8 Charitable Giving Behavior and the Evaluation of Tax Policy

The preceding chapters have focused exclusively on positive questions related to the effect of federal taxes on charitable giving. The objective of this final chapter is to conclude the analysis by, first, summarizing the major findings and, second, providing a broader framework for the evaluation of tax policy toward charitable giving. The first section presents a brief summary of findings from empirical studies of tax effects on charitable giving, notes some of the important implications for tax policy, and lists several important unanswered questions. The second section discusses the normative evaluation of tax policy toward charitable giving, noting in particular the relevance of empirical work on charitable behavior.

8.1 Tax Effects on Charitable Giving: An Overview

From the evidence presented in the preceding chapters, it is possible to draw conclusions regarding the effect of tax policy on charitable behavior and to highlight some of the most important implications of this empirical work. It is useful to begin with a brief summary of the findings from econometric studies.

8.1.1 Summary of the Findings

Econometric analysis has focused on four major areas of charitable behavior: individual contributions, volunteering, corporate giving, and charitable bequests. There is also some empirical evidence on the effect of taxes on foundations, but no econometric studies have been done in that area. The bulk of econometric analysis and attention in economic studies has been directed toward individual giving, which seems appropriate given the large share of total gifts accounted for by individuals. Contribu-
tions by individuals vary widely by income level and age as well as among individuals within those classifications. The major tax policy instrument affecting individual giving is the charitable deduction allowed in the calculation of taxable income for taxpayers who itemize their deductions. As a result of this tax treatment, there are two major tax effects on individual giving: the tax liability affects the after-tax income from which taxpayers can make contributions and the deduction reduces the net price per dollar of contribution made. The econometric analysis of individual giving implies that the income tax has a strong effect on giving. This is not to say, however, that taxes are the only or the major influence on individual contributions, only that they are one significant factor.

Taken as a whole, the empirical work on tax effects and individual giving is notable for the number and variety of studies in the area and the consistency of the findings. In few other applied areas in public finance has there been such extensive replication of empirical findings using different data sets. Studies of charitable contributions have used aggregated and individual data, data from tax returns and survey data, and foreign as well as U.S. experience. The consensus of these studies is that the price elasticity for the population of taxpayers is probably greater than 1 in absolute value, although there are certainly estimates that are smaller and estimates that are considerably larger than this. The range of most likely values appears to be about $-0.9$ to $-1.4$. Taxes also influence giving through an income effect, with most estimates of the income elasticity falling between $0.6$ and $0.9$.

In order to appreciate the implications of these findings, it is necessary to consider the specific hypotheses, different uses of data, and qualifications that apply to the studies themselves. For example, one maintained hypothesis is that itemization status and marginal tax rate work together through the price effect to affect giving, and that there is no separate "itemization effect." Separate tests of such an effect, in fact, confirm this maintained hypothesis. Another important question is whether the price elasticity varies by income level. The extensive analysis on this question has failed to provide a definitive answer, but it appears that the elasticity rises in absolute value with income. It is reasonable to conclude, however, that the price elasticity is significantly less than zero even for low-income taxpayers. A question of particular importance for evaluating the impact of tax policy is whether taxpayers respond immediately to changes in price and income. Evidence on this question suggests that there are substantial lags in giving behavior, with the result that short-run responses are much less complete than those in the long run. One other question related to the impact of fiscal policy on contributions is whether increased government spending "crowds out" private giving. The econometric evidence on this question shows little if any effect of this sort in spite of the apparent rela-
tionship observed among nations in the size of government and the strength of private giving. Throughout this empirical literature certain econometric issues have had to be dealt with, in particular the high correlation between price and income. Based on attempts to correct for possible biases as well as the variety of data and models used in these studies, it appears that these econometric problems are not a major factor in explaining the pattern of estimates.

Along with individual contributions, volunteering is one of the two major sources of private support for the charitable sector. In contrast to individual giving, however, our knowledge about the tax effects on volunteering is quite limited. For one thing, data on volunteering are sparse, and data linking volunteering to tax variables are even more limited. In theory, income taxation can have two broad effects on volunteering: a direct effect through the influence of tax rates on the allocation of time, and an indirect effect, through the charitable deduction for donations. The former effect depends on whether volunteering is simply a competing use of time, such as leisure, work, and household production, or whether it is a form of investment in human capital. The latter depends on whether gifts of money and gifts of time are complements or substitutes. The evidence on these questions is both limited and mixed. An analysis of volunteering by women suggests that contributions and volunteering are complements, implying that the charitable deduction encourages volunteering as well as donations. Also, volunteering tends to be crowded out by market work. To the extent that work and volunteering are rival uses of time, tax policies that encourage labor force participation among women tend to reduce their volunteering.

