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**A Note on the Economics of Philanthropy**

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# A Note on the Economics of Philanthropy

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## Abstract

This note starts with a short review of the economic literature on philanthropy. Next, it provides some estimates of philanthropic giving in advanced and middle-income economies and discusses how innovative financial instruments can leverage charitable giving. The note concludes with a discussion of the controversial aspects of philanthropic activities.

*JEL Classification:* D64, H21, H44

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# 1 Introduction

The etymology of philanthropy is *love of humanity*. Philanthropy is normally associated with an altruistic behavior that takes the form of charitable gifts of money and assets by individuals, foundations, or corporations. Philanthropy is sometimes distinguished from charity because while charity aims to relieve the suffering associated with a particular social problem, the objective of philanthropy is to address the root cause of the problem.<sup>1</sup>

In many countries philanthropic activities are encouraged with tax subsidies. In the United States, which is the country for which we have better data, charitable gifts amount to approximately 2% of GDP (about USD 400 billion in 2016) with donations above USD 2,200 for the average American household (Andreoni, 2015).

The objective of this note is to highlight a few issues that may be of interest to conference participants. With this objective in mind, we briefly review the literature on the economics of philanthropy (Section 2),<sup>2</sup> describe the state of philanthropic giving in a sample of advanced economies (Section 3), discuss how innovative financial instruments can leverage charitable giving (Section 4), and conclude by discussing some controversial aspects of philanthropic activities (Section 5). Moreover, we provide an extensive reference list for readers interested in learning more about any of these topics.

## 2 The Economics of Philanthropy

There is a large academic literature that studies philanthropy from different disciplinary point of views, including marketing, evolutionary and biological psychology, neurology, sociology, political science, anthropology, and economics. Bekkers and Wiepking (2011) review this vast literature and classify philanthropic giving into eight categories: (i) awareness of need; (ii) solicitation; (iii) values; (iv) efficacy; (v) reputation; (vi) altruism; (vii) psychological benefits; and (viii) costs and benefits.

The economic literature emphasizes the categories related to altruism, psychological effects, and costs and benefits. It focuses on the interaction among individual donors, charitable organizations, and the government (Andreoni, 2015; List, 2011).

A first strand of this literature studies why people engage into philanthropic activities. The standard assumption is that economic agents maximize their utility subject to a budget constraint (Andreoni and Payne, 2013). Charitable giving was originally modeled as arising from pure altruism in an environment in which there is no internal or external reward for

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<sup>1</sup>However, in this paper, the words philanthropy and charity are used interchangeably.

<sup>2</sup>The focus on the economic literature does not imply any value judgment. It is simply driven by our comparative advantage.

engaging in philanthropic activities (Bergstrom et al., 1986).

However, if philanthropy is a public good, self-interested individuals will have an incentive to “free-ride” on other people’s philanthropic efforts. Andreoni (1988) shows that in a growing economy purely altruistic giving converges to zero, a prediction which is not supported by the data. An alternative class of models assumes that people engage into impure altruism and obtain direct utility (a private good) from their philanthropic activities. According to the *joy-of-giving* or *warm-glow* explanation, there is a positive emotional feeling from helping others, and this warm-glow reward is part of the individual’s utility function (Andreoni, 1989).<sup>3</sup>

According to these types of models, individuals decide on their charitable activities by comparing the monetary costs of giving with their psychological benefits. As tax exemptions reduce the monetary costs of giving, other things equal, they increase philanthropic activities. Ribar and Wilhelm (2002) study the drivers of giving to charitable organizations and show that warm-glow considerations dominate pure altruism. Singer (2015) distinguishes warm-glow givers from effective altruists. He argues that the former group tends to give small amounts to many charities instead of concentrating their resources on activities in which they can have the maximum impact.

A second strand of the economic literature on philanthropic behavior focuses on the interaction between philanthropists and the government. The key objectives of this literature are the evaluation of how philanthropic donations respond to tax incentives and the design of the optimal tax structure for charitable giving. The two key concepts are *treasury efficiency* and *social efficiency*. A treasury efficient subsidy generates an increase in donations which is greater than the value of the subsidy. A socially efficient subsidy increases social welfare. Treasury efficiency is neither necessary nor sufficient for social efficiency.

Treasury efficiency can be measured with standard econometric techniques. The first step in assessing the optimal tax treatment of charitable donations consists in estimating the price elasticity of charitable giving, which measures the percentage change in the demand of a given good brought about by a one percentage change in the price of the good. Formally, the cost (or price) of a gift ( $g(1 - t)$ ) is given by the value of the gift  $g$  minus the reduction in taxation associated with the gift  $t$ . Tax deductions for charitable giving are considered treasury efficient if the price elasticity exceeds unity in absolute value (i.e., if the percentage increase in  $g$  is bigger than the percentage decrease in  $t$ ).

There is substantial variation in the estimated price elasticity of charitable giving and there are also differences between the short- and long-run effects

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<sup>3</sup>Giving can also be fully motivated by self-interest if it boosts an individual’s self-esteem or social status. Rose-Ackerman (1996) focuses on the joy-of-giving impulse according to which acts to charity generate self-satisfaction or pride.

of changes in the tax regimes. Available estimates suggest that short-run elasticities are significantly larger than long-run elasticities (these elasticities measure the permanent change in charitable donations brought about by changes in the tax code). Most studies find short-run elasticities ranging between  $-1.1$  and  $-1.6$  (indicating that a one percent tax reduction leads to an increase in charitable donations that ranges between 1.1 and 1.6 percent) and long-run elasticities that range between  $-0.4$  and  $-0.6$ . More recent studies (Sherlock and Gravelle, 2009), however, have challenged the view that tax exemptions are treasury efficient even in the short-run and suggest that the short-run tax elasticity is lower than one.<sup>4</sup>

Social efficiency is harder to evaluate because it requires formulating and evaluating a social welfare function. A tax subsidy for charitable donations is socially efficient if and only if the subsidy leads to the production of public goods with a social value which is greater than the social value of public goods that would have been produced by the state with the lost tax revenue. An evaluation of a socially optimal tax structure requires estimating the social benefits of charitable giving and comparing them with the social benefits of public expenditure. Suppose that a USD 1 tax benefit increases charitable donations by USD 1.25 (the subsidy is thus treasury efficient), then the tax benefit would be socially efficient if and only if USD 1.25 of charitable activities have a social value which is greater than USD 1 of public expenditure.<sup>5</sup>

Social efficiency is often assumed by economists when they compute price elasticities. However, the available evidence suggests that philanthropic donations are often more focused on achieving the philanthropist's objectives and preferences than to directing funds toward activities with the highest possible social value. Reich (2013) argues that there is limited evidence for this type of social efficiency of tax deductions because most donations target impure public goods and, at least in the US, tax incentives tend to be regressive and distort tax dollars towards types of expenditures that are favored by the rich. He concludes that "the subsidy rationale for justifying

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<sup>4</sup>Taussig (1967), Feldstein and Taylor (1976), Feldstein and Clotfelter (1976), Clotfelter (1985), and Tiehen (2001) find price elasticities that range between  $-1.1$  and  $-1.5$ . Randolph (1995) studies the effects of US tax reforms and finds a permanent price elasticity of  $-0.51$  and a transitory price elasticity of  $-1.55$ . Auten et al. (2002), instead, find that charitable giving is more sensitive to permanent price with coefficients between  $-0.8$  and  $-1.3$  than to temporary changes with coefficients between  $-0.4$  and  $-0.6$ . Bakija and Heim (2011) also find large and persistent price elasticity of donations which are always in excess of  $-1$ .

<sup>5</sup>Suppose, for instance, that we are passionate about the welfare of cats and we donate USD 1,000 to a foundation that takes care of abandoned cats. In the presence of tax incentives, this donation will only cost us USD 750, and USD 250 is a loss of tax revenues for the government. Further suppose that these tax lost revenues could have been used to help orphaned children. If society as a whole cares four times more about the welfare of orphaned children with respect to the welfare of abandoned cats, the tax deduction will be inefficient from the point of view of society.

tax incentives for charitable giving is not compelling, all the more so if one believes that charity ought to be mainly an activity that serves to benefit the poor” (Reich, 2013, p. 533).

While more research is needed to establish whether tax deductions satisfy the definition of social efficiency described above, Reich (2010, 2013) suggests an alternative rationale for tax subsidies. According to his view, which he calls the “pluralism rationale,” the favorable tax treatment of philanthropic donations is justified by the fact that tax subsidies contribute to creating a “diverse, decentralized, and pluralistic associational sector” which is a necessary condition for a well-working liberal democracy. In Reich’s view, the real public good provided by philanthropic organizations is not the product of the organization but the associational life promoted by organization. The public good is social capital (Putnam, 2000). If this were the case, however, there would be no rationale to give tax benefits to large donations which involve a very small number of rich donors.

