The Heritage Foundation Backgrounder

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HOW A FLAT TAX WOULD AFFECT CHARITABLE CONTRIBUTIONS

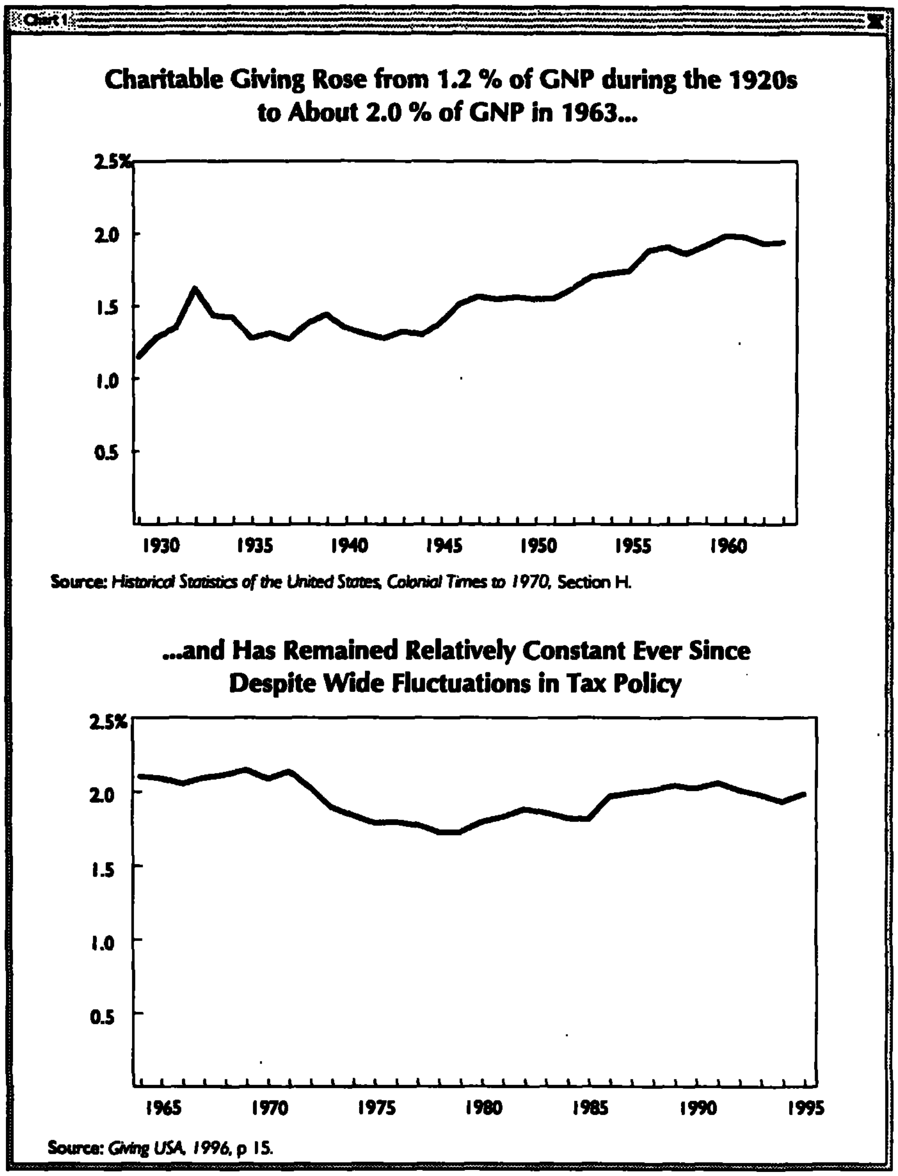
INTRODUCTION

Congress passed the income tax deduction for charitable contributions in 1917, only four years after ratification of the Sixteenth Amendment, which established the federal income tax. The purpose of the deduction then, as today, was to promote private donations to nonprofit institutions. Through the ups and downs of federal income tax rates, the deduction for charitable contributions has remained constant and unquestioned—until now.

With talk of overhauling the federal income tax in favor of a simple, consumption-based flat tax also has come talk of eliminating the charitable contribution deduction. This has raised considerable controversy. Many proponents of a flat income tax call for retaining the charitable deduction, but there are substantial reasons to eliminate the charitable deduction as part of any flat tax proposal. Contrary to popular opinion, the data suggest that giving to charities probably would increase with passage of a flat tax with no charitable deduction. The reason: The flat tax increases economic growth, personal income, savings, and net wealth, all of which lead to higher levels of giving. Specifically,

- **Despite large variations in federal tax rates over the past two decades, donations as a percentage of personal income have remained constant.** Although the top marginal income tax rate has ranged from 28 to 91 percent over the past two decades, the amount that individuals donate to nonprofit organizations has remained relatively constant: around 1.83 percent of personal income.
- **The flat tax would increase personal income, leading in turn to increased donations.** Because the percentage of income donated to charities historically has been so constant, the surest way to increase charitable donations is to increase personal income. Put another way, even if the number of slices of the income pie donated to charity remains the same, a larger pie means larger slices.

- **Several factors other than tax treatment determine how much individuals donate to charitable organizations.** Various surveys indicate that marital status, religious participation, and age all significantly affect the percentage of income an individual donates to charity. But these factors lie largely outside the income tax structure and therefore have little to do with whether the federal income tax is flat or not.



Retaining the charitable deduction as part of a flat tax carries with it several negative consequences, all of which hinder the underlying goal of a flat tax: to make the federal income tax system fairer and less intrusive by taxing all income only once and at its source, presumably at a low rate. Any proposed change should be measured against this standard. In particular, retaining the charitable deduction would have the following detrimental effects:

- **A higher tax rate.** Retaining the charitable contribution necessitates a higher tax rate that would be faced by all taxpayers, including those in lower income brackets.

- **The possibility of other deductions.** The best excuse for any deduction is the previous one—and the next one might well not be as admirable as the charitable deduction.

- **Federal government social engineering.** The overriding problem with the current tax code is that it arbitrarily encourages certain behaviors and discourages others. Retaining any deductions under a flat tax regime, including the charitable contribution deduction, will continue this practice. Individuals should be free to chose how they spend their own hard-earned money.

