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The Growth of Nonprofits

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The Growth of Nonprofits:
A Reality Check

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Wouldn't it be nice to keep all of your income rather than giving up some of it to the government in the form of taxes? You can't legally get out of your responsibility to pay taxes, but there are organizations often referred to as "nonprofits" in the economy that are free from paying taxes. The Internal Revenue Service (IRS) calls them Exempt Organizations since they are exempt from paying most types of taxes. You have probably encountered one or more of these nonprofits recently. Organizations such as churches, the Boy Scouts, the Campfire Girls, your local museum and the public library are likely to be nonprofits. So how many nonprofits are there in this country? First consider how many nonprofits might exist nearby. Perhaps you would guess there are about a thousand nonprofits in your state. If your state is somewhat representative of the remainder of the states then there would be approximately 50 times a thousand or 50,000 nonprofits in the country. You would be underestimating by a very large amount! The IRS granted tax exempt status to 53,086 organizations in 2002 alone. There are currently over 1.4 million tax exempt organizations in this country at this time according to the database kept by the IRS (not including many churches).

Nonprofits are organizations that are formed with the intention of providing some good or service without the promise of monetary rewards like a private business enterprise. Organizations intent on making the owner or owners rich are considered "for-profits." It seems counter to economic theory that someone would create a nonprofit organization since the motivation of financial reward has been removed. However, there are other things besides wealth creation motivating some people (apparently) since many nonprofits are created each year. Their motivation is to provide goods or services to people in the hopes of improving their community. At least that is the intention of the laws governing and authorizing the operations of nonprofits. These laws are generally focused on allowing the nonprofit to forgo paying business or income taxes since they are expected to be performing a public service. Thus, as you can imagine taxes play a very important role in the creation of a nonprofit.

Even long before this country had an income tax there were those who provided for the public good with private wealth. The people were usually the extremely wealthy such as Andrew Carnegie. Carnegie, upon retirement at the beginning of the 1900's, decided to dedicate his time to spending his great wealth on projects he considered important to the public welfare. He wrote about his motivation in a document that became know as his "Gospel of Wealth" (Carnegie, 1889) where he discussed the three options people like him have in disposing of excess wealth. One could leave the wealth to family, which he considered to be a huge mistake. A better solution was to bequeath the wealth for specific public purposes after the person died, but he considered this option disgraceful. The best option was to use the wealth for the greater good during the life of the possessor. To this end Andrew Carnegie created a foundation to administer the use of his great wealth for purposes he deemed important in solving the problems between rich and poor and return his wealth to the "mass of their fellows in the forms best calculated to do them lasting good." Such an organization today would be exempt from paying income taxes on gains made by investing the wealth so long as the organization provided an adequate amount of goods or services for the benefit of the public and no individual owns or benefits from those investment returns. Of course Carnegie's motivation might not have been totally unrelated to taxes. The first exemption from income taxes was instituted in the first federal income tax rules under the Tariff Act of 1894. Carnegie wrote his opinion essay on wealth in 1889, just five years before. He would have very likely been involved in discussions among the politicians and wealthy in this country debating the need for taxation to provide for expanded government funding.

In addition to being exempt from taxes, some nonprofits (not all) also get an additional special consideration from our system regarding taxes. Some nonprofits, often known as charities, can receive contributions and the contributor gets a tax deduction for the gift.

This tax deduction reduces the contributor's taxable income and thereby reduces the amount of taxes they pay. This creates an incentive for people to give to charities. It has the added effect of lower tax revenues needed to pay for public goods and services coming from the government. This arrangement has the effect of empowering individuals with the ability to choose which public goods and services they want to be funded. People who like the programs offered by the government will simply pay their taxes. People who want their tax money spent on programs provided by nonprofits (charities) will withhold their taxes from the government by giving it directly to the nonprofits. However, those people will have to contribute a greater amount to the nonprofit to get the full impact of their taxes since their tax deduction will only reduce their taxes by a percentage according to their income level. So the incentives influencing charitable giving are complicated but involve avoiding taxes, controlling the types of goods and services, controlling who provides the goods and services, and altruism, the desire to help others.

