

TAX-DEDUCTIBILITY AS A TAX-FINANCED GOVERNMENT SUBSIDY

How “private” is “private charity” in this country?

I. INTRODUCTION

Imagine a world in which government’s *operating* budgets must always be balanced, at least over the business cycle.

Operating Budget: By operating budget is meant the budget for spending on the government’s normal operations – paying government employees, including the military, for their services, purchasing goods and services for use in the budgeted year by government (e.g., paper, fuel, etc.), purchasing goods and services on behalf of citizens from private vendors (e.g., buying health care for the elderly through the Medicare program or health care for the poor through the Medicaid program), making cash payments (subsidies, retirement payments or welfare payments) to individuals, business firms and other institutions, and so on. Ideally, such an operating budget should be balanced -- i.e., tax- and other government revenues should cover government operating expenditures, at least over the business cycle.

Capital Budget: In principle, the government’s spending on long-lived assets – real estate, infrastructure such as airports, seaports and roads, equipment with a use life exceeding one year – should not be part of the operating budget, but approved and managed through a *capital budget*, as business firm’s and some state and local governments actually do. This kind of spending should be approved through capital-budgeting techniques – typically called “project evaluation” in government – and they should be financed with debt instruments to be paid off with tax revenues collected over the use life of the assets.¹ It is not clear why one year’s taxpayers should pay taxes to build a road with a 50 or more year use life.²

II. THE CONCEPT OF “TAX EXPENDITURES”

In what follows we shall focus only on a genuine *operating budget* for government that does not include either the *capital budget*. In principle, such an operating budget should be balanced over the business cycle. We shall assume, then, that government manages its operating budget that way, or should manage it so.

Furthermore, let us assume that, on behalf of voters – or, as it often turns out, special interests – our legislative representatives have decided to finance a particular bundle of federal activities such

¹ In practice, the maturity structure of government debt is not set to match the use life of the long-lived assets the debt finances, but for macro-economic management purposes.

² Unfortunately, our federal government combines both its operating budget and its capital budget into one overall budget, which completely distorts any public debates on budget policy. And it gets worse. The budgets you see discussed in the news media are the combined total of the so-called “*on-budget*” and “*off-budget*” budgets for federal spending. The “*on-budget*” includes all federal government revenues and expenditures except those included on the “*off-budget*.” The “*off-budget*” includes cash inflows and outflows of the Social Security trust funds (Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds) and the Postal Service Fund. The “*unified budget*” combines the “*on- and off-budget*” totals. It is the “headline budget.” Thus, balancing the “*unified budget*” is not compelling in principle.

as those enumerated above when we defined the operating budget. One can always debate the merits of any particular form of spending, of course; but here we assume that the debate is over.

Given that decision, it then follows that government must raise an equal amount of revenue in the form of taxes or other revenues (e.g., user fees for government-owned assets).

Most importantly for our purposes here, it also follows that whenever government makes an individual's or business firm's expenditure on particular items tax-deductible – be it spending on something like health care or ethanol based fuel or interest on home mortgages, or on charity -- government implicitly grants a public subsidy to these entities, and that subsidy must then be tax-financed by other taxpayers.

On that line of reasoning, economists call so-called “tax preferences” or “tax loopholes” – such as the tax deductibility of certain forms of spending a “**tax expenditure.**”

Some people bristle at this language. They think of such “tax expenditures” simply as tax cuts and argue that calling it a form of government spending implies that government owns all of the GDP and that any income it lets you keep is then ipso facto a government expenditure.

That is not how economists think, however. By using the term “tax expenditure” economists merely seek to draw attention to the fact that any tax reductions granted some citizens by means of a tax preference must be made up by other tax payers in the form of added taxes – that these tax preferences are not a free lunch.

If you can follow economists here, you are way ahead of many seasoned adults.

III. TAX-DEDUCTIBILITY OF SPENDING ON A PARTICULAR GOOD OR SERVICE

If government makes spending by private individuals on a particular good or service – health care or education or whatever – tax deductible, we can think of that tax-preference simply as an *ad-valorem* subsidy.

It is easiest understood in terms of the algebraic model which we had already covered in connection with sales taxes or – subsidies. Let's assume spending on our legendary widget is tax deductible.

Thus, let

X = the price received by sellers per widgets

P = the net price the buyers pay, after deducting from what they paid sellers (X) the government subsidy they receives from the government (in the form of lower income-tax payments, here equal to the marginal tax rate t faced by buyers times the price X paid the sellers).

Q = the number of widgets offered for sale or demanded by buyers, per period

For simplicity, we assume that all buyers face the same marginal income tax rate “ t ”.

With this notation, we write the buyers' market demand for widgets as

$$[1] \quad P = a - b Q ,$$

where all factors driving demand other than the price of widgets are held constant and subsumed in the intercept “ a .”

We can think of P here as the maximum net price (net of any subsidy) that the buyers in the market would bid to absorb a batch of Q widgets per period.³

Now, we would write the sellers' supply curve to the market in terms of the price to which sellers react, that is X , as follows:

$$[2] \quad X = c + dQ .$$

We can choose to express, solve and graph this two-equation model in terms of either the price sellers get (X) or in terms of the net price (net of the subsidy) buyers pay (P). Let us use X in what follows, although this is arbitrary, as you know.

If we express the model in terms of price X , we must replace the P wherever we encounter it with $(X - tX)$, where tX is the subsidy granted by the government. To illustrate, if sellers charge us $X = \$80$ for a bottle of wine whose consumption is tax deductible and our marginal tax rate is $t = 30\%$, then the subsidy we receive is equal to $(.3)\$80 = \24 , and the net price P we pay for the wine is $\$80 - \$24 = \$56$.

In our model, the supply curve is already expressed in terms of price X . The demand curve, however, is expressed in terms of P . To express it in terms of X as well, we plug in $(X-tX)$ for P and rewrite the equation as

$$\begin{aligned} [1a] \quad & (X - tX) = a - bQ \\ \text{or} \quad & X(1-t) = a - bQ \\ \text{or} \quad & X = [1/(1 - t)] (a - bQ) \\ \text{or} \quad & X = [1/(1 - t)]a - (1/(1 - t)) bQ \end{aligned}$$

We now plot this two-equation model [1a] and [2] on the next page, with X on the vertical axis. It is seen that then the demand curve shift with changes in t . The text book would rationalize this by saying that "buyers got the subsidy." Had we expressed the model in terms of price P and put P on the vertical axis, the supply curve would have shifted with changes in t .

