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WHY THE BUSH TAX CUTS ARE NO THREAT TO PHILANTHROPY

STUART M. BUTLER, PH.D.

President George W. Bush's proposals to reduce marginal tax rates and eliminate the estate tax (the death tax) have raised the concern that gifts to charitable organizations could decline. The argument is that the value or actual "price" to the donor of charitable gifts that currently qualify for income tax or estate tax deductions is reduced because of the tax saving. The higher the individual's tax rate, the bigger the benefit of the tax break and thus, so it is said, the greater the inducement to give. The concern is that under the Bush plan, tax rates would be lowered, thereby lessening the tax savings and hence the incentive to give.

Such concerns overlook the historical relationship between tax benefits and donations. Specifically:

- **Changes in tax rates have a surprisingly small effect on donations.** Charitable organizations predicted that tax rate reductions in 1981 and 1986 would reduce giving. These predictions proved to be incorrect. According to *Giving USA 2000*, an annual report on philanthropy, by 1984, when President Ronald Reagan's economic plan was fully in effect, total charitable giving was 11.8 percent higher (accounting for inflation) than it had been in 1980. Between 1985 and 1989, contributions in inflation-adjusted dollars rose by 19.1 percent, slightly above the long-term increase for similar periods.

  Despite large variations in federal tax rates over the past quarter-century, charitable donations as a percentage of personal income have remained remarkably constant. Although the top marginal income tax rate has ranged from 28 percent to 70 percent during this period, the amount that individuals donate to nonprofit organizations has remained relatively constant at around 1.8 percent of personal income.

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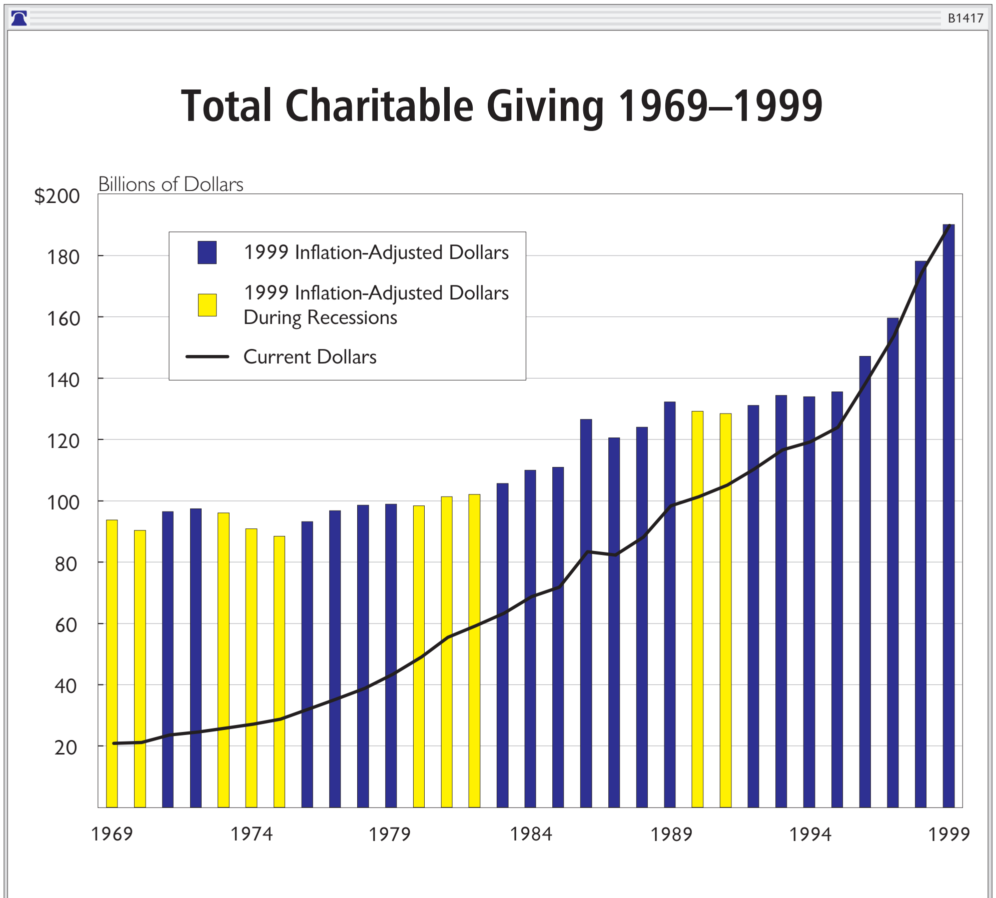
- **The critical economic factor in the level of donations is income, not tax breaks.** When the economy is strong, donations rise. Thus, with reductions in marginal tax rates stimulating the economy and personal income, the most likely result (and the historical pattern) would be an increase—not a reduction—in donations.