There is a much larger econometric literature on the effect of taxes on corporate giving. The new evidence presented in this study is broadly consistent with earlier findings and suggests that the corporation tax has both a price and a net-income effect on corporate giving. Such behavior by firms would be consistent with a number of models other than pure profit maximization. The estimates of the income-effect elasticity using the cash flow measure of income are close to 1, suggesting that contributions are proportional to after-tax income. An important question remains, however, regarding the proper specification of this income measure. Qualitatively similar results are obtained using after-tax net income. The estimated price elasticities appear to be smaller than those estimated for individual contributions, but the estimates presented here leave some doubt due to the difference in results using marginal and average tax rates, respectively. Taken together, these results suggest that the price elasticity is less than 1 in absolute value. Finally, there is evidence that corporations time their gifts in order to take more deductions during years in which tax rates are higher.
Tax effects are also apparent in bequest giving and foundation activity. The econometric evidence of bequest giving presented in this study, like previous work, produces estimates subject to substantial variation. Nevertheless, these estimates imply that the deduction in the estate tax has quite a strong effect by and large. Most estimates of the price elasticity are greater than 1 in absolute value. Bequests also rise with estate size, but the elasticity of estate size is substantially smaller than 1. On estimates obtained for the very important group of the wealthiest decedents, those with net estates over $1 million, the estimated price elasticity was greater than 2 in absolute value, and the income elasticity exceeded 1. In any assessment of the aggregate effect of estate tax changes on charitable bequests, the largest estates are of paramount importance because they account for most bequest giving. No comparable econometric evidence on foundation activity has as yet been produced. The limited information that is available suggests, though, that the provisions in the Tax Reform Act of 1969 related to private foundations had the effect of raising payout rates without threatening the existence of foundations.

8.1.2 Implications for Tax Policy and the Nonprofit Sector

The major conclusion arising from this empirical work is that federal taxes, especially tax provisions affecting charitable giving, have important effects on the size and distribution of giving. The deductions in the individual, corporate, and estate taxes are of course most important, in the sense that no other tax changes with comparable revenue effects would influence charitable giving as much as the elimination of these deductions. But other, more general tax provisions and changes also have profound effects on giving. Probably the most important of these effects arise from the combination of the standard deduction, nominal tax schedules, and inflation. The effect of inflation has been to erode the value of the standard deduction, causing an increase in the proportion of taxpayers who itemize their deductions. This in turn affects the price of giving. Another important set of tax changes not directly related to charitable giving has been revisions in the rate schedule itself. In particular, the decline in top marginal tax rates from 91 to 50 percent over the last three decades has had a sizable effect on the prices faced by taxpayers in the highest income classes. A tax change such as the 1981 tax act combines several changes likely to affect charitable giving. Simulations based on estimated models of individual giving suggest that the combined effect will be a slight increase in the rate of giving, resulting from a large increase in giving by nonitemizers due to the “above-the-line” deduction and a slight decline in giving among upper-income taxpayers due to the drop in tax rates.

Similarly, the econometric evidence presented here implies that federal taxes will affect other forms of giving as well. Policies that encourage la-
bor force participation of women—for example, the deduction for secondary earners—may tend to discourage volunteering. The extension of the charitable deduction to nonitemizers, on the other hand, may encourage volunteering if gifts of time and money are complementary. The recent changes in the corporate tax resulting in an increase in the number of firms with no tax liability will tend to discourage corporate giving by raising its average net price. The implications of the empirical analysis of bequests are similar to those applying to individual contributions. The 1981 tax act, which reduces the number of taxable estates and lowers the marginal tax rate for many estates, is likely to discourage bequest giving by raising the net price of charitable bequests.