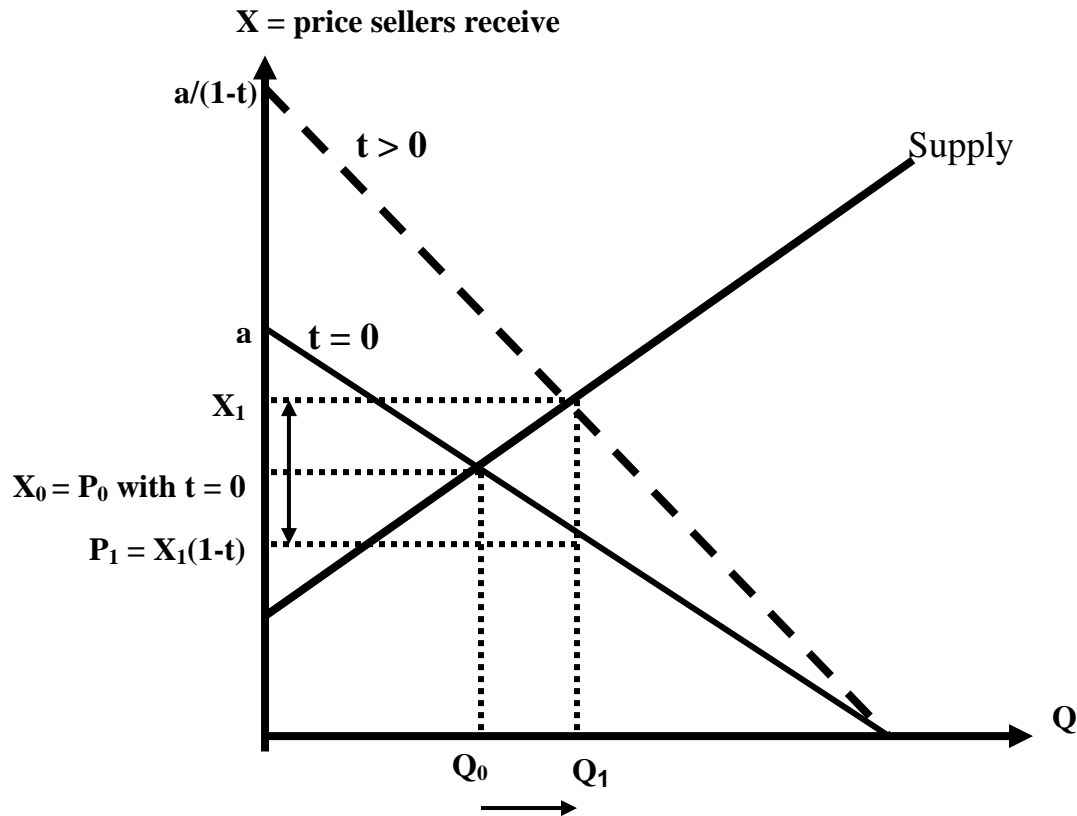
Note that, in a plot of this model with X (the price received by sellers) on the vertical axis and Q on the horizontal, two things happen when the buyers' marginal tax rate t increases: (1) the intercept of the demand curve $(1/(1 - t))a$ will increase and (2) the slope of that curve $-(1/[1 - t])b$ will become steeper.

Next, look at what a happy world tax-deductibility begets for the sellers and buyers of the tax-favored commodity.

If the purchase of widgets, in this case, were not tax deductible, then Q_0 widgets would be bought and sold in the market, at a price $P_0 = X_0$. After making the purchase of widgets tax deductible, the number of widgets bought and sold increases to Q_1 , the price sellers receive increases to X_1 , while the net price buyers pay has decreases to $X_1(1-t)$. Everybody should live happily ever after.

³ We recall, of course, that, for any Q , the corresponding P yielded by the equation is actually the maximum bid price of only the marginal buyer – the last buyer to enter the market who just broke even in terms of the value he attributes to the widget he or she bought. All other buyers actually purchasing widgets would have bid a higher price, had push come to shove, but they all now get widgets at the P determined by the last trade and thus earn a consumer surplus.

Everybody, except general taxpayers. They now must make up with added tax payments the shortfall equal to $Q_1(tX_1)$ in taxes not paid by the lucky buyers of widgets. In the graph, the other taxpayers pay in *toto* a sum equal to $tX_1 \times Q_1$. Perhaps this is fair. Perhaps it isn't.



IV. THE REGRESSIVITY OF TAX-DEDUCTIBILITY

As you know, the income-tax rates tax payers pay on additional increments in income rise in step form. It means that the marginal tax t rate faced by high-income earners is larger than that faced by low-income earners.

A consequence of progressivity in the tax code is that making spending on a good or service tax-deductible effectively lowers the net, after-tax price of that good or service lower for high income people than it will be for low-income people.

To illustrate, consider the latest new, new thing in American health policy, so-called "*Consumer Directed Health Care*." Basically, this is a code name for health insurance policies with very high deductibles (between \$2,000 to \$15,000 or so per family per year) and coinsurance on top of it.⁴

⁴ To make it *Consumer Directed Health Care*, prospective and actual patients would need to have reliable information on the price of health services and their quality provided by different, competing doctors, hospitals, drug companies etc. Only in rare instances do American patients now have access to such information. Therefore, the label "*Consumer Directed Health Care*" can be said to be a deceptive marketing gimmick for high-deductible health insurance.

The deductible in an insurance policy is the amount the insured must pay out of pocket before any payment for claims is made by the insurer. A coinsurance rate of, say, 20% means that the insured must pay 20% of every bill received from a doctor or hospital, with the insurer picking up the other 80%.

For a family with one or two chronically ill members, this high degree of cost sharing for health care can constitute a heavy drain on the family's budget.

To help families defray these large out-of-pocket costs, the President and the Congress allow families annually to make *tax-deductible* deposits out of their own budgets into a so-called *Health Savings Account (HSA)* whose balance at any time can then be used to cover spending on deductibles and coinsurance. Any amount in the account not spent in one year can be carried over for future years. It is, in effect, a tax-preferred savings account, although usable only for specified health-care services.

The intent of this tax preference is benign, but one should recognize that it is regressive. Any deposits into the HSA made by a high-income person facing a marginal tax rate of, say, 50% (for all kinds of income-based taxes) will reduce that person's after-tax income by only half as much. The other half is indirectly put into the HSA by other taxpayers. On the other hand, any such deposit made into the account by a person with a marginal tax rate of 20% will reduce that person's income by 80% of the deposited amount.

In effect, then, in absolute dollar outlays, the HSA mechanism makes, say a \$1,000 root canal cost the high-income person only \$500. The other \$500 is paid for by other taxpayers. By contrast, a \$1,000 root canal would cost a low-income person with a marginal tax rate of 20% \$800, and taxpayers need to subsidize that root canal only to the tune of \$200.

In short, making an individual's spending on health insurance, on out-of-pocket payments for health care at the time it is received, or on deposits into a *Health Savings Account* tax-deductible effectively makes these items cheaper for high-income persons than for low-income persons. It does so by forcing other taxpayers to grant the high-income person a larger tax-financed subsidy towards buying these items than they grant low-income persons.

What are your thoughts on that tax preference? Although ethics is not normally part of the economist's purview, an economist certainly is free to wonder what religion or other ethical precept might justify having low-income persons pay 60% more for a root-canal treatment to get rid of a toothache than a high-income person has to pay, and ditto for other health care.

What has been said here about health care applies with equal force to the tax-deductibility of spending on other things, such as education. Every so often it is proposed to make tuition payments for children tax-deductible. That, too, would constitute a regressive public subsidy

IV. THE TAX-DEDUCTIBILITY OF CHARITY

With very few exceptions, donations to recognized charities are tax-deductible in this country. Economists have estimated that this feature is a major catalyst for such charitable giving. Here, too, regressivity rears its ugly head.

Suppose my favorite Charity Y engages in an activity of which I heartily approve and I wish to support. If I write a check of \$10,000 for that charity, the latter can use it to attract \$10,000 worth of *real resources* (labor, energy, materials) to its cause.

In other words, by writing the check, I indirectly redirect \$10,000 worth of real resources from wherever else they would have been used in the economy toward my favorite charity which, incidentally, my tax-paying neighbor may hate.