- **Worries about the impact of eliminating the estate tax are misplaced.** Although changes in the death tax might alter the manner and timing of charitable contributions, it is unlikely that they would have any significant effect on total giving—except possibly to increase it. The professional economic research tends to support the hypothesis that households do not plan to consume all of their personal savings during their own lifetimes; instead, they expect to pass some savings on to their children, and only what is left over after this parental bequest—and after costs such as taxes are paid—is considered a "residual" for supporting charities. Thus, eliminating the death tax would actually increase the residual available for charitable bequests since the after-cost of planned contributions to heirs would be reduced.



Source: *Giving USA 2000.*

Professor Paul Schervish, who directs the Social Welfare Research Institute at Boston University, once opposed repealing the estate tax but now has changed his view. Data developed by the institute on a sample of individuals with assets of more than $5 million suggest that if estate taxes were reduced, most of the savings would go to a *larger* charitable contribution. As he writes in the January 11, 2001, issue of *The Chronicle of Philanthropy*:

> Instead of resisting repeal, charities and fund raisers might do better to contemplate how to become effective in an environment in which contributions can flow to them through a far less circuitous and expensive route than what the estate tax creates.

Thus, if the philanthropic sector wants to see tax policy that will increase donations, it would be wiser for it to support tax changes that will boost the long-term growth of income and savings—such as rate reductions and the elimination of the estate tax—rather than opposing these changes in the Bush tax plan because of concerns that the benefits of tax deductions would be reduced.

—Stuart M. Butler, Ph.D., is Vice President for Domestic and Economic Policy Studies at The Heritage Foundation.

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WHY THE BUSH TAX CUTS ARE NO THREAT TO PHILANTHROPY

STUART M. BUTLER, PH.D.[1]

President George W. Bush's tax plan calls for reductions in marginal tax rates, elimination of the estate tax (the death tax), and reinstatement of the "above-the-line" tax deduction for charitable donations by households who do not itemize their tax returns and thus do not qualify for that deduction today. These measures and various congressional tax-cut proposals are raising the concern that gifts to charitable organizations would decline if such changes were implemented. The argument is that the value or actual "price" to the donor of charitable gifts that currently qualify for income tax or estate tax deductions is reduced because of the tax saving. The higher the individual's tax rate, the bigger the benefit of the tax break and thus, so it is said, the greater the inducement to give. The concern is that under the Bush plan, tax rates would be lowered, thereby lessening the tax savings and hence the incentive to give.

These concerns are misplaced. They overlook both the reasons why people give to charitable organizations and the historical relationship between tax benefits and donation. Specifically:

- **People donate to charity for religious, civic, or philosophical reasons besides their tax benefits.** In addition to donations from individuals, sources for private donations include corporations, foundations, and bequests.
- **Several factors other than economic circumstances influence how much individuals donate to charitable organizations.** Various surveys indicate that marital status, religious participation, and the donor's age significantly affect the percentage of income each individual contributes.
- **Changes in tax rates have had a surprisingly small effect on donations.** Predictions in 1981

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1. This paper includes significant text and updates information and data provided by former Heritage analyst John S. Barry in "How a Flat Tax Would Affect Charitable Contributions," Heritage Foundation *Backgrounder* No. 1093, December 16, 1996. The author gratefully acknowledges his work and contribution to this paper.

and 1986 that large rate cuts would hurt giving proved to be incorrect. Despite large variations in federal tax rates over the past quarter-century, charitable donations as a percentage of personal income have remained remarkably constant. Although the top marginal income tax rate ranged from 28 percent to 70 percent during this period, the amount that individuals donate to nonprofit organizations remained relatively constant—around 1.8 percent of personal income.

- **The critical economic factor in the level of donations is income, not tax breaks.** When the economy is strong, donations rise. Thus, with reductions in marginal tax rates stimulating the economy and personal income, the most likely result (mirroring the historical pattern) would be an increase—not a reduction—in donations.