As the simulations of individual giving show, one of the most important implications of existing empirical work is that tax policy can affect the distribution as well as the level of contributions. Since donors at various income levels differ markedly in their propensities to make gifts to various kinds of charitable organizations, tax changes that affect the distribution of giving among income classes will tend to affect the distribution of support to various parts of the philanthropic sector. For example, the 1981 tax act had the effect of significantly reducing marginal tax rates for taxpayers in the top brackets in both the income and estate taxes. If the effect of such price changes outweighs the influence of changes in net income or net estate, which they in fact appear to do, these tax changes are likely to cut the relative share of giving undertaken by the wealthy. This would imply a decline in support for institutions such as colleges, universities, cultural institutions, and private foundations and toward religious organizations and certain health and welfare groups. It is important to emphasize, however, that implications such as these are based on price and income effects and do not account for any possible changes in behavior by donors or charitable organizations.

The econometric estimates also have implications for proposed or hypothetical tax provisions. Simulations in the text examine several proposals that involve changes in the charitable deduction or general tax rate revision. Probably the largest effect would be observed if the charitable deduction were eliminated altogether, perhaps as part of some comprehensive income tax. Such a change would have important effects on the distribution as well as the level of contributions, with gifts by wealthy taxpayers falling the most. Substituting a tax credit for the present deduction, depending on the rate used, would have the effect primarily of redistributing the pattern of gifts between low and high income groups. Smaller changes would come about as a result of less sweeping revisions, such as the constructive realization of appreciated assets given as gifts or the expansion of the deduction at low and middle income levels. Each of the proposals noted here would affect overall tax revenues, and it is im-
important in simulating their effects to adjust for this. Similar effects could be calculated for bequest giving, with the elimination of the deduction in the estate tax having much the same kind of effect.

8.1.3 Unanswered Questions

Even though it encompasses many different studies, the econometric literature linking taxes to charitable giving still leaves a number of important questions unresolved. Some of these could in principle be answered within models such as those that have been estimated. In order to answer others, it would be necessary to employ more general models. Within the context of the models that have been estimated, questions remain in every major area of charitable giving. We still do not have a precise idea, for example, of the magnitude of the price elasticity for low-income households. This is an important policy question because of the introduction of the new deduction for nonitemizers and because of the distributional implications of general tax changes. A second unanswered question is how the response to taxes varies according to the type of donee organization being supported. Although it might be difficult to estimate separate price and income elasticities by detailed donee class, it might well be possible to determine whether religious giving is affected differently from other types of contributions. The estimation of tax effects on volunteering requires data on individuals' volunteering, wage rates, labor force participation, and taxes. Given the available studies, it is simply impossible to determine beyond any doubt whether the present deduction encourages or discourages volunteering. Although there is a fair amount of consistency among studies of corporate giving, there remains considerable uncertainty as to the precise price elasticity and the appropriate measure of corporate income. Within the context of the models estimated, however, there is one additional question on which more information is required. If the deduction for charitable contributions were limited or eliminated, corporations would have the incentive to substitute other deductible expenditures for corporate gifts. Because of this substitutability, the price elasticities based on the current regime of full deductibility would not be applicable. Concerning charitable bequests, the instability of elasticity estimates in several studies suggests that our knowledge about the tax effects is not as good as we would like.

Other questions left unanswered by existing empirical work would require broader models than have been used in previous work. The models underlying virtually all empirical work on charitable contributions are partial equilibrium in nature. They ignore interactions among various kinds of giving as well as interactions between donors and donee organizations. It seems reasonable to suppose that changes in the tax treatment of contributions in one tax could affect contributions made subject to another. For example, a restriction in the deductibility of charitable bequests
might will increase lifetime giving. Except as between volunteering and lifetime gifts, there is no evidence on interactions of this kind. More generally, most of the empirical analysis of charitable giving subject to a given tax assumes that the tax base itself is given. A more general analysis would recognize the possibility of endogenous changes in the tax base. The models employed are also inadequate in their failure to reflect interactions among donors and interactions between contributors and charitable organizations. Contributions by peers may increase or decrease an individual's contributions, and this relationship has important consequences for tax policy effects. Charitable organizations, for their part, may respond to changes in tax policy by varying their solicitation efforts. As long as effects such as these are not reflected in econometric models, projected effects based on those models must be seen as conditional statements only.

8.2 Normative Criteria for Evaluating Tax Policy toward Charitable Giving

The fundamental normative questions in the evaluation of tax policy toward charitable giving are whether and to what extent such giving should be subsidized. If charitable giving were just another category of personal spending by consumers, there might be no reason to consider any form of subsidy whatsoever. A secondary question has to do with the proper form the subsidy should take, given that some subsidy is appropriate. In addressing questions such as these, it is useful to begin with the standard public finance criteria of efficiency and distributional equity. Other, more specific considerations may also be important. Before discussing these criteria, it is useful to note a fundamental distinction relevant to one specific form of subsidy—the deduction.