Estimates by Heritage Foundation analysts indicate that aggregate contributions would increase slightly with passage of a flat tax even without a charitable contribution deduction. Certainly, some nonprofit organizations would benefit more than others; but, it can be presumed that religious congregations and human service charities would benefit most from a flat tax.

In order to estimate the probable impact of a flat tax on charitable giving, it is necessary to examine three areas:

- **What** sorts of organizations make up the nonprofit sector,
- **Who** makes up the donor population, and
- **How** the nonprofit sector finances its activities.

DEFINING THE NONPROFIT SECTOR

Modern American society generally has organized its activities into two categories, the public and private sectors. The private sector, or market, includes businesses, corporations, and other entities motivated to earn a profit by selling a good or service. The public sector, or government, is meant to provide those services that are not produced by the market. Lester Salamon and Helmut Anheier describe this dual system in the following terms:

> Despite the immense diversity of organizations that comprise modern society, we have come to accept the existence of two grand complexes of institutions—two broad sectors—into which it has become conventional to divide social life. We refer to these typically as the *market* and the *state*, or the *private* and the *public* sectors.[1]

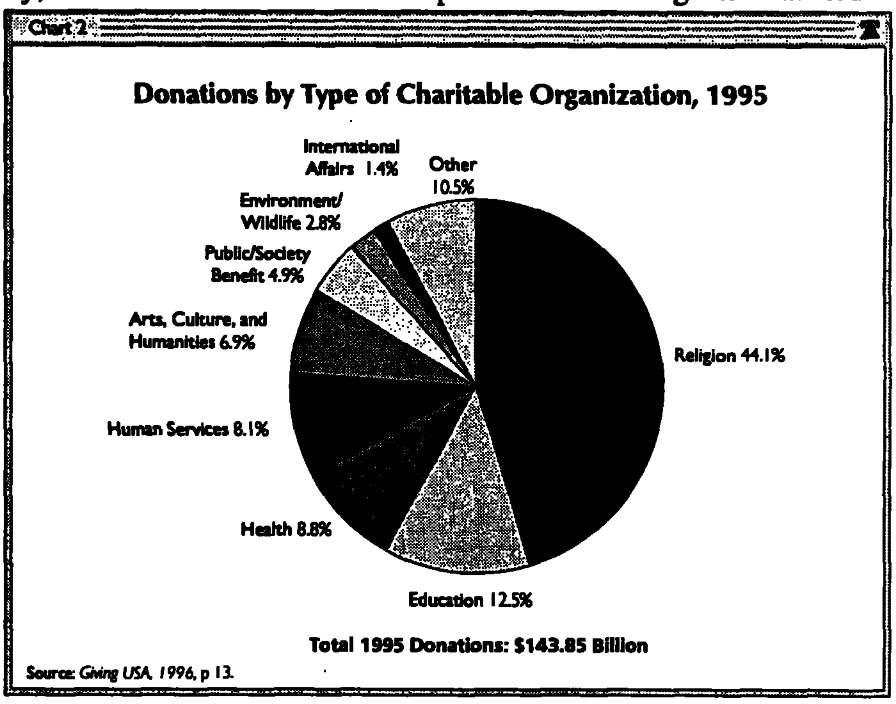
This definition, however, overlooks a broad category of important organizations generically known as nonprofits. These organizations constitute what Salamon and Anheier term the "emerging sector." The emerging or nonprofit sector employs more than 7 million people (or 5.7 percent of all employed workers) and constitutes roughly 6 percent of total annual output (roughly $350 billion). For comparison, the entire construction industry employs only about 5 million workers and represents 4 percent of total annual output.[2]

1 Lester M. Salamon and Helmut K. Anheier, *The Emerging Sector, An Overview* (Baltimore, Md.: Johns Hopkins Comparative Nonprofit Sector Project Studies, 1994), p. 1.

2 Council of Economic Advisers, *Economic Report of the President, 1996*, Table B-1; Salamon and Anheier, *The Emerging Sector, An Overview*, pp. 126-127; and Bureau of Labor Statistics, "Employment and Earnings Report," January 1995.

Generally, nonprofit organizations are private entities whose purpose is to provide a service or good without profit as a primary motivation. While this definition may seem circular, it is the most basic description that applies to all nonprofit organizations. Nonprofits cannot really be classified as part of the market because, unlike private businesses, they do not have profit as their primary goal. Nor are they really a part of government because they cannot levy taxes to sponsor their activities. Within this general classification exists a great variety of organizations, from soup kitchens and homeless shelters, to art galleries and symphony orchestras, to political parties and campaigns.

Clearly, using this general definition, nonprofits have existed throughout American history. However, it was not until 1917 and passage of the charitable contribution deduction that the nonprofit sector obtained a second definition, this time a legal definition. Since the deduction was instituted, it has been necessary for the government to decide what organizations should be considered legally nonprofits, and therefore worthy of special treatment through the tax code, and which organizations and activities should not receive special treatment. What has emerged is a hodgepodge of organizations that may classify as a nonprofit in the general definition but be ineligible for favorable tax treatment because the federal government has determined that their activities are not of special value. For example, donations made to political campaigns (clearly nonprofit) are not tax-deductible, while donations to hospitals are (despite the multi-million-dollar salaries of some doctors). Unfortunately, most data collected on the nonprofit sector are organized according to the legal definition rather than the general one. Therefore, although this paper is concerned with charitable activity in general, it is limited in some senses to the legal definition of a nonprofit.



The pattern of giving is such that religious organizations receive the highest percentage of donations: about 44 percent of total contributions in 1995. Education groups, primarily private colleges and universities, are the second-largest category, with 12.5 percent of total contributions in 1995.[3] Other categories include

3 *Giving USA 1996: The Annual Report on Philanthropy for the Year 1995* (New York, N.Y.: AAFRC Trust for Philanthropy, Inc., 1996), p. 13.

health organizations, international support groups, environmental activist organizations, and the arts.

