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NEW THOUGHTS ON CHARITABLE DONATIONS AND TAX REFORM

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The conventional wisdom assumes that the income tax deduction for charitable donations is the most significant factor in determining the level of individual giving. Following this line of reasoning, any fundamental tax reform that simultaneously eliminates the deduction and lowers tax rates will result in a substantial decrease in individual donations to nonprofit organizations.¹

But two new studies, one by Pearl Richardson of the Congressional Budget Office (CBO)² and the other by Alan Reynolds, Director of Economic Research at the Hudson Institute,³ dispel this myth. They also highlight several important considerations with respect to charitable donations and fundamental tax reform that often are overlooked by the conventional thinkers, including:

- The broad nature of the nonprofit sector;
- The weak economic rationale for special tax treatment granted to nonprofit organizations;
- The importance of individual income and wealth in determining giving patterns; and
- The historical evidence that giving does not depend on high tax rates and the charitable deduction.⁴

1 One study estimates that donations from individuals would decrease by as much as 22 percent if the flat tax plan proposed by Representative Richard Arney (R-TX) and Senator Richard Shelby (R-AL) were passed. See "The Impact of Fundamental Tax Reform on Nonprofit Organizations" in Charles T. Clotfelter and Richard L. Schmalbeck, eds., *Economic Effects of Fundamental Tax Reform* (Washington, D.C.: Brookings Institution Press, 1996), pp. 232-233.

2 Pearl Richardson, "The Potential Effects of Tax Restructuring on Nonprofit Institutions," Congressional Budget Office, February 1997.

3 Alan Reynolds, "Death, Taxes and the Independent Sector: Reflections on the Past and Future Growth of Private Charities and Foundations," *Philanthropy Roundtable*, March 1997.

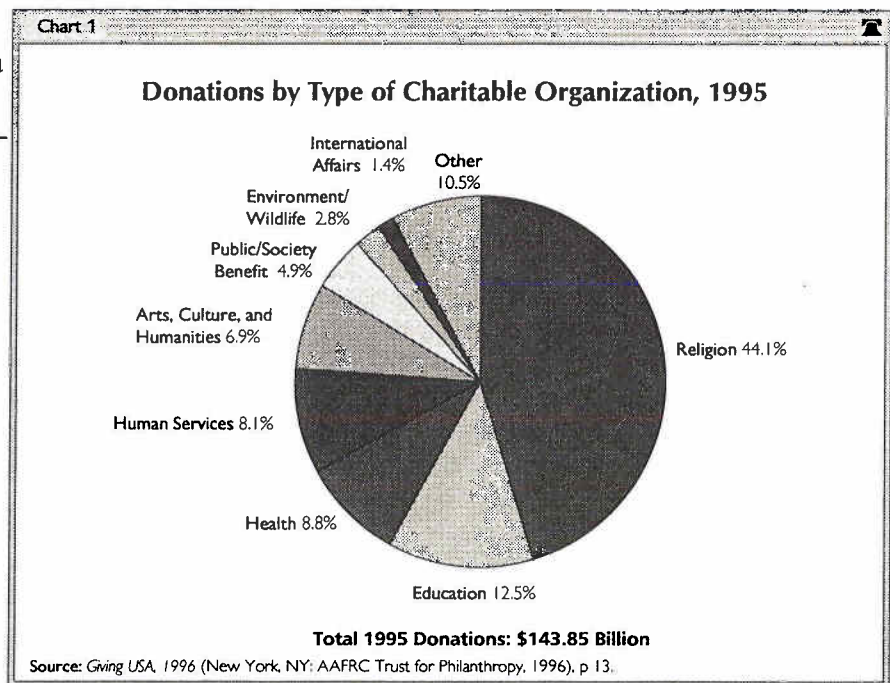
4 For a guide to the issues surrounding the flat tax and charitable donations, see John S. Barry, "How a Flat Tax Would Affect Charitable Contributions," Heritage Foundation *Backgrounder* No. 1093, December 16, 1996.

These considerations (and others) point to a different view of the effect fundamental tax reform might well have on charitable donations. They should not be overlooked in this important debate.

THE NATURE OF THE NONPROFIT SECTOR

What is the nonprofit sector? Typically, Americans think of nonprofit groups exclusively as charitable organizations—such as soup kitchens and women’s shelters—whose aim is to help the disadvantaged. But this perception overlooks the tremendous diversity of the nonprofit sector. In fact, “human service/welfare” organizations received only 9 percent of all charitable contributions in 1994. As the Richardson and Reynolds studies point out, it is important to remember that charitable organizations are only a small part of the entire nonprofit sector when considering the effects of fundamental tax reform on these important institutions.