8.2.1 Two Views of the Charitable Deduction

Two quite different kinds of arguments have been offered to justify the present deductions for personal contributions and bequests. According to the first, the deductions are necessary adjustments in calculating the proper tax base. Andrews (1972) argues that contributions are properly excluded from the income tax base because they constitute neither accumulation nor consumption, the two components of income under the accretion concept. Although contributions emanate from personal expenditures, he argues, they are not consumption in the usual sense because they effect a transfer of resources to others. Similarly, Wagner (1977) argues that a deduction is the correct mechanism for calculating the proper base for estate taxation, on the basis that funds set aside for charitable

1. See also Musgrave and Musgrave (1980, pp. 343-47) for a definition of the accretion concept of income.
purposes are funds that cannot be enjoyed by the heirs of an estate. By this reasoning, horizontal equity thus requires that contributions be deducted in calculating the tax base.²

An alternative justification for the current charitable deduction is to view the deduction as an incentive by which the tax law encourages desirable behavior. According to this view charitable giving is an item of discretionary spending that warrants an incentive. A deduction is only one of several forms such an incentive might take; a tax credit or some matching arrangements might be as good or better. Since contributions are seen as discretionary expenditures by this view,³ there is no necessity to provide the incentive in the form of a deduction from income. In contrast, the first view plainly requires the use of a deduction.

The implications of these views for the normative analysis of the tax treatment of charitable giving should be clear. If the deduction is seen as an absolutely necessary adjustment to income, it becomes "a matter of principle" (Free 1977, p. 1530), and there remains little to discuss concerning the proper tax treatment of charitable giving. If it is an incentive, however, alternative subsidies are fair game for consideration. The tax policy debate over the last two decades suggests that the first view is by no means universally accepted. That debate has focused on the form as well as scope of incentives for charitable giving. And, due to the existence of the standard deduction, the charitable deduction itself (along with the other itemized deductions) has been effectively limited to a minority of taxpayers. Accordingly, the remainder of this chapter is predicated on the assumption that the form of tax subsidy is not determined a priori, but rather is a question subject to normative policy analysis.

8.2.2 Efficient Tax Incentives for Contributions

The concept of economic efficiency is important in any full assessment of tax provisions related to charitable contributions. Indeed, efficiency criteria are necessary for answering the primary question of whether charitable gifts should be subsidized at all. In order to give more concreteness to the application of economic efficiency to charitable contributions, it is useful to begin by presenting a stylized illustration of a tax policy decision involving incentives for charitable giving. Consider the choice be-

². See also Posnett 1979 for a description of this view.

Similar reasoning underlay the justification for the deduction given in a 1938 Congressional Report: "The exemption from taxation on money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare" (U.S. Congress, House of Representatives 1938, p. 19). The statement makes no explicit reference to the proper income tax base.

³. Wagner (1977, p. 2342) notes, disapprovingly, that the "conceptualization of charity as an act of personal consumption is conformable to the proclivities of many economists."
tween an increase of $1 million in government expenditures and an increase of the same amount in tax subsidies for charitable giving, both being financed by an increase in tax rates. Further suppose the new incentive leads to an increase in charitable giving of \(X\) million. Obviously, government expenditures under the first option will be higher by $1 million. By the same token, charitable giving will be higher under the second; it will be \(X\) million higher if increased government expenditures do not crowd out private charity. Assuming no crowding out, the income available to households after taxes and charitable giving will be \((X-1)\) million less in the second case.

One definition of efficiency used in connection with tax policy for charitable giving focuses on the size of the incentive effect. As stressed in a number of empirical studies of tax effects on charitable giving, if the price elasticity of charitable giving is greater than 1 in absolute value, a tax incentive producing a marginal change in the rate of subsidy to contributions will increase giving by more than the associated revenue loss. Accordingly, some writers have defined the “efficiency” of the charitable deduction in terms of the ratio of increased contributions to foregone revenue.\(^4\) By such a definition, the incentive described in the present example would be “efficient” if the elasticity is greater than 1 in absolute value because the rise in contributions \((X\) million) would exceed the revenue cost \($1 million\). Clearly this is quite a specialized definition of efficiency. This concept takes no account of the comparative social benefit derived from private contributions compared to public expenditures. Nor does it give any weight to the change in income after taxes and contributions.

