (and far more substantial) portion of this section will examine whether or not churches qualify as producing significant positive externalities for society. An econometric model will be specified and used to test the relationships between religiosity, crime, and education on a state-by-state basis. However, as will be seen, what remains is still a fairly unconvincing case for the affirmative production of positive externalities due to religiosity.

The third section will introduce a mathematical model to explain the inefficiencies resulting from the inability of donors to know whether their donations are going toward charitable or private goods. Crucial to this model is the aforementioned idea that there is a significant difference between demonstrably public benefit-producing activities (soup kitchens, food banks, foundation donations, etc.) and decidedly private benefit-producing activities (advertising for the church, sermons, church functions, etc.). As will be explained further, this unknown percentage of benefit versus non-benefit from donations produces issues for a donor who has an ideal amount of positive externality-producing publicly beneficial goods in his utility function, yet may be misled via signals into believing that donations to a church benefit the public on a dollar-per-dollar basis.

Basically, a donor is better served with better information about his donations. Of course, the lack of information may result in a warm glow for a donor who *thinks* his donations are exclusively funding charitable works, so increasing information addresses only those who get

utility from their donations benefiting society, not those who simply enjoy giving. It is the altruistic aspect of the individual donor's utility function that is to be explored.

The fourth section will explain the proposed alternative solution to increase the economic efficiency of donations to churches. In short, the notion is that churches should be reclassified as 501(c)(4) organizations, but with explicit permission to establish 501(c)(3) subsidiaries (with all normal benefits) that are required by law to focus entirely on demonstrably publicly-beneficial and positive externality-producing activities.

Two benefits accrue from this: first, the individual can choose what proportion of what *would* have been donated to the church as a whole will go to the church's secular, public-focused activities and what proportion will go to the church's private funds. This, naturally, will allow each individual donator to more closely represent his or her ideal split between the two (based on individual preferences). Second, it will remove the current phenomenon of the government subsidizing privately-beneficial goods at the expense of the publicly-beneficial goods that *could* be subsidized with the same allocation of funds. Neither segment of the church will have to pay federal income tax, but the private 501(c)(4) section will not have access to tax-deductible donations in the same way its 501(c)(3) section will.

Again, it should be noted, this proposal exists entirely in the realm of economic framework; it should not be taken as a pragmatic attempt to implement policy that may run contrary to existing precedent.

Section five will outline potential areas for further study that extend beyond the scope of this paper. The data analysis of this piece can provide a strong starting position for more complex regressions looking at the complexities of religious preference with regard to the moral

and educational level of each individual state, for example. It may be used as well for a more definitive policy proposal that takes this paper's conclusion from the realm of theory into its pragmatic application.

Section six will provide a conclusion derived from the data examined in previous sections, and, additionally, extend the logic of this paper's conclusions. Such would be beneficial for making an affirmative case for the neutrality (lack of notable positive or negative externalities) of private church efforts. This paper reduces the affirmative claims of public benefit to nebulous, esoteric notions that are relatively unconvincing, but it does not go the extra step toward making a claim that churches positively do *not* produce positive externalities with their religious activities. Another paper, therefore, is quite welcome to assume the burden of proof that currently exists with the proponents of the 501(c)(3) status of churches.

## **Section I – Literary Contributions and Analysis**

Despite being a relatively new branch of economics, the investigation of the decision-making regarding contributions to non-profits has amassed a considerable amount of insightful literature. One formative piece (one of the earliest in this field) yielded conclusions that contributed to the basis of this paper (Roberts). His piece's method of modeling charity as a part of an individual's utility function is somewhat mirrored in Section III. The basic model represents an individual as valuing his own consumption as well as the consumption of another (Roberts 137). Two notable factors of this simple equation will be reincarnated in this paper.