If I am a high-income person facing a 45% marginal tax rate, my disposable, after-tax income will go down only by \$5,500 when I write a \$10,000 check to a charity. Under our balanced-budget assumption, other taxpayers now will be forced to contribute the other \$4,500 to my favorite charity by paying higher taxes to cover the \$4,500 I no longer send to the Internal Revenue Service. For all we know, they may never have heard of that charity or may not like it, if they had. It does not matter. My tax-paying citizens are forced to contribute to that charity because (a) I like it and (b) my charitable donation is tax-deductible.

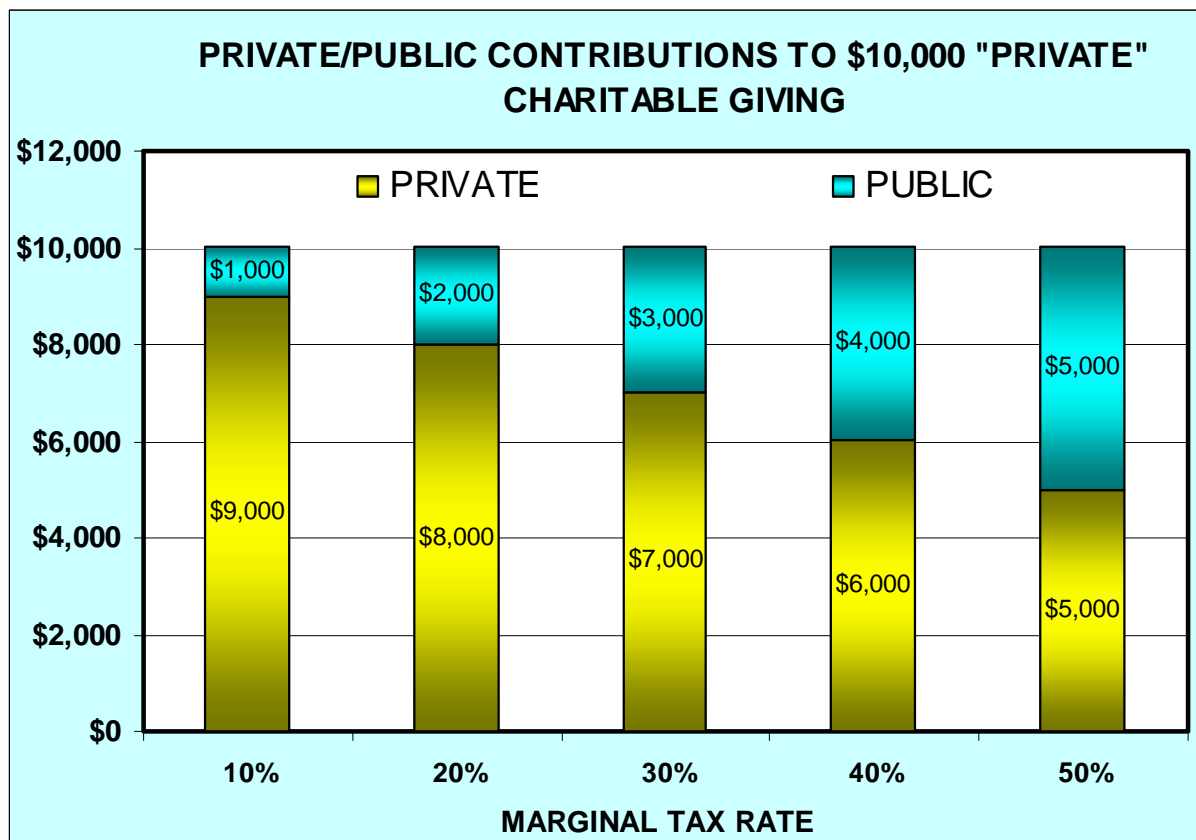
By contrast, if a lower-income person facing a 20% marginal tax rate were to write a \$10,000 check to a charity, that person's disposable income would be reduced thereby by \$8,000 and other taxpayers would be forced to contribute only \$2,000 to that charity.

In other words, high income persons have much higher leverage to redirect real resources to their favorite charities, per dollar of after-tax income they sacrifice, than do lower-income persons.

Another way of putting it is that for every \$1 of true (after-tax) sacrifice the charitable citizen makes, other tax payers are forced to contribute $\$t/(1-t)$ toward the charity preferred by the charitable citizen. The expression $t/(1-t)$ increases in value as t rises. (Just take a derivative of the expression with respect to t .)

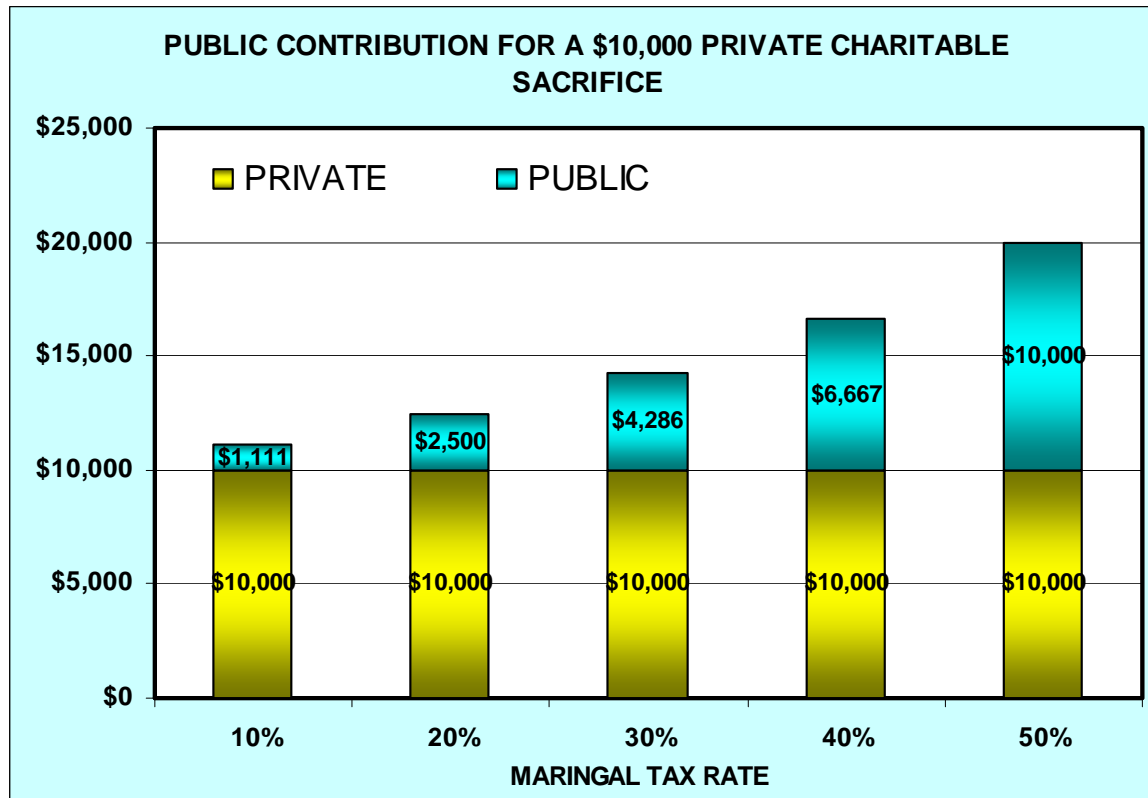
The next two charts illustrate that tax-rate effect.

In the first chart, we assume that a private philanthropist sends a \$10,000 cheque to a particular charity. The graph then shows, on an after-tax basis, how this \$10,000 contribution is shared by this philanthropist and general taxpayers, as a function of the marginal tax rate faced by the philanthropist. You notice that the higher the marginal tax rate, the less money the philanthropist will actually sacrifice to see \$10,000 directed to the charity, and the higher will be the contribution extracted from general taxpayers.