The third strand of the economic literature studies whether public grants crowd out private donations. While earlier studies found no evidence of crowding out, Payne (1998) finds that government grants have a large negative effect on private donations. Successive work by Andreoni and Payne (2003) decomposes this crowding out effect into two potential transmission mechanisms: the substitution of private charity for government grants through taxes, and a reduction in the fundraising efforts of organizations that receive government grants. Using US data, they find that grants have a large negative impact on fundraising activities (a result which is corroborated by Andreoni and Payne, 2011). Specifically, they find that a government grant of USD 10,000 to a charity only increases the charity’s resource by USD 2,500 because private giving decreases by about USD 7,500. More than two-thirds (USD 5,250) of this reduction in private giving is caused by a reduction in fundraising activities by the charity. Interestingly, Andreoni et al. (2014) find no evidence of a crowding out effect for charities based in the United Kingdom.

The finding that public sector grants reduce fundraising effort led to a literature aimed at studying the drivers of fundraising activities and the importance of matching grants. Karlan and List (2008) and Huck and Rasul (2011) conducted a series of experiments and found that individuals respond to the presence of matching grants but not to the level of the match. A campaign with a one-to-one match raises the same amount of private funds as a campaign with a three-to-one match.

Summing up, the economic literature shows that tax incentives are efficient in increasing philanthropic donations and in substituting for public grants. There are, however, two key gaps in this literature. First, we do not know much about the socially efficient level of tax incentives. Second, most of the existing literature focuses on the US because it is hard to find good data for other countries.

### 3 Measuring Philanthropy

This section starts by describing the main trends in philanthropic giving in both advanced and middle-income economies, and by comparing philanthropic giving targeted to developing countries with official development assistance flows (ODA) and with overall philanthropic giving. It shows that a relatively small fraction of philanthropic giving is directed towards developing countries. There is, however, substantial cross-country heterogeneity which may also be explained by differences in data quality and coverage.

Next, we illustrate the main trends of philanthropic giving in the US, which not only is the largest donor, globally, but is also the country with the best data, and briefly describe the activities of US foundations.

We then present some data on the number of foundations that operate in different European countries and conclude with some trends about Swiss foundations.

#### 3.1 Global Trends

The 2030 Agenda of the Sustainable Development Goals (SDGs) calls for a greater role for philanthropy in tackling global challenges. A recent OECD study which surveys more than 100 private philanthropic foundations in various countries finds that philanthropic activities toward the SDGs focus mainly on general health and education issues (62% of the total), followed by agriculture, forestry and fishing (9%), and government and civil society (8%). Africa (29%) and Asia (16%) are the main recipients, but only one third of giving is directed to countries classified as least developed countries. Two thirds of the allocation go to middle-income countries (OECD, 2017).

The Center for Global Prosperity (CGP) at the Hudson Institute estimates that global philanthropic giving to developing countries increased from USD 42 billion in 2006 to over USD 64 billion in 2014 (Figure 1). In 2014, the US accounted for nearly 70% of total philanthropic giving (Figure 2), followed by the UK (8%), Japan (7%), and Germany (3%). Overall, the 10 largest donor countries account for 95% of total philanthropic giving to developing countries. With 1.1% of total philanthropic giving, Switzerland is 9<sup>th</sup> in this ranking, just after the Netherlands and before South Korea.

These differences in philanthropic giving are influenced by differences in economic size. For instance, with a total GDP of nearly USD 17 trillion, the US economy is about 25 times the Swiss economy. Scaling charitable donations to developing countries by GDP leaves the US and the UK as top donors with 0.25% and 0.16% of GDP respectively, but also moves small countries like Ireland, Belgium, and Switzerland ahead of larger economies like Japan and Germany (Figure 3).

It is also worth noting that there are large cross-country differences in ODA to developing countries. For instance, in Sweden and Norway,



ODA is above 1% of GDP, while in another four countries (Denmark, UK, Luxembourg, Netherlands), ODA is above or close to the 0.7% of GDP target. In the US and Japan, instead, ODA is below 0.2% of GDP (Figure 4). It is thus possible that citizens of certain countries like the US prefer to donate to developing countries through private philanthropic activities, while citizens of Nordic countries favor tax-financed ODA.

However, there is no clear tradeoff between private philanthropy and ODA. On average, countries with more generous official flows also have larger private flows. A regression of ODA flows on private philanthropic flows to developing countries shows a positive and statistically significant correlation between these two variables, indicating that a one percentage point increase in private flows is associated with a two percentage points increase in official flows. Figure 5 shows that the US - and to some extent, Norway, Sweden, and Denmark - are outliers in this positive correlation between private and official donations to developing countries.

If we add up ODA to charitable giving to developing countries, we find that Sweden, Norway, and Denmark become the top three donors (relative to their GDP, Figure 4), the UK moves to the 4<sup>th</sup> position and the US is no longer among the 10 most generous countries. With 0.4% of GDP, the US is now ranked 12<sup>th</sup>, just below Ireland and above Australia.

Data on philanthropic giving for a sample of 24 advanced and middle-income economies are also available from the Charities Aid Foundation (CAF). There are two key differences between CAF and CGP data. First, while CGP only reports data for philanthropic activities directed toward developing countries, the CAF dataset reports data on total philanthropic giving. Second, while CGP data are available for every year over the 2006-2014 period (with a gap between 2011 and 2014), CAF data are available only for one year and not for the same year in all countries (for instance, US data are for 2014 and Swiss data are for 2011).

According to CAF data, in 2014, US philanthropic donations amounted to more than 1.4% of GDP, followed by New Zealand and Canada (both close to 0.8% of GDP) and then the UK, Korea, and Singapore (Figure 6). Data on total donations paint a different picture from data on donations to developing countries. A comparison of the two datasets suggests that in the US, total donations are nearly 6 times larger than donations to developing countries, while in Switzerland, Sweden, Japan, and Ireland donations to developing countries absorb almost all of charitable donations (Figure 7).

These differences are partly due to the fact that the two datasets are not comparable.<sup>6</sup> However, they are also likely to depend on preferences and on the way in which social services are provided. Countries where non-profit private institutions are large providers of education and health care services

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<sup>6</sup>In fact, in the case of Switzerland giving to developing countries is larger than total giving!

are more likely to have a large share of domestic philanthropic activities directed to these institutions.<sup>7</sup>

The bottom line is that data are sparse and hard to compare. More investment in data collection is needed and international organizations such as the OECD and the World Bank could contribute to this effort. The US is a good example of what type of data could be collected and disseminated.

### 3.2 Philanthropic Giving in the US

In the US, charitable donations increased from USD 133 billion in 1990 to more than USD 390 billion in 2016. As a share of GDP, however, donations decreased slightly from about 2.5% to just above 2% in recent years (Figure 8).

More than 70% of donations come from individuals, 15% from foundations, 8% from bequests and the remaining 5% are corporate donations (Figure 9). In terms of recipient sectors, about one-third of donations are directed to religious organizations. The second and third largest recipients are educational institutions (15%) and human services (12%) which include charities, such as food-banks and homeless shelters, that provide direct help to people in need (the Red Cross is included in this category). Foundations collect 10% of donations and health care institutions 8%. Finally, about 6% of donations are for international affairs and 5% for art and culture (Figure 10).

While foundations only contribute to 15% of US giving, they are important players because some of them are very large and, as a group, have assets which are close to USD 1 trillion.<sup>8</sup> The 85,000 US foundations are far from being homogenous. While, on average they have assets just above USD 1 million, the largest 50 US foundations have assets that surpass USD 2 billion each. Moreover, the largest 5 US foundations have assets above USD 10 billion, with the Gates foundation comfortably above the USD 40 billion threshold (Figure 11). In 2014, the average foundation gave away USD 700,000, while the largest 10 foundations donated nearly USD 8 billion (Figure 12). In 2016, the Gates Foundation made grants for USD 4.3 billion.

### 3.3 European Foundations

In Europe, the philanthropic sector is smaller than in the US in terms of total giving, but larger in terms of the number of foundations. According to the Donors and Foundations Networks in Europe (DAFNE), an informal network which covers 23 countries and includes approximately 7,500 foundations and

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<sup>7</sup>Differences in the provision of such services cannot explain the case of Italy, where donations according to CAF data are 55 times larger than donation to developing countries.

<sup>8</sup>According to the Foundation Center, total assets stood at USD 865 billion in 2014 (Foundation Center). If we apply a 6% growth rate (the average growth rate over 2002-2014), we obtain a value of USD 975 billion for end 2016.

grant makers, there are approximately 141,000 foundations that operate in Europe versus the 85,000 foundations that operate in the US. The large majority of European foundations are family foundations (about 90% in Germany, Italy and the UK, 85% in Belgium, and nearly 60% in France), while less than 50% of US foundations are family foundations ([The Economist Intelligence Unit, 2017](#)).

A study of ultra high-net-worth individuals (defined as individuals with investible assets - excluding personal assets and primary residences - of at least USD 30 million) estimates that total lifetime giving by these households amounts to 12% of assets in the US and 9% in Europe ([The Economist Intelligence Unit, 2017](#)).

DAFNE data show substantial cross-country variation, with more than 20,000 foundations in Germany and Hungary, and less than 5,000 in France.

In terms of foundations per thousand inhabitants, Liechtenstein, Hungary, Switzerland, Sweden and Norway are the top five countries. With nearly one foundation every three inhabitants, Liechtenstein is an outlier. The other four countries range between 13 and 21 foundations per thousand inhabitants (Figure 13). The largest five European countries have less than 3 foundations per thousand inhabitants (2.5 in Germany, 1.9 in the UK and Spain, 1.1 in Italy, and 0.6 in France).

