Charitable deductions

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Preferential tax treatment of expenditures or gifts to organizations that the law qualifies as having a socially beneficial characteristic and for which the donor is not motivated by direct benefit when making the contribution.

Since 1917, individual federal taxpayers have been allowed to deduct gifts to charitable and certain other nonprofit organizations. Such organizations (hereafter called “charitable”) were already exempt from the income tax. A charitable deduction extended the benefits of exemption to individual taxpayers, so that income donated to charitable organizations was exempted from all levels of income taxation.

The deduction was intended to subsidize the activities of private organizations that provide viable alternatives to direct government programs. The 1917 law increased tax rates, and the deduction was introduced to alleviate congressional concern that the higher tax rates would discourage private charity (Wallace and Fisher 1977). To control the revenue loss, total charitable deductions were limited to 15 percent of taxable income. Corporations were first allowed a deduction in 1935.

Under the current federal income tax, individuals who itemize deductions can deduct contributions to certain organizations operated for religious, charitable, scientific, literary, or educational purposes. The list also includes domestic government entities, fraternal societies, organizations that prevent cruelty to children or animals, and several other types of socially beneficial organizations. Organizations must be operated in a nonprofit form and are subject to other restrictions.

Types of deductible contributions include cash, financial assets, and other noncash property such as real estate, clothing, and art work. In general, the law limits gifts of cash or other non-capital gains assets to no more than 50 percent of the (slightly modified) adjusted gross income. Contributions of capital gains property are generally limited to 30 percent of adjusted gross income. Both individuals and corporations can carry forward contributions that exceed the limits and use them as deductions in later years. Samansky (1993) provides a comprehensive discussion of current law.

A donation of appreciated capital gains property can be deducted at its full current market value. The capital gains portion is, in effect, deducted twice. It is implicitly deducted once against itself because the capital gains will never be taxed. It is also explicitly part of the itemized deduction, so that other income is shielded from taxation.

In 1991, individual deductions totaled \$60.6 billion and corporate deductions totaled \$4.8 billion. For fiscal 1995, the Joint Committee on Taxation estimates the tax expenditure at \$17.3 billion for deductions by individuals and \$1.2 billion for deductions by corporations.

The deduction subsidizes giving by lowering the price that people must pay privately to support charitable organizations. A charitable contribution of one dollar that is deducted from taxable income lowers the donor’s tax bill and thus decreases the resources available for the donor’s other consumption, the price, by less than a dollar. For example, if a donor’s marginal tax rate is 30 percent, a deductible one-dollar cash gift to charity will reduce the donor’s taxes by 30 cents, so the price of the gift to the donor will only be 70 cents.

This price reduction affects giving in two ways, which economists refer to as income and substitution effects. The income effect results because the reduced price effectively makes more income available for all consumption. If people normally give more as income rises, the income effect of the price reduction will induce people to increase giving. The substitution effect arises because the reduced price makes giving cheaper relative to other commodities, which will induce people to give more. Empirical studies indicate that both the income and substitution effects cause people to increase charitable giving (Clotfelter 1985).

Many policy justifications have been offered for the charitable deduction. Some argue that an ideal income tax should not treat gifts to charity as part of an individual’s income (Andrews 1972). Under this view, an income tax should reallocate resources that would have been used for private consumption and use them for public consumption. Because charitable giving is not used for the giver’s private consumption, it would not be fair to include it in the tax base.

Some argue that private charitable activity is superior to direct government activity (Belknap 1977). For example, private social and religious organizations provide some services that substitute for government programs, such as providing food or shelter for the poor. The tax deduction and tax exemption subsidize those organizations while avoiding the direct participation of government, which might be more intrusive and also risk violating the constitutional principle of separation of church and state. A similar argument can be made for encouraging donations to private educational institutions. Not only might the tax deduction be less intrusive than direct government spending, but private institutions sometimes approach education differently from public institutions. Competing approaches can encourage pluralism and increase innovation.