It is not new for charitable organizations to express concern about tax rate reductions. Perhaps understandably, they tend to assume that changes in the after-tax "price" of contributions will influence total contributions. But the evidence indicates that while Americans may take advantage of tax benefits in choosing how and when to contribute, the most important economic influence on their contributions is their economic circumstance. Thus, charitable organizations should be stressing the importance of tax rate reductions as a factor in economic growth, not arguing that taxes should be kept high to "help" philanthropy.

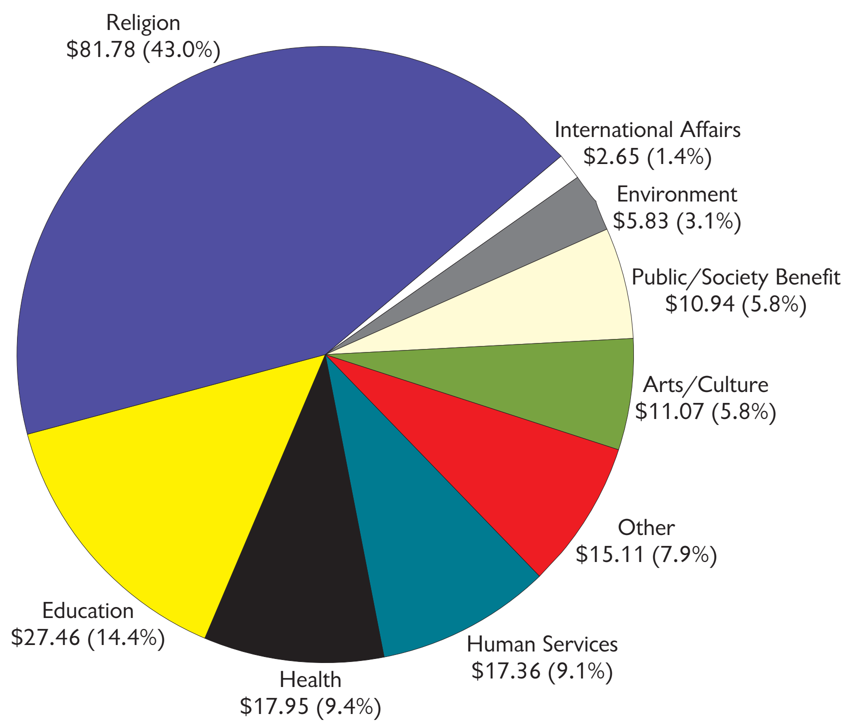
Finally, worries about the impact of eliminating the death tax are misplaced. Although changes in the tax may alter the manner and timing of charitable contributions, it is unlikely that they would have any significant effect on total giving—except possibly to increase it.

WHO RECEIVES CHARITABLE CONTRIBUTIONS?

Religious organizations receive by far the highest percentage of donations; in 1999, they received about 43 percent of total contributions. Education groups—primarily private colleges and universities—are the second largest category, with 14.4 percent of total contributions in 1999.[2]