### 3.4 Swiss Foundations

The first Swiss foundation was created in 1354 as part of the will of Anna Seiler, a rich widow from Bern. The will stated that:

In the knowledge that nothing is more certain than death and that nothing is more uncertain than the hour of death... I wish to establish a hospital, in which 13 bedridden and needy persons should be accepted, as well as three honest people to look after them.<sup>9</sup>

Over a period of nearly 700 years, this institution, now named Inselspital (the hospital of the island), has become the main hospital in the Swiss capital.

This long philanthropic tradition notwithstanding, it is difficult to find data on charitable activities in Switzerland. The main source of information is the Center for Philanthropy Studies (CEPS) at the University of Basel which collects data on the foundations which are listed in the Swiss Commercial Registry.

CEPS data show that since 1990 the number of Swiss foundations has more than doubled, from 5,165 to 13,172. The charitable sector increased at constant rate of about 4-5% until 2009, but slowed down afterwards (Figure 14).

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<sup>9</sup>Mirza F. (2004). Bern hospital has long history, Swissinfo.

As mentioned in the previous section, Switzerland has a large density of foundations per thousand inhabitants with respect to other European countries. However, there is a large cross-canton heterogeneity. For instance, Basel-city has the largest density with 46 foundations per thousand inhabitants, followed by Glaris with 30, and Grisons with 24.9. However, Aargau and Thurgau have less than 10 foundations per thousand inhabitants (Figure 15).

Another interesting feature is the distribution of foundation purposes. Overall, 23% of Swiss foundations are active in culture and leisure activities, followed by social services (22%), and education and research (20%). Less than 5% of Swiss foundations are religious (Figure 16).

## 4 Philanthropy meets the Markets

Traditional philanthropic activities consist of donating money to worthwhile causes. One source of concern is that philanthropic donations are just a drop in the bucket and cannot make a dent in the world's most pressing problems.

Consider, for instance, aid to developing countries. In 2014, total philanthropic donations to developing countries amounted to USD 64 billion (Figure 1) and ODA flows amounted to USD 146 billion (about 10% of these flows are for humanitarian assistance, Carbonnier, 2015), for a total of USD 210 billion. This total is between 4% and 6% of the estimated cost of reaching the Sustainable Development Goals by 2030, which ranges between USD 3.3 and USD 4.5 trillion per year.<sup>10</sup>

It is possible to leverage traditional philanthropic activities by using financial instruments which fund profitable activities that also have a positive social impact. This is the idea behind the concept of impact investing.

The phrase “impact investing” was coined in a 2007 meeting convened by the Rockefeller Foundation. It describes an investment approach that has the dual objective of generating measurable social impact alongside a financial return. The two key words in the definition of impact investing are “objective” and “measurable”. The intentionality of achieving social returns is central in the definition of impact investing and so is the measurability of these returns.

One challenge of impact investing is the identification of the tradeoffs between impact and financial returns.<sup>11</sup> Depending on the primary goal of the investment, impact investing is often categorized as either “financial first” or “impact first”. An impact first strategy is mostly focused on addressing a particular problem, at the cost of sacrificing some level of financial return. A

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<sup>10</sup>Maasho A. (2015). U.N. conference agrees on plan to finance development goals, Reuters.

<sup>11</sup>Grabenwarter and Liechtenstein (2017) argue that such a tradeoff does not exist and that investors can maximize both profits and impact. However, this view is, by the authors' admission, unconventional.

financial first strategy aims at maximizing financial returns while also having an impact on a specific problem.

A second challenge has to do with the definition and measurement of impact. This process involves four steps (So and Staskevicius, 2015): (i) defining impact and developing metrics and data collection methods to monitor impact; (ii) conducting due diligence aimed at estimating impact; (iii) collecting data and using the metrics defined under the first step to monitor impact; and (iv) conducting ex-post assessments of the social impact of the investment project. Not all types of outcomes are easily measurable and there are practical and conceptual challenges in implementing these four steps.

Over 2013-15, the impact investment sector grew from USD 25 billion to USD 35 billion (The Global Impact Investing Network, 2016) and some authors have estimated that the sector could reach USD 500 billion by 2020 (World Economic Forum, 2013, reports recent estimates which range from USD 400 billion to USD 1 trillion). However, these estimates seem optimistic as the sector would need to grow at an annual rate of 70% over 2015-20 to reach the USD 500 billion target. If the sector continues to grow by 20% per year, it will reach USD 90 billion by 2020.

Growth, however, could be much faster if foundations decide to allocate a large share of their assets to impact investing. For instance, US-based foundations extent grants for approximately USD 60 billion per year and have assets close to USD 1 trillion. Under the classic model of philanthropy, the foundations focus on how to best allocate the grants, while the assets are managed to maximize returns (possibly under some responsible investment negative screen, where the guiding principle is “do no harm”). In this traditional model, foundations only use a part of their balance sheet to achieve their objectives. With impact investing, they can put their full balance sheet at work.

There is evidence that young philanthropists are keen to leverage their grant-making activities with the asset side of their foundations’ balance sheet. A recent survey found that, while more than 45% of older donors think that financial donations are important, only 25% of millennials think that they make the biggest differences. Young philanthropists seem to be more interested with self-sustaining models such as impact investing (The Economist Intelligence Unit, 2017). They are not alone, even the Catholic Church is moving in this direction after Pope Francis suggested that there is a “precious and primordial unity between profit and solidarity”.<sup>12</sup>

Impact investing can leverage and catalyze standard (i.e., for profit only) investment by de-risking new business models which, once are up and running, can then tap the commercial capital market. Of course, impact investment

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<sup>12</sup>The Economist (2017). Faith, hope and impact: The Catholic church becomes an impact investor.

is not for everything, as there are many philanthropic activities that cannot generate economic returns.

Impact investing is part of a broader trend which is sometimes referred to as social finance. Social Impact Bonds (also known as Pay for Success Bonds) are among the most innovative products in the social finance landscape. Social Impact Bonds are contracts with the public sector in which repayment is conditional to achieving a certain social outcome ([Social Finance, 2016](#)).

Social Impact Bonds are different from standard debt contracts because they do not offer a fixed rate of return (or a return which is linked to some other interest rates). They are instead, equity-like instruments in which the return depends on the outcome (in this case the social impact) of a certain investment project. Repayments are either made by the government, using the savings which derive from improved social outcomes, or by donors interested in achieving a determinate social outcome.

The first Social Impact Bond was launched in the UK in September 2010. The proceeds of the GBP 5 million bonds were used to finance the rehabilitation of 3,000 short-term inmates from Peterborough prison. Repayment, by the Ministry of Justice and the Big Lottery Fund, was conditional to a 7.5% reduction in reconviction rate. The program was successful (the reoffending rate of short-sentenced offenders dropped by 9% through 2015) and the 17 original investors were repaid in full.

The Peterborough bond was followed by more than 60 social bond initiatives that have raised more than USD 510 million in 16 countries ([Floyd, 2017](#)). The largest players are the UK (32 Social Impact Bonds) and the US (10 Social Impact Bonds).

Development Impact Bonds are a variation of Social Impact Bonds with a specific focus on developing countries. One key difference with respect to Social Impact Bonds implemented in advanced economies is that in many developing countries the government cannot generate enough revenues to fund social programs. Hence, some or all of the payments need to be provided by external funders. A report by the [Center for Global Development and Social Finance \(2013\)](#) describes the opportunities and challenges of building a market for Development Impact Bonds.<sup>13</sup>

An interesting example is the Programme for Humanitarian Impact Investments launched by the International Committee of the Red Cross (ICRC) in September 2017.<sup>14</sup> The program, which is modeled after the Social Impact Bonds, can be described as the first Humanitarian Impact Bond.<sup>15</sup>

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<sup>13</sup>The International Finance Corporation, the private sector arm of the World Bank, has also developed a social bond program targeted to developing countries. However, these social bonds are different from those described above because they are issued to invest in commercial companies which are supposed to be financially viable and able to generate the revenues necessary to service the bond.

<sup>14</sup>For a primer on Humanitarian economics, see [Carbonnier \(2015\)](#).

<sup>15</sup>However, like other social impact bonds, the Programme for Humanitarian Impact

The initial funding of CHF 26 million will be used to build and manage three new physical rehabilitation centers in Nigeria, Mali, and the Democratic Republic of Congo. The pilot phase will last five years and in this period, the program will be under constant evaluation. In 2022, the five donors that participate in the program (i.e., the governments of Belgium, Switzerland, Italy and the UK, and the Spanish “la Caixa” Foundation) will pay the ICRC an amount which is contingent on the efficiency of the three centers.<sup>16</sup> The ICRC will then use these funds to pay back the initial social investors which include a subsidiary of the Munich Re Group and the Geneva-based bank Lombard Odier.

One natural question is why do we need such a complicate financial contract? Why doesn’t the donor (or the government in the case of Social Impact Bonds in Advanced Economies) directly fund the social service or development activity that needs to be provided? And if a government intervention is needed to promote social finance, what is the market failure that justifies such intervention?

Proponents of social finance suggest that the answer to these questions has to do with risk-sharing and incentives. The main advantages of a Social Impact Bonds with respect to directly funding a social program is that the Social Impact Bonds transfer the risk of unsuccessful interventions to a third party which has stronger incentives to monitoring the service provider because its payment depends on achieving the target. Moreover, Social Impact Bonds come with a built-in evaluation process which enhances the transparency of public service delivery.

