

Background

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Obama's Latest Proposal to Reduce Charitable Deductions Would Crowd Out Civil Society

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Abstract: *President Barack Obama's FY 2012 budget proposal would harm charitable organizations by raising the tax rate on upper-income individuals and families and reducing their income tax deduction for charitable donations. These two changes in the tax code would discourage charitable donations and leave the most generous donors with less money to donate. Predictably, they would shift resources from private nonprofit charitable organizations to the federal government, which is consistently less effective and efficient in caring for the needy.*

In the face of recent economic challenges, charitable organizations have been forced to do more with less. This situation will likely continue because unemployment is expected to remain significantly elevated through at least 2014. Charitable organizations often serve those in need more effectively or efficiently than government agencies can. Many nonprofits rely on large gifts from wealthy individuals and families. Especially during tough economic times when total charitable giving tends to decrease,¹ public policy should encourage voluntary donations to organizations that help the poor.

If enacted, President Barack Obama's proposed budget for fiscal year (FY) 2012 will likely dampen charitable giving. The President not only calls for raising the tax rate on high earners beginning in January 2013, but also proposes reducing their income tax deduction for charitable giving beginning in January 2012. This both weakens the incentive for the

Talking Points

- President Barack Obama's proposal to raise income taxes and reduce charitable deductions for high earners mistakenly assumes that government bureaucracy can deploy citizens' resources more effectively than private citizens and nonprofit civil society organizations can.
- Under the President's plan, annual charitable giving would likely drop by more than the combined annual operating budgets of the American Cancer Society, World Vision, St. Jude Children's Research Hospital, Habitat for Humanity, and the American Heart Association. Universities and medical centers could be hit particularly hard.
- Perhaps more important, by absorbing more of the resources dedicated to social welfare, government would likely crowd out civil society organizations that provide for those in need.
- The President's plan moves the dial of social responsibility one more notch in the direction of the state at the expense of local institutions that serve the poor more personally and efficiently.

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wealthy to give and shifts the perceived responsibility for social welfare from individual donors to the state.

Bad News for Charities

In February, the White House unveiled its FY 2012 federal budget, which includes tax proposals that would directly affect those who give the most to charity.

First, the President calls for raising taxes on individuals making \$200,000 or more and families making \$250,000 or more per year.² If these tax hikes take effect in two years, the tax rate for those in the highest marginal income bracket will

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increase from 35 percent to 39.6 percent. The tax rate in the second highest bracket will increase from 33 percent to 36 percent. The total tax increases on upper-income families will cost them an estimated \$709 billion over 10 years.³

Second, the proposed budget would reduce the value of itemized tax deductions for higher-income taxpayers beginning on January 1, 2012. Currently, American citizens in the top bracket who donate to charities can receive a tax deduction equal to their tax rate, which is 35 percent. This write-off not only provides an incentive to give to organizations that serve the needy, but also allows citizens to control more of their own money, enabling them, if they wish, to donate more to charity.

The President's proposal would limit the rate at which taxpayers can take itemized deductions to 28 percent, which is well below the 35 percent of current law or the proposed 39.6 percent tax rate. By

lowering the deduction rate to 28 percent and raising the tax rate to 39.6 percent, Obama's proposals would reduce the value of this deduction by 30 percent for donors in the highest tax bracket.

Obama's plan is particularly bad news for charities that rely on large gifts. The proposal both raises the income tax rate on those most able to give large gifts and reduces the deduction for their charitable gifts. While these changes would affect only a small percentage of American households, the affected households currently contribute almost half of the donations claimed each year as charitable deductions.⁴ Obama's proposal would likely have a negative effect on contributions to hospitals, educational institutions, and nonprofits that help the poor.

