

Charitable Giving and the Personal Income Tax



MICHAEL RUSHTON
Associate Professor and
Director of MPA and
Arts Administration Programs
School of Public and Environmental Affairs
mirushto@indiana.edu

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*Peer Reviewers and Contributors:
Leslie Lenkowsky, Clinical Professor,
School of Public and Environmental Affairs,
Indiana University; and Kirsten Grønbjerg,
Professor and Governance & Management
Faculty Chair, School of Public and
Environmental Affairs, and Efrogmson
Chair in Philanthropy, Center on
Philanthropy, Indiana University*

Summary

President Obama has proposed lowering the rate at which high-income taxpayers can claim deductions from their income tax for charitable donations. From an economics perspective, this paper reviews three challenges to policy makers for treating charitable donations equitably: (1) how much to incentivize charitable giving, (2) whether equity among taxpayers ought to be defined before or after their donations, and (3) if, and how much, the tax rate should grow with income level.

Considering the Proposal

In his budget for fiscal year 2011, President Obama proposed a reduction in the rate at which high-income earners could claim an income tax deduction for charitable donations. Ordinarily, if taxpayers are allowed to deduct \$1, for example, from their taxable income for a charitable donation, then the tax they owe falls by whatever is their *marginal tax rate*, that is, the tax rate that applies to the last dollar of their taxable income. Since marginal tax rates increase with taxable income, higher-income individuals tend to get more tax reduction per dollar of charity (or any other itemized deduction). In the Obama proposal, high-income taxpayers in the 36 or 39.6 marginal tax rate brackets would have the tax value of their deductions limited to 28 percent, the marginal tax rate affecting more middle-income earners. In the Treasury Department's explanation of the proposal,

Increasing the income tax liability of higher-income taxpayers would reduce the deficit, make the income tax system more progressive, and distribute the cost of government more fairly among taxpayers of various income levels.¹

Regarding the issue of fairness, then Director of the Office of Management and Budget, Peter Orszag, explained:

[L]et's look at how the tax code treats two different contributors to a non-profit. If you're a teacher making \$50,000 a year and decide to donate \$1,000 to the Red Cross or United Way, you enjoy a tax break of \$150. If you are Warren Buffet or Bill Gates and you make that same donation, you get a \$350 deduction – more than twice the break as the teacher.

This proposal walks that difference back some of the way – it would limit the tax benefit for Buffet or Gates to \$280. In other words, we are not eliminating the deduction – just reducing it to 28 percent (or \$280 on the hypothetical \$1,000 contribution) for the 5 percent of families at the very top of the income distribution.²

Harvard University economist Martin Feldstein writes: “the proposed tax on charitable gifts hits at the foundation of our pluralistic society,”³ referring to the expected reduction in charitable giving that would occur should the proposal become law.

¹Department of Treasury, “General Explanation of the Administration's Fiscal Year 2011 Revenue Proposals,” February 2010.

²Peter Orszag, “The Budget and Charitable Donations” [<http://www.whitehouse.gov/omb/blog/09/02/27/TheBudgetandCharitableDonations/>]; posted February 27, 2009.]

This article will show the complexity underlying what seems on the surface to be a relatively straightforward change to the treatment of charitable giving in the income tax, and that, while economists have *something* to contribute to the debate, they don't have all the answers.

To evaluate the treatment of charitable donations in the income tax, it's best to begin with the multiple goals of a well-designed personal income tax.

- *Efficiency*, which involves ensuring that the tax system is generating incentives for desirable behavior,
- *Horizontal equity*, which is about treating those in similar circumstances in a similar way, rather than with arbitrary distinctions between taxpayers,
- *Vertical equity*, the moral view that the total amount of tax assessed on an individual should be related to his ability to pay,
- *Ease of tax administration and enforcement* (by the government) and compliance (by the taxpayer).

Issues for Policymakers

The challenges in figuring out how best to treat charitable donations are:

1. We are not sure by how much we want to incentivize charitable giving
2. There has long been disagreement about whether "similar circumstances" for the purposes of horizontal equity should be measured prior to or after charitable donations have taken place
3. There are widely divergent views on the extent to which the tax rate ought to increase, if at all, with ability to pay.