There are, however, also potential risks associated with these innovative forms of financing. There is the risk that most funds will go to activities with measurable outcomes or where the likelihood of success is very high. This may leave unfunded equally important programs which are either riskier or harder to evaluate.

## 5 The Dark Side of Philanthropy

There are two main sources of controversy about philanthropy. The first has to do with the tax treatment of philanthropic donations and the second relates to the power of large foundations.

According to [Reich \(2013\)](#), in 2011, US tax subsidies for charitable giving amounted to nearly USD 54 billion. Total giving in the US that year was about USD 300 billion. Hence, nearly 20% of “donations” were actually funded by the US taxpayer. The situation is made worse by the fact that

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Investments is not a proper bond because it is privately placed and non-tradable.

<sup>16</sup>The efficiency of the three centers will be verified by independent auditors. If the results are above the benchmark specified in the contract, the social investors will receive a bonus. If instead, the performance is below benchmark, the investors will lose part of their capital.

in the US, tax subsidies for philanthropic donations tends to be regressive (i.e., for any given donation, richer taxpayers tend to receive a larger subsidy, [Thaler, 2010](#)). In Reich's (2013) words: "foundations do not simply express the individual liberty of rich people. We all pay, in lost tax revenue, for foundations, and, by extension, for giving public expression to the preferences of rich people."

As discussed in Section 2 of this note, there is a large literature aimed at estimating whether tax subsidies are treasury efficient. A treasury efficient subsidy generates an increase in donations which is greater than the value of the subsidy. However, treasury efficiency is neither necessary nor sufficient for social efficiency. A tax subsidy is socially efficient if and only if the subsidy leads to the production of public goods with a social value which is greater than the social value of public goods that would have been produced by the state with the lost tax revenues. This may be the case, but at this stage, we have no hard evidence in either direction.

There is also the issue that generous subsidies for charitable donations may create incentives for gaming the system. For instance, in the US there is an ongoing discussion on the growing importance of Donor Advised Funds (DAF). Over 2010-15, the value of assets held in DAFs doubled to approximately USD 80 billion. According to some, DAFs are efficient instruments for channeling money towards charitable activities. However, there is also evidence that DAFs are used to evade rules that require foundations to give at least 5% of their assets each year and to direct money to political campaigns and lobby groups by individuals who want to hide their identity.<sup>17</sup>

The issue of the political power of large philanthropic organizations is discussed in detail in a [2014](#) essay by Gara LaMarche, the former head of two large US-based foundations (Atlantic Philanthropies and the Open Society Institute).

LaMarche recounts that he started having doubts about "the legitimacy of philanthropy in its engagement with the democratic process" when the leaders of American philanthropy joined forces in opposing President Obama's proposal to cap the income tax deduction for charitable contributions in order to fund his health care reform. LaMarche states that:

What that situation made plain to me was not just that philanthropy is quite capable of acting like agribusiness, oil, banks, or any other special-interest pleader when it thinks its interests are jeopardized. It helped me to see that however many well-intentioned and high-minded impulses animate philanthropy, the favorable tax treatment that supports it is a form of privatization. Money that would otherwise be available for tax revenue that could be democratically directed is shielded from public control for private use.

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<sup>17</sup>[The Economist \(2017\)](#). [Give and Take: A philanthropic boom: "donor-advised funds"](#).



LaMarche is also worried about the power of large foundations to influence the decision-making process in developing countries. For instance, according to Luis Garret of the Council of Foreign Relations (quoted in LaMarche), the Gates Foundation's focus on a small number of big diseases has crowded out funds from primary care, nutrition, and transportation. There are also claims that caregivers that administer vaccination program funded by the Gates Foundation are instructed to downplay the importance of diseases that cannot be prevented with vaccines.

LaMarche does not focus on these examples to criticize the Gates Foundation, which he praises for its willingness to accept criticism and change behavior when necessary, but to emphasize the fact that large philanthropies are powerful players that can influence the democratic process while they have limited accountability. He also applies this criticism to policies he favors.

Not all criticisms come from liberal observers. There is also criticism from conservative scholars who think that tax subsidies to charitable giving favor left wing causes and that there is no justification for giving subsidies for charities that target foreign countries. For instance, Judge Posner, probably the most prolific conservative legal scholar in the US, wrote that:

A perpetual charitable foundation, however, is a completely irresponsible institution, answerable to nobody. It competes neither in capital markets nor in product markets (in both respects differing from universities), and, unlike a hereditary monarch whom such a foundation otherwise resembles, it is subject to no political controls either. It is not even subject to benchmark competition... I also question the appropriateness of American foundations' spending money abroad. A foreign aid program is an instrument of U.S. foreign policy that can be undermined by private expenditures in the amount now being spent abroad by the Gates Foundation. And I have trouble understanding why American taxpayers should (via the tax breaks for charitable giving) help finance foundations' contributions to foreign countries... There is a further question, given that Gates and Buffet remain active in business, how much of their charitable giving is actually in support of their businesses. ... The Gates Foundation helps to polish Microsoft's image. There is nothing wrong with corporate image building, but there is no reason to favor it with tax breaks.<sup>18</sup>

Posner's discussion of the role of foundations was a response to a blog post by Gary Becker, the winner of the 1992 Nobel Memorial Prize in Economic

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<sup>18</sup>Posner R. (2006). [Charitable Foundations - Posner's Comment, The Becker-Posner Blog](#).

Sciences, that argued that “foundations are much too prone to spend their resources on the latest popular causes and fads”.

## 6 Conclusion

We started by defining philanthropy as *love of humanity*, and love of humanity should undisputedly be a good thing. And yet, not everybody agrees.

Critics from the left and the right question the rationale for subsidizing charitable giving and worry about the political power of large foundations.

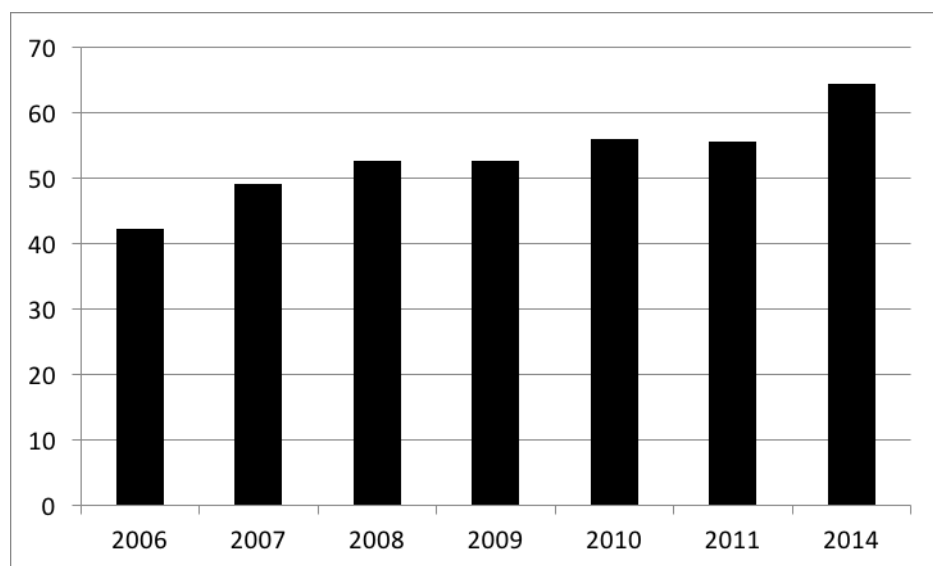
The issue is that we do not know enough. We do not have good models to evaluate the social efficiency of philanthropic activities. Most research aimed at evaluating the treasury efficiency of tax subsidies for philanthropic activities focuses on a small number of countries (mostly the US and the UK) for which we have good data.

Peter Drucker famously stated that “If you can’t measure it, you can’t improve it”. More and better data are necessary for evaluating and improving philanthropy. Many foundations ask for independent evaluations of the activities of their grantees, and donors have tools for evaluating the financial efficiency of charities. However, taxpayers do not have tools for evaluating the overall effectiveness of the charity sector.

More research is needed. Is anybody interested in funding it?