Chart 1 B1417

1999 Contributions: $190.16 Billion
By Type of Recipient Organization
(In Billions of Dollars)

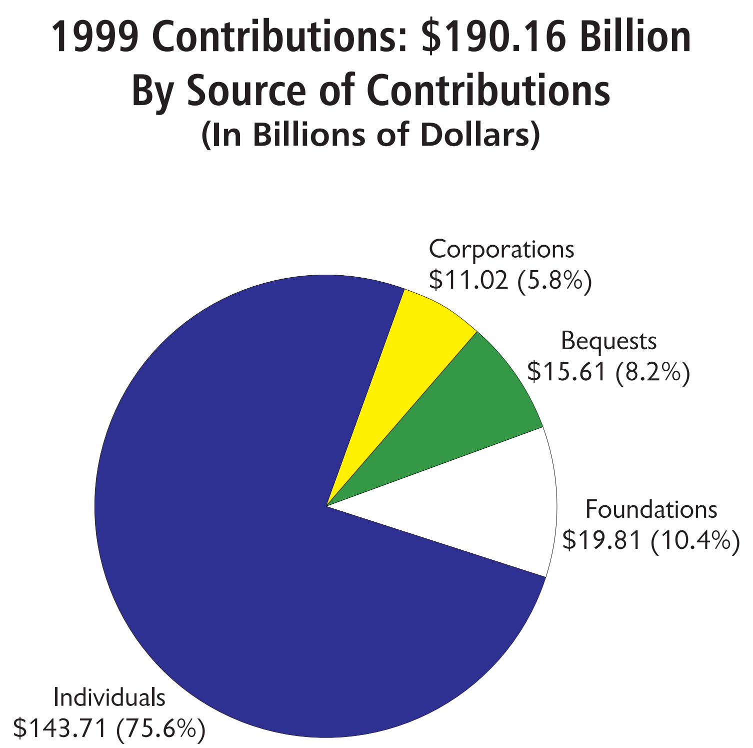


Source: *Giving USA 2000.*

Despite the diversity of recipient organizations, most Americans tend to think of charitable organizations only as those whose aim is to help the disadvantaged. But the so-called human service/welfare nonprofits that do fit this widely held definition received only 9.1 percent of all charitable contributions in 1999. Health-related organizations received just 9.4 percent.

One feature of the pattern of giving that is often overlooked by analysts, however, is the role that religious organizations play in providing basic assistance and counseling to disadvantaged groups. A 1993 study found that over 90 percent of America's religious congregations sponsor human service/welfare programs through the donations they receive. These activities range from youth groups (72.6 percent of religious congregations engage in this activity) and food kitchens (50.1 percent participation) to family and marriage counseling (62 percent participation).[3] In 1991, religious congregations donated a total of $28 billion to other charitable activities, including $11 billion in volunteer time. The $17 billion in direct expenditures represented 31 percent of the total donated to religious congregations that year. In other words, nearly one-third of the money donated to religious congregations is spent on charitable activities other than religious functions.[4]

Chart 2 B1417



Source: *Giving USA 2000.*

WHO CONTRIBUTES TO CHARITABLE ORGANIZATIONS?

Nonprofit organizations receive operating income from a variety of sources. A 1996 study indicated that only 10.1 percent of revenues for a sample of nonprofits came from tax-deductible contributions. The other 89.9 percent came from program service revenues (71.7 percent), government grants (7.9 percent), and other sources (10.3 percent).[5] Different types of nonprofit organizations tend to receive money from different sources. For example, hospitals and nursing homes, although they are generally nonprofits, offer services they can price and sell. These and other groups rely heavily on fees and sales. Homeless and poverty shelters, on the other hand, rely heavily on charitable donations.

Private donations also come from a variety of sources. There are four major donor categories: individuals, foundations, corporations, and

2. *Giving USA 2000: The Annual Report on Philanthropy for the Year 1999* (Indianapolis, Ind.: AAFRC Trust for Philanthropy, Inc., 2000), p. 23.

3. 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.

4. *Ibid.*, pp. 78–79.

bequests. Each has unique characteristics that influence which charities are supported and at what level. In 1999, as Chart 2 shows, individuals contributed the vast majority of dollars (75.6 percent), with foundations, corporations, and bequests responsible for the remaining contributions, for a total of $190.16 billion.

- **Individuals.** Individual donations in 1999 accounted for $143.71 billion worth of private contributions.[6] By far the largest category, it also is the most diverse. Individual donors range from one-income households who give change to their local churches, without any tax relief, to rich families who donate millions of dollars each year to universities or art museums.
- **Foundations.** Donations from foundations amounted to $19.81 billion in 1999. There are more than 38,000 charitable foundations in the United States, most of them small foundations established by individuals. To be sure, one reason foundations exist is to avoid paying taxes. For example, many foundations are established to avoid paying the estate tax, which can be as high as 55 percent of the transfer amount. But foundations also exist for other reasons. For example, they may be a convenient way for many individual donors to pool their gifts and fund projects that would not be possible at the individual level—as is the case with community foundations. Or individuals may establish foundations with specific instructions regarding the causes to which the money will be donated upon their death. Thus, an individual creates a legacy of support for causes that are of importance to him.
- **Corporations.** Corporations accounted for some $11.02 billion in contributions in 1999. There are many reasons why corporations donate to charitable causes: general goodwill among the corporate executives and tax considerations, for example. However, public image and profitability, the main responsibilities of private firms, also are important. Surveys have shown that consumers consider a company's public image in deciding whether to purchase its goods or services. In addition, many companies promote volunteer activities among their employees because, among other reasons, they have found that such service improves employee morale.
- **Bequests.** Donations made by bequest accounted for $15.61 billion in charitable giving in 1999. Bequest, or willed, giving is becoming an increasingly important source of donations for nonprofits.

FACTORS INFLUENCING DONATIONS

Several factors influence the percentage of income an individual donates to charity and the pattern of contribution.