First, it is important that the utility of an individual depends upon his consumption and upon the consumption of others, yet is in no way affected by the actual *utility* of the others. This is a critical distinction because it allows this paper to view religious devotion as a good to be

either consumed or not, with value given to the amount consumed. It allows the avoidance of entangling factors like assumptions on behalf of devotees that consumption is inherently “good” for individuals whether they express demand for it or not.

A second key component to this equation is the lack of importance of agency in a donor’s utility function; that is, it does not matter if the recipients’ consumption rises due to the donor’s contributions, or by any other means. This means the equation is focused entirely on the combination of one’s own consumption and one’s altruistic donations with no represented effect of any “warm glow” agency-related additional utility generators. This is critical because, as was stated above, if the public perception is that donations to churches, whether used for provable public good or for private church expansion and the like, are indeed efficient and all go toward bettering people, then the warm glow effect will remain entirely intact even if *none* of the money actually ended up producing positive externalities. By focusing on the altruistic aspect, the effects, not the signaled interpretations, can be evaluated to see what *actually* is efficient in the sense of producing the amount of public benefit each individual prefers as part of his or her unique utility function’s distribution of resources (adhering to his or her budget constraint, naturally).

An additional section of Roberts’ paper bears mentioning, and that is that the government has a tendency to over-provide charitable goods when the authority to subsidize them is ceded to said government (Roberts 147). While this paper refers primarily to charitable goods, any good that is seen as a form of well-doing should theoretically be subject to the same overprovision (though perhaps at a lesser rate). While it is debatable if an inefficient overprovision of a good that produces strong positive externalities is preferable or not on the whole, it seems clear that a

private good which is overproduced due to government subsidization is decidedly inefficient as there are no substantial positive externalities to even threaten to outweigh this overprovision.

There has, naturally, been other literature regarding the financial privatization of church funds. In particular, one piece argues that churches are already a unique entity, being almost entirely funded by private donations yet focusing on the public as a whole. Its focus is on the functioning of churches as religious clubs and how the benefit of the donating agents is not the sole concern of the church leaders. This paper provides much of the basis for the “dual nature” viewpoint of church activities detailed below (Zaleski).

An additional paper bears mentioning due to its input regarding the variables used in this paper. It contributes a study of various characteristics relating to religious participation and finds that it is difficult to locate any specific socioeconomic trend that relates predictably to any trend of religiosity. The details of their results will not be explained here in detail, but their data and conclusions contribute extra impetus to the notion that religiosity can be examined directly instead of via proxy (Owen).

## **Section II – Outlining the Requirements**

With regard to the two aforementioned requirements, one sees two decidedly different parameters used. The first parameter, the apolitical clause, is so inherently nebulous that it is nearly impossible to determine on a case-by-case basis which institutions are in violation and which are not without substantial legal analysis, and even then it is impossible to determine a hard and fast rule that leaves no room for uncertainty (Samansky 21). Naturally, this poses a serious dilemma: on one hand, church leaders are by definition supposed to provide substantial moral guidance and direction for their congregants, while on the other hand, doing so in a

manner that *is* substantial and that could potentially have a meaningful effect could be interpreted as becoming invested in the realm of politics and, thus, garner the loss of 501(c)(3) tax exemption.

Churches, naturally, are extremely heterogeneous and difficult to cover with blanket assertions. Given the sheer amount of nuance related to this plank of this requirement, it is nearly impossible for one to state outright that churches either do or do not inherently violate this clause. In fact, there has only been one case in which the Internal Revenue Service sought to remove a church's tax exemption (*Branch Ministries v. Rossotti*), and it would be foolhardy to apply that case's decision to indeed shatter the church's 501(c)(3) benefits to all churches (Samansky 22). Instead, let this inherent murkiness serve not as a rejection of churches' justifications, but as a mitigating factor. For this purpose, the primary focus will be on that which can be subjected to statistical analysis rather than legal proceedings. This, of course, leads into the second, more demonstrable justification for 501(c)(3) status: the promotion of substantial positive externalities that would otherwise be underproduced without tax subsidies.