Furthermore, Obama uses the "cost" of extending alternative minimum tax (AMT) relief for three years to justify lowering the deduction to raise \$321 billion over 10 years. Congress originally designed the AMT to prevent *über*-wealthy earners from lowering their tax liability too severely. It was never intended to apply to middle-income earners. While Congress failed to index the AMT for inflation, it has consistently raised the AMT threshold each year to prevent the AMT from taxing middle-income families.

The President's budget uses the phantom revenue "lost" by adjusting the AMT for inflation to justify lowering the charitable deduction.

In accordance with this congressional practice, Obama's budget proposal raises the AMT threshold for the next three years. However, it pretends that this represents a tax cut that must be offset by other means—namely, a reduction in the charitable deduction rate. In effect, Obama proposes to avoid the unintended AMT tax hike by limiting the chari-

1. Press release, "Giving USA: Charitable Giving During Recessions Doesn't Keep Up with Inflation," Giving USA Foundation, February 11, 2008, at http://www.aafrc.org/press_releases/releases/PR_021108.pdf (March 23, 2011).
2. Barack Obama, "The Budget Message of the President," The White House, February 14, 2011, at http://www.whitehouse.gov/sites/default/files/omb/assets/budget/03_Presidents_Message.pdf (March 23, 2011).
3. Curtis S. Dubay, "Obama's 2012 Budget: Higher Taxes, Slower Growth," Heritage Foundation *Background* No. 2533, March 21, 2011, at <http://www.heritage.org/Research/Reports/2011/03/Obamas-2012-Budget-Higher-Taxes-Slower-Growth>.
4. See Internal Revenue Service, "SOI Tax Stats—Individual Income Tax Returns," updated December 20, 2010, at <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=133414,00.html> (March 23, 2011).

table deduction to raise taxes.⁵ In short, the President's budget uses the phantom revenue "lost" by adjusting the AMT for inflation to justify lowering the charitable deduction. This is a poor excuse for raising taxes that will hurt civil society.

Likely Results

Even a small percentage reduction in charitable giving would mean billions of dollars less each year for charities, especially if the weak economy continues as the President's own economic forecast suggests.⁶

Obama made a similar attempt to reduce charitable deductions in his FY 2010 budget. During that debate, scholars at the Center on Philanthropy at Indiana University estimated that Obama's proposed changes would have reduced total itemized giving by wealthy households by almost \$4 billion.⁷ While this is only a small percentage of total annual charitable donations, it is more than the combined annual operating budgets of the American Cancer Society, World Vision, St. Jude Children's Research Hospital, Habitat for Humanity, and the American Heart Association.⁸

Reduced donations would likely reduce employment either by slowing the creation of new jobs or by eliminating existing jobs because of the lack of funds.

More recently, a survey of health care development professionals found that 61 percent of fundraisers expected such a reduction of the charitable giving deduction to reduce donations by 10 percent to 19 percent.⁹ This would likely lead non-profit hospitals and health care providers to cancel or delay purchase of medical equipment, hospital renovations, and hospital expansions.

Few donors give based solely on the charitable deduction, but experts suggest that the tax deduction can influence the manner and the timing of giving and the number and size of the gifts.¹⁰ This is especially true with large gifts from high-income Americans. The proposed reduction of charitable deductions would most affect organizations that depend on donations from donors in the top tax brackets. Universities and medical centers could be hit particularly hard. These institutions and other