Even within these broad categories, there is wide diversity. For example, the College Democrats, the University of Notre Dame, and Sidwell Friends Middle School are all categorized as "educational organizations." Similarly, the Heritage Foundation and the Brookings Institution are both classified as educational organizations and yet are very different in outlook, structure, focus, and membership. To speak of "the nonprofits" as if they somehow constituted a single entity is therefore misleading.

Despite this diversity, most Americans continue to think of nonprofit groups exclusively as charitable organizations whose aim is to help the disadvantaged even though "human service/welfare" nonprofits—those which do fit this widely held definition—received only 8.1 percent of all charitable contributions in 1995. The diversity of the nonprofit sector also is overlooked by many analysts who argue that as the federal welfare system is dismantled, nonprofits will have to "pick up the slack" in helping cure social ills. The question asked by Rev. Fred Kammer, president of Catholic Charities, USA, is typical: "Where will the money come from to save those people from starvation, illness, or death?"[4] These are valid concerns, but they are overstated with regard to elimination of the charitable contribution deduction, which affects giving to all nonprofits, not just human service organization.

The Importance of Religious Organizations

Another factor often overlooked by analysts is the role that religious organizations play in providing basic charity to disadvantaged groups. Most surveys determine how much money is donated to religious organizations but not how this money is used. Because donations to religious organizations represent about 44 percent of all donations, this is a very important consideration.

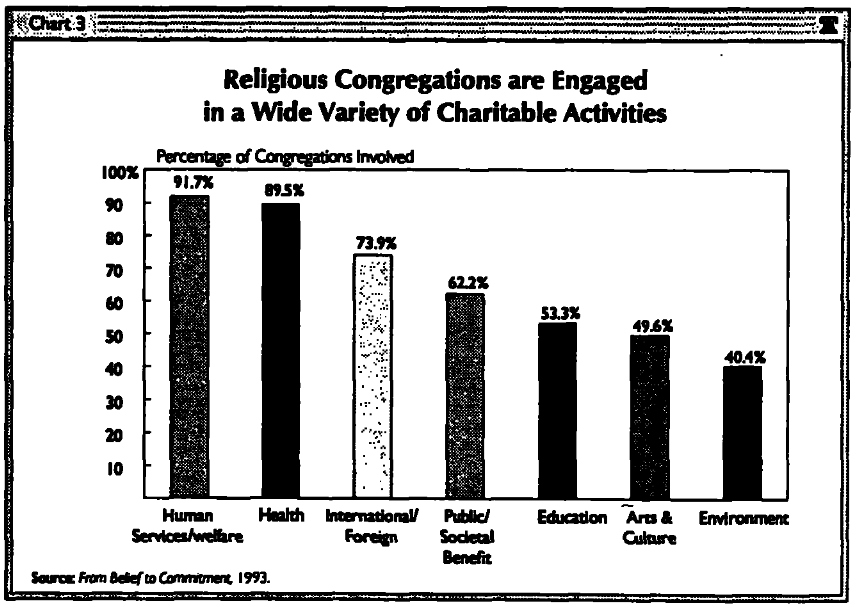


Chart 3

Religious Congregations are Engaged in a Wide Variety of Charitable Activities

Source: *From Belief to Commitment*, 1993.

A full 91.7 percent of religious congregations in America 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 mar-

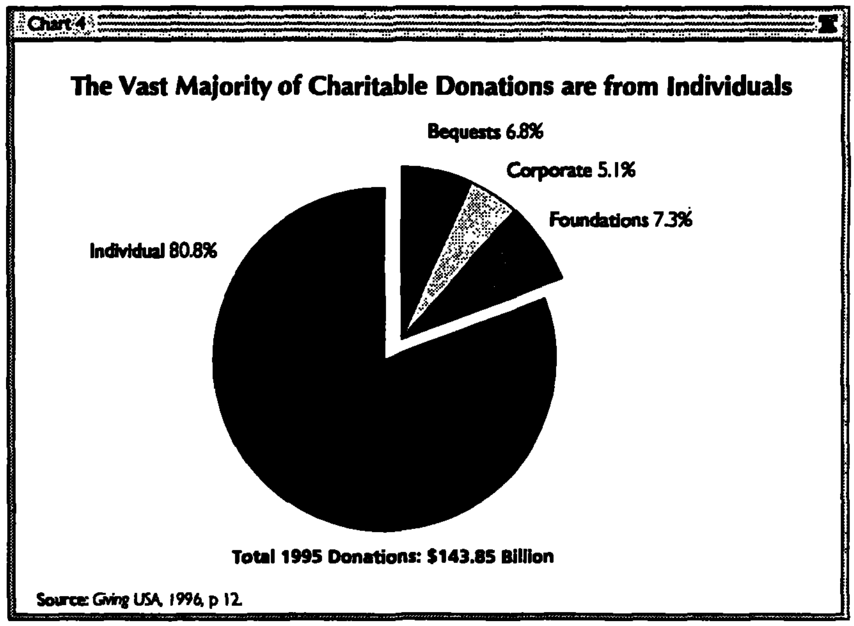
4 "Republicans' Welfare Reform Could Be Charities' Burden," *The Chronicle of Philanthropy*, November 29, 1994, pp. 6-7.

riage counseling (62 percent participation).[5] 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 in that year. In other words, nearly one-third of the money donated to religious congregations is spent on charitable activities other than religious functions.[6]

As will be demonstrated below, donations made to religious congregations will likely increase with passage of a flat tax. The activities which these congregations sponsor, therefore, will see a corresponding increase in funding. It is important to consider the activities of religious congregations when researching human service nonprofits.

DEFINING THE CONTRIBUTORS

Nonprofit organizations receive operating income from a variety of sources. In fact, only 10.1 percent of revenues for all nonprofits come from contributions. The other 89.9 percent is received from program service revenues (71.7 percent), government grants (7.9 percent), and other sources (10.3 percent).[7] The nature of an individual nonprofit largely determines its primary source of income. For example, hospitals and nursing homes, although they are nonprofits, have services they can price and sell. These groups rely heavily on entrance fees and ticket sales. Homeless and poverty shelters, on the other hand, do not have a good market because their "customers" are unable to purchase their services. These organizations therefore must rely more heavily on charitable donations.