The next graph, shown on the next page, illustrates how much money a philanthropist willing to sacrifice \$10,000 on an after-tax basis can funnel to his or her favorite charity, after conscription his or her fellow citizens, so to speak, to make their contribution to that charity as well, even though they may never have heard of that charity or might not like it, if they knew it.

We see that a high-income philanthropist has far more leverage than a low-income philanthropist to channel contributions by other taxpayers to his or her favorite charity. That leverage increases noticeable as the marginal tax rate rises.



Members of Congress may argue that they regret the regressivity inherent in tax-deductibility but accept it as an unavoidable, untoward side-effect of an otherwise benign policy. That excuse won't wash.

Most of you probably could figure out why. Instead of making expenditures Congress favors tax-deductible, the law might say that anyone who deposits an amount into a *Health Savings Account*, or who donates \$1,000 to a museum or to another charity, can deduct a flat percentage of that amount from taxes owed the government. It would convert "tax-deductibility" into what is known as a "tax credit."

If the tax credit were made "refundable," then even very low-income households that do not actually pay federal taxes could benefit from, say, charitable giving, because they could then claim an amount equal to the flat percentage times the amount they gave to charity from the government, which would send the household a check as the so-called "refund."

.Thus, it seems fair to argue that, in making an expenditure *tax deductible*, government quite deliberately wishes to favor well-to-do people more than low-income people. This may seem like a harsh judgment on our legislators, but it is really implausible?

V. SUMMARY AND CONCLUSION

Several points emerge from the preceding discussion, to wit:

1. If government followed the dictum that over the business cycle its operating budget should be balanced, then every time legislators grant someone a tax preference – such as tax-deductibility of particular forms of private spending – they should think hard about the added taxes they thereby impose on other taxpayers. There is no free lunch here.
2. Making private spending on particular goods or services is made tax-deductible in effect bestows an ad-valorem subsidy on that commodity (the opposite of an ad-valorem sales tax or tariff). That subsidy benefits both the buyers and the sellers of the commodity, but comes at the expense of other taxpayers.
3. Although we measure total “private charitable giving” in this country (usually about 2 percent of GDP) by the donations made by individuals, business firms or other private institutions to charitable organizations, the word “private charitable giving” is really a misnomer. Usually the private donation is a mixture of the private donor’s sacrifice and a contribution literally coerced from other taxpayers through the tax code. The graphs above have illustrated this effect.

I hasten to add that this lecture is not to be construed as an argument against private charitable giving, which is an admirable feature of American society and does much good in many areas.

I have merely sought to help you think straight about this facet of our society, and also on how one could alter the tax code to make it more horizontally equitable among donors.

Two additional points may be registered in conclusion.

First, dictionaries usually reserve the word “charity” or “charitable” for the imagery of generosity towards the poor and the helpless. But much of what is reported as charitable giving in the US is more accurately described as “voluntary private financing, with substantial, matching contributions from government” of public goods or societal benefits – museums, churches, educational institutions, parks, etc – aimed at the entire spectrum of society, not just the poor and helpless and often hardly at all for them.

Second, it is unavoidable that charitable organizations spend some of the funds donated to them on fund-raising and other administrative overhead, which means that less than 100% of the donated funds actually bestow real resources on the charity’s mission in the field. The question is how much of total donation should be absorbed by fundraising and administration. Here the record is quite mixed. Many private charities are very efficient and conscientious in their use of donations. Others burn much more than half of donations on fund raising and administration. I attach examples of the latter hereto. (Click, for example, on http://www.scsos.com/From_the_Secretarys_Desk/Media_and_News_Releases/id/85 or <http://www.charitynavigator.org/index.cfm/bay/content.view/cpid/280>).

Fortunately, there exist several web-based guides to charity that can be helpful in sorting efficient from inefficient charities – e.g., Charity Navigator <http://www.charitynavigator.org/> or Guide Star <http://www2.guidestar.org/> and yet others

Some so-called "charitable" activities are just not likeable. Shown below is one I do not like. At the fringe of tax-deductibility, you will find all manner of vignettes that are at once entertaining in vexing.

THE NEW YORK TIMES OP-ED SATURDAY, APRIL 17, 1999

Hunting for Fun and 'Charity'

By Matthew Scully

VISITORS to the Smithsonian Institution's National Museum of Natural History will soon have a chance to tour the new Kenneth

E. Behring Family Hall of Mammals, named for the trophy hunter who shot some 200 of the mammals and then graciously donated them to the Smithsonian, along with \$20 million. Missing from the collection will be the carcass of Mr. Behring's rarest prize — the endangered Karatau argali sheep that he took in Central Asia.

Just weeks before the donation was settled in late 1997, the Smithsonian applied for a waiver to import the banned argali, as well as four other sheep that Mr. Behring had felled. The argali's remains are now in storage at a Canadian taxidermy shop while the United States Fish and Wildlife Service examines the Smithsonian's permit application.

Most people are probably surprised to learn that there is such a thing as a sheep safari, let alone that a man may be willing to pay millions to import and house his sheep trophies. Mr. Behring is part of a small but influential group, and the controversy over his gift offers a glimpse into the world of competitive — and tax-deductible — sport hunting.

Mr. Behring, a California developer, belongs to Safari Club International, a 32,000-member group based in Tucson, Ariz. With annual revenue of more than \$13 million, Safari Club is a powerful "conservation" lobby in Washington. The club's idea of conservation can be seen in its "Official Record Book of Trophy Animals," a Manhattan-directory-sized volume immortalizing the exploits of members. In 1996, the Smithsonian's benefactor reached what is known as the Fourth Pinnacle of Achievement — just a few sheep short of the Crowning Achievement.

I spent four long evenings in January at the Safari Club convention in Reno watching these awards being presented. Before ascending to the First Pinnacle of Achievement, members must complete a series of Grand Slams in various species. The Bears of the World Grand Slam, for instance, requires bringing home an Alaskan brown bear, a grizzly, a Eurasian brown bear and a polar bear.

This last category presented prob-

lems until last year, when, after years of lobbying by Safari Club, Congress lifted a ban on polar bear trophies imported from Canada. Four or five stuffed polar bears were already in Reno, joining the stuffed elephants, stuffed giraffes and thousands of other creatures in the

Kill a sheep, get a tax deduction.

370,000-square-foot exhibit hall.

Kill by kill, members enter an august realm known as the Inner Circle. Within the Inner Circle are ascending levels — Copper, Bronze, Silver, Gold and Diamond — each requiring a dozen or more kills. To get a Diamond in all 29 Inner Circle categories, members must slay at

least 322 animals. This year's Crowning Achiever was a man who, after a drum roll and an Oscars-type buildup, received the coveted Bronze Buffalo in honor of his "trophy animals in over 369 species." (They give trophies for trophies at Safari Club.)