The most common legal form of nonprofit organization is known as a 501(c)(3). This number refers to the section of the IRS code that defines the rules for the nonprofit. There are actually many other 501(c) sections of the IRS code defining nonprofits as shown below:

(1) Gov Instrumentality
(2) Title-Holding Corp
(3) Charitable, Educ, Literary, Cruelty Prevention, Public Safety, Religious, Scientific
(4) Civic, Employee Assoc, Social Welfare
(5) Agricultural, Horticultural, Labor
(6) Trade Board, Business League, C of C, Real Estate Board
(7) Social, Recreational, Pleasure
(8) Fraternal Beneficiary
(9) Voluntary Employees Beneficiary (non-gov)
(10) Voluntary Employees Beneficiary (gov)
(11) Teachers Retirement
(12) Life Ins, Mutual Ditch, Mutual Telephone
(13) Burial, Cemetery
(14) Credit Union, Other Mutual Corp
(15) Mutual Insurance (non-life or marine)
(16) Crop Financing Corp
(17) Unemployment Trust
(18) Employee Funded Pension
(19) War Veteran Orgs
(20) Legal Service Org
(21) Black Lung Trust
(23) Veteran Assoc (pre 1880)
(24) Trust (4049 ERISA)
(25) Title Holding for Pension
(26) High Risk Health Ins (State-sponsored)
(27) Workers' Comp Reinsurance (State-sponsored)
(40) Apostolic and Religious Org (501(d))
(50) Coop Hospital Service (501(e))
(60) Coop Service of Operating Educ Org (501(f))
(70) * Child Care Org
(71) * Charitable Risk Pool
(80) Not defined in handbook
(81) * Tuition Program (State-sponsored)
(90) Not defined in handbook
(91) Not defined in handbook
(92) Private Foundation
(93) Not defined in handbook

The determination of being exempt from taxes depends on which section of the code the organization is best characterized. The most common type of exempt oganization is the 501(c)(3) nonprofit entity. Data from the Internal Revenue Service's Exempt Organizations Master Listing from 2005 will serve as the basis for this study.

According to these data there are more than one million nonprofits in existence. The number of new nonprofits obtaining exempt status has been increasing dramatically. At the turn of the century, when Andrew Carnegie created his foundation, the number of nonprofits was very small. As Figure 1 shows, the number of new nonprofits per year was about 20,000 in the late 1960s and thirty years later in the 1990's there were almost 50,000 new nonprofits created each year.

If we allow for a reasonable amount of variability there appears to be several distinct periods of stability in the entry of new nonprofits organizations. In other words there are periods of time where the numbers of new nonprofits per year remained relatively constant. The first period was the pre World War II period. During that period there were very few new nonprofits added per year. The second period is the post World War II, or early Cold War, period where approximately 10,000 new nonprofits made their entry into the economy. The third observable period begins with the Vietnam War and continues until the end of the Cold War. Marked by civil unrest and major changes in social conditions within the United States, this period experienced a doubling of the number of new nonprofits per year to 20,000. Most of the century is divided into these three periods of relatively constant growth. However, in the latter part of the decade a new trend appeared. Starting around 1991 the number of new nonprofits per year increased every year. The rate jumped to almost 50,000 per year by 2000. Recall that the previous constant trend was only 20,000 per year. Within approximately ten years from the end of the Cold War the number of new nonprofits per year more than doubled. During the same time period the U.S. economy experienced the longest economic expansion in its history.

For much of the century the new nonprofits each year were almost split evenly between organizations qualifying for deductible contributions and those not qualifying for deductible contributions. The share of organizations qualifying for deductions was slightly greater than those not qualifying. However, the share of new nonprofits per year qualifying for deductible contributions has been increasing since the late 1970s. Figure 2 shows the growth of those organizations seeking and obtaining deductibility status.

However, new nonprofits not qualifying for deductible contributions have remained fairly constant for long periods of time as seen in Figure 3. Deductibility was clearly a desirable objective for organizations being created.