5 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.

6 *Ibid.*, pp. 78-79.

7 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.

Concentrating on private donations alone demonstrates another layer of diversity. There are four major donor categories: individuals, foundations, corporations, and bequests. Each has unique characteristics that determine, in general, which charities are supported and at what level. As Chart 4 shows, individuals contribute the vast majority of dollars (a full 81 percent in 1994), with corporate, foundation, and bequest giving making up the remaining 19 percent (approximately 4.7, 7.6, and 6.7 percent, respectively, in 1994).

Individuals. Individual donations accounted for $116.23 billion worth of private contributions in 1995.[8] By far the largest category, it also is the most diverse. Individual donors range from the poor who give change to their churches to the rich who donate millions each year to universities or art museums. In order to understand how the flat tax without a charitable donation deduction will effect individuals, it is necessary to identify which groups donate to what charities, why they contribute, and what characteristics determine the amounts individuals donate to nonprofits.

The American Association of Fund-Raising Counsel (AAFRC) Trust for Philanthropy reports that total individual donations have remained relatively constant since 1974, averaging 1.83 percent of total personal income. The lowest level was in 1985 (1.71 percent of total personal income); the highest, in 1989 (1.95 percent).[9] Despite the relative consistency of aggregate individual donations over time, many factors, including the tax code, influence how much an individual donates, the sorts of nonprofits that receive support, and the types of donations that are made.

Foundations. Foundations accounted for $10.44 billion in donations during 1995.[10] There are more than 38,000 charitable foundations in the United States, most of them small foundations established by individuals. But it is the 775 largest foundations that control 65 percent of total foundation assets and award nearly half of the country's foundation grants.[11]

Foundations exist for many reasons. One of the primary reasons is to avoid paying taxes. For example, many foundations are established upon an individual's death to avoid paying the estate tax, which can be as high as 55 percent of the transfer amount. Another example is the provision passed in 1984 which allows tax-free donations of equities (at present market value) to charitable foundations. With this in mind, wealthy individuals can establish and donate stock holdings to the foundation. They may then claim a tax deduction and retain control over the ultimate destination of the donation.

But there are other reasons foundations exist. 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 as to which causes the money will be donated upon their death. Thus the individual creates a legacy of support for

8 *Giving USA 1996*, p. 56.
9 *Ibid.*
10 *Ibid.*, p. 72.
11 *Ibid.*, p. 75.

causes that are of importance to him. Quite simply, an individual may create a foundation to separate himself from the day-to-day decisions of making donations, entrusting those responsibilities to a board of trustees instructed by general guidelines on how the money is to be distributed. These considerations may be made in addition to tax considerations, but are largely independent of such financial concerns and would likely remain important even after significant tax reform.

Corporations. Corporations accounted for some $7.4 billion in contributions in 1995.[12] There are many reasons why corporations donate to charitable causes. General goodwill among the corporate executives and tax considerations are two. 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. Firms realize this and often take an active role in their local community to promote themselves as good corporate citizens. Many companies also have found charitable causes to be a good source of advertisement or marketing. For example, computer companies will donate products to universities knowing that students, being familiar with the product, likely will purchase that same brand once they have left school. Finally, many companies promote volunteer activities among their employees because such service is believed to improve employee morale and attract more productive workers.

Bequests. Donations made by bequest accounted for $9.77 billion in charitable giving in 1995.[13] Bequest, or willed, giving is becoming an increasingly important source of donations for nonprofits because the workers of the 1950s and 1960s, who benefited from a rapidly growing economy and were able to accumulate significant wealth, are beginning to reach old age. This generation will be followed by the baby boomer generation. The wealth of the former and large volume of the latter ensure that willed giving will remain a growing source of support.

Factors Affecting Individual Gifts[14]

Several factors influence the percentage of income an individual donates to charity. The level of income itself is important insofar as the dollar amount donated is concerned. However, there is no constant relationship between income and donations as a percentage of income. For example, donors earning less than $20,000 give more to nonprofits as a percentage of income than those earning between $50,000 and $100,000.[15] The average donor earning less than $10,000 in 1994 gave just over $200 to charitable organiza-

12 *Ibid.*, p. 88.

13 *Ibid.*, p. 66.

14 Many fundraisers and analysts are concerned with the effect a flat tax will have on donations from the "super rich" because these donations tend to provide the "marginal" income for some nonprofits. In other words, numerous donations from small donors constitute a relatively stable source of income. Fundraisers therefore concentrate their efforts on attracting one or two big donations from wealthy donors. As important as these marginal donations are, they are not the main subject of this paper; this paper addresses charitable giving in general. Donations from the wealthy and foundations (usually established by wealthy individuals) will be addressed in a forthcoming study.

15 *Giving and Volunteering in the United States: Findings from a National Survey, 1994 Edition, Vol. I* (Washington, D.C.: Independent Sector, 1994), pp. 110-111.

tions, or 2.7 percent of income; donors earning between $40,000 and $50,000 gave approximately $575, or only 1.3 percent of income.[16]

Income level also directly 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. In 1993, the average income for donors to the arts and humanities was $56,535; the average for donors to environmental causes was $50,922; and the average for donors to educational institutions was $50,527. On the other end of the spectrum, the average income of donors to religious organizations was $40,923, and the average for donors to human service organizations was $47,099.[17]

Put another way, an individual donor earning over $60,000 per year is seven times more likely to contribute to the arts and humanities than a donor earning less than $20,000 per year; donations to educational institutions are 4.3 times more likely to come from wealthier individuals; and wealthier individuals are 3.7 times more likely to donate to environmental causes. On the other hand, wealthy donors (again, those earning more than $60,000 per year) are only 1.5 times more likely to donate to religious organizations and only 2.9 times more likely to donate to human service organizations.