- **Level and Stability of Income.** Although there is no constant relationship between income and donations as a percentage of income, personal income is the most important determining factor in the level of giving. The level of personal income also influences the type of organization to which an individual donates. Upper-income individuals are more likely to give to the arts and humanities, environmental causes, and educational institutions. Lower-income individuals tend to give to religious congregations and human service groups. An individual donor earning over $60,000 per

5. Charles Clotfelter and Richard Schmalbeck, "The Impact of Fundamental Tax Reform on Nonprofit Organizations," in *The Economic Effects of Fundamental Tax Reform* (Washington, D.C.: The Brookings Institution, 1996), p. 214, Table 6–3. This includes hospitals and nursing homes, which account for about 45 percent of the total nonprofit sector (measured by revenues) and receive 93 percent of their income from program service revenues. However, even excluding hospitals, contributions account for less than 35 percent of revenues for nonprofits. Note: these data are based on a sample of nonprofit organizations required to file a 990 tax form, and thus do not include data from organizations not required to file such forms.
6. *Giving USA 2000*, p. 22.

year is roughly seven times more likely to contribute to the arts and humanities than is a donor who earns less than $20,000 per year. On the other hand, those earning more than $60,000 per year are only 1.5 times more likely to donate to religious organizations. The prospect of good economic times also influences giving. A 1999 survey by Independent Sector, a national coalition of voluntary organizations, foundations, and corporate giving programs, found that economic conditions are an important factor; as households become less worried about their economic condition, their propensity to give increases significantly.[7]

- Demographic Factors. Several demographic factors influence the amount of income that individuals donate to charity, regardless of income level. The most important are age, marital status, and church participation. In general, older individuals who have been married and who attend church regularly tend to donate a larger percentage of their income to charitable organizations than do young, single, non–church-attending individuals. In addition, simply being asked to give is a major factor in contributions.[8]
- Religious Observance. There is a strong relationship between religious observance and donations. A survey by Independent Sector found that 84 percent of those attending religious services weekly in 1998 made household contributions.[9] This compares with an average for all households in the survey of 70.1 percent.[10]

WHY CONTRIBUTIONS ARE LIKELY TO BE STABLE DESPITE TAX CHANGES

The historical evidence strongly suggests that future tax rate changes as such will have very little effect on total charitable donations. But to the extent that tax cuts stimulate the economy, the rise in personal income will mean a rise in donations.

It is possible to draw three important conclusions from the historical and economic evidence.

1. The economy is the critical factor in the level of donations; and to the extent that tax policy spurs economic growth, donations will increase.

The level of charitable giving as a percentage of income and economic output has remained relatively constant for decades. But donations do tend to track economic conditions, meaning that an improvement in the economy tends to leverage a more rapid increase in giving. As noted earlier, surveys do indicate that people's tendency to give is quite sensitive to their view of the economy. In the past five years, fast economic growth and high consumer confidence have coincided with a rise in both the volume of donations by individuals and corporations and the percentage of income donated.

This pattern suggests that steps to stimulate economic growth (and thus personal income growth)—such as marginal tax rate cuts designed to spur saving, investment, and work—are very likely to be associated with increased giving.