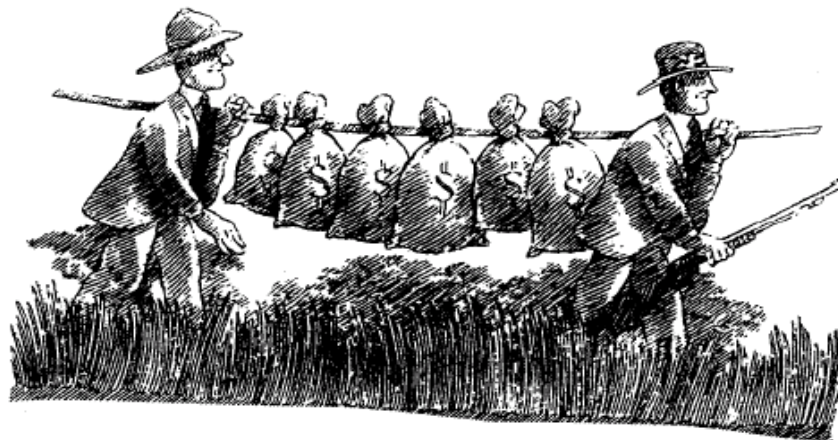
Visitors could also pick up a handy document called "Secrets of Tax Deductible Hunting," which offers money-saving tips, including the "Keep the Monster" technique: "Donate everything collected on your hunt but the one animal you really need. Very popular among sheep hunters and advanced rare species." Or there's the option to "Give Away the Monster": "Donate your record book animal for the mouth-watering tax deduction. Use the tax savings to go on another hunt." The general idea is to make each hunt pay for the next, a sort of frequent-slayer program.

Safari Club itself, as the Internal Revenue Service determined in 1985,

is a 501(c)(3) enterprise "organized for exclusively charitable and educational purposes." In one of the group's tax schemes, members become "curators" by donating their trophies to the club while agreeing to "store and maintain the collection" — each donor, in effect, declaring a portion of his house a wildlife museum. In Reno there was a seminar in which members were exhorted to name Safari Club as the sole beneficiary of their estates, with lawyers on hand to help secure tax benefits for years to come.

Hardly a wild creature on earth, however endangered or harmless, is spared from this onslaught in the name of conservation and charity. Maybe it's time for the I.R.S. to set forth on a little safari of its own.

Matthew Scully, a speechwriter in the Bush Administration, is a contributing editor of *National Review*.



Chief of Veterans Charities Grilled on Groups' Spending

By Philip Rucker
Washington Post Staff Writer
Friday, January 18, 2008; A01

A congressional investigation yesterday uncovered new allegations of questionable spending practices at two veterans charities, **including one that paid retired Army Gen. Tommy Franks \$100,000 to appear in its solicitation letters using money the nonprofit raised to help soldiers returning from [Iraq](#) and [Afghanistan](#).**

At a raucous, three-hour hearing yesterday, House members questioned [California](#) entrepreneur Roger Chapin about his management of two charities. One charity, Help Hospitalized Veterans, spent hundreds of thousands of dollars in donations that were to help wounded soldiers on personal expenses for Chapin, executive director Mike Lynch and Richard A. Viguerie, to whom the charity has awarded millions of dollars in fundraising-consulting contracts, the hearing found.

The expenses included at least \$340,000 in meals, hotels and entertainment; a \$135,000 loan to Lynch for a divorce settlement with his former wife; a \$17,000 country club membership; three airplane tickets to [Hawaii](#); and a \$1 million loan to Viguerie for a start-up initiative at his firm, several members of the committee said.

The second charity, the Coalition to Support America's Heroes, used Franks in its solicitation letters, the House Committee on Government Oversight and Reform found.

[Rep. Henry A. Waxman](#) (D-Calif.), chairman of the committee, said Help Hospitalized Veterans raised more than \$168 million from 2004 to 2006. The charity spent a quarter of those donations on the veterans, with the rest going to direct-mail fundraising, salaries and other expenses, Waxman said.

Republicans and Democrats voiced outrage over what Waxman called "an intolerable fraud."

"Most of the millions they receive never reach veterans or their families," Waxman said. "Instead, the groups waste those contributions on bloated overhead costs and self-enrichment."

There are no laws that regulate how much charities spend on fundraising and overhead costs. There also are no requirements that nonprofit groups disclose such breakdowns in their solicitations. Several lawmakers signaled yesterday that they may introduce legislation aimed at helping donors better understand the finances of nonprofit groups.

[Rep. Christopher Shays](#) (R-Conn.) asked Chapin what would happen if his charities told donors how their donations were spent.

"If we disclose, which I'm more than happy to do, we'd all be out of business," Chapin said. "Nobody would donate. It would dry up."

Chapin said few people know how expensive fundraising can be.

"If I could do better, I would," Chapin said. "I've tried television, I've tried radio, I've tried foundations, I've tried corporations and the only thing that works is direct mail."

Waxman said Chapin evaded U.S. marshals trying to serve him with a subpoena to testify at a hearing in December, but has since cooperated by submitting internal records and sitting for a lengthy deposition last week.

Chapin's nonprofit groups are two of several veterans charities under scrutiny for their spending practices. The American Institute of Philanthropy, a leading watchdog group, has suggested that Chapin's groups are among 19 military-oriented charities that manage their resources poorly.

Some other veterans charities consistently received high marks from the institute and other watchdog groups.

[The Washington Post](#) previously documented the six-figure salary that Help Hospitalized Veterans pays Chapin, as well as more than \$200 million it reported in federal tax filings to have spent on fundraising and public education campaigns from 1997 to 2005.

In one heated exchange yesterday, [Rep. Elijah E. Cummings](#) (D-Md.) questioned Chapin's compensation. In 2006, Chapin and his wife took home a combined \$561,971 in salary, bonuses and pension contributions, the committee said.

"I've tried everything under the sun to lower our fundraising costs," Chapin said.

"How about reducing your salary?" Cummings said. "You appear to be doing quite well for yourself and your wife."

"By whose standards?" Chapin shouted back.

"The public thought this money was going to veterans, but instead it went to you and your wife," Cummings said. "This sounds like a great business for you and Mr. Viguerie, but a lousy deal for contributors and veterans."

As House members introduced the committee's findings, Chapin acknowledged them and offered impassioned defenses.

"Throughout my life I have endeavored to do well for my family while I try to do good for the world," said Chapin, 75.

Defending the millions of dollars his charity pays Viguerie's firm, Chapin said he does "the best I can."

Viguerie said direct-mail flyers, stickers and trinkets do "far more" than bring in donations, raising awareness of the problems some veterans face. He said that fundraising

for a national charity is "an enormous operation." Mass-mailings are a costly way to raise money, considering high printing fees and postage as well as the limited yield on investment.

A committee member, [Rep. Chris Cannon](#) (R-Utah), expressed anger over his colleagues' harsh scrutiny of Chapin's charities.

"I am deeply concerned that we're whacking on groups that are supporting the military," Cannon said.

[Rep. Diane Watson](#) (D-Calif.) questioned expenses such as flights to Hawaii and the country club membership. Chapin said he later repaid the charity for the flights and said the golf club membership was a "perk" for board members.

Chapin then asked lawmakers about their own use of campaign funds, to which an angry Watson slammed her hand several times on the wooden dais.

"The commitment that you said you have made to veterans seems to be squandered," she said. "This is not a campaign. This is your organization that collects money to be able to give to veterans."

Diana Aviv, president of the Independent Sector, a national umbrella organization of nonprofit groups, said in an interview that donors have the right to "be ensured that the money will be used for the purposes intended."

Chapin said he did not see anything wrong with the Coalition to Support America's Heroes paying Franks \$100,000. Chapin said the former Iraq war commander helped raise millions of dollars for the nonprofit group, which it otherwise might not have collected.

"I thought it was totally appropriate," Chapin said.