These differences are significant when considering changes in the tax code. Independent Sector, a national coalition of voluntary organizations, foundations, and corporate giving programs which encourages philanthropy and nonprofit initiatives, estimates that 65.3 percent of donors to the arts and humanities plan to itemize. Only 44.4 percent of donors to human services are itemizers, and only 38.1 percent of those who donate to religious organizations find it advantageous to itemize on their federal income tax returns.[18]

Several demographic factors influence the amount of income an individual donates 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. 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 to charity. 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.[19]

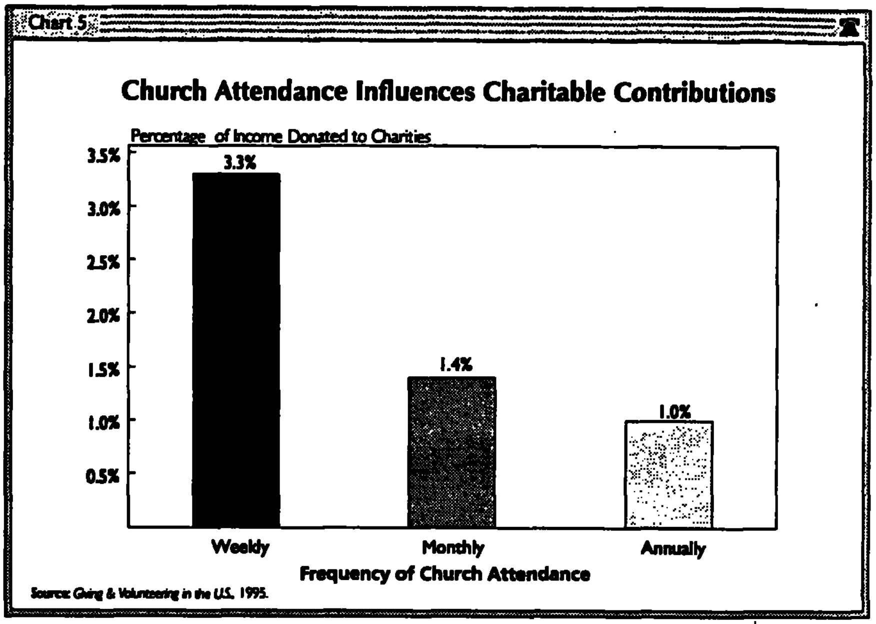
16 For a more in-depth analysis of the relationship between income and charitable giving, see especially Paul G. Schervish and John J. Havens, "Do the Poor Pay More: Is the U-Shaped Curve Correct?" *Nonprofit and Voluntary Sector Quarterly*, Spring 1995, pp. 86-87.

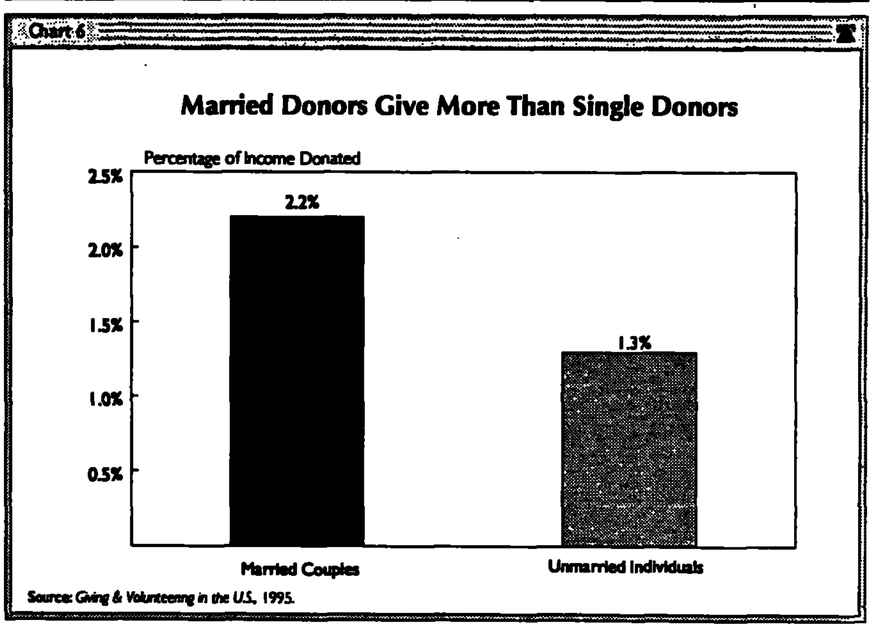
17 *Giving and Volunteering in the United States: Findings from a National Survey, 1994 Edition, Vol. II* (Washington, D.C.: Independent Sector, 1994), various pages.

18 *Ibid.*

19 *Giving and Volunteering in the United States, 1994 Edition, Vol. I*, pp. 109-116.

Perhaps the single most important indicator in determining an individual's level of charitable giving (to all charitable causes, not just religious congregations) is church attendance. In 1994, donors who attended church gave an average of 2.2 percent of their income to charity; those who did not attend church averaged only 1.4 percent. With specific reference to the frequency of church attendance, again in 1994, donors who attended church services weekly donated 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.[20]