1. How much incentive for charitable giving?

Econometric studies on the question suggest that the elasticity of charitable donations with respect to changes in the marginal rate at which donations can be deducted from taxable income is around unity. In practice this means that the increase in government revenues from reducing the effective tax deduction is almost exactly offset by the change in the donations charities receive. Martin Feldstein calls the Obama proposal a "tax on charitable gifts" because, as an approximation, the increase in government revenue is matched by a decline in gifts received by charity. Noting that the tax change applies only to high-income households who itemize their deductions, Indiana University's Center on Philanthropy estimated that, if implemented, the tax proposal would reduce charitable donations by about \$3.9 billion of the estimated \$187 billion itemized annually in charitable gifts (which, of course, is less than the total amount of giving).⁴

Suppose that estimates of a decline in donations matching an increase in government revenues are roughly correct. That

³Martin Feldstein, "A Deduction from Charity," *Washington Post*, March 25, 2009.

⁴"Obama's Tax Plan Could Cause Giving by the Wealthy to Drop by Several Billion Dollars Annually" *Chronicle of Philanthropy*, February 27, 2009.

information alone doesn't confirm whether this is a good or a bad policy move by the government because we cannot simply assume that the *existing* incentives for donations were right in the first place. In efficiency terms – i.e., in terms of getting the incentives right for charitable giving – there was never anything magical about the previous system where the incentive was set at a level equal to the individual taxpayer's marginal tax rate. After all, there are systems that give *greater* incentives for giving than what has existed in the US. In Canada, for example, taxpayers receive a *tax credit* for charitable donations at a rate equal to the top marginal income tax rate. To use Peter Orszag's example again, instead of lowering the tax benefit for high-income individuals to the level received by others, in Canada the tax benefit for middle-income families is *raised* to the level received by the richest donors – and this in a country where the marginal tax rate (and thus the value at the margin of the tax benefit) is already higher than in the US.

In terms of the incentives provided for charitable giving, there is nothing special about the extant system in the US. It could be made stronger or weaker, depending on the degree to which policy makers are prepared to sacrifice government revenue (which must be made up in higher taxes elsewhere, or in cuts to expenditures) in order for nonprofits to have more revenue.

2. What is horizontally equitable when it comes to the tax treatment of charitable giving?

Consider first the fact that taxpayers who are self-employed can deduct expenses incurred in earning a living from their taxable income. As long as the expenses are truly necessary and a part of the business, few would object to this provision in the tax code, since most believe it is fair and equitable to tax net earnings rather than gross receipts, net earnings being a far better indicator of a person's economic circumstances and wellbeing.

On the other hand, most taxpayers would object if there were a tax deduction based on consumption of bananas (but no other foods). It would seem crazy that two people of equal income and circumstance would be taxed differently because one liked to purchase bananas and so received a generous tax deduction, while the other strongly preferred to buy other fruit and received no deduction.

In terms of equity, i.e., treating people in similar circumstances without arbitrary distinctions between them, are charitable deductions more akin to business expenses or consumption of bananas? If charitable donations are akin to business expenses in terms of defining a person's circumstances, then the way donations have been treated in the past makes some sense.

The question above may seem silly, but it has been a part of the discussion of the design of the personal income tax from the beginning. Although taxpayers have become accustomed to this itemized tax deduction, it has long made many economists uneasy. If net personal income is the best measure of individuals' circumstances because it defines their power over the allocation of resources – whether they choose to spend it, save it, or give it away – then the tax deduction for charitable donations is no longer so easy to defend. Since one individual can choose to give money to the Indianapolis Museum of Art, for example, and another individual with similar income can choose not to, it's unclear why the first

ought to get a tax deduction simply because he *chose* to use some of his discretionary income in that particular way.

3. *How progressive should the income tax be?*

The Obama administration proposal aims to limit the rate at which *only* high-income earners could claim the charitable deduction. And so another question is whether it is good policy to increase the income tax paid by rich charitable donors while leaving the tax rates for others unchanged. (This, of course, ignores the many other changes to the overall tax and government expenditure system that affect all individuals in different ways).