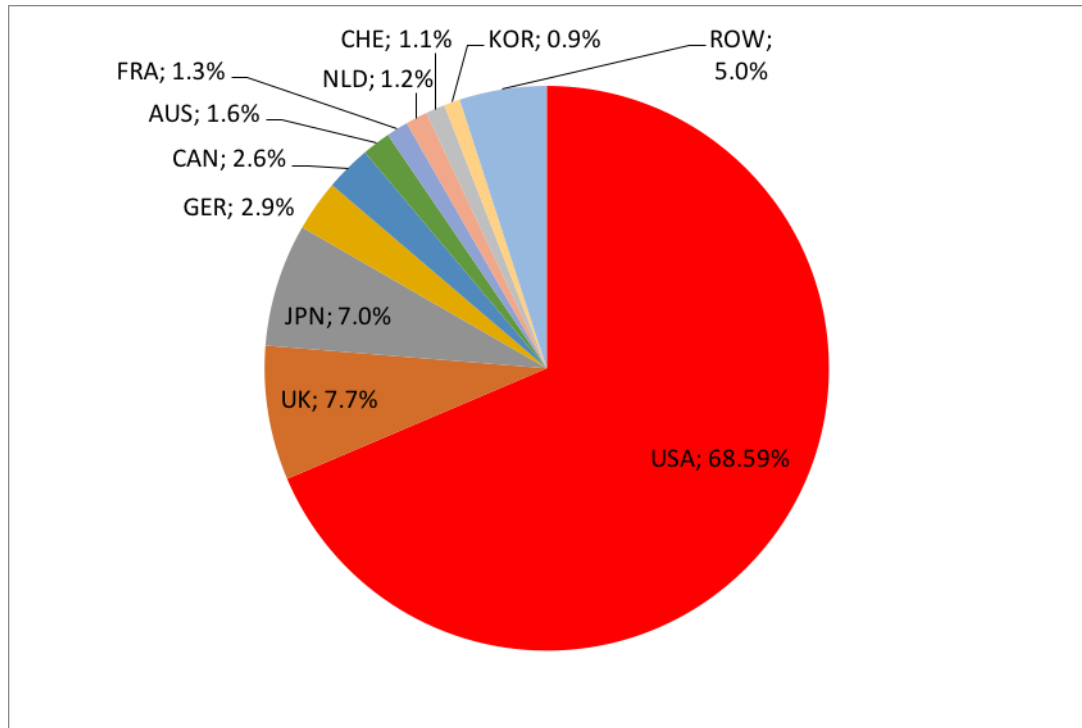
## Figures

**Figure 1:** Total philanthropic donations to developing countries (billion USD)



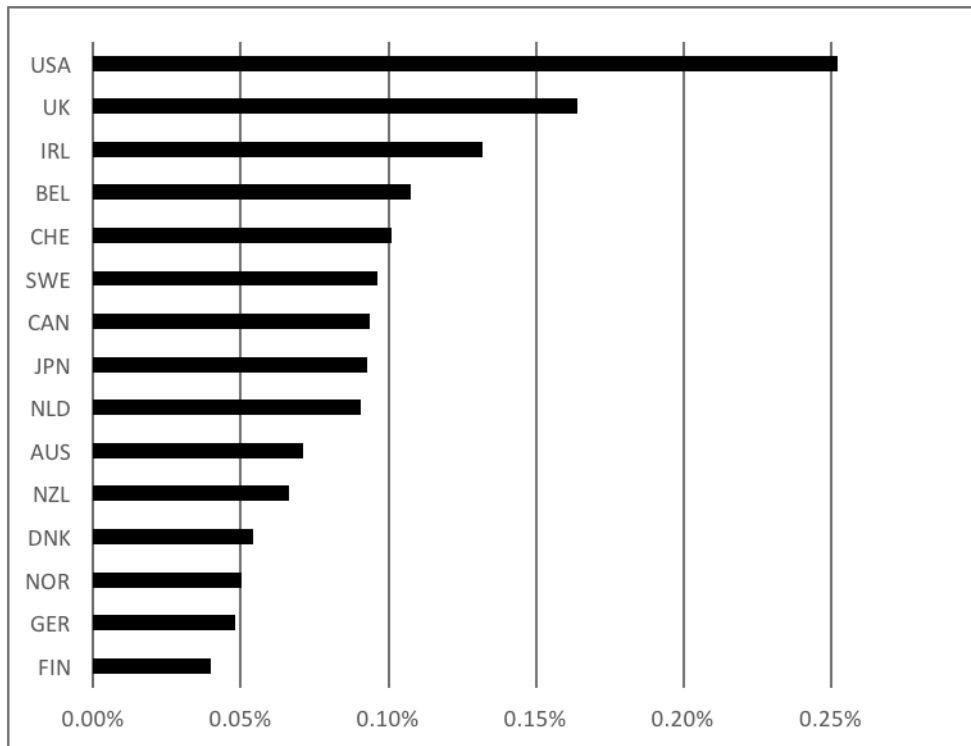
Source: Own elaborations based on data from the Center for Global Prosperity, Hudson Institute.

**Figure 2:** Country shares of philanthropic donations to developing countries



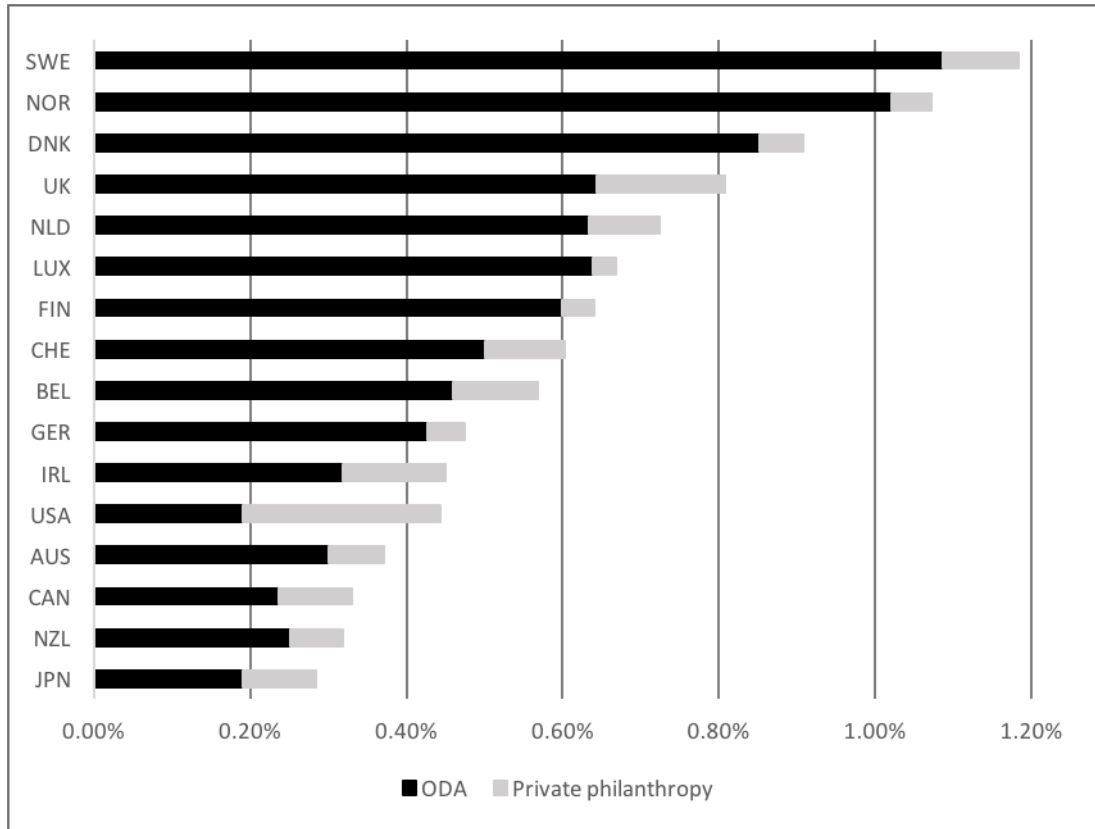
Source: Own elaborations based on data from the Center for Global Prosperity, Hudson Institute. Data are for 2014.

**Figure 3:** Total philanthropic donations to developing countries (percent of donor country GDP)



Source: Own elaborations based on data from the Center for Global Prosperity, Hudson Institute. Data are for 2014.

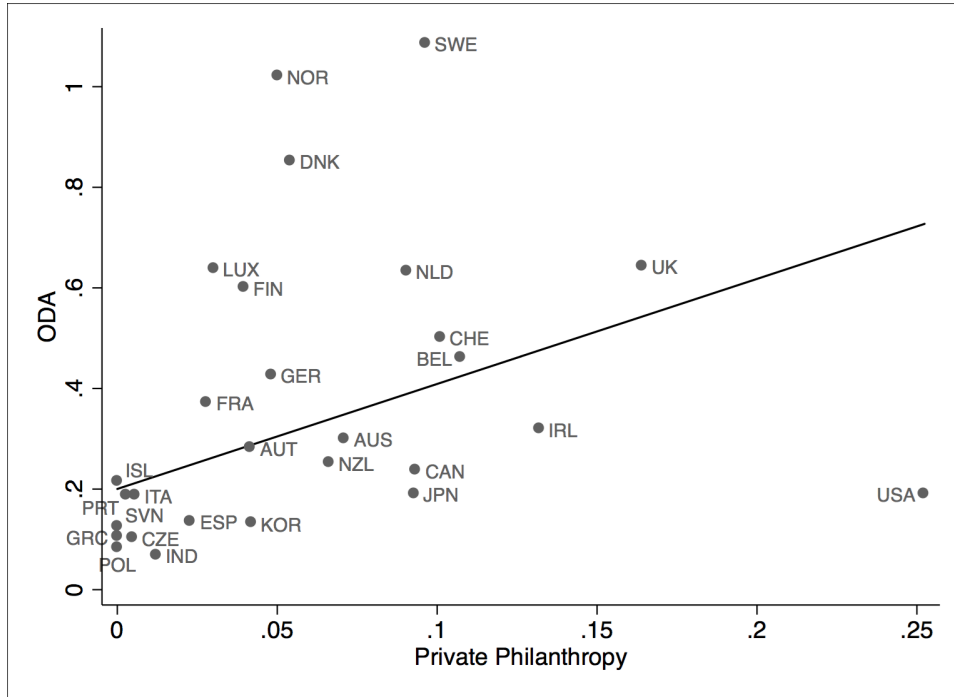
**Figure 4:** Total donations (ODA plus private philanthropy) to developing countries (percent of donor country GDP)



Source: Own elaborations based on data from the Center for Global Prosperity, Hudson Institute. Data are for 2014.

