Government Funding—Crowding Out

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To be appeared in
Encyclopedia of Nonprofit Management, Leadership, and Governance
by Edward Elgar Publishing Ltd.

I. Defining the crowding out effect of government funding

Do donors withhold their charitable giving to nonprofits when they receive government grants? Crowding out theory suggests “yes.” Altruistic donors may perceive government spending on social services as a substitute for their private donations, theoretically by dollar for dollar (Warr 1982; Roberts 1984). As a result, the efficiency of government grants to nonprofits may not be as desired since it may not increase overall support for nonprofits.

This theoretical perspective initiated the research line studying the relationship between government expenditures and private giving. However, the magnitude and direction of the crowding out effect are still inconclusive after several decades of empirical studies.

II. Application to the Nonprofit Sector & Challenges

Crowding out knowledge serves as a tool for awareness, cautioning nonprofit professionals about revenue inefficiencies that may occur from governmental support. Revenue inefficiencies occur when, for example, a nonprofit only generates 28 cents in private donations for every government dollar it receives (Andreoni and Payne 2003).

Crowding out evidence should not be feared. Instead, this information can propel both nonprofit and government professionals to innovate strategies so that the two primary sources of financial revenues for nonprofits can leverage each other. And while there is no standardized approach to applying the knowledge about crowding out into practice, there are fundamental questions nonprofit professionals need to ask when assessing evidence about the effect. The questions and insights below are a good baseline to understand crowding out effects and possible mitigation strategies.

1. Is the magnitude of the crowding out effect significant?

Consensus about the direction and magnitude of the crowding out effect is mixed (Lu 2016; de Wit and Bekkers 2017). The issue of unobserved variable prolongs this inconsistency because we cannot conclude a causal relationship between the observed fluctuations in both government spending and private giving if analyses do not account for third factors that may affect both (Payne 2009, 163).

Several streams of research have been attempting to address this issue. The earliest research line uses archival data and advanced analysis methods of econometrics. These studies generally find that private donations indeed fall when a nonprofit receives government support. But these lower levels of private donations are more explained by decreased fundraising efforts due to governmental support rather than changes in donors’ giving behaviors (Andreoni and Payne 2003; 2011).

Later another stream of research that utilizes experimental methods became popular. In these experimental designs (e.g., survey, laboratory, and online experiments), researchers analyze if donors change their giving or are willing to give when presented with information about government grants in controlled settings. Through different approaches and platforms, for example, social media advertising (Jilke et al. 2018) and experimental giving lab games (Korenok, Millner, and Razzolini 2014), experimental studies suggest that donors are ultimately indifferent to information about government funding, and still give to the nonprofit of their choice.

To obtain a definitive answer to the crowding out effect, a few meta-analyses have attempted to summarize a reliable estimation of the effect from different perspectives. Some conclude that the effect of government spending on private donations is minimal and not practically significant (Lu 2016). Others highlight methodological differences across different studies, showing that experimental research designs yield higher estimates than nonexperimental studies (de Wit and Bekkers 2017, 309).

2. Are crowding out effects relevant to my service area?

One key dynamic of the crowding out effect is that it does not affect all nonprofits equally. Nonprofits working in some service areas may be more resilient to crowding out than others. For example, crowding out effects are less evident in art organizations than social services organizations (Lu 2016). Explanations about why the effects vary by service area are scarce, but we know that donors may redirect philanthropic giving according to their perceived societal challenges.

Some nonprofits can even benefit from crowding out effects because donors may not *reduce* but rather *redirect* their giving. For instance, governmental support to a nonprofit may prompt donors to redirect their giving to another similar nonprofit, helping sustain focal interventions within a service domain (Ek 2017). Alternatively, donors may also redirect giving towards marginalized public services—a study of countries with high government support for health and social protection services finds donors redirecting their donations to environmental services, international aid, and the arts (De Wit et al. 2018). Social ties in the nonprofit sector may also impact how nonprofits experience crowding out effects. Nonprofits that are well-connected through board members may experience some redirection of donations from neighboring nonprofits that receive government grants (Ma 2020). Simply put, crowding out effects are not ionized phenomena, and the funding process is a complex and interactive system.

In the crowding out literature, these mechanisms in which donors redirect their giving are commonly referred to as “crosswise crowding” or “substitution of giving.” Research in this realm is a relatively new advancement and a promising direction for further studies.

3. Are there ways my organization can proactively mitigate crowding out effects?

Although there is no definitive answer to whether the crowding out effect is substantial, its awareness and implications on revenue are crucial. With this information, nonprofits can prepare mitigation strategies, for example, diversifying revenue sources or robust fundraising efforts, to mitigate the revenue inefficiencies.

Nonprofits should also take advantage of government grants. They are not only a substantial source for revenue diversification but also signal a nonprofit’s financial health and encourage more giving—a phenomenon known as the “crowd-in effect” (Steinberg 1991, 592; Grasse, Searing, and Neely 2022). However, solely relying on revenue diversification as a mitigation strategy for crowding out may be insufficient because crowding out can happen between different revenue sources, for instance, between different government grants (Zhao and Lu 2019) or charity spending crowding out government

expenditure (Cheng 2019). These interactions are important for assessing the feasibility of mitigation strategies.

III. The Future

While the consensus on the direction and magnitude of crowding out is weak, scholars have untangled many nuances in the relationship between government expenditures and private donations. A comprehensive discussion on how to handle crowding out effects is beyond the scope of this entry, but the guiding questions and empirical studies presented here are good sources for professionals to assess their organizations' own risk of crowding out.

For researchers, future inquiries about crowding out will continue to rest on robust methodology. There are a few promising directions, especially comparative analyses with emphasis on non-Western cultures, differentiating dynamics between *substitution* of giving and *redirection* of giving (Ma 2020, 251), and the relationship between crowding out and revenue diversification.

(1,092 words, excluding reference list below)

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