The advantage yielded by focusing upon this element of the justification is that one can measure the effects of religious adherence (religiosity), albeit in an imperfect way. It is clearly impossible to look at relationships between religiosity and other characteristics and attempt to determine causal links based upon circumstance.

### **Section III – Modeling Relationships of Religiosity**

Regrettably, citizens do not have strict indicators of religiosity floating above them. While it may at first be tempting to look at church attendance or even church donations per capita, such would defeat the purpose of the regression to be run. The intent here is to establish



what benefits are gleaned from religiosity itself, whether it is private or public. After all, the argument that religious faith and belief promote positive public externalities does not presuppose a unique distinction between public and private expressions thereof. The most effective way, then, to determine an individual's religiosity is to ask him or her. While this is not a perfect method by any stretch (after all, some may misrepresent their level of religiosity due to expectations of the social response from the individual collecting the data), there is no more effective way to determine one's preferences when they cannot be objectively determined based upon actions.

Of the polls sought out for this paper, the most robust and substantial by far was a Gallup poll from early 2009 with a sample size of 355,344 adults across the nation interviewed via telephone (Newport 1). Individuals were asked to respond to the question, "Is religion an important part of your daily life?" with the only options being yes, no, or refusal to answer (which occurred roughly one percent of the time) (1). The data is broken down state by state with percentage of answers in each category reported with a very slim margin of error (typically plus or minus one percent) (2). For purposes of congruence with other tabulated data, only information from the fifty states was compiled, with districts and territories excluded.

The task of measuring what is and is not a positive externality is naturally one with room for interpretation, and so for that reason this model uses two very unambiguous tests for classic arguments of religious benefits. First, the claim that religion helps to educate a populace is tested with regard to each state's high school graduation rate. While it is tempting to analyze data with more education-intensive collegiate and post-graduate education levels, socioeconomic conditions could lead to inequalities that federally-mandated high school attendance would presumably largely avoid. The second claim to be examined is the notion that religious

adherence results in the imparting of morality and an increase in goodwill. To avoid questions of the comparative morality of different crimes (i.e. whether one instance of shoplifting reflects a tangible character flaw or not), the severe category of violent crime is used for comparison.

There is little doubt that cases of murder, rape, robbery, and aggravated assault clearly qualify as expressions of what could commonly be considered immorality. State-by-state data reflecting high school graduation rates was readily available from the United States Census' website, and the United States Bureau of Justice Statistics provided the necessary violent crime data.

Results are outlined below:

**Fig. 1**

States	Religiosity (%)	Violent Crimes (per 100,000)	High School Graduation Rate %
Alabama	82	448	75.3
Alaska	51	661.2	88.3
Arizona	61	482.7	81
Arkansas	78	529.4	75.3
California	57	522.6	76.8
Colorado	57	347.8	86.9
Connecticut	55	256	84
Delaware	61	689.2	82.6
Florida	65	1414.3	79.9
Georgia	76	493.2	78.6
Hawaii	57	272.8	84.6
Idaho	61	239.4	84.7
Illinois	64	533.2	81.4
Indiana	68	333.6	82.1
Iowa	64	294.7	86.1
Kansas	70	452.7	86
Kentucky	74	295	74.1
Louisiana	78	729.5	74.8
Maine	48	118	85.4
Maryland	65	641.9	83.8
Massachusetts	48	431.5	84.8
Michigan	64	536	83.4
Minnesota	64	288.7	87.9