- **Richardson:** “Tax-exempt institutions are a diverse group. They include foundations, colleges and universities, art museums, hospitals, churches, social welfare institutions, fraternal beneficiary societies, war veterans’ organizations, employee-funded pension trusts, religious and apostolic organizations, farmers’ cooperatives, and many others.”⁵



- **Reynolds:** “The nonprofit, independent, or voluntary sector is quite large and relatively unique to the United States. As we will see, however, the phrase ‘nonprofit sector,’ or the slightly narrower concept of an ‘independent’ sector, does not adequately describe this extremely diverse set of organizations and activities. Generalizations about the whole group, the individual parts of which actually operate in many different ‘sectors,’ are almost always misleading.”⁶

THE RATIONALE FOR SPECIAL TAX TREATMENT

What is it about nonprofit organizations that warrants special tax treatment? The conventional approach to understanding charitable donations takes it for granted that because nonprofits fill the space between government and private provision of goods and services, the tax system must provide special relief for donors to these institutions. Both Richardson and Reynolds cast doubt on this assumption.

5 Richardson, “The Potential Effects of Tax Restructuring on Nonprofit Institutions,” p. 3.

6 Reynolds, “Death, Taxes and the Independent Sector,” p. 6.

- **Richardson:** “In part, the rationale for the deduction for charitable contributions rests on the notion that it stimulates increased giving. But empirical studies on how much it does that show varying results. If giving is less responsive to the deduction, the rationale for the subsidy is weakened. Likewise, if the availability of tax-exempt financing stimulates overexpansion of capital facilities and results in an inefficient allocation of resources, the rationale for that subsidy is weakened as well.”⁷
- **Reynolds:** “To make a case for special tax treatment of any sort, there would have to be sizable external benefits to the public at large, which is hard to find in many cases (e.g., the whole society may indeed benefit from having well-educated neighbors, but the primary financial benefit of a college degree clearly goes to its owner).... So far, economists’ efforts to find a rationale for broad-based use of tax exemption for non-charitable [yet still nonprofit] purposes have had very little success.”⁸

THE INCOME EFFECT VS. THE PRICE EFFECT

A flat tax would eliminate the income tax deduction for charitable donations while lowering tax rates. Both of these changes would have an impact on individual giving. Eliminating the charitable deduction—*while holding all else constant*—would have a negative effect on giving. This is known as the “price effect.” But not all else is held constant with the flat tax. Specifically, lower tax rates would produce greater economic growth and raise personal income, which would have a positive effect on giving. This is known as the “income effect.” Whether the income effect or the price effect is dominant is a matter of debate, but it obviously is important to account for both effects when making judgments about fundamental tax reform.

- **Richardson:** “Any proposal that eliminates or cuts back the deduction for charitable contributions, or that lowers tax rates, effectively raises the price of giving for taxpayers who itemize their deductions—and vice versa. How much that would affect contributions is uncertain. Even if (all else being equal) eliminating or cutting back the deduction would result in less giving, lower tax rates could have a compensatory effect, so giving might remain unchanged.... [More recent evidence] suggests that taxpayers are less responsive to the deduction for charitable donations than was previously thought and that earlier work may have confounded the transitory and long-term responses of taxpayers to changes in the tax price of giving.”⁹
- **Reynolds:** “Lower tax rates did dilute the value of tax deductions, but they had other beneficial effects on the growth of income and wealth that more than offset any negative effects on giving. When high-income families perceive themselves to be unfairly overtaxed, they (1) have less disposable income left to give, and (2) do not feel generous. People may also react to punitive tax brackets in ways that reduce their ability to be generous—one spouse drops out of the labor force, the other retires early.... The rate of growth of contributions depends almost entirely on growth of income and wealth.”¹⁰

7 Richardson, “The Potential Effects of Tax Restructuring on Nonprofit Institutions,” p. 16.

8 Reynolds, “Death, Taxes and the Independent Sector,” p. 21.

9 Richardson, “The Potential Effects of Tax Restructuring on Nonprofit Institutions,” pp. 31–33.

10 Reynolds, “Death, Taxes and the Independent Sector,” pp. 24, 27.

THE HISTORICAL EVIDENCE

On several occasions, analysts and the heads of charitable organizations have predicted certain consequences for charitable giving because of major changes in the tax code. In almost every case, however, they have been proven incorrect as individual giving as a percentage of income has remained stubbornly close to 1.8 percent regardless of marginal tax rates or specific deductibility rules. For example, many predicted a significant drop in giving after passage of the Reagan tax cuts of 1981 and 1986 and a significant increase after the Clinton tax increase of 1993. In both instances, as Reynolds points out, these predictions were proven dead wrong. The lesson of history is that changes in the pattern of individual giving following changes in the tax code cannot be predicted with any certainty.

- **Richardson:** “In general, the more recent work suggests that the stimulative effect of the deduction for charitable contributions, although not negligible, is smaller—and the windfall to contributors larger—than some economists had previously assumed.”¹¹
- **Reynolds:** “The Foundation Center claims that, ‘lower personal income tax rates enacted by the Tax Reform Act of 1986 led to a decline in the growth of charitable contributions, and also created a disincentive for establishing foundations.’ Independent Sector writes that ‘in 1992 [sic] a new Tax Act was passed that increased tax rates for affluent families and the annual rate of change in private contributions increased to 3.4 percent between 1992 and 1994.’ ... Figures supplied by these same organizations totally contradict their claims. It almost looks as though those writing the text for these reports were entirely unaware of the statistics in the same volume.... From 1982 to 1989, while marginal tax rates were falling, real annual giving by individuals rose by 27.8 percent. After two increases in tax rates in 1990 and 1993, by contrast, giving apparently declined through 1994 (although 1994–95 estimates are quite rough, because IRS data are not yet available).”¹²

STILL OVERLOOKED?