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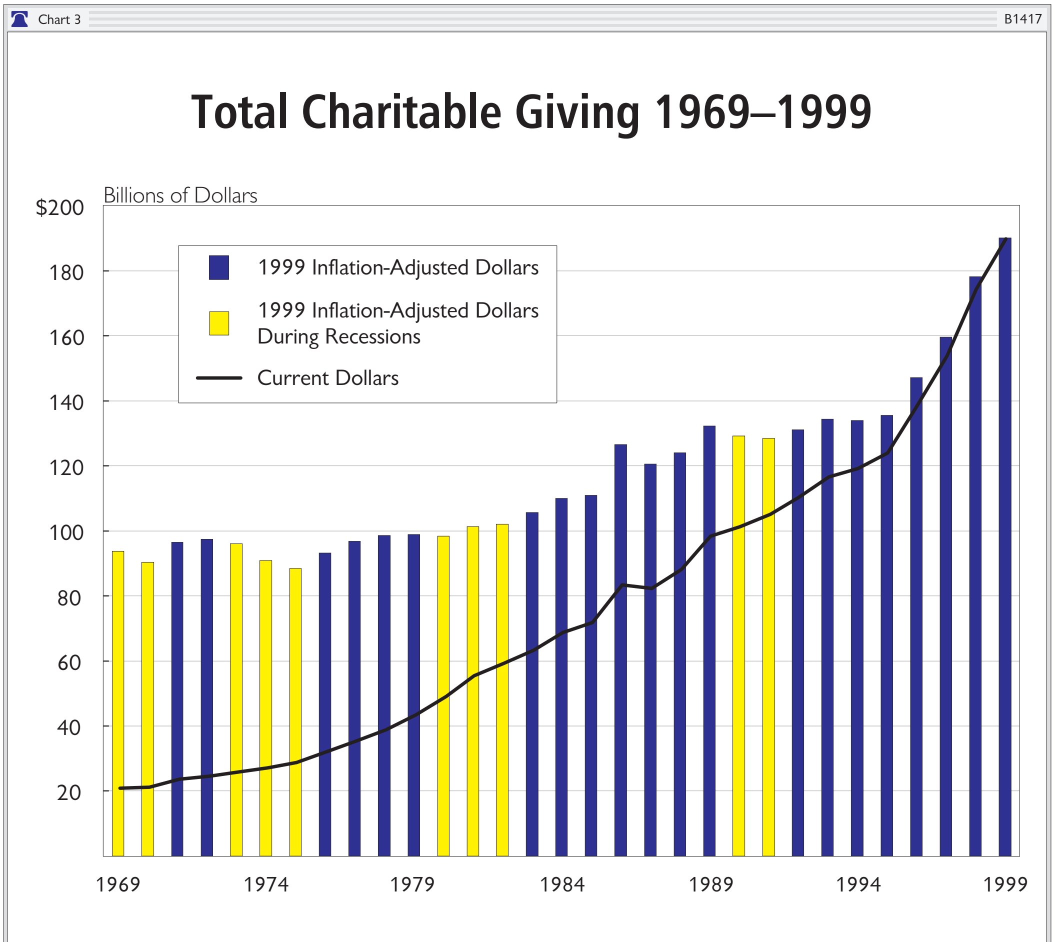
7. *Giving and Volunteering in the United States: Findings from a National Survey* (Washington, D.C.: Independent Sector, 1999); see "Economic Conditions and Charitable Behavior," at *http://www.independentsector.org/GandV/s_econ.htm* (February 22, 2001).
8. *Giving and Volunteering in the United States*, "Household Giving," at *http://www.independentsector.org/GandV/s_hous.htm* (February 22, 2001).
9. *Giving and Volunteering in the United States*, "The Relationship Between Religious Involvement and Charitable Behavior," at *http://www.independentsector.org/GandV/s_rela2.htm* (February 22, 2001).
10. *Giving and Volunteering in the United States*, "Key Findings," at *http://www.independentsector.org/GandV/s_keyf.htm* (February 22, 2001).

2. There is no significant long-term effect from changes in income tax rates.



Source: *Giving USA 2000.*

Although tax policy may increase donations by stimulating economic growth and income, there is little evidence that changes in the tax code as such have a significant long-term effect on total giving. Over the past two decades, there have been quite dramatic changes in marginal tax rates, the number of tax brackets, and other changes that influenced the after-tax "price" of charitable donations. During most of these changes, concerns very similar to the worries expressed today were raised about the impact of the tax proposals on philanthropy. But while tax changes may have influenced the short-term timing of donations (such as deciding between December or January for tax purposes), just as other decisions can be influenced in the short term by tax code changes, there is no indication of any significant relationship between these tax changes and charitable giving over the long term.

Consider these two examples:

- **The 1981 rate cuts.** On several occasions, analysts and organizations have predicted dire consequences for charitable giving because of major changes in the tax code. One such occasion was in 1981, when Ronald Reagan's first economic plan sharply reducing marginal tax rates became law. The plan included an across-the-board reduction of 25 percent in marginal tax rates for individuals and a reduction in the highest individual rate from 70 percent to 50 percent. Many analysts and most directors of nonprofit organizations feared a significant decrease in charitable donations.

  These fears were never realized. By 1984, when the Reagan economic plan was fully in effect, total charitable giving was actually 11.8 percent higher (accounting for inflation) than it had been in 1980.[11] The economic growth that resulted from reducing the marginal tax rates actually boosted the amount of charitable donations. Moreover, total giving accounted

11. *Giving USA*, p. 137.

for 1.8 percent of gross domestic product (GDP) in 1984 compared with 1.7 percent in 1980.[12] Between 1980 and 1984, the amounts contributed by donors in every category (individuals, corporations, foundations, and bequests) increased, as did the levels of contributions received by nonprofits in every category (from the arts to human service organizations). And these increases occurred despite the recession of 1981–1982.