A spokesman for Franks said the retired general made several speeches for the charity in 2004 and 2005, as well as allowing his name to appear on direct mailings for about a year. He ended his support "when he learned that the percentage of money raised that was going to the troops was less than 85 percent, a figure which was then and remains today, his criteria for supporting charitable organizations," said retired Col. Michael Hayes, Franks's chief of staff.

Lynch told The Post this week that Help Hospitalized Veterans meets the [Better Business Bureau](#)'s standards, but bureau President H. Art Taylor said yesterday that both Chapin charities do not.

HARTFORD COURANT

Charities' Costs Sap Aid For Vets

<http://www.courant.com/news/local/hc-vetcharity1110.artnov10,0,2361826.story?coll=hc-headlines-home>

By MATTHEW KAUFFMAN
Courant Staff Writer

November 10 2005

From daybreak on the East Coast to nightfall in the West, young men with telephone headsets line the cubicles of professional call centers, pleading with a patriotic nation.

"The American Veterans Coalition is dedicated to helping veterans right here in (state calling) who are homeless or in desperate need," reads a script created for a Seattle-area charity run by businessman Robert M. Friend. "The Foundation provides assistance for these veterans in the form of food, shelter, clothing, job search assistance and any other reasonable request.

"Do you think you could support our efforts with a gift of \$75?"

Most of the people called will hang up before the pitch is over. But this is a numbers game, and with a relentless telephone campaign, professional fundraisers in 2003 collected almost \$1 million for the American Veterans Coalition and three other charities created simultaneously by Friend.

But that dialing came at a staggering cost. Under Friend's deal with the solicitors, fundraisers pocketed 85 cents of every dollar raised. Of the money left over, half was spent on printing and administrative costs, including the rented mailbox that served as the charities' official address. The other half, Friend paid in salaries to himself and his wife.

And money spent on food, shelter or clothing for those desperate veterans?

\$0.

With Veterans Day approaching and a war raging in Iraq, Americans are opening their wallets to support homeless vets, paralyzed vets, jobless vets. Faced with a blizzard of telephone and mail solicitations, Americans donate more than \$1 million a day to veterans' groups.

But while helping veterans is a well-established and popular cause, a computer analysis by The Courant of hundreds of veterans' charities across the nation shows that, as a group, they lag far behind other nonprofits in the efficiency of their fundraising and the amount of money devoted to charitable services.

A handful of veterans' groups spend almost nothing on veterans' causes, diverting 90 percent or more of their money to administrative and fundraising costs. Scores of others claim hefty spending on charitable programs, but only by including a large portion of the cost of their fundraising drives as charitable expenses.

At the Foundation for American Veterans in Michigan, just 6 cents of every dollar raised goes to services for veterans. At the American Ex-Prisoners of War Service Foundation in Tennessee, it's 2 cents. At the American Veterans Relief Foundation in California, not even a penny.

"It's disgusting," said Trent Stamp, president of Charity Navigator, a nonprofit watchdog group in New Jersey. "You can't respect your donors if you think that people who write you a check are entitled to have 2 or 3 cents of every dollar reach veterans."

But under current laws and court rulings, almost nothing can be done about it.

Expensive Tactics

Americans have been donating to veterans' groups for more than a century, and the most successful military charities have grown into \$100-million-a-year household names. But The Courant's review showed that veterans' charities large and small still rely on expensive fundraising tactics, fueling their reputations for inefficiency.

Using financial data provided by GuideStar, a Virginia-based organization that compiles information reported by more than 1 million registered nonprofits, The Courant analyzed 286 veteran-related charities. The list generally excluded military associations, such as the American Legion and VFW posts, as well as museum and memorial funds and charities that raise less than \$25,000, the threshold for filing a detailed IRS return.

Among the findings: Veterans' groups are more than twice as likely as other charities to use professional solicitors, which typically keep 70 to 90 cents of every dollar they raise. As a result, veterans' charities overall spend a vastly greater percentage of their budgets on fundraising, leaving less money available to help ex-GIs struggling with health care, housing or financial problems.

"We actually get a lot of calls from people looking for a good veterans charity," said Daniel Borochoff, president of the American Institute of Philanthropy. He doesn't have an answer for them. Of 13 veterans' groups rated by the institute, one received a grade of C-plus and the rest earned D's and F's. The culprit in many cases: excessive fundraising costs.

Excluding small charities, American nonprofits report spending about 2 percent of their budgets on fundraising, according to the IRS. For the veterans' groups reviewed by The Courant, that figure exceeds 17 percent, and for veterans' charities that use professional fundraisers, it's 31 percent.

Likewise, charities nationwide say they spend 82 percent of their money on charitable causes, rather than fundraising and administrative expenses. For veterans' groups, the figure is 71 percent.

That gap alone amounts to at least \$150 million a year in lost charitable spending. But it doesn't tell the whole story, because loose accounting standards and weak enforcement make it easy for nonprofits to appear better on paper than they really are - by underreporting fundraising costs or treating administrative expenses as charitable program services.

Nearly half the veterans' groups reviewed by The Courant that raise money directly from the public claim to spend nothing on fundraising. And many count money paid in taxes, accounting fees, mailing-list rentals and even commissions to professional fundraisers as dollars spent for charitable services.

But others make no effort to mask their pennies-on-the-dollar numbers.

In Santa Ana, Calif., the American Veterans Relief Foundation has raised millions from the public in support of its mission of "helping veterans when they need it most." According to the charity, that includes assisting with mortgage payments and medical bills, sending "Thinking of You" packages to patients in VA hospitals and giving money to build veterans' memorials.

But out of \$3.6 million raised and spent in four years through March 2005, the foundation has paid out just \$21,000 in grants and assistance to veterans and veterans' groups. That's 58 cents in help for every \$100 donation.

And while veterans got \$21,000, professional fundraisers have collected nearly \$3 million.

William Peterson, who stepped down earlier this year as the foundation's president, said he accepted the post at the request of a friend, whom he did not identify. He would not answer questions about the charity, but said that he had not been actively involved in running the group.

Instead, the entire operation was run until recently by a for-profit business that shared office space with the American Veterans Relief Foundation and two other charities. In 2003, SR-1 Financial Services was paid \$640,000 by the charities for "administration," under an agreement in which the for-profit firm kept all but a small portion of the money turned over by professional fundraisers.

SR-1's take in 2003 was 18 times what the charities spent helping those in need.

A receptionist at the American Veterans Relief Foundation said SR-1 Financial Services is no longer in business. And in a financial audit filed with the state of Illinois in August, an accountant for the charities reported that charity officials have been interviewed in connection with a federal grand jury investigation involving the financial company.

Hitting Pay Dirt

At the American Veterans Coalition in Washington state, where veterans didn't see a single penny in 2003, the charity made a slight improvement in 2004. Last year, the group - which raised about \$1.1 million from the public - gave \$14,500 to established veterans' groups and wrote a \$500 check to one veteran's family. The rest went for fundraising, salaries, administrative costs and public awareness campaigns.

The direct take for veterans: 1.4 cents on the dollar.

It's not how charity President Robert Friend said it would be. In the group's application for tax-exempt status with the IRS, Friend and his wife, Shao Mei Wang, who serves as vice president, said they planned to spend about half their budget on direct assistance to needy veterans.

"There will not be a cookie-cutter approach to aiding clients, but rather an attempt to assess the client's individual needs in such a way as to make the client feel as if they have been noticed by those beyond their family and immediate caregivers," the pair wrote.