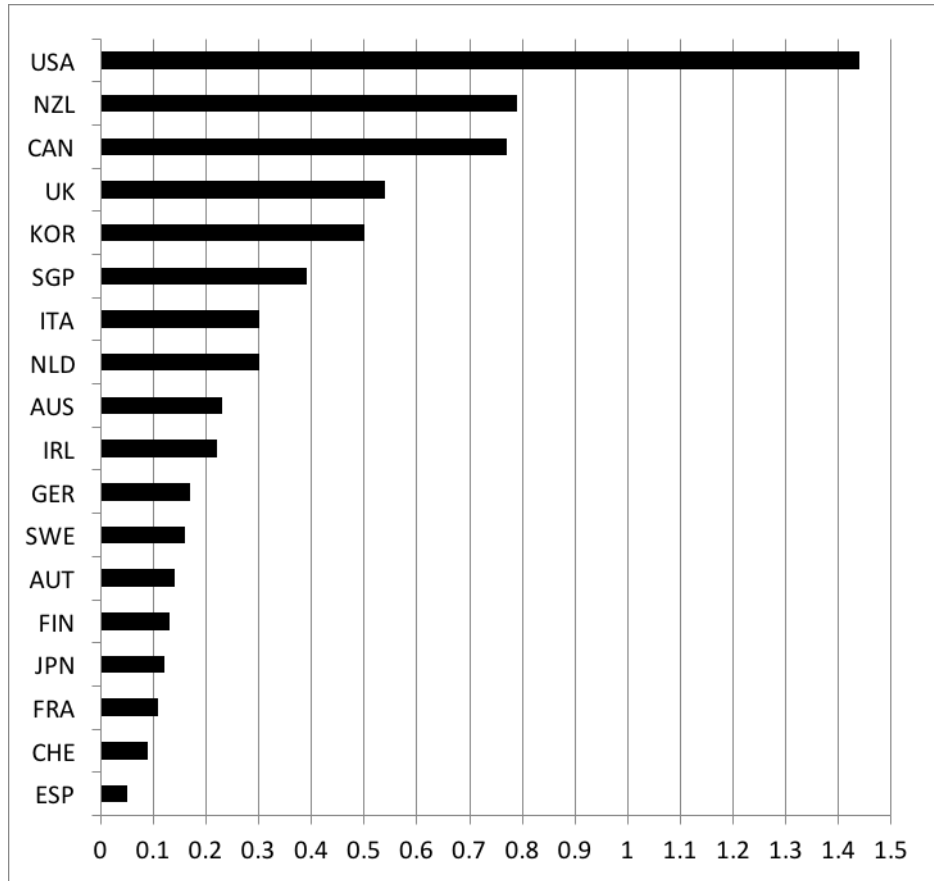
**Figure 5:** ODA versus private philanthropy

Note: The x-axis plots private donations as a share of GDP and the y-axis plots ODA as a share of GDP. Data are for 2014.



Source: Own elaborations based on data from the Center for Global Prosperity, Hudson Institute.

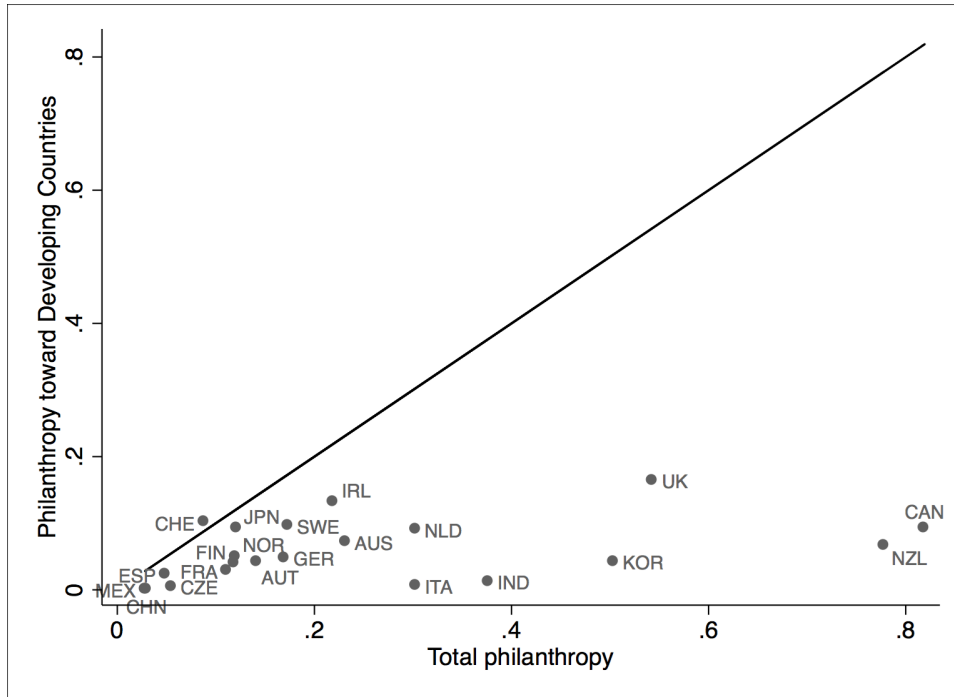
**Figure 6:** Total philanthropic donations as percent of GDP (various years between 2011 and 2014)



Source: Charities Aid Foundation.