5. Dubai, "Obama's 2012 Budget."
6. U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2012* (Washington, D.C.: U.S. Government Printing Office, 2010), p. 202, Table S-13, at <http://www.whitehouse.gov/omb/budget/Overview/> (March 25, 2011).
7. "Obama's Tax Plan Could Cause Giving by the Wealthy to Drop by Several Billion Dollars Annually," *The Chronicle of Philanthropy*, February 27, 2009, at <http://philanthropy.com/news/updates/index.php?id=7285> (April 7, 2009). The study looked at how the Administration's tax proposals would have affected giving among taxpayers earning more than \$200,000 in 2006 (the most recent year for which itemized deduction data were available at the time of the study).
8. Calculation based on figures in American Cancer Society, "Combined Financial Statements as of and for the Years Ended August 31, 2008 and 2007," February 23, 2009, at http://our.cancer.org/downloads/AA/ACS_Combined_Financials_FY2008.pdf (March 23, 2011); World Vision, "2010 Annual Review," at http://www.worldvision.org/content.nsf/about/ar-financials?Open&lpos=bot_txt_2009-Annual-Review#FinancialAssesmentAndOutlook (March 23, 2011); St. Jude Children's Research Hospital, 2009 annual report, 2010, at http://www.stjude.org/SJFile/annual_report_09.pdf (March 23, 2011); Habitat for Humanity International, "Consolidated Financial Statements: Years Ended June 30, 2010 and 2009," at http://www.habitat.org/support/report/2010/consolidated_financial_report_2010.pdf (March 23, 2011); and American Heart Association, "Financial Statements," June 30, 2010, at http://www.heart.org/idc/groups/heart-public/@wcm/@global/documents/downloadable/ucm_318583.pdf (March 23, 2011).
9. See Association for Healthcare Philanthropy, "The Effect of Proposed Changes to Charitable Gift Tax Deductibility on Health Care Philanthropy: AHP Survey Results—February 2011," at <http://www.ahp.org/Resource/advocacy/us/giftstaxesIRS/taxdeductibilitycharitablegiving/Documents/AHPTaxDeductibilityofCharitableGivingSurvey-February2011.pdf> (March 23, 2011).
10. Raymund Flandez, "Tax Proposals Worry Hospital Fund Raisers," *The Chronicle of Philanthropy*, March 16, 2011, at <http://philanthropy.com/blogs/prospecting/tax-proposals-worry-hospital-fund-raisers/29041> (March 23, 2011), and John H. Graham IV et al., letter to President Barack Obama, March 4, 2011, at http://www.independentsector.org/uploads/Policy_PDFs/FY2012CharitableDeductionLetter-final.pdf (March 23, 2011).

nonprofits employ many people, so reduced donations would likely reduce employment either by slowing the creation of new jobs or by eliminating existing jobs because of the lack of funds.

Crowding Out Civil Society

Since taking office, Barack Obama has often repeated the claim that the wealthy need to bear more of the burden for government social services. However, he has carefully avoided acknowledging that the less than 5 percent of taxpayers who earn more than \$200,000 annually already pay 48 percent of all federal income taxes.¹¹ Furthermore, these same taxpayers make significant donations to private charities.

Through both their charitable giving and their taxes under the current system, the wealthy already shoulder a larger burden for social welfare. The issue is not whether higher-income persons should pay more in taxes than lower-income persons—they already do—but whether the federal bureaucracy can deploy the resources of the wealthy more effectively than nonprofit, civil society organizations can.

Obama's proposal clearly reflects the belief that government knows best how people should spend their money.

The proposed tax changes not only fail to strengthen the role of civil society organizations, but also risk pushing them to the periphery in the provision of social welfare. This “crowding out” occurs when government claims increasing responsibility for tasks traditionally performed by civil society and

absorbs a larger percentage of the resources dedicated to carrying out those tasks. This phenomenon can be seen in many policies that expand government's role in society.

For example, before Medicare Part D was enacted in 2003, two-thirds of Medicare enrollees received prescription drug coverage from another source.¹² Analysts have found that the new drug benefit is crowding out private coverage at a rate of 72 percent: Five of every seven prescriptions now paid for by the government would previously have been privately financed.¹³ The State Children's Health Insurance Program (SCHIP) has had a similar crowding-out effect. The Congressional Budget Office estimates that in 2007, 25 percent to 50 percent of children covered by SCHIP expansions were likely crowded out of private coverage.¹⁴

Regardless of where it occurs, crowding out tends to yield the same result: Private institutions that can better care for those in need are left with fewer resources, while more resources are transferred to government programs that are consistently less efficient and less effective.