Another justification for the deduction and the exemption is that private charitable organizations may provide social goods more efficiently than the government. Because taxes are mandatory and the burden of taxation and governance is spread among many people, individuals can have little incentive to increase government efficiency. In the private nonprofit sector, however, competition among organizations for donations creates an incentive for the organizations to operate efficiently.

Popular policy justifications can often be reduced to descriptions of the many socially desirable activities of charitable organizations. To an extent, this justification is simply an individual expression of taste for more of a good thing. It is natural for such people to argue for a subsidy that encourages others, whose tastes may differ, to give more.

Even if tastes did not differ, however, some charitable activities would be supplied inadequately if there were no subsidy. This is because the activities may create additional social benefits, external to those experienced by a donor. A person who donates money to help the poor, for example, receives private satisfaction from the act of generosity, but other people, aside from the poor, also benefit from a reduction in poverty. The donor does not account for this external benefit, however, but decides how much to give by comparing the private cost of a contribution with the private satisfaction received. Consideration of the additional external benefits would warrant a larger donation. All potential donors could be made better off as a group if they were either compelled through taxes or encouraged by subsidy to give more.

Examples of subsidized activities with external benefits abound. Education and religion can improve moral conduct, decrease crime, and increase civic responsibility. Education can decrease poverty. Education and scientific research increase general knowledge and speed the rate of technological progress, which can improve the standard of living. In each case, benefits extend to people beyond those who provide voluntary financial support or benefit directly from the activities.

Economic efficiency of the tax subsidy provided by the charitable deduction can be evaluated by comparing costs with benefits. The cost of a deductible charitable contribution is shared with other taxpayers. The after-tax cost is borne privately by the donor, but the amount by which the deduction reduces taxes is an additional social cost shared with other taxpayers. Cost-sharing occurs, whether it means that taxes must be increased or government spending decreased to make up for the tax revenue forgone as a result of the deduction.

The amount of external benefit provided by the subsidy increases with the satisfaction that other potential donors experience if the subsidy increases giving, measured by the extent by which the amount of charity would have been inadequate without a subsidy, and the degree to which the subsidy actually does increase giving. External benefits can be difficult to measure and probably vary greatly among subsidized activities. For example, people probably benefit by different amounts from poverty reduction and scientific innovation. Further, many subsidized organizations provide a mix of public services that have external social benefits with social goods that could be provided adequately to organization members through the use of member-ship fees. A subsidized increase in such services would provide no external benefits. Finally, even if a charitable activity has external benefits, the tax subsidy only increases the external benefits to the extent that it increases giving.

Substantial empirical research suggests that the subsidy does increase giving (Clotfelter 1985), although the estimated size of the effect is not very robust in more recent evidence (Steinberg 1990). Some published evidence suggests that the subsidy increases certain types of charitable giving more than others. For example, Schiff (1990) found that giving to support elementary education is more sensitive to the subsidy than giving to health and medical charities. This evidence suggests that the most efficient policy might subsidize different types of charity at different rates. Randolph (1995) suggests that studies have generally overstated the degree to which the subsidy increases giving, which weakens, somewhat, its economic policy justification.

Economists often argue that a deduction is not the best device for providing a subsidy. An efficient subsidy would vary with the amount of external benefits, whereas the tax subsidy rate provided by a charitable deduction varies only with the giver's tax rate. A deduction thus provides larger subsidies to charitable organizations favored by higher-income taxpayers, because they face higher marginal tax rates. The deduction also currently provides no subsidy for gifts by people who do not itemize deductions. Some argue that a tax credit would be a fairer and more efficient form of subsidy because the subsidy rate would not depend as much on the giver's level of income (Hochman and Rodgers 1977).

Additional readings

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Cross references: adjusted gross income; itemized deductions; Joint Committee on Taxation, U.S. Congress; nonprofit organizations, federal tax treatment.