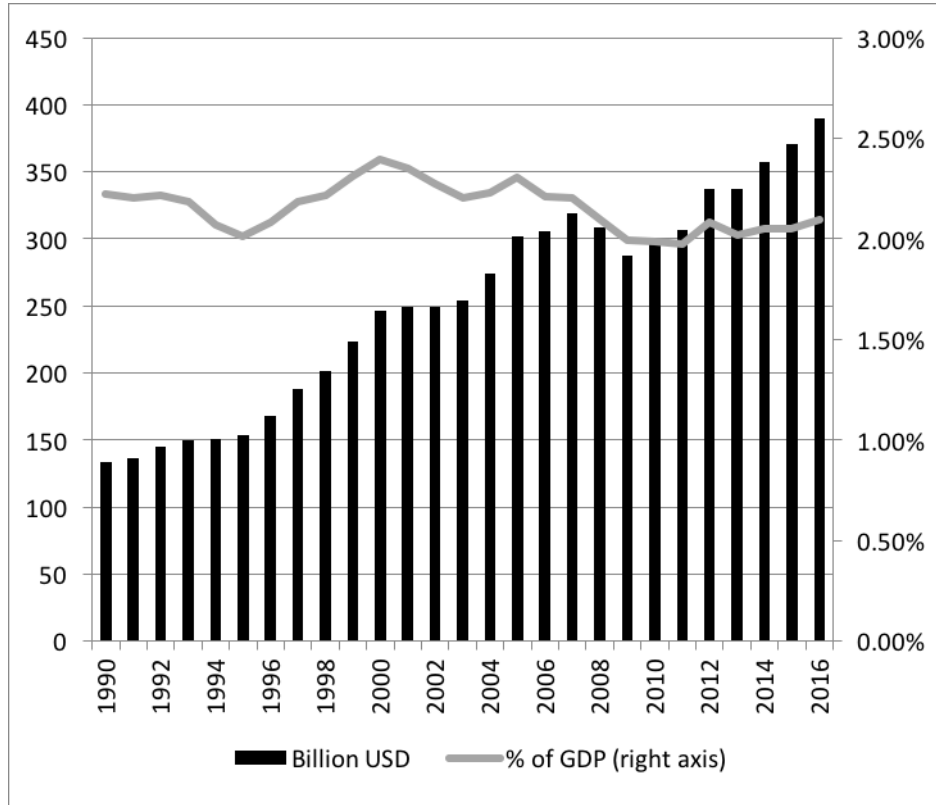


**Figure 7:** Total philanthropic donations versus donations to developing countries (percent of GDP)



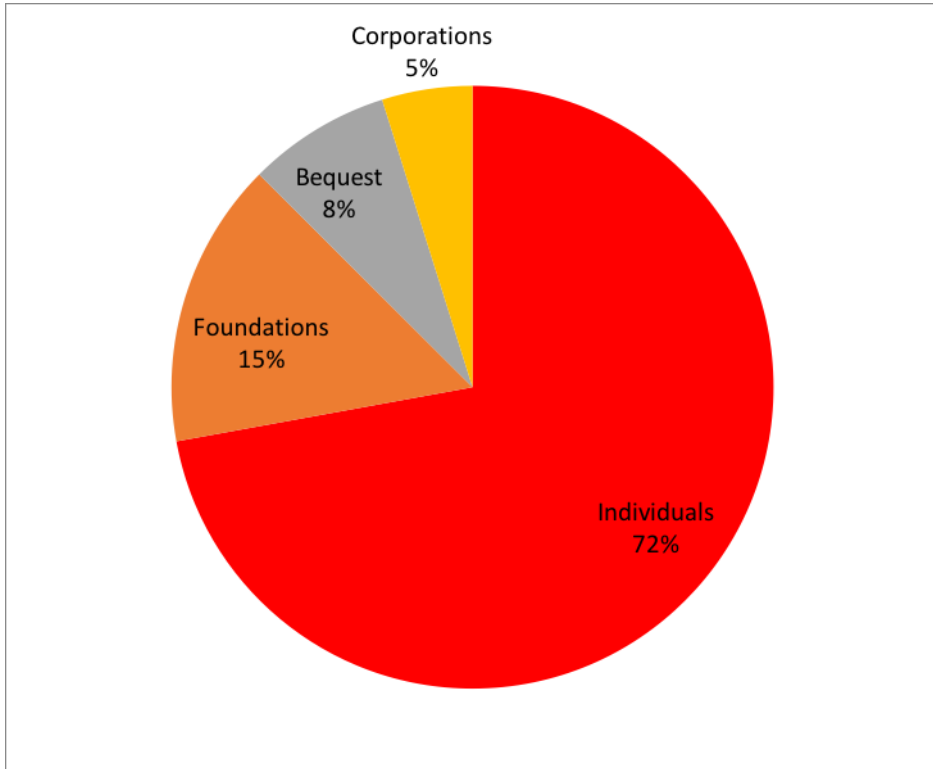
Source: Own elaborations based on data from the Center for Global Prosperity and the Charities Aid Foundation. The US are not included in the graph to prevent distorting the picture.

**Figure 8:** Charitable donations in the US



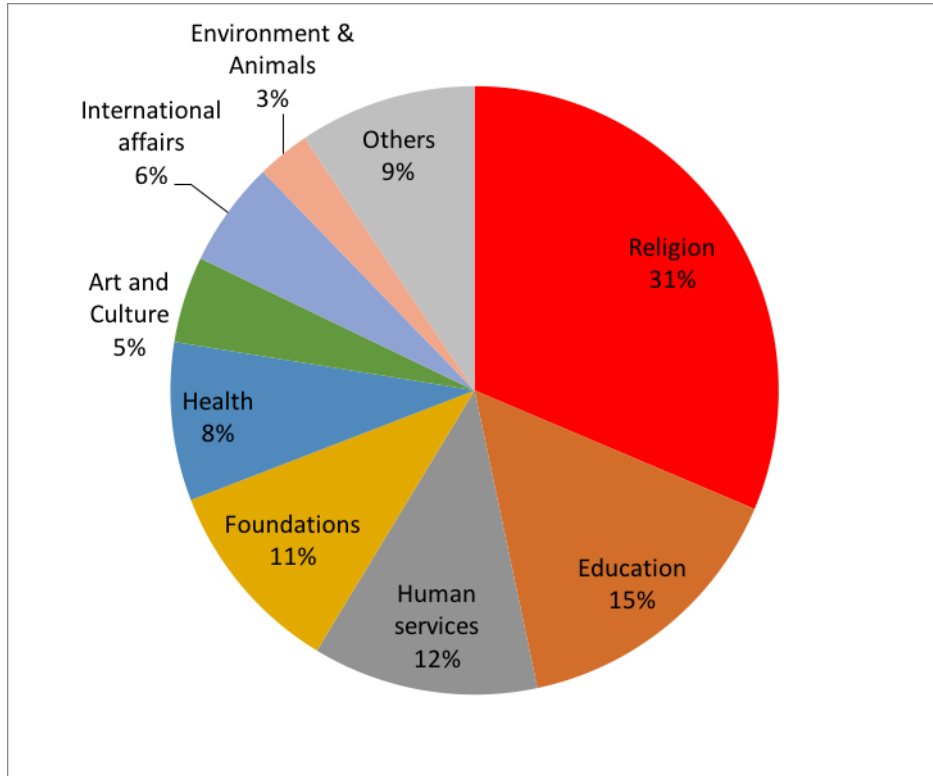
Source: Own elaborations based on US Giving Data.

**Figure 9:** Sources of charitable donations in the US



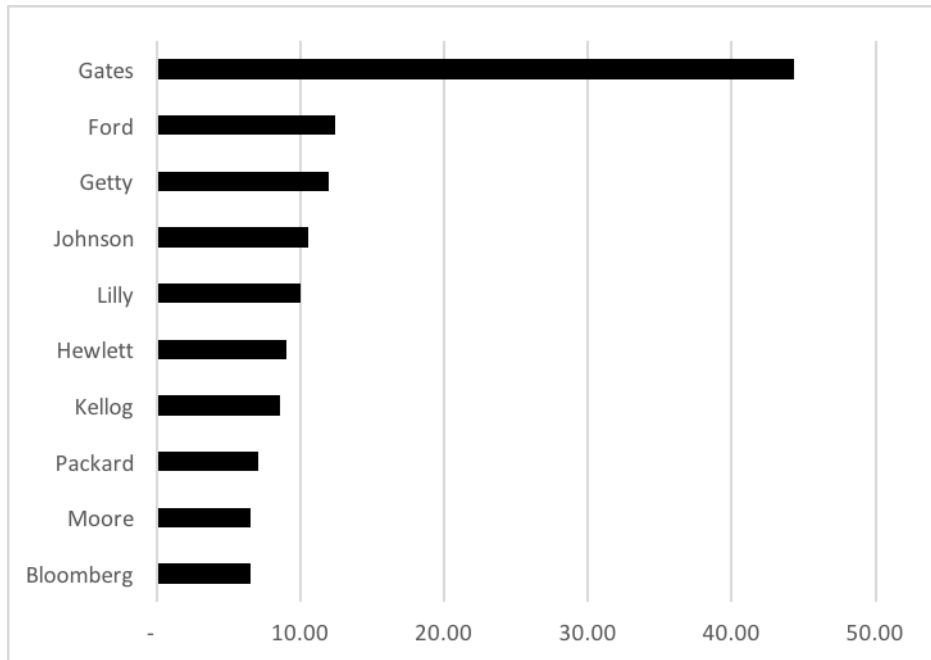
Source: Own elaborations based on US Giving Data. Data are for 2016.

**Figure 10:** Recipients of charitable donations in the US



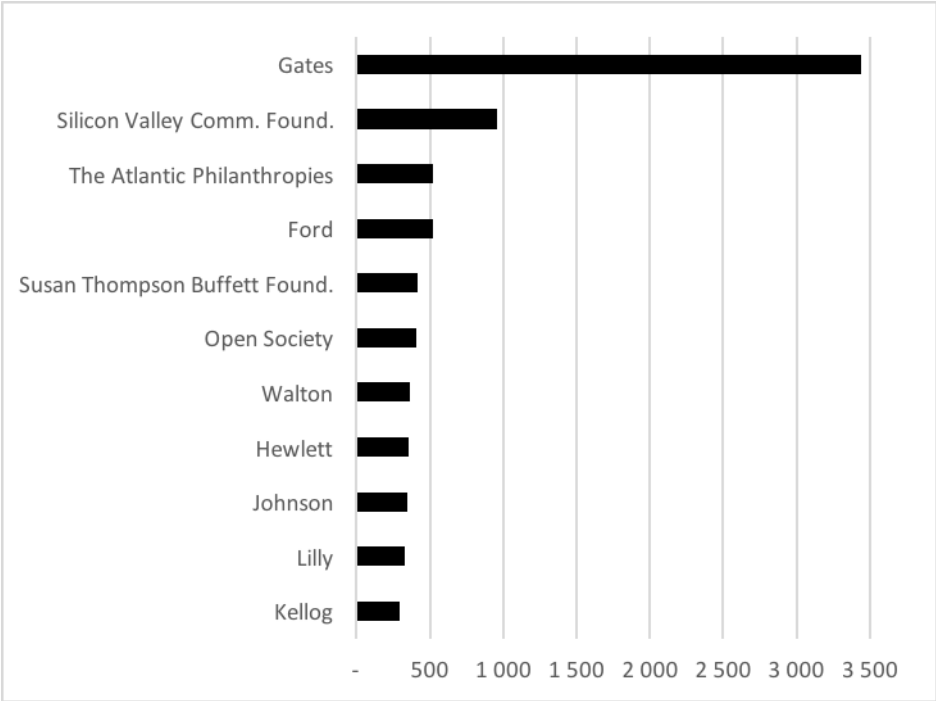
Source: Own elaborations based on US Giving Data. Data are for 2016.