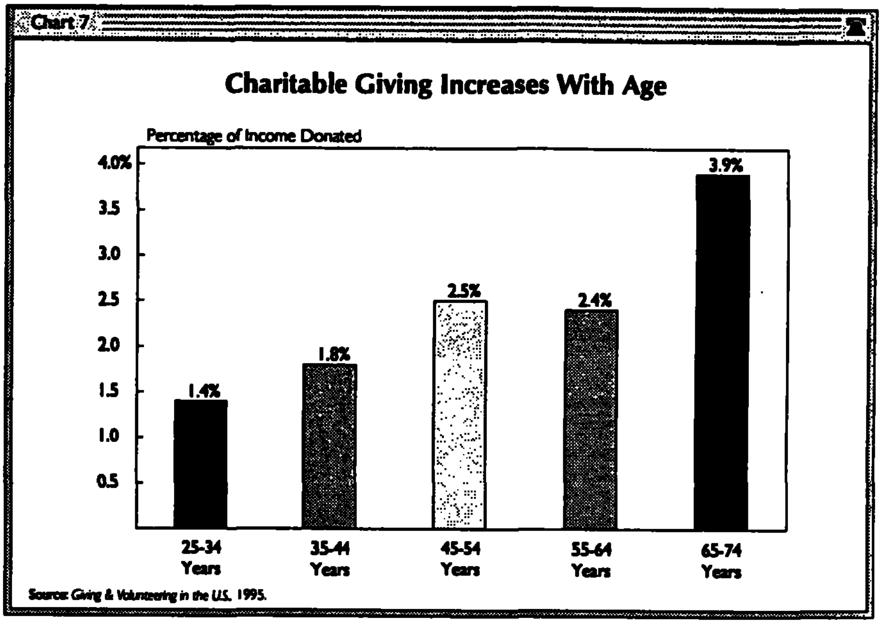


There are two major conclusions to be drawn from any study of the donor community. First, individuals constitute by far the largest source of donations, contributing nearly 81 percent of all donations. Second, upper-income individuals (those most likely to itemize and therefore to be directly affected by elimination of the charitable contribution deduction) give primarily to the arts, hospitals, and universities. The majority of non-itemizers give to churches and human service organizations. These individuals, by and large, would not be affected negatively by the elimination of the charitable contribution deduction.

20 *Ibid.*, p. 119.

EFFECT OF ELIMINATING THE CHARITABLE DEDUCTION WITH A FLAT TAX

The nonprofit sector is a heterogeneous collection of organizations with various revenue sources (from product sales to contributions) and a wide range of donors (from multi-billion-dollar corporations to relatively unaffluent individuals) providing various services (from opera to soup kitchens). Therefore, it is impossible to determine how each and every nonprofit would fare under a flat tax without a charitable contribution deduction. Several important economic patterns and incentives must be considered in trying to anticipate the aggregate impact a flat tax would have on the nonprofit sector.



It is important to consider all of the facts when determining the effect a flat tax will have on charitable donations. 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 will have on taxpayers. These analysts are working "within the box" of the current system. But the flat tax represents such a fundamental shift in American life that it is necessary to step away from the box and take a new approach that evaluates all the important considerations.

Heritage scholars have taken such a complete, "outside-the-box" approach and determined that aggregate charitable donations actually will increase under a flat tax. Before describing these results, however, it is important to understand some of the misunderstandings that cause some analysts to conclude that eliminating the charitable deduction must lead to a fall in donations.

1) **The price of giving is not the only factor.** Many analysts believe that elimination of the charitable tax deduction would decrease significantly the amount of money donated to nonprofits. However, this is based on the mistaken assumption that the primary driving force behind charitable donations is the income tax deduction. In other words, these analysts believe that individuals donate a certain amount of money almost solely because there is a benefit to be had through the federal tax code. If an individual faces a tax rate of 28 percent, giving a dollar to charity actually costs him only 72 cents because he will save 28 cents in taxes; and as this benefit decreases in value (as happened in 1980 and 1986 with the lowering of tax rates), the "price" of giving goes up and, it is argued, donations can be expected to decrease.

This argument describes the price effect of the charitable deduction. But focusing on this price effect to the exclusion of all other factors is like saying that the only reason people purchase a house is to take advantage of the home mortgage income tax deduction. While tax incentives are part of the giving equation, the price-effect position ignores the fact that making charitable donations or buying a home still has a real cost. Making a contribution to charity is foregone income or wealth, whether it costs the donor 72 cents, a dollar, or any amount in between.

Several other factors are more important than deductibility in determining the level of charitable giving. As mentioned above, church attendance, marital status, and age all make more of a difference in the decision to give and the amount given to charity than the presence of an income tax deduction. If the deduction were the most important determinant, one would expect that individuals with a certain income who itemize, regardless of church attendance, marital status, or location, would contribute about as much as non-itemizers with the same income. However, this is not the case. In fact, many non-itemizers who are weekly church attendees donate more than those with similar incomes who itemize and do not attend church services on a regular basis.

But even limiting ourselves to tax code variables that affect charitable donations, the price effect ignores two important points:

First, there is the income effect: the economic effect that as an individual's income increases, he is able to afford more of a specific good without changing the relative amount of income donated. In the case of charitable donations, this principle means that an individual is able to make more donations in absolute terms without increasing the percentage of income being donated. The size of the pie has increased, and although the number of slices remains the same, each slice is larger.

Second, some 46 million American households give to charities but do not claim an income tax deduction. Non-itemizers account for roughly 64 percent of all donors.[21] Because these donors do not itemize, they do not face the price effect; it costs them as much to give an additional dollar as it does to use the money in some other way. They do face the income effect, however. Therefore, any plan which simultaneously increases income and reduces or eliminates the price incentive can be expected to increase aggregate giving only if the income effect is larger than the price effect, keeping in mind that more donors are influenced by the income effect than by the price.

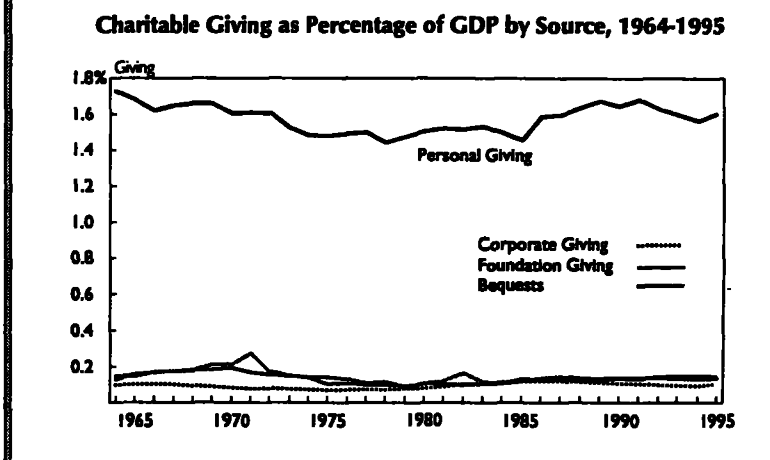
Taking these two points into consideration, Heritage analysts estimate that the amount of money donated to charities each year under the flat tax would be about 3.8 percent more than would have been donated under the current system.[22] This figure assumes both the elimination of the charitable contribution deduction, which increases the "cost" of donating (but only for itemizers), and the increased income that is projected to flow to all individuals, regardless of itemizer status, because of more

21 *Giving and Volunteering in the United States, 1994 Edition, Vol. I*, p. 48.
22 For a complete description of how this estimate was calculated, see technical appendix, *infra*.

rapid economic growth projected under the flat tax. In other words, the income effect overwhelms the price change.