Mississippi	85	291.3	72.9
Missouri	68	504.9	81.3
Montana	56	287.5	87.2
Nebraska	67	302.4	86.6
Nevada	54	750.6	80.7
New Hampshire	46	137.3	87.4
New Jersey	60	329.3	82.1
New Mexico	66	664.2	78.9
New York	56	414.1	79.1
North Carolina	76	466.4	78.1
North Dakota	68	142.4	83.9
Ohio	65	343.2	83
Oklahoma	75	499.6	80.6
Oregon	53	287.6	85.1
Pennsylvania	65	416.5	81.9
Rhode Island	53	227.3	78
South Carolina	80	788.3	76.3
South Dakota	68	169.2	84.6
Tennessee	79	753.3	75.9
Texas	74	510.6	75.7
Utah	69	234.8	87.7
Vermont	42	124.3	86.4
Virginia	68	269.7	81.5
Washington	52	333.1	87.1
West Virginia	71	275.2	75.2
Wisconsin	61	290.9	85.1
Wyoming	58	239.3	87.9

*Sources: Newport 2, United States Census (2000), Bureau of Justice Statistics*

Given the inherent difficulty in attributing causality in these relationships, the choice of dependent and independent variables is largely preferential. For the sake of simplicity, the regression chosen has religiosity as the dependent variable run against the independent variables of violent crimes per 100,000 citizens and high school graduation rates (%).

Religiosity (not church attendance or church donations per capita) is being looked at because the analysis is attempting to extract the purely religious element from the church

experience, which is typically a combination of religiosity and community charity. The latter, naturally, can be assumed to produce public benefit, so it is only the former which needs analysis. This model is unique in that it severs out the other elements of church participation and focuses in on the only one that is suspect. In addition, though this paper is based around the notion of donations to churches, basing the analysis on donations per capita by state would face additional issues of varying socioeconomic conditions.

The same, in fact, could be said for church attendance. After all, church density can be expected to vary from one state to the next. Also, certain individuals may have a higher opportunity cost for attending church, so their absence is not necessarily an indicator that they get less utility from it than those who attend. For these reasons, this paper is looking into the effects of religiosity based upon the assumption that church finances used toward increasing religiosity do in fact increase it. Given that donations may allow churches to advertise, purchase new equipment, maintain their property, and the like, such an assumption is reasonable.

Violent crime statistics are being used to represent morality. No one indicator (or group of indicators) can effectively capture morality in an objective way, but this blunt instrument is most definitely representative of moral deficiencies. Other crimes, such as petty theft, are not included because there is at least some ambiguity about their moral standing. Solid analysis is not best served by debating the normative justifications of stealing a loaf of bread. Since the same indicator is used for all fifty states, its imperfections will at least occur uniformly. This metric is being used to simplify the regression and reduce the importance of moral opinion as much as possible.

As explained previously, the high school graduation rate is also an imperfect, yet uniform and generally accepted measurement of education. This model continues to seek barebones simplicity because, as will be shown, even with such clear-cut measurements, there is still a substantial amount of noise in the results. Further complication of the variables would only increase the ambiguity of the unexplained sum of squares.

The results regarding the relationship between violent crime and religiosity were inconclusive (.002 with a standard error of .005), and thus the null hypothesis of no relation could not be rejected (Halcoussis 315). However, to justify the affirmative case for the teaching of morality, a statistically significant negative correlation between religiosity and violent crime would be required. It is of note, though, that it has not been *proven* that there is no relationship; instead, one simply could not be found with the extensive state-by-state data used.

The relationship between religiosity and high school graduation rates, on the other hand, is very much evident (-1.485 with a standard error of .268). This indicates that on average and with all else held constant (and between states, not exerting a change on an existing state), each additional percentage of respondents who indicate that religion is an important part of their daily lives will likely yield nearly one-and-a-half percent lower high school graduation rates within that same state. This correlation is statistically significant even at the 99% level (with a t-statistic of 5.55), and despite a priori concerns about multicollinearity between rates of violent crime and high school graduation rates, an auxiliary regression showed an r-squared value of .14 between these two factors – a noticeable amount of multicollinearity, but not enough to realistically invalidate the massive t-value (Halcoussis 313). So, essentially, that which is inherent in the model has not been found to skew the statistical significance substantially.