**Figure 11:** Largest 10 foundations in the US by assets (billion USD)



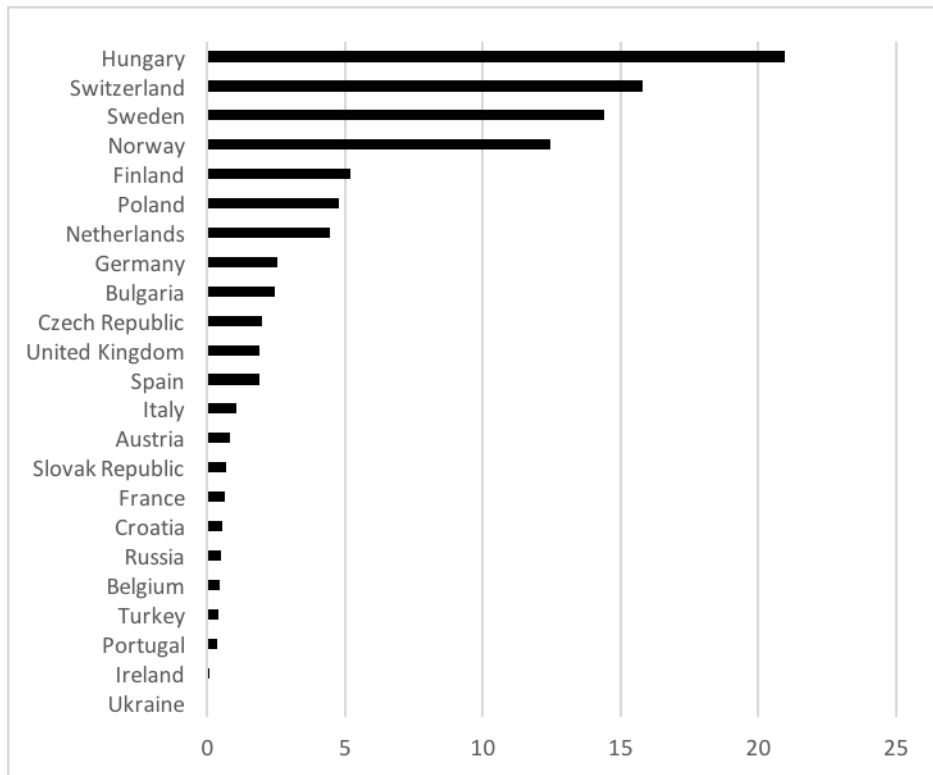
Source: Own elaborations based on Foundation Center data. Data are for 2014.

**Figure 12:** Largest 10 foundations in the US by giving (million USD)



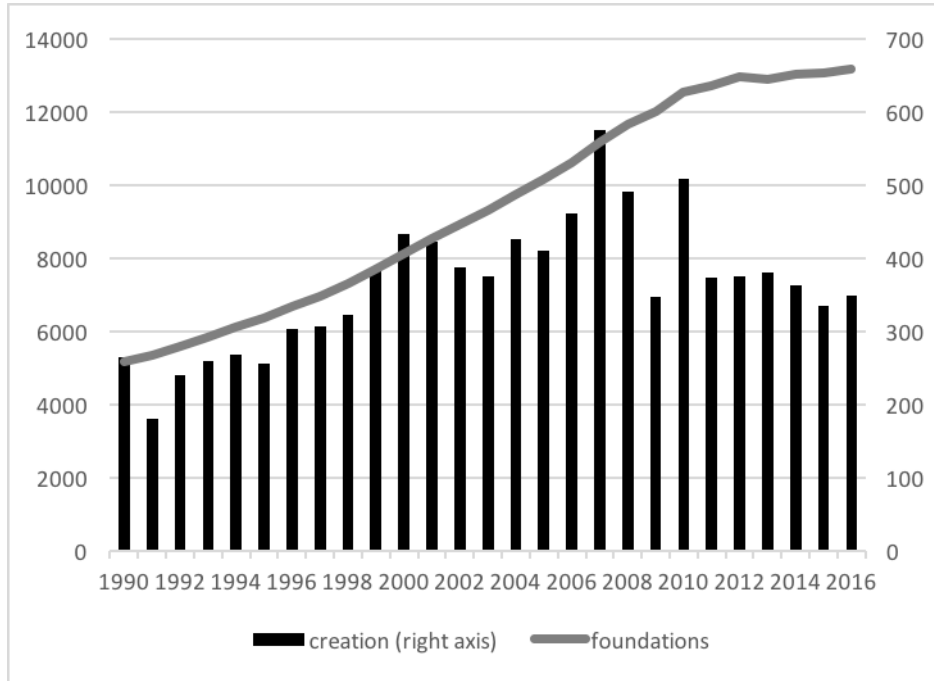
Source: Own elaborations based on Foundation Center data. Data are for 2014.

**Figure 13:** Density of European Foundations (number of foundations per 1000 inhabitants)



Source: Own elaborations based on DAFNE data.

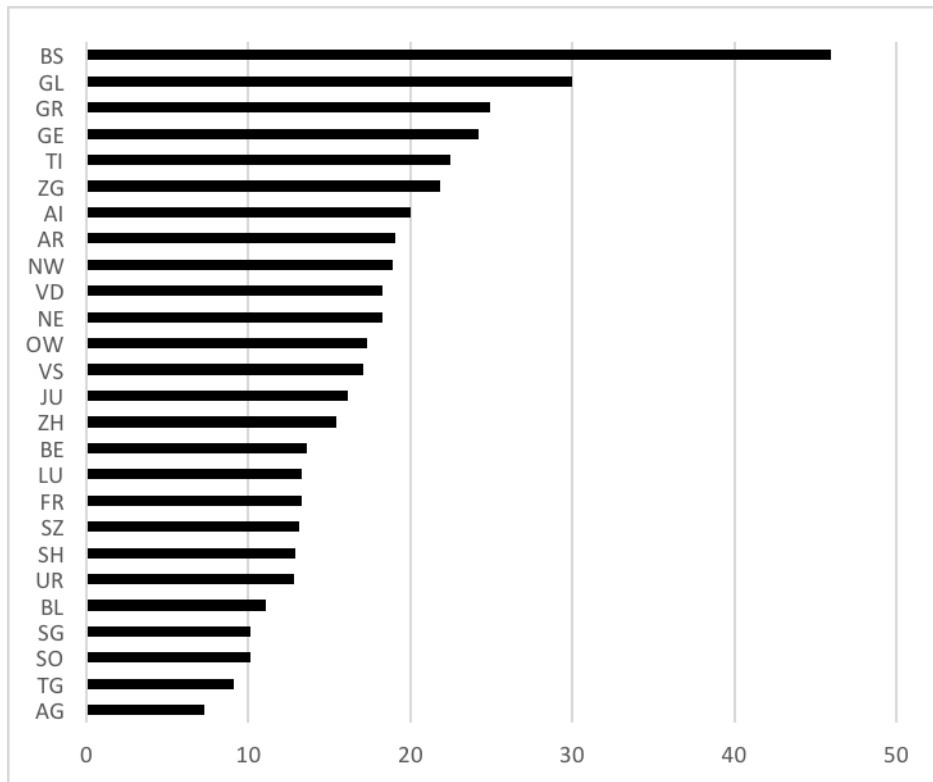
**Figure 14:** Foundations in Switzerland



Source: Own elaborations based on CEPS data.

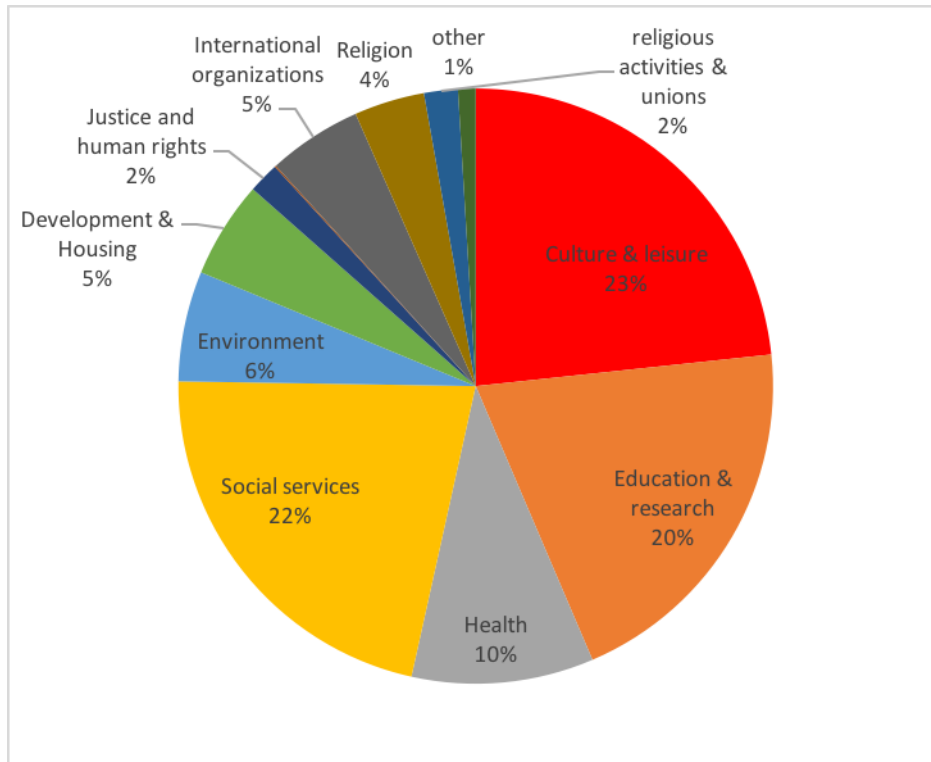


**Figure 15:** Density of Swiss foundations, by Cantons (number of foundations per 1,000 inhabitants)



Source: Own elaborations based on CEPS data. Data are for 2016.

**Figure 16:** Recipients of charitable donations in Switzerland



Source: Own elaborations based on CEPS data. Data are for 2016.

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