- **The 1986 tax reform.** The 1986 tax bill eliminated numerous deductions in the federal income tax code and lowered the top individual marginal tax rate from 50 percent to 28 percent (certain features did result in a rate slightly higher than 28 percent for some taxpayers). Among other actions, the bill eliminated the "above-the-line" tax deductibility of charitable contributions that had allowed all taxpayers, whether they itemized their returns or not, to deduct charitable contributions from taxable income between 1981 and 1986.

  As in the early 1980s and even today, many analysts predicted a dramatic reduction in the amount of money donated to charitable organizations because of the lower marginal rates on philanthropy and the elimination of the above-the-line deduction. *Philanthropy Monthly*, for example, published an article citing an Independent Sector report that charitable giving would decline by $8 billion because of the 1986 tax bill.[13] But this confused short-term effects with long-term trends. Total donations did fall by 1.3 percent between 1986 and 1987 (by $1.01 billion in current dollars), but the 1986 total had been a sharp 16.1 percent higher than the total in 1985. This 1986 "blip" was most likely due to donors' having advanced giving originally planned for 1987 to 1986 to take account of that year's larger tax break. Donations then rose strongly again in 1988 and 1989, even though the final rate reductions of the 1986 Act were being phased in. Taken together, contributions in inflation-adjusted dollars rose by 19.1 percent between 1985 and 1989, slightly above the historical increase for similar periods.[14] Far from the bleak outcome predicted by analysts, charitable contributions actually increased after enactment of the 1986 tax bill—again, principally as a result of strong economic growth.

3. Reduction or repeal of the estate tax is unlikely to have a major impact on giving.

Many analysts and organizations believe that individuals would have a much-reduced incentive to leave money to charities if the estate tax laws were repealed or reduced. Current estate tax law allows an unlimited deduction for charitable contributions. Instead, the argument goes, people would leave all of their money to their children or other non-charitable causes rather than avoiding tax by making a charitable donation through their estate.

But economic analysis suggests that this would not be the case. Economic theory suggests two ways of looking at how households decide what to do with their lifetime savings and bequests.

- **The "life cycle hypothesis,"** first advanced by economist Franco Modigliani, maintains that households act to accumulate an amount of savings that they plan to exhaust in their own lifetimes. At the end of their lives, a "residual" sum may be left that can be willed to children, charities, or others, depending to a degree on the after-tax cost of leaving money to these various individuals or groups. Under this view, reducing or eliminating the estate tax would decrease the amount bequeathed to charities compared with heirs.
- **The "permanent income" or "overlapping generations" theory,** commonly credited to economist Milton Friedman, maintains that households do not plan to consume all of their

12. *Ibid.*, p. 143.

13. Bruce Hopkins, "Some Fine Print in Tax Reform," *Philanthropy Monthly*, June 1986, p. 15.

14. *Giving USA*, p. 137.

personal savings during their own lifetimes; instead, they expect to pass some savings on to their children, and only what is left over after this parental bequest is considered a "residual" for supporting charities. Under this theory, the current tax on bequests to family members serves to reduce contributions to charitable organizations because of the high after-tax cost of leaving money to heirs. Thus, eliminating the estate tax would *increase* the residual available for charitable bequests, since the after-tax cost of planned contributions to heirs would be reduced.

The professional economic research in recent years has tended to support the view that the permanent income/overlapping generations motive has dominated household saving and bequest behavior in the United States.[15] This implies that any public policy that increases the amount of savings available to households—such as eliminating estate taxes or other taxes on savings—will increase the "residual" left to charitable organizations as well.

Although charitable organizations generally continue to take the view that reducing or eliminating the impact of the estate tax would not be in their interests, this view is by no means universal. Some analysts and organization officials have come to recognize that although donors will take advantage of available tax breaks when they plan or make a gift, eliminating the estate tax could simply alter the way a donation is made by an individual, as well as its timing, rather than reducing the total amount (and may lead to a net increase in the gift).