2) **Giving has remained remarkably stable over time despite changes in the tax code.** Although the tax code has changed dramatically over the past 70 years, the level of charitable giving as a percentage of income and economic output has remained relatively constant. Giving as a percentage of personal income has hovered around 1.8 percent. Moreover, charitable giving from all sources has averaged 1.94 percent of gross domestic product (GDP) per year over the past 30 years, during which the rate has neither dropped below 1.72 percent of GDP (in 1978) nor risen above 2.14 percent of GDP (in 1969).[23] This narrow range has persisted despite a top marginal tax rate fluctuating between 28 and 91 percent.

Chart 8



Source: *Giving USA, 1996*, pp 18-19.

Moreover, despite changes in the tax code which have shifted the tax burden from the corporate sector to individuals and back again, and despite the creation and elimination of various tax loopholes and incentives, the levels of charitable donations from each of the four main sources also have remained relatively constant over time.

Example No. 1: The 1981 rate cuts. On several occasions, analysts have predicted particularly dire consequences for charitable giving because of major changes in the tax code. In 1981, for example, Ronald Reagan's first economic plan became law, dramatically reducing marginal tax rates. 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 1986, when President Reagan's economic plan was fully in effect, total charitable giving was 16 percent higher (accounting for inflation) than in 1980. The economic growth that resulted from reducing marginal tax rates actually boosted the amount of charitable donations. Moreover, total giving accounted for 1.9 percent of GDP in 1986 compared with only 1.7 percent in 1980.[24] Between 1980 and 1986, the amounts contributed by donors in every category (indi-

23 *Giving USA 1996*, p. 15.
24 *Ibid.*

viduals, 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 harsh recession of 1981-1982.

Example No. 2: The 1986 tax reform. Another case study of the effect the tax code has on charitable deductions is the 1986 tax bill. That bill eliminated numerous deductions in the federal income tax code and lowered the top individual marginal tax rate from 50 percent to 28 percent. The bill also eliminated the "above-the-line" tax deductibility of charitable contributions by which, prior to 1986, all taxpayers, whether they itemized or not, could deduct charitable contributions from taxable income.

As in the early 1980s, many analysts predicted a dramatic reduction in the amount of money donated to charitable organizations because of the lower marginal rates and the elimination of the above-the-line deduction. For example, *Philanthropy Monthly* published an article citing an Independent Sector report that charitable giving would decline by $8 billion because of the 1986 tax bill.[25] However, charitable donations for 1987 totaled $90.3 billion, a 7.6 percent increase over 1986, and total giving in 1986 amounted to $83.9 billion, a 15 percent increase over 1985. In fact, total charitable donations increased (in inflation-adjusted terms) every year between 1983 and 1989.[26] Far from the bleak outcome predicted by analysts, charitable contributions actually increased after enactment of the 1986 tax bill—again, as a result of strong economic growth.

3) **Not all charitable organizations would be affected equally.** While the aggregate level of giving is projected to increase under the flat tax, the change would affect different nonprofits in different ways. The degree to which a particular nonprofit shares in the benefits of the flat tax would depend on what service it provides and who its donors are.

Human service/welfare organizations and religious congregations generally could expect to benefit the most from passage of the flat tax, primarily for two reasons. One is that individuals tend to see such donations as a basic obligation rather than as discretionary. The other reason is that the majority of donors to these activities are nonitemizers who would not be affected or dissuaded by the elimination of the charitable deduction but would be induced to give more thanks to increased after-tax income.

Of all nonprofits, religious congregations have experienced the most constant support over time. They also enjoy the broadest base of support across all income brackets. Therefore, it can be expected that instead of being hurt by elimination of the charitable deduction, religious congregations will be helped significantly from increased income following from faster economic growth. In addition, 92 percent of religious congregations across the nation are engaged in social activities; in 1991, $2.4 billion was spent by religious congregations on human service projects. This form of

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

26 *Giving USA 1996*, p. 14.

social welfare thus would likely enjoy a significant increase in funding as a result of the flat tax.

The effect on other nonprofits, such as universities, art and theater companies, and environmental groups, which are most dependent on donations from the wealthy, is unclear. On the one hand, it is primarily the wealthy who take advantage of the charitable deduction. Donations may decrease for this reason. On the other hand, elimination of the capital gains and estate taxes would allow wealthy individuals to donate more money during their working years rather than setting the money aside in a bequest or foundation. Donations might increase for this reason. In the long run, increased income as a result of lower taxes and increased economic growth will likely mean more donations for all non-profits, the arts, environment, and universities included.

However, because after-tax personal income for all taxpayers would increase with a flat tax, those individuals who continue to donate would have more money to give. Moreover, the loss of charitable donations means only that nonprofits will be forced to innovate and raise money through new channels. This may include increasing entrance fees, designing new products (such as symphony recordings) for sale to the public, or refocusing fundraising activities. Again, one of the primary benefits of the flat tax is that it removes special treatments from the tax code. Thus, nonprofits will have to innovate for funds just as private firms are expected to react to changes in the economic environment.

ADDITIONAL CONSIDERATIONS

Although aggregate giving would increase with passage of a flat tax, many questions surrounding elimination of the charitable deduction remain, both because the nonprofit sector is so diverse and because the deduction has become so ingrained in the federal income tax code and in the minds and emotions of so many donors. For example, what about giving from non-individuals such as companies and foundations? Why endure the political pain to maintain just this one deduction? Why elimination and not some alternative?

Why not keep just the deduction for charitable contributions?