Again, there is no easy answer. When economists have tried to estimate how progressive the income tax ought optimally to be, they combine what they know about taxes and incentives on work and saving together with somewhat arbitrary social welfare functions that positively account for both the total income of society and how evenly after-tax income is distributed. However, there is no scientific way to find that social welfare formula, and there are no calculations that would indicate how to value equality.

That doesn't mean these exercises are worthless. The wave of tax reform around the globe in the 1980s which involved sharp cuts in the very high marginal tax rates for the highest income earners were a result, in part, of studies that showed that even in countries that cared a lot about after-tax income equality, those very high top marginal rates were producing big losses in total income with very little gain in equality. Hume's Law probably applies here: "ought" statements cannot be derived from "is" statements, and discussions about how much the rich ought to be taxed cannot be based purely on econometric studies of incentive effects.

Implications for the Obama Proposal on Charitable Giving

Economists certainly can contribute to this policy question. First, they can identify the incentive effects of changing policies, and provide estimates of their magnitudes. There cannot be a sensible discussion of a policy issue that involves trade-offs without having *some* idea of the numbers involved, and sound empirical evidence can take the ensuing discussion past anecdotes about how one donor or another responds to changes in the tax law.

Second, there is no ideal system. Rather, what ought to be done is determined in the real world by a complex interaction between how people respond to incentives, and what is believed to present fairness in taxation.

The optimal design of the income tax, including how it treats charitable giving, is a *political* question – political in the best sense. It is something that has to be worked out between citizens and their elected representatives based on a compromise of values between what constitutes fairness in taxation, and the degree to which they believe it is sound policy for the government to actively encourage charitable giving. Policy analysis can contribute estimates of important magnitudes, and provide a framework for organizing thoughts on the subject, but beyond that, deliberations and democracy must prevail.

Comments on “Charitable Giving and the Personal Income Tax”



by Kirsten Gronbjerg

Professor Rushton's assessment of the impact of changes in the tax law on charitable giving rightly emphasizes the complexity of this important policy issue. As he notes, there are not only major questions about the economic

impact of tax changes, but the social and political dimensions to these issues are at least as problematic.

My reading of the literature leads me to slightly more nuanced conclusions about the impact of changes in tax incentives for charitable contributions than his. There is, for example, some evidence that clear-cut changes in tax incentives have a temporary effect on charitable giving, especially for very high-income groups.¹ That is, if tax rates are scheduled to decline January 1, individuals may move their gifts forward in time to take advantage of the more favorable tax incentives while they are in force. If these individuals then make smaller/fewer gifts immediately following the decrease in tax rates, it appears that charitable contributions are lower after the change in tax rates than before.

While there is also some evidence that changes in tax rates have a long-term or permanent effect on the propensity to give, few studies test for timing vs. permanent effects. Moreover, tax incentives are not the primary reasons why donors give.² Indeed, there are many non-economic factors to take into account. For example, men give larger sums to fewer charities than women and tend to be more generous when it is cheap to give (e.g., high tax incentives), while women tend to be more generous when the cost of giving is high (e.g., low tax incentives).³

One other observation further complicates the analysis of tax incentives and equity issues. That has to do with what Paul Schervish and colleagues refer to as the “hyperagency” of wealth, that is, the ability of wealthy donors to have a disproportionate impact on charities because they can – and do – give large gifts with strings attached.⁴ In other words, major donors – the ones affected by the proposed changes in the deductibility of charitable donations – would continue to receive significant tax incentives for making charitable contributions, just not higher incentives

¹See Jon Bakija and Bradley T. Heim. (Forthcoming). “How Does Charitable Giving Respond to Incentives and Income? New Estimates from Panel Data.” *National Tax Journal*.

²See Lise Vesterlund. (2006). “Why Do People Give?” Pp. 568-590 in Walter W. Powell and Richard Steinberg (Eds.), *The Nonprofit Sector: A Research Handbook*. New Haven and London: Yale University Press.

³See Baris K. Yörük. (2010). “Charitable Giving by Married Couples Revisited,” *Journal of Human Resources* (45): 497-516.