While there are just under 130,000 nonprofits that are not categorized as a 501(c)(3) organization and still qualify for tax deductible contributions, this represents a small fraction (13 percent) of the 1.4 million nonprofits in existence. The vast majority of nonprofits approved to receive tax deductible contributions are categorized in subsection 3 of section 501(c) of the IRS code.

In order to maintain an organization's tax exempt and deductibility status they must continue to operate under the conditions described at the time of their ruling date. If the structure of the organization changes in ways that the operations could benefit certain individuals, it could lead to a loss in exempt status. Therefore the managerial hierarchy is important as well as forms of compensation if they exist. In addition, for organizations receiving contributions that are tax deductible the source of annual revenues and how those are translated into final products are of major importance. There are not enough individuals with Andrew Carnegie's wealth to account for the large numbers of new nonprofits, so an examination of the type of organization as it relates to funding is next.

Up to the late 1960s the mixture of organization types varied widely. However, starting around 1970 the variability declines and a pattern emerges. Organizations with substantial government funding or general public support and organizations with minor investment funding and substantial general public support appear to capture the majority share of new nonprofits per year. These two types of organizations share one critical characteristic: they obtain substantial funding support from the general public. The combined shares of these two types of organizations appears

Figure 1: New Organizations per Year

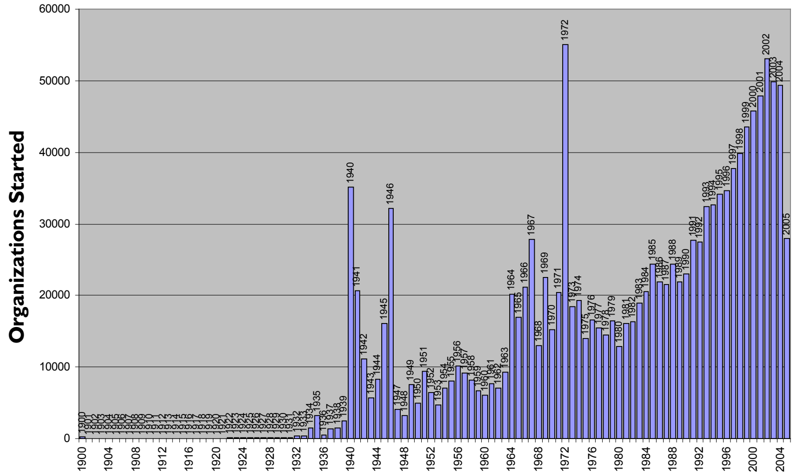


Figure 2: Contributions are Deductible

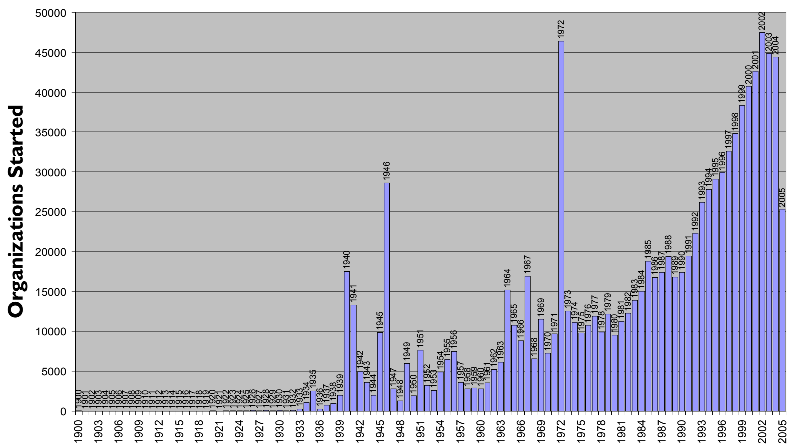
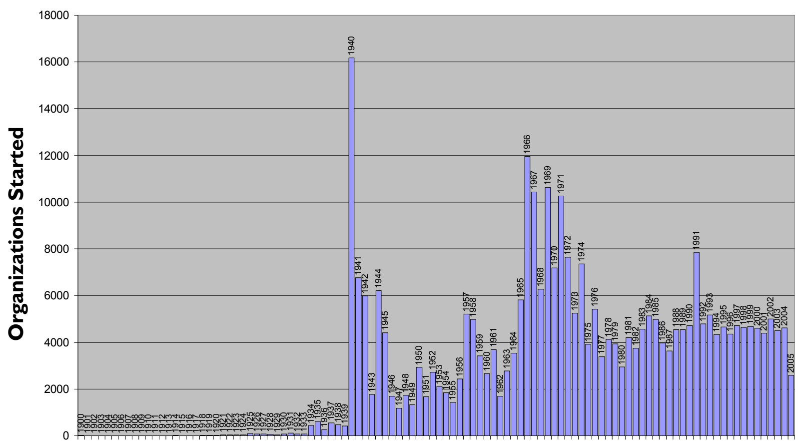