For example, Professor Paul Schervish, who directs the Social Welfare Research Institute at Boston University, once opposed repealing the estate tax but now maintains that the economic impact of repeal would generate more direct charitable donations. He also notes that research conducted by the institute during the 1990s indicates that charitable bequests have risen more rapidly than the size of total estates (lending support to the permanent income hypothesis). Moreover, data developed by the institute on a sample of individuals with assets of more than $5 million suggest that if estate taxes were reduced, most of the savings would go to a *larger* charitable contribution. Writes Schervish:

> Instead of resisting repeal, charities and fund raisers might do better to contemplate how to become effective in an environment in which contributions can flow to them through a far less circuitous and expensive route than what the estate tax creates.[16]

Analysis by David Joulfaian of the Treasury Department's Office of Tax Analysis indicates that tax rates, wealth, and demographic favors have a complex relationship, making it hard to determine the effect of a change in the estate tax. Joulfaian notes that wealthier individuals generally prefer to make contributions through their estates rather than during their lifetimes (where many see their ability to deduct contributions eroded by the alternative minimum tax). But since the decision to contribute through an estate is affected by income tax rates, estate tax rates, and the ability to accumulate wealth—itself affected by income tax rates during the donor's lifetime—the net effect of reducing estate taxes on total giving is difficult to gauge.[17]

Craig Wruck, chairman of the government relations committee of the National Committee on Planned Giving, notes that estate tax repeal proposals also tend to have other features that would stimulate giving, such as alterations in the rules affecting charitable remainder trusts.[18] Others note that today's estate tax can have a very per-

15. Laurence J. Kotlikoff and Lawrence H. Summers, "The Role of Intergenerational Transfers in Aggregate Capital Accumulation," *Journal of Political Economy*, Vol. 89, No. 41 (1981), pp. 706–732. See also Angus Deaton, "Understanding Consumption," *Clarendon Lectures at Oxford University* (New York, N.Y.: Oxford University Press, 1992), p. 217.

16. Paul G. Schervish, "Philanthropy Can Thrive Without an Estate Tax," *The Chronicle of Philanthropy*, January 11, 2001, p. 47.

17. David Joulfaian, "Charitable Giving in Life and at Death," July 2000, unpublished paper prepared for the Brookings Institution/University of Michigan Conference on "Rethinking Estate and Gift Taxation," May 4–5, 2000.

verse effect on charitable contributions, and elimination could lead to little change or an increase in contributions. Jean Hocker of the Land Trust Alliance, an umbrella group of 1,200 land-conservation groups, believes that elimination of the tax "could be a plus and a minus." While some owners may conserve land today to take advantage of the estate tax's charitable deduction, she notes, family members in other cases are forced to sell land for development to pay a huge estate tax bill.[19]

A recent survey of wealthy individuals, reported in *The Chronicle of Philanthropy*, also suggests that reducing or eliminating the estate tax would have little impact on contributions. According to the *Chronicle*, "[e]liminating the federal estate tax would not cause most people, including the wealthiest Americans, to change their charitable-giving habits…."[20]

CONCLUSION

Although a marginal tax rate reduction stimulates work and savings, by reducing the value of tax deductions, it raises questions about the impact it will have on charitable donations. On its the face, a rate reduction makes a donation less economically attractive and so threatens to reduce contributions—a concern routinely expressed by philanthropic organizations when rate cuts are proposed.

To be sure, a tax change may change the year in which a contribution is made to enable the donor to obtain the largest tax benefit. In this regard, contributions are subject to the same temporary end-of-tax-year effects as any tax-advantaged spending. Moreover, whether a gift is given during a person's lifetime or through an estate is influenced by the relative incidence of estate and income taxes (including the alternative minimum tax). But empirical evidence gives little indication that there is any long-term effect from tax rate changes other than to increase total giving because of increases in income and wealth caused by faster economic growth.

If the philanthropic sector wants to see tax policy that will increase donations, it would be wiser to support tax changes that will boost the long-term growth of income and savings—such as rate reductions and the elimination of the estate tax—rather than opposing these changes in the Bush tax plan because of concerns that the benefits of tax deductions are reduced.

—Stuart M. Butler, Ph.D., is Vice President for Domestic and Economic Policy Studies at The Heritage Foundation.

18. Thomas J. Billitteri, "A Taxing Dilemma," *The Chronicle of Philanthropy*, July 27, 2000, p. 18.

19. *Ibid.*

20. "New Poll Shows How Wealthy View Estate Tax, Other Giving Issues," *The Chronicle of Philanthropy*, January 25, 2001, p. 23.