⁴See Paul G. Schervish, Planton E. Coutsoukis, and Ethan Lewis. (1994). *Gospels of Wealth: How the Rich Portray Their Lives*. Westport, CT and London: Praeger Publisher.

than those in the second-highest tax bracket. In fact, their tax incentives would continue to be notably higher than for families in the lowest tax brackets. Moreover, there would be no erosion of the social and political benefits high-income donors get from their charitable donations – the ability to impose their will on the agendas of charities receiving their gifts. Those types of benefits are rarely available to those who can afford only modest gifts, even though the aggregate value of their gifts is significant.⁵ Moreover, nothing prevents high-income individuals (those with income of \$250,000 or more under the current⁶ proposal) from continuing to make high-impact gifts, but it is a political question whether taxpayers should continue to underwrite such gifts to a greater extent than the smaller gifts from the vast majority of families (roughly 95 percent of families had incomes below \$200,000 in 2006).

So I fully agree with Professor Rushton's overall conclusion, that policy decisions in general, and this one in particular, should be based on a solid understanding of the complexities of charitable contributions, but that we must go beyond econometric analyses to consider broader political and social implications.

⁵Families with income of less than \$250,000 (about \$200,000 in 2002 dollars) account for 52 percent of all charitable contributions. See table 23.5 in John J. Havens, Mary A. O'Herlihy, and Paul G. Schervich. (2006). "Charitable Giving: How Much, by Whom, to What, and How?" Pp. 542-68 in Walter W. Powell and Richard Steinberg (Eds.), *The Nonprofit Sector: A Research Handbook*. New Haven and London: Yale University Press.



by Les Lenkowsky

Using as President Obama's unsuccessful effort to reduce the deductibility of charitable giving by the wealthy as an example, Michael Rushton makes valuable observations about the limits of economic and public policy analysis in decision-making. Tax policy, he notes, is ultimately the product of democratic debate, not social science research and analysis. At its best, economic (and public policy) analysis can usefully inform choices by illuminating the context in which they are made or the results they produce. But political debate and discussion are necessary to evaluate the merits of decisions or determine which goals are worth seeking.

Even so, social science is not politically neutral. Deliberately or not, by the nature of the questions asked, the data collected, or the interpretations placed on the results, analysts can – and do – espouse political positions, sometimes under the cloak of conducting objective research. The debate over the impact of taxation on charitable giving provides a good example of that, too.

The standard economic model of how public policy affects giving relies chiefly on two factors. One is addressed in Rushton's paper: the effect of tax deductions or credits in increasing (or

decreasing) the incentive to donate. By reducing the value of the charitable gift deduction for high-income taxpayers, the Obama administration's proposal would, according to its critics, lead to less charitable giving. On the other hand, its defenders claim any such effect would be small and justifiable in non-economic terms, such as by producing greater equity in the tax system.

For over 40 years, the bulk of the research into the effect of public policy on giving has focused on tax incentives and so, not surprisingly, have political debates. But the second factor in the model is also important: the amount of disposable income a person has. As studies such as *Giving USA* have shown, aggregate changes in the level of charitable giving closely follow changes in national income (and wealth, as measured, for example, by stock market indices). Among individuals, while raising or lowering deductions has more immediate significance, gains or losses in income are not inconsequential – and if they continue for a number of years, have a cumulative impact.

These two factors can be seen in debates over the impact of abolishing the estate tax on charitable giving. Those who favor reinstating it argue that the estate tax contained a strong incentive for philanthropy by permitting a deduction for bequests. On the other hand, those who support its abolition maintain that people will be more likely to accumulate wealth if they thought it would not be taxed away at death and, thus, more generous to charity in their lifetimes as well.

Most estate-tax research, like most studies of tax policy's impact generally on charitable giving, has focused on the bequest deduction's incentive-effects, rather than on how inheritance taxation has affected increases in wealth or the timing of charitable giving. ("Supply-side" advocates would say that the dynamic effects of taxation on personal and capital income are under-studied as well.) Yet, almost surely, despite the preferences of researchers for studying and debating the Obama administration's proposed change in the tax incentive for donations by the wealthy, the success of its economic policies in stimulating growth in income and wealth will have a far more profound effect on charitable giving.

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