Figure 3: Contributions are not Deductible



to dominate and have the effect of stabilizing the variability overall. The possible types of organizations are listed below:

(00) Not 501(c)(3)
(02) Private Operating (exempt from excise or investment income taxes)
(03) Private Operating (other)
(04) Private Non-Operating
(09) Suspense
(10) Church
(11) School
(12) Hospital or Medical Research
(13) Government Unit (benefiting college)
(14) Government Unit
(15) Org w/Substantial Gov or General Public Funding
(16) Org w/Minor Investments and Major General Public Funding
(17) Orgs Supporting 10 to 16
(18) Public Safety Testing

After 1972 variability disappears almost completely for private non-operating organizations. These private non-operating organizations were declining since the mid-1950s, but since 1972, with a 5% share, have been steadily growing to almost 20% in 1996. Non-operating means these organizations manage funds and make them available to other nonprofits rather than produce any goods or services for the public themselves. After 1996 it declined as organizations with substantial government funding or general public support dominates. These organizations with substantial government support or general public support have been taking shares from organizations with minor investment funding and substantial general public support and churches since the early 1970s. In other words government funds have been playing a greater role in the funding of nonprofits.

Since the early 1990s, the predominant share of new nonprofits went to government-supported organizations. This gain in government-funded organizations came at the expense of organizations supported by funds from the general public initially and then later at the expense of private non-operating organizations. The trend shown for private non-operating organizations are very similar to the growth in the economy including the bubble and subsequent recession in 2000 and 2001 respectively. As private wealth grew so did the number of nonprofits based on funding from private wealth. The share of new nonprofits of the "churches" type has remained fairly constant during the same time. In summary the trend favors the growth of publicly supported organizations that receive their funding from government units and the general public, especially in the years since the bubble burst and the chances of new individuals becoming wealthy have declined.

In addition to how a nonprofit is organized, the activities they actually get involved in help determine whether they belong in the 501(c)(3) category. These activities are what they are doing primarily or exclusively. Any significant change in an organization's activities can become a reason to revoke their tax benefits.

Activities for new nonprofits have changed over the last half of the century. New organizations involved in religious activities stabilized a little during the mid-1970s and then grew slightly through the 1980s. The list of possible activities is shown below:

(1) Religious
(2) Schools and Colleges
(3) Cultural, Historical, and Other Educational
(4) Training and Other Instruction
(5) Health Services
(6) Scientific Research
(7) Business and Professional Organizations
(8) Farming
(9) Mutual Organizations
(10) Employee or Membership Benefit
(11) Sports, Athletic Recreational and Social
(12) Youth
(13) Conservation, Environment and Beautification Purposes and Activities
(14) Housing
(15) Inner City or Community
(16) Civil Rights
(17) Litigation and Legal Aid
(18) Legislative and Political
(19) Advocacy
(20) Other Directed to Individuals
(21) Support to Other Organizations
(22) Other

In 1989 the share of new nonprofits engaged in religious activities (Activity 1) started declining and continued to decline to less than 10% of the total by 2001. This is lower than the share of new organizations for 1950 involved in religious activities. After 2001 the share of nonprofits engaged in religious activities has been increasing.