But while veterans have seen little from the American Veterans Coalition, Friend, Wang and their fundraisers have hit pay dirt. Between the coalition and three other charities that share the same Gig Harbor, Wash., mailbox, Friend and Wang paid themselves just under \$140,000 last year - eight times what they gave away in grants. Meanwhile, fundraising fees for the four charities approached \$1.8 million.

Friend said his salary is justified.

"That's for four charities. You should see how much work goes into running four charities," he said. "You should come sit in this chair and do this work, and do these registrations, and every rule and regulation that every state requires of you, see the expenses involved, the time that's involved, the 80 to 100 hours a week you have to put in to get this done."

He said he had no control over fundraising costs. "You have to understand that in the fundraising industry, it's very difficult to raise money without professional fundraisers," he said. "Whenever you have professional fundraisers, it brings the amount of money that can be given away down substantially, because there's such a high cost for using a good-quality fundraiser."

In the IRS application, Friend and Wang wrote that they expected fundraising to account for 20 percent of costs; in 2003 and 2004, it was 85 percent.

It's a misjudgment any novice might make. But Friend and Wang were not new to the nonprofit game. For three years before setting up the American Veterans Coalition, the couple ran a group in California called Tomorrow's Abundance, which raised money purportedly to help veterans, children with cancer and the blind. In that group's final year of operation, Friend and Wang raised and spent about \$450,000 - 94 percent of which went for fundraising, administrative expenses and salaries for the couple.

Asked about the representations in his IRS filing, Friend said he would only answer questions in

writing and hung up the phone. He did not respond to a series of questions later e-mailed to him.

Diane Besunder, a spokeswoman for the IRS, said the agency could not respond to actual or hypothetical questions about how charities spend their money, and instead provided a summary of IRS rules covering activities that can lead to revocation of a nonprofit's tax-exempt status.

Revocations, however, are rare, and the IRS has acknowledged to Congress that its resources for investigating charities have declined steadily. Between 1996 and 2001, for example, the number of tax forms filed by nonprofits jumped 25 percent, while the IRS staff charged with examining those forms dropped 15 percent.

The Senate Finance Committee is considering ways to improve oversight of nonprofits, where abuses cost the U.S. Treasury billions annually in unwarranted tax deductions. Rick Cohen, executive director of the National Committee for Responsive Philanthropy, said charities should be re-evaluated periodically to weed out those that aren't performing.

"I think for some veterans' organizations, and probably for others as well, maybe at one point they performed a valued mission, but you can't tell anymore, from their expenditures," Cohen said. "And that's probably a rationale for why some entity on a regular basis, maybe every five years or every 10 years, ought to be looking at whether a nonprofit is still delivering a valued mission warranting their tax-exempt status."

'Straitjacketed'

Although federal officials grant nonprofit status, regulation of charities is mostly left to the states. But First Amendment protections require attorneys general to prove dishonesty or theft - not simply wild inefficiency - before they can take action against a charity.

Two years ago, Connecticut Attorney General Richard Blumenthal brought suit against Connecticut Vietnam Veterans Inc. and its fundraiser, American Trade and Convention Publication Inc., which kept as much as 87 cents of every dollar raised.

But it was misuse of funds by the charity's president and the fundraiser's failure to file registration papers that led to the suit - not the paltry return on fundraising.

"We can take action against fraud and deception," Blumenthal said. "But we're straitjacketed in many significant areas, such as excessive amounts going to telemarketers or paid solicitors."

Blumenthal accused the charity's president, Edward Frederick of East Haven, of diverting tens of thousands of dollars in donated funds, which he used in part to buy liquor, cigarettes, lingerie and memberships in two online dating services. Frederick was later convicted on criminal larceny charges.

But nonprofit watchdogs say they don't believe fraud is the primary reason small veterans' charities are often inefficient. Instead, they say, many are simply naive about financial issues, making them easy targets for opportunistic fundraisers.

"It's a sector rife with amateurs," Stamp said. "A lot of people enter this sector with good intentions. It's an emotional cause. People have seen their loved ones come back - or not come back - and want to do something to help."

That leads to a lot of look-alike charities that discover they don't have the means to raise money on their own.

"If your organization does and sounds exactly like every other organization, then you rely on a professional fundraiser," Stamp said. "It's a short-term, scorched-earth policy where you don't really care about the sector as a whole and you just want to get yours now."

One Man. \$4 Million.

At the National Veterans Services Fund in Darien, Phil Kraft takes a dozen calls a day from veterans who are down on their luck or getting the runaround from the federal government. It's a one-man operation, and Kraft ran it last year with \$125,000 collected by professional fundraisers.

Kraft has been counseling vets for 14 years, and from his perspective, he runs a lean operation. But the \$125,000 that Kraft sees started out as \$4.3 million in donations from the public, before fundraising costs ate away nearly 98 cents of every dollar.

That makes the National Veterans Services Fund among the least efficient of the 286 charities evaluated by The Courant. But Kraft is unapologetic.

"It's that necessary evil, that price you pay to stick around," he said. "If it were possible for some wonderful donor to say, 'Look, here's \$1 million. Go do good deeds,' I would call the fundraisers and say, 'You know guys, it's been fun. So long.' But that's just not going to happen."

Kraft's direct-mail soliciting is done by Direct Response Consulting Services of McLean, Va., which takes a 75 percent cut. Additional printing and other fundraising costs left the charity with only 2.2 cents on the dollar.

But Kraft has nothing but praise for Direct Response, saying the company is continuously reinvesting in the business and thinking up new fundraising ideas.

"It's constantly being plowed back in," Kraft said of the company's fees. "I don't think Direct Response is buying real estate in Florida or anything."

Not Florida, perhaps. But the fundraiser's principals have done well in their home state of Virginia. Co-founder Byron C. Hughey has lived since 1992 in a six-bedroom house with a four-car garage and a pool in McLean, valued in 2003 at \$2.2 million. His business partner, Jerry Watson, lives 2 miles away in a 13-room house worth \$2 million.

Still, Kraft says high-commission fundraising is the only way he can survive, even if it means that millions in donations don't reach their intended target.

"If we're getting 25 percent of every dollar that the direct-mail fundraiser makes, that's 25 percent of something, which is better than 100 percent of nothing," Kraft said. "It's hackneyed, but it's the truth."

That rings hollow to Borochoff, the American Institute of Philanthropy president.

"That's what they say - 'It's money that we wouldn't ordinarily have' - even though it's totally disrespecting the people who gave it," Borochoff said. "Giving is a fixed pie. And money given to this guy is money not available to another charity - a more efficient charity."

Borochoff believes lawmakers should set reasonable limits on how much tax-exempt groups can spend on fundraising. He said he would favor laws requiring that large charities representing popular causes - including veterans - spend no more than 35 percent of their budgets on fundraising. Newly formed charities, those with budgets under \$500,000 a year and those that advocate for controversial causes would be exempt.

It is a proposal unlikely to find much support on the nation's highest court. The U.S. Supreme Court has consistently shot down state laws that attempted to put a cap - any cap - on how much professional fundraisers can pocket from solicitation campaigns.

The rationale: Limiting how groups can raise money might hamper the ability of advocates to advance causes, a right the court has ruled is guaranteed by the First Amendment. It is a frequent defense offered by nonprofits and fundraisers who support the status quo: Advocacy groups promoting civil rights 50 years ago or AIDS awareness 25 years ago might never have found a willing fundraiser for their controversial or unpopular causes if state laws put a limit on how much the solicitors could keep.

The court has also struck down laws that would require paid fundraisers to tell all potential donors how much of their contribution would go to charity, ruling that it would amount to "forced speech."