In order to consider the implications of a more complete definition of efficiency, two kinds of theoretical models of incentives for contributions are discussed below. The first focuses on the presumed external benefits that result from contributions. The second includes more general optimal tax models that rest on an explicit maximization of welfare.

**External Benefits**

It appears to be widely agreed that in contrast to most other types of expenditures, charitable contributions often contain a substantial element of external benefit. While donors may reap some direct benefit from their contributions, much of that giving materially benefits others. It might also be argued that charitable organizations produce an external benefit for society to the extent that they offer alternatives to government services. One longstanding justification for public encouragement of charitable giving appeals to the value of diversity in a pluralistic society.\(^5\) It is a

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4. Feldstein testified: “a higher elasticity implies a greater efficiency; that is, more additional giving per dollar of lost tax revenues” (U.S. Congress, Senate 1980, p. 219). Also see Boskin (1976, p. 55) and Donee Group (1977, p. 73) for similar references.

5. See chapter 7 for a discussion of this point in relation to foundations.
basic theorem in applied welfare economics that goods producing external benefits tend to be underprovided in private markets and that economic efficiency can be served by subsidizing such goods. In equilibrium the price faced by each individual should ideally equal his personal marginal valuation of the good, with the subsidy making up the difference between marginal cost and marginal valuation. Where the “good” is dollars of charitable contributions, (with a marginal cost of $1), \( v \) is marginal valuation per dollar, and \( s \) is the subsidy per dollar, the relevant private optimality condition for individual \( i \) is simply:

\[
v_i + s_i = 1.\]

Assuming the individual in equilibrium equates his marginal valuation with the price he faces \((1 - s_i)\), the social optimum will be achieved when \( s_i \) is set at the marginal external benefit. The greater the external benefit, the larger the optimal subsidy.\(^6\)

Hochman and Rodgers (1977) and Posnett (1979) analyze the tax treatment of charitable contributions using similar normative models in which contributions are assumed to be pure public goods. Hochman and Rodgers show that a set of tax subsidies based on a Lindahl solution achieves the optimal allocation.\(^7\) They argue further that, for a wide class of cases, a constant subsidy rate such as a tax credit satisfies the optimality condition. Posnett demonstrates, however, that the general superiority of a constant rate of subsidy cannot be shown. About the most that can be gleaned from these theoretical studies is that tax subsidies of some kind for contributions can be justified on efficiency grounds.

Practically speaking, it is quite inconceivable that any subsidy scheme could be devised to meet the conditions of a Lindahl solution. Both the characteristics of gifts and the tastes of individuals differ too much. A more modest objective would be to set subsidy rates according to the average amount of external benefit from contributions of different kinds. Hochman and Rodgers (1977, pp. 13-15) recommend tax credits for contributions as a way of approximating the Lindahl solution and imply that subsidy rates might well differ by category of giving. They argue that religious giving may have a more important external component than gifts to organizations that have some government counterpart (p. 13). On the other hand, Schaefer (1968, p. 30) maintains that nonreligious giving involves much more redistribution than religious giving, the latter being used largely “to preserve houses of worship and to maintain the activities of congregations.” Discrimination among donees on the basis of external benefits

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6. For a general treatment, see Musgrave and Musgrave 1980, pp. 78–80.
7. A Lindahl solution to the public-good allocation problem is one in which each individual pays a price equal to his marginal evaluation and the sum of marginal valuations equals the marginal cost of the good. See Hochman and Rodgers 1977, p. 4.
would be difficult, both analytically and politically, but there are precedents. Contributions to private foundations are accorded less favorable treatment in the lower percentage limitation of gifts, lack of carryover, and limitations on the deductibility of gifts of appreciated assets. And contributions to schools practicing racial discrimination are not deductible at all.¹

Although the present deduction does not provide for any discrimination in subsidy rates by type of charitable donee (except for the nondeductibility of some gifts), subsidy rates definitely do differ by income level. As illustrated for 1980 in table 2.7 the rate of subsidy tends to rise with income because the marginal tax rate rises with income. For example, the average taxpayer in the $10,000–15,000 class in 1980 faced a marginal tax rate of 0.16, compared to a rate of 0.49 for a taxpayer in the $50,000–100,000 class. Distributional issues aside, this variation in subsidy rates may be judged in the light of the welfare economics of subsidizing goods with external benefits. If the charitable activities supported by high-income taxpayers—such as higher education, cultural institutions, and private foundations—have a higher component of external benefits than activities supported by lower-income households primarily religion and community-welfare agencies—this structure of subsidies may be justified. However, if these activities cannot be distinguished on the basis of their external benefits in this way, differing rates of subsidy would not be efficient.² In any case, it is important to identify the structure of subsidy rates as primarily a question of efficiency, although distributional equity is relevant to the resulting pattern of tax burdens and the distribution of the benefits of charitable activities.