Schools (Activity 2) held a very large share of new nonprofits each year up until the early 1970s when they declined to about half of their previous share. The activities that increased share at the same time were cultural (Activity 3), training (Activity 4), and health (Activity 5) activities.

In the mid-1970s a significant share of new nonprofits were involved in inner city or community activities (Activity 15). Prior to that time the share of this activity was almost too small to measure. The emergent category of activity included activities such as area development, urban renewal, homeowners associations, attracting new industry, and crime prevention. While its share was only about 4% each year, it maintained that share of new nonprofits for the remainder of the century. Another new activity that appeared in the 1970s was advocacy (Activity 19) by groups that attempted to influence public opinion concerning fire arms control, the selective service system, national defense policy, weapons systems, government spending, taxes, separation of church and state, foreign policy, anti-Communism, right to work, capital punishment, ecology, consumer interests, urban renewal, etc. The advocacy (Activity 19) activity makes up only a small share (1% to 3%) of the purposes of new nonprofits; however, the activity did not exist in measurable amounts prior to that time. Other activities directed to individuals (Activity 20) included supplying money, goods or service to the poor; non-scholarship gifts or grants; loans to individuals; marriage counseling; family planning; credit counseling, job training or counseling; etc. This activity accounted for less than 1% of the new nonprofits per year prior to 1974, when it increased to over 5%. It continued to account for approximately 5% for the remainder of the century.

The community chest and booster club (Activity 21) activity was one of the activities that lost share in the 1970s. It regained share during the 1980s as it increased to approximately 10% of the new nonprofits. This activity had declined to less than 5% in the last couple of years of the century and has been increasing in the last couple of years.

The activity that has grown the most since the 1970s is the "catch all" category for other purposes and activities (Activity 22). It started with its biggest share increase in 1973. Specific activities in this category include cemetery or burial activities, perpetual care funds, emergency or disaster aid fund, community trust, government instrumentality, testing products for product safety, consumer interest groups, veterans activities, patriotic activities, title holding corporation, erection or maintenance of public buildings, cafeteria, restaurants, snack bar, food services, thrift shop, retail outlets, book and gift stores, advertising, loans or credit reporting, endowment fund or financial services, Indian tribes fund-raising, etc. This category of activity allows nonprofit organizations to provide goods and services that compete with the private "for-profit" firms. The activity has grown considerably from about 5 percent of new nonprofits in the early 1970s to a peak of about 45 percent in 1998. It has declined in the most recent years as religious (Activity 1) activities have increased (perhaps impacted by the faith-based initiatives promoted by the federal government).

Overall trends during the 1990s are that religious (Activity 1), cultural (Activity 3), training (Activity 4), youth activities (Activity 12), community chest activities (Activity 21) and other activities directed toward individuals (Activity 20) are declining as a share of new nonprofits per year, while sports/athletic/recreational/social activities (Activity 11), and schools (Activity 2) are increasing slightly. The major increase in shares of new nonprofits is in other purposes and activities (Activity 22), the activity that comes closest to private sector behavior and that activity seems to be related to religious activities (Activity 1) in recent years.

The number of new nonprofits has grown from about 20,000 per year in 1991 to over 50,000 per year in 2001 and the rate has dropped slightly since then. New nonprofits seeking the added benefit of tax deductibility for their contributors has been increasing too and new nonprofits not qualifying for deductible contributions have remained fairly constant. Therefore, deductibility appears to be desirable objective for organizations being created. In addition, the trend favors the growth of publicly supported organizations that receive their funding from government units and the general public, especially in the years since the bubble burst and the chances of new individuals becoming wealthy have declined. In other words government funds have been playing a greater role in the funding of nonprofits. These new nonprofits are engaging in activities that come closest to private sector behavior. The incentives to go into commercial-like activities must be very strong since even churches have deviated from their primary focus on religious activities. In conclusion, there are a large number of nonprofits and many more are created each year. These data suggest possible reasons for the increase including tax avoidance or control over tax spending; desire to influence public policy; and a transition toward "privatization" of public goods and services.

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