"I wish we could require that every telemarketer say in the first or second sentence: 'Please contribute, but you should know that 90 cents will go to the paid solicitor and only 10 cents will go to the veterans' group that you want to support,'" Blumenthal said. "That should be as straightforward as the ingredients on a box of cereal. But the Supreme Court has said that we can't require that message."

In the most recent Supreme Court case, the Illinois attorney general brought fraud charges against a fundraiser that pocketed 85 cents of every dollar raised for a veterans' group called Vietnow. The court ruled in 2003 that states can sue if a fundraiser lies to potential donors about how much money is sent to a charity. But the court maintained its ban on laws that arbitrarily limit how much fundraisers can keep.

The case took 12 years to move through the courts, and in that time, not much has changed. Vietnow is still around, and it still uses professional fundraisers. In its most recently reported year, the charity received 11.2 cents for every dollar raised, among the worst returns of the hundreds of charities analyzed by The Courant.

Rich Sanders, president of Vietnow, based in Rockford, Ill., said he runs an all-volunteer organization that has no choice but to use professional fundraisers. And he said veterans' charities don't have the same advantage as charities raising money for high-profile causes, such as disaster relief after hurricanes and tsunamis, where media coverage often drives sympathetic donors.

"I don't know that those same people wake up in the morning and say, 'You know, I think there are probably some homeless veterans on the streets that probably could use some help,'" Sanders said. "We have to have somebody ring that doorbell, so to speak, and say, 'Would you consider contributing to some veterans?'"

"We do look, we shop the market whenever our contracts come up with our fundraisers," Sanders said. But he said he hasn't found a fundraiser willing to give him a better deal. "If we could find that, we'd definitely be there."

Errol Copilevitz, a Kansas City lawyer who represents fundraisers and nonprofits, said telemarketers earn their high commissions by assuming all of the risks of a fund drive, with no upfront investment by the charities. He also said caller-ID and do-not-call lists have made it more expensive to raise money for charities, and he has a ready response when donors gripe about how little the charities net from their donations.

"When I get into a heated discussion with someone about that," Copilevitz said, "the first question I fire at them is: 'When's the last time you called up a charity that you wanted to support and asked them how to send a check to them?'"

Reporting Tricks

In an effort to empower consumers, several states now publish annual reports of fundraising drives, listing how much was raised for each charity and what percentage was kept by the fundraiser. Some states also have online charity searches that report basic financial information, including pie charts showing how much the charity says it spends on programs and fundraising.

But many nonprofits that report respectable numbers - with a high percentage of expenses apparently devoted to charitable services - spend most of that money on "public awareness," "public outreach" or "membership" campaigns that are primarily fundraising drives.

The Freedom Alliance in Dulles, Va., claims it spent 82 cents of every dollar in 2003 on program services. But that included \$2.7 million - more than half the charity's entire budget - in costs related to fundraising campaigns that were treated as "educational" costs.

The Disabled Veterans Associations in Ohio reports that just 30 percent of its spending goes to charitable services, a figure that helped it earn a failing grade from one charity-rating agency. But even the majority of that money is paid directly to a professional fundraiser, who inserts an "information piece" in each mailed request for money. Excluding the fundraiser's fees, the charity spent just 9 cents of every dollar helping veterans.

Even the largest veterans' charities count huge amounts from their fundraising campaigns as charitable programs.

The Disabled American Veterans' main operation in Cincinnati spent \$118 million last year, including \$54 million originally listed as fundraising costs. But the group shifted \$21 million into program services, counting it as a "public awareness outreach" program to donors, thereby dropping its apparent fundraising costs from 48 percent of spending to 28 percent.

Still, the DAV's use of in-house fundraising staff allows it to keep a far higher percentage of donations than it would if it relied on professional fundraisers. And while direct-mail solicitations are expensive, Susan Loth, director of fundraising for the DAV, said the method makes business sense.

"That is how we acquired our donors for a long time, and so once you acquire a donor that way, that is how the donor continues to give," Loth said. "To completely eradicate that business model would be foolish, because you'd just cut off your lifeline."

With wide variations in how nonprofits allocate their spending, watchdogs say it is important for donors to dig into a charity's finances, including what it reports on the Form 990 federal tax return that most larger charities file. But that rarely happens.

Earlier this year, Public Agenda, a nonpartisan research organization, assembled focus groups in six cities to assess how donors feel about charities. Everyone on the panels had voted in the last election, given at least \$300 to charity, belonged to a civic group and served as a volunteer.

But not one had ever looked at a nonprofit's tax return.

Joyce Glenn never bothered to do much research when veterans' groups came calling at her Muncie, Ind., home.

"They send me papers all the time - the Veterans of Foreign Wars, the veterans of this and that - and I always send a little money back," Glenn said.

That changed after a call from a fundraiser for the American Veterans Coalition. Glenn's son, a veteran, was killed in a car accident four years ago, and her county veterans' affairs office helped with his funeral.

"I felt it was time to give some back to Delaware County," Glenn said. "So I told him that I would donate if it was going to the Delaware County veterans. He said fine."

But when Glenn received an envelope to send in her donation, she discovered the money wasn't destined for a local group.

"It just made me mad. I kept insisting that the only way that I would donate through them would be for it to go to the Delaware County veterans. And then they sent me literature and my check was to go to somewhere else. And I thought, 'No, this is not right.'"

John Paul Schaffer used to be on the other end of calls like those. Schaffer, of Parkersburg, W.Va., began working for a telemarketing company called Civic Development Group as a 17-year-old high school student who was thrilled to be making \$7 an hour.

Schaffer's pitch would typically start at \$75, and then drop to \$50, and then \$35. "If the answer was still no, you'd say, 'The vets really need your help. Why don't I just put you down for a 'booster' amount of \$25?'"

And then he'd try \$15.

For common resistance lines - "I'm on a fixed income" or "I have to check with my spouse" - Schaffer kept a sheet on one wall of his cubicle, with time-tested comebacks to keep the call going.

"You pitch them until they hang up on you, basically," Schaffer said. "It's really rude."

But he said he understands the economics for charities. "They're usually guaranteed 15 percent. And all they have to do for that is give the professional fundraiser permission to use their names," he said. "The shame is that that much has to be wasted so that little bit gets through."

Bracing For An Influx

In the meantime, workers at the Seattle Vet Center, about 25 miles from the American Veterans Coalition's mailbox, are bracing for an influx of veterans returning from Iraq and Afghanistan.

"This is a prolonged period of conflict that we've been in, and we're going to have more veterans, and so the need is going to be greater now that it has been in the past," said Karl Schaffer, a social worker at the VA-funded center.

Veterans make up at least a quarter of the nation's homeless population, and counselors at the center often refer vets to local shelters and other social-service agencies that rely on donations. They know there are unmet needs and that legitimate nonprofit agencies could do more, if they had more.

"It's so gratifying when the money gets to the right place and to watch the good it does and the gratitude that veterans have for it," Schaffer said. "If there was more money there, they would sure do more with it."

It is those lost opportunities that most frustrate charity watchdogs.

"That's the tragedy in this whole thing: That you have sympathetic donors who believe in the cause, who want to support veterans, and you have veterans who need support," said Stamp, of Charity Navigator. "And somehow or another, you have inefficiencies or abuses in the middle which cause donor and recipient not to get matched up.

"That's absolutely the tragedy in this."

A discussion of this story with Courant Staff Writer Matthew Kauffman is scheduled to be shown on New England Cable News each hour today between 9 a.m. and noon.

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