**Optimal Tax Models**

A more general treatment of the efficiency of tax incentives for charitable giving can be obtained with an optimal taxation model, as developed by Atkinson (1976) and Feldstein (1980). Atkinson's model incorporates an additive social-welfare function in which individual utilities depend on their contributions. The well-being of a needy group in society can be affected either by contributions or government expenditures. The effectiveness of private giving in aiding this group can be more or less than that of government. Atkinson (p. 21) shows that the optimal tax-credit rate for contributions is higher, among other things, the more effective private giving is.

8. Private schools in North and South Carolina whose practices were found to be discriminatory were denied the right to receive deductible contributions in 1982. See New York Times, 16 October 1982, pp. 1, 7.

9. See Culyer, Wiseman, and Posnett (1976, pp. 44–46) for a proposal to replace the British deduction by a matching grant with rates determined according to the externality criterion. Posnett 1979 also endorses such a policy in general terms.
Atkinson also spells out the special assumptions under which the narrow "efficiency" concept noted above is an appropriate rule for determining whether the introduction of a charitable deduction improves social welfare. Two conditions are necessary: contribution dollars must be as effective as public expenditures in helping the needy group, and the social-welfare function must be Rawlsian, with all weight being given to the utility of recipients. In terms of the example given above, the first assumption allows dollars of giving to be compared directly to dollars of government revenue; the second makes it unnecessary to be concerned with donors' incomes after taxes and contributions. The deduction is a social improvement if the rise in contributions exceeds the revenue cost (if $X > 1$), that is, if the elasticity is greater than one in absolute value. In general, however, the desirability of a deduction depends not only on the effectiveness of contributions, but also on the weight given to the preferences of donors and the equity effects of a deduction compared to a credit. An elasticity of $-1$ has no general efficiency connotations.

Feldstein's (1980) model compares the cost, measured by a representative individual's willingness to pay, of increasing the consumption of some preferred good through government expenditure versus private giving. The effectiveness of the two types of expenditure is allowed to differ. His model, like Atkinson's, implies that a subsidy for charitable contributions is desirable under certain conditions, particularly when the government is less efficient in provision, when labor supply is more sensitive to the marginal tax rate, and when there is no preexisting subsidy. Feldstein points out that these findings conflict with the view that all "tax expenditures" should be eliminated. Significantly, Feldstein's model implies that the optimal subsidy does not depend on the price elasticity of giving.

Other Efficiency-Related Considerations

More generally, issues related to administrability or neutrality are proper considerations in the design of tax incentives for contributions. Administrability covers such issues as the compliance and administrative costs of tax provisions. As an illustration, proposals that would specify differing rates of subsidy for different types of charitable organizations might well entail higher enforcement costs. Alternatively, the extension of a tax subsidy for charitable gifts to low-income households might require significant increases in record keeping by taxpayers.

Neutrality arises as an issue particularly in the treatment of different types of charitable gifts. Long (1977) notes, for example, that the charitable deduction in the income tax provides neutral treatment as between gifts of time and money since the value of either kind of gift is excluded in the calculation of taxable income. Thus any important change in the tax

10. See especially Atkinson 1976, p. 25.
11. Boskin (1976, p. 50) makes a similar point.
incentive for contributions in any major tax could distort taxpayers' choices among lifetime gifts, volunteering, bequests, and even gifts made through a corporation. Another way of putting this point is that such tax incentives may affect the various tax bases. The elimination of the charitable deduction in the estate tax might well increase the amount of wealth given away during life, thus reducing the size of estates.  