There are some notable drawbacks to the method used above, of course. First, there was substantial noise in the data (r-squared value of .45), which, while it did not likely affect the overall results in an absolute sense, may have somewhat distorted the magnitude of the relationship. Additionally, availability of data (and lack thereof) resulted in small time discrepancies between the information used by each variable. Again, this did not likely result in substantial fluctuations given that none of the information is more than ten years old, but it may introduce additional noise into the results. Finally, as mentioned above, the collection mechanism for determining religiosity was self-report, and thus potentially not entirely accurate (it is not hard to imagine individuals artificially enhancing their religiosity when asked directly about it). But all of these shortcomings are dwarfed by the reliable and statistically significant results found, as well as the fact that the burden of proof would be upon finding relationships that ran *in favor* of positive externalities coming from religiosity.

#### **Section IV – The Alternative**

Due to the fact that churches are inherently compound actors, completely removing 501(c)(3) status would represent a unique persecution given that many churches engage with frequency in activities that *are* demonstrably producing of positive externalities (soup kitchens, charity drives, etc.). The proposal, therefore, is for the required segmentation of church resources into two distinct categories: 501(c)(4) religiosity-enhancing and guidance-providing activities, and 501(c)(3) secular activities for clear public benefit.

This requirement, naturally, is only asked of those churches which wish to maintain their 501(c)(3) status. A church that wishes to keep its finances unsegmented may deign to forego tax-exempt status. Presumably, this will result in the necessary government assistance for the

provision of publicly-beneficial goods that may entail free-rider effects while avoiding the public subsidization of ostensibly private benefits. Further, it would be naturally Pareto inefficient for tax subsidies to be provided for a good (religiosity) that actually, according to the data, is correlated with negative effects (namely, lack of high school graduation).

## **Section V – For Further Study**

For purposes of data collection for analysis, the concept of religiosity is applied in a uniform manner, wherein it is assumed that each religion is equivalent to another. It is entirely possible that this is not the case; presumably, different regions' populations of adherents to various religions could be analyzed further. While such is not examined in this paper, it is possible that certain religions may produce public benefit while others do not, and that the broad nature of the data used overlooks that fact. While this would not be terribly useful for pragmatic purposes (the notion of having certain religions' churches tax-exempt while others are not is both improbable and dangerous), one could look for similarities among certain *types* of religiosity-producing church activities.

Other potential comparisons could be made between urban, suburban, and rural areas; if, for example, churches are found to produce public benefit in urban areas, it may be more efficient to provide only urban churches with tax-exempt status. Additionally, the importance of the types of churches could come into consideration as well. Different styles of organization may result in different levels of inefficiency. But such is all secondary to the primary purpose of this paper: the determination of what (if any) positive societal benefits religiosity provides. The evidence provided points very strongly toward religiosity having no clear provable positive correlation with societal morality or education, let alone causality.

## **Section VI – Conclusion**

Due to the stubbornness of the data outlined above, it can be stated with confidence that there is an inverse relationship between religiosity and high school graduation rates. It should be noted, as was mentioned above, that there is no apparent statistically significant relationship between religiosity and violent crime rates.

As a cautionary note, let it be stated once more that causality is not assumed; whether religiosity breeds a decreased appetite for high school education, or whether those who lack strong education turn to religion for guidance is irrelevant. What is clear is that there is most certainly no affirmative evidence of religion's educating or morality-providing role in the fifty states of the United States.

The information gleaned from the regression run in Section III can be used to comfortably suggest that the elements of religiosity, therefore, cannot be given carte blanche to use tax subsidies for the purpose of promoting a private good that produces no detectable positive externalities in the same manner that abject charity would (so long as economic efficiency is still sought). Separate from normative claims, this piece has displayed through positive, verifiable econometric analysis that there is a dearth of support for the notion that churches should be given full tax exemption as a matter of economic efficiency.



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