As broad and comprehensive as the Richardson and Reynolds reports are, however, they are confined to purely economic explanations for charitable activity. There are other factors that influence philanthropic activity in general and an individual’s decision to give in particular. Most of these influences lie completely outside the tax code and the realm of economics.

Perhaps the most important influence on charitable activity is religious participation. Reynolds hints at this: “There is no reliable measure of the charitable activities of religious organizations, but it is clear that they are far too important to ignore.”¹³ Indeed they are. In 1993, for example, a report published by Independent Sector found that a full 91.7 percent of religious congregations in the United States sponsored human service/welfare programs through the donations they received. These activities ranged from youth groups (72.6 percent of religious congregations were engaged in this activity) and food kitchens (50.1 percent participation) to family and marriage counseling (62 percent participation).¹⁴

On the individual giving side, religious participation is equally important. In 1994, donors who attended church gave an average of 2.2 percent of their income to charity; those who did not attend

11 Richardson, “The Potential Effects of Tax Restructuring on Nonprofit Institutions,” p. 34.

12 Reynolds, “Death, Taxes and the Independent Sector,” pp. 23–24.

13 *Ibid.*, p. 40.

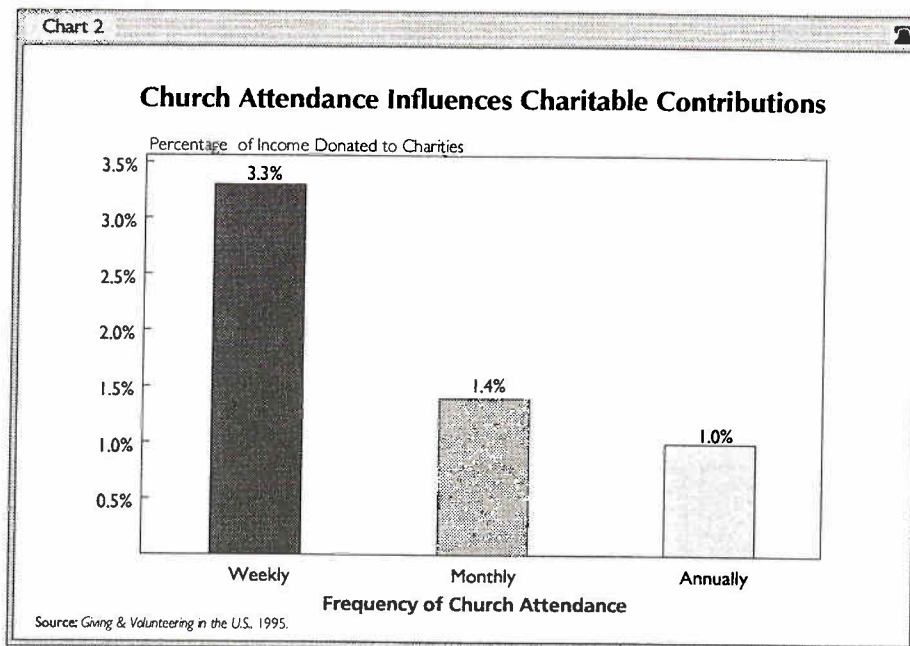
14 Virginia Hodgkinson and Murray Weitzman, *From Belief to Commitment: The Community Service Activities and Finances of Religious Congregations in the United States* (Washington, D.C.: Independent Sector, 1993), p. 45.

church averaged only 1.4 percent. With specific reference to the frequency of church attendance, again in 1994, donors who attended church services weekly gave an average of 3.3 percent of their income to nonprofits; those who attended monthly averaged 1.4 percent; and those who attended only once or twice a year averaged only 1 percent.¹⁵

Other demographic factors also are important determinants of individual

giving patterns. Age is important. Specifically, retirees (individuals over the age of 65) give about 3.4 percent of their income to nonprofits. Those below the age of 45 give an average of about 1.6 percent of their income. Likewise, those who are married or who have been married in the past donate about twice as much on average (as a percentage of income) as do single individuals.¹⁶

All too often, analysts and other interested parties focus on one or two aspects of the current tax code or donating public but ignore the fundamental changes a flat tax would have on taxpayers. These analysts are working within the box of the current system. But the flat tax would represent such a shift in American life that it is necessary to step out of the box and take a fresh look at *all* the important considerations. With these new reports, Pearl Richardson of the CBO and Alan Reynolds of the Hudson Institute have done just that.



HERITAGE STUDIES ON LINE

Heritage Foundation studies are available on the Internet. The Heritage Foundation's World Wide Web home page address is www.heritage.org. Bookmark it for new information daily. Also, www.taxation.org is Heritage's comprehensive source for the latest on tax reform.

15 *Giving and Volunteering in the United States: Findings from a National Survey, 1994 Edition, Vol. I* (Washington, D.C.: Independent Sector, 1994), p. 119.

16 *Ibid.*, pp. 109–116.

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