8.2.3 Distributional Aspects of Tax Incentives

The charitable deduction has come in for sustained and vigorous criticism for its alleged favoritism toward high-income taxpayers. Because the tax savings per dollar obtained from the deduction rises with one's marginal tax rate, high-income taxpayers enjoy a bigger proportional tax reduction in their giving than taxpayers at lower income levels. One critic (Nielson 1979, p. 16) states:

the so-called "tax incentives" for charitable giving which are now embodied in the Internal Revenue Code are so extravagantly discriminatory as between poor and rich donors that for the social-action movements they are effectively meaningless as a help in soliciting individual gifts.

The tax system as a whole is of no assistance in enabling them to be self-supporting through the contributions of their own members. Rather, it condemns them to dependence on baronial benefactors.

Others point out, however, that the differing rates of subsidy are merely an inevitable by-product of the progressive rate structure itself. If successive amounts are taxed at higher and higher rates, then a reduction of a dollar of taxable income must produce a bigger tax reduction at higher incomes.  

Clearly this would not be the case with a tax credit, a fact that has led some critics of the deduction to favor a credit over the deduction on distributional grounds.  

It is important to ask whether this differential subsidy effect has any relevance for distributional equity. In doing so, it is useful to distinguish two kinds of effects resulting from the deduction: effects on the tax liabilities of taxpayers and effects of changes in giving patterns. On the "tax side" the deduction affects taxpayers in much the same way a price reduction does: there is both an income and a substitution effect. The income effect is associated with the improvement in utility for a taxpayer who makes donations, as illustrated in figure 2.3. The substitution effect is the change in the relative price of giving. This substitution effect has no importance for distributional equity per se; it is important primarily for its efficiency implications. Its only distributional importance is in its effect on the pattern of support for charitable organizations, discussed below.

12. See Boskin 1976 for a discussion of this point.
13. See, for example, Wagner 1977, p. 2344.
By contrast, there are clear distributional consequences in the deduction's income effect. These are reflected in the effect of the deduction on tax liabilities. If the charitable deduction were eliminated the distribution of taxable income would change, and along with it the measured progressivity of the income tax. As between any two taxpayers the elimination of the deduction would raise average rate progression\textsuperscript{15} if

\begin{equation}
m_2(G_2/Y_2) > m_1(G_1/Y_1),
\end{equation}

where \(Y\) is income, \(m\) is marginal tax rate, \(G\) is the level of contributions after elimination of the deduction, and the lower- and higher-income taxpayers are denoted by 1 and 2, respectively. In order to see the likely effects on progressivity, table 8.1 shows how tax liabilities would change, based on the simulation model presented in chapter 3. Revenues are held constant in each simulation by means of proportional changes in tax rates. The results show that it is quite likely that eliminating the deduction would in fact increase the progressivity of the income tax. Accounting for the anticipated fall in contributions, those simulations imply that tax liabilities for taxpayers with incomes under about \$30,400\ would decline due to the overall reduction in tax rates made possible by the expansion of the tax base. For taxpayers with incomes over \$36,500,\ taxes would rise. Conversion to a tax credit would increase tax progressivity even more. It is clear, therefore, that the existence and form of the incentive accorded to charitable contributions has effects on tax progressivity. While it would certainly be possible to neutralize the impact of any change in the charita-

\begin{table}[h]
\centering
\begin{tabular}{lcc}
\hline
Income (thousands)\textsuperscript{a} & Elimination of Deduction & 20 Percent Tax Credit \\
\hline
\$6.1 under 12.2 & 0.97 & 0.91 \\
\$12.2 under 18.3 & 0.98 & 0.96 \\
\$18.3 under 24.3 & 0.98 & 0.97 \\
\$24.3 under 30.4 & 0.99 & 0.99 \\
\$30.4 under 36.5 & 1.00 & 0.99 \\
\$36.5 under 60.9 & 1.01 & 1.02 \\
\$60.9 under 121.7 & 1.01 & 1.03 \\
\$121.7 under 243.4 & 1.00 & 1.03 \\
\$243.4 under 608.5 & 1.01 & 1.03 \\
\$608.5 under 1217 & 1.03 & 1.05 \\
\$1217 or more & 1.04 & 1.06 \\
All classes & 1.00 & 1.00 \\
\hline
\end{tabular}
\caption{Ratio of Taxes under Two Proposals to Actual Taxes in 1983, by Income}
\end{table}

\textit{Note:} Simulations use constant income and price elasticities. See chapter 3.
\textit{a}Taxpayers under \$6,100\ have no tax liability under any of the simulated taxes.