What Obama's Proposal Communicates

Perhaps most important and problematic, Obama's proposal clearly reflects the belief that government knows best how people should spend their money.

In *To Empower People*, Peter Berger and the late Richard John Neuhaus describe the importance of “mediating institutions” to a healthy democratic society. These institutions are forms of association (e.g., family, church, and other nonprofit organizations) that stand between citizens and the large institutions of public life (e.g., government).¹⁵

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11. See The Heritage Foundation, “Who's Paying How Much to IRS,” *A La Chart* No. 39, December 10, 2008, at <http://origin.heritage.org/Multimedia/InfoGraphic/Who-s-paying-how-much-to-IRS> (March 23, 2011).
 12. Joint Economic Committee, U.S. Congress, “Medicare Beneficiaries' Links to Drug Coverage,” April 10, 2003. For more on the crowding out caused by Medicare Part D, see William W. Beach, “The 2009 Index of Dependence on Government,” *Heritage Foundation Center for Data Analysis Report* No. CDA10-01, March 4, 2010, at <http://www.heritage.org/research/reports/2010/03/the-2009-index-of-dependence-on-government>.
 13. Frank R. Lichtenberg and Shawn X. Sun, “The Impact of Medicare Part D on Prescription Drug Use by the Elderly,” *Health Affairs*, Vol. 26, No. 6 (November 2007), pp. 1735–1744.
 14. Congressional Budget Office, “The State Children's Health Insurance Program,” May 2007, p. 12, at <http://www.cbo.gov/fipdocs/80xx/doc8092/05-10-SCHIP.pdf> (December 14, 2009).
 15. Peter L. Berger and Richard John Neuhaus, *To Empower People: From State to Civil Society*, 20th anniversary ed. (Washington, D.C.: AEI Press, 1996), p. 158.

Mediating institutions are essential for generating and maintaining the operative values of American society. They are also well equipped to provide personalized care to those in need. They have intimate knowledge of and personal relationships with those in need. They also understand social problems in up-close and personal ways. Driven by deep convictions and compassion, such organizations can provide loving forms of assistance and care that government programs simply cannot offer, and they often do so for less money. Smaller and more flexible than most government bureaucracies, local congregations and charities can also spawn creative social innovations that benefit those in need.

Berger and Neuhaus claim that public policy should “cease and desist from damaging mediating structures.”¹⁶ More than that, public policy should protect mediating institutions and, where possible without co-opting them, further empower them in their efforts to promote the common good.

The tax plan in Obama’s 2012 budget proposal would have the opposite effect. It assumes that the state should take responsibility for people’s needs, even at the expense of vital mediating institutions. It communicates the notion that America is better off with expansive and intrusive government rather than limited government.

In short, the Administration’s proposed tax plan penalizes those who can give the most, shifts dollars from citizens and local private charities to distant and unaccountable government bureaucracies, and prioritizes mandatory taxation over voluntary tithing and giving.

Regrettably, President Obama’s proposed tax changes would move the dial of social responsibility one more notch in the direction of the state. This sets the stage for adopting future policies that could further chip away at local, personal, and mutual obligations and increase dependence on government.

Conclusion

The Administration’s proposed tax changes would extract more taxes from families in the highest marginal income tax brackets, leaving them with less money to donate to charitable organizations at a time when charities most need resources to care for the poor.

The President should use his authority and influence to encourage voluntary giving and to protect nonprofit groups, especially during tough economic times. President Obama speaks articulately and often of the important role that charitable institutions play in America, yet his proposed budget would undermine them. He should change his policy to match his rhetoric, beginning with dropping his proposed limits on charitable donations.

Ultimately, the best solution would be true tax reform that encourages productive behavior and allows citizens to direct more of their resources to the charitable programs and institutions of their own choosing.

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16. *Ibid.*, p. 163.