\textsuperscript{15} Using the average rate progression measure, a tax is progressive if the average tax rate rises with income. See Musgrave and Musgrave 1980, p. 376.
ble deduction on tax progressivity by an appropriate restructuring in the tax schedule, it remains that the form of the incentive is a factor in determining the progressivity of the tax.

Tax incentives for giving may also have distributional consequences in their effect on giving patterns. Although the structure of net prices resulting from a tax incentive has no direct distributional effect on donors, the pattern of prices can affect the distribution of charitable support to various groups of charitable organizations. Because the present deduction results in net prices that fall with income, charities and charitable activities favored by the wealthy receive disproportionate encouragement. The result, in Vickrey's (1947, p. 131) words, is "a serious plutocratic bias to the activities of privately supported philanthropic, educational, and religious institutions."

To identify this bias is not to determine its ultimate distributional effect, however. A complete assessment of the distributional impact requires an examination of who ultimately benefits from the programs of charitable organizations. It is quite possible, as Schaefer (1968, p. 27) in fact suggests, that the charitable activities favored by the wealthy are more redistributive than organizations supported by lower-income taxpayers.16 Unfortunately, little research into the distribution of benefits from charitable programs is available. Fragmentary evidence presented in chapter 2 on the distribution of church expenditures suggests that a significant portion of expenditures by religious groups is used in support of congregational needs rather than redistribution, but this may be a poor measure of the distribution of actual benefits. It is quite conceivable that charities favored by the wealthy have no larger redistributive component.

Finally, it is possible that the examination of the distributional impact of the charitable deduction should go beyond conventionally measured economic benefits to include the distribution of economic power. Some criticisms of the current deduction clearly imply that the present tax incentives for contributions have the effect of concentrating power at upper income levels.17 This possibility is most evident in the private foundation. Simon writes (1978, p. 5):

We have to acknowledge the fact that private economic power is being deployed, often dynastically, through the device of the charitable foundation and the power it gives the founder and the founder's family to select the objects of their charitable bounty and to manage the charitable assets.

He concludes that, while the legal form and tax treatment of private foundations make it easier to achieve power, the "spectre of privilege" applies

16. Boskin (1976, p. 50) also emphasizes the importance of identifying the beneficiaries of charitable programs, in the context of his discussion of the estate tax.
17. See, for example, Schaefer 1968, p. 25; Donee Group 1977; and Nielson 1979.
to some degree in all tax subsidies for giving available to wealthy taxpayers (Simon 1978, pp. 17, 27). Still, one would expect that the distributional impact of a tax credit would be different from that of a deduction.

8.3 Conclusion

Federal tax policy has a substantial impact on the level and distribution of charitable giving in the United States. The empirical analysis discussed in this study suggests that support for charitable organizations responds both to explicit tax incentives for charitable contributions and to general changes in effective tax schedules. Certainly responses of this sort are important for assessing the implications of actual or proposed tax provisions on the nonprofit sector.

In the normative evaluation of tax policy from the viewpoint of society as a whole, such behavioral response is only one of a number of considerations. Efficiency and distributional equity are the two principal criteria for judging the desirability of tax incentives for charitable giving. The present deductions in the income and estate taxes have effects on the overall progressivity of those taxes, and the degree of behavioral response to tax incentives is relevant in measuring this effect. The differential pricing of contributions arising from the deduction is not itself an equity issue, but this price structure has distributional implications due to the particular pattern of contributions that are encouraged and the benefits that are enjoyed as a result. Again, the degree of behavioral response determines the importance of this distributional effect. In judging the efficiency of tax incentives for contributions, the magnitude of the price elasticity of charitable contributions is only one of several important factors that need to be considered. Others include the external benefits derived from charitable giving, the value of diversity in the provision of services, the effectiveness of such giving compared to government expenditures, and the distributional impact on donors and recipients. Except under very special assumptions, it is impossible to state any simple relationship between the price elasticity and the efficiency of tax incentives for charitable giving.

The United States is distinctive among Western countries in its reliance on nonprofit institutions to perform major social functions. This reliance is rooted in American history and is fostered by federal tax provisions for charitable giving. This study had demonstrated that changes in tax policy—effected through legislation or inflation—can have a significant impact on the level and composition of giving. As long as the nonprofit sector retains its important role in the United States, understanding the effect of the tax structure on charitable giving will be an essential part of the study of public policy in education, health, and many areas of social welfare. Whether or not taxes are an explicit part of policy in any of these areas, taxes are certainly an important implicit component.