One of the most important features of the flat tax is that it does not favor one activity over another. No one action is treated "better" under a flat tax than any other. Including the charitable deduction would violate this important feature. "As long as people make gifts, even to worthy causes, primarily because they are tax deductible and not because that cause is passionately important to them," writes *World Magazine* publisher Joel Belz, "both the tax code and the government behind it are way too important. Yes, we may lose a few gifts to our charitable organizations—but in the end, both we and they will breathe so much more deeply of the great air of freedom that it will be a good trade."[27] Including any deductions, even the deduction for charitable contributions, in a flat tax plan breaches the equality principle and opens the door for increased

27 Joel Belz, "The Flat-tax Society," *World Magazine*, February 3, 1996, p. 5.

government activism. The federal tax code should be used to raise money, not influence behavior.

Also, the best excuse for the next income tax deduction is the last one. Once the door is open for some special interest, as important as that interest may be, other interest groups will be knocking at the door for their own income tax deduction.

Finally, retaining the deduction for charitable contributions, as with any other deduction, would necessitate a higher flat tax rate to raise the same amount of revenue as a pure flat tax. Assuming a revenue neutral flat tax is passed, including the charitable deduction would require a rate that is 0.8 percentage points higher than otherwise would be necessary without the deduction. This would hurt disproportionately those people who do not find it advantageous to claim the charitable contribution deduction, forcing them to pay higher taxes to subsidize those who are able to take the deduction. Lower-income individuals, in other words, would wind up subsidizing the activities of wealthier individuals.

What about charitable bequests and elimination of the estate tax?

Many analysts believe that individuals no longer would have an incentive to leave money to charities if such donations were no longer tax-deductible. Instead, the argument goes, people would leave all of their money to their children or other non-charitable causes, and nonprofits will lose a valuable source of revenue.

This view overlooks several important points. One is that only a small fraction of charitable contributions (6.7 percent) results from bequests. Even a drastic reduction of 30 percent in bequest giving would reduce overall giving by only 2 percent. The increased economic growth likely under a flat tax would more than make up for this shortfall.

Economic theory traditionally has suggested two ways of looking at how households decide what to do with lifetime savings and bequests. The life cycle hypothesis, first advanced by MIT Nobel Laureate Franco Modigliani, maintains that households act to accumulate savings which they plan to exhaust in their own lifetimes. At the end of their lives, a "residual" sum may be left which can be willed to either children, charities, or others depending on the cost of leaving money to these various individuals or groups. The current tax on bequests to persons and institutions other than nonprofits acts to encourage giving to charities and to discourage bequests to relatives, according to this theory. Thus, eliminating the estate tax would decrease the amount bequeathed to charities.

The other major approach to analyzing household behavior is the permanent income or overlapping generations theory, commonly credited to University of Chicago Nobel Laureate Milton Friedman. This theory maintains 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 so they may enjoy an adequate level of income, and only what is left over after this paternal bequest can be considered a "residual" and used to support charities. Under this theory, the current tax on bequests to family members serves to reduce contributions to charitable organizations. Thus, eliminating the estate tax will increase the residual available for charitable bequests.

In the last 15 years, professional economic research has tended overwhelmingly to verify that the permanent income/overlapping generations motive has dominated household saving and bequest behavior in the United States.[28] Therefore, any public policy that increases the amount of savings available to households will increase the "residual" left to charitable organizations as well. The flat tax, accompanied by elimination of the charitable contribution deduction and estate tax, would do just that.

What about grants from charitable foundations?

As mentioned above, foundations exist for many reasons. Therefore, it is impossible to determine the effect a flat tax will have on any individual foundation or on the decision of a particular individual to create a foundation. It is possible, however, to make some generalizations.

First, many foundations are created for reasons wholly outside the tax code. They may be a more convenient way for many individual donors to pool their gifts and fund projects, as is the case with community foundations. Or individuals may establish a foundation to remove themselves from the day-to-day operation of charitable activities. Whatever these non-tax reasons may be—and they are as unique as foundations themselves—a change in the federal income tax code would have little impact on their existence and activities.

The second reason for the existence of foundations is to gain a tax advantage. For example, the Tax Reform Act of 1984 made equities donated to foundations tax deductible at their present market value. Thus individuals can create a foundation, donate equities, and receive a tax benefit while retaining control over the ultimate destination of the donations. Other tax incentives include avoiding the estate tax or significant capital gains taxes. It is quite accurate to believe that the flat tax would have a significant impact on the structure of foundations from this tax perspective. However, the exact and total effect is not clear. For example, removal of the estate tax likely would increase donations while elimination of the 1984 law likely would work in the opposite direction. Furthermore, even if a flat tax were to remove one reason for the creation of a foundation by an individual, it does not follow that the total contributions by the individual would decline. With fewer tax considerations to take into account, the individual might simply make larger contributions directly to organizations during his or her working life.

To the extent that existing foundations might be affected by a flat tax, the primary concern would be whether the legislation contained "fine print" to ensure fair treatment. For example, the excise tax that foundations currently pay on investment income should be reclassified for what it really is: a capital gains tax. This tax would be eliminated with the passage of a flat tax.

28 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.

What would happen to corporate giving?

There is no reason to believe that corporate giving would decrease with passage of a flat tax.

While there are many reasons why corporations make donations, the overriding reason is to assist the company in making money for their employees and stockholders. The primary reason that corporations donate to charity and support charitable causes, therefore, is to increase their image within the community. Alternatively, corporations engage in quasi-charitable activities that offer a "community-friendly" venue for advertisements: sponsoring a community parade, for example, or donating goods and services to local schools or active community groups. Finally, corporations may make donations because it is an opportunity to increase the image of their products. That companies offer computers to universities is a good example of this last point. These incentives to engage in charitable activity will not disappear with passage of the flat tax.

In fact, it is likely that charitable contributions from corporations would increase as corporate profits increase under the flat tax. Noted Harvard economist Dale Jorgensen has estimated that general economic activity would increase by 9 percent with passage of the flat tax.[29] As the general economy grows and corporate profits increase, companies will have larger budgets; thus, even the same percentage of giving would yield increased amounts of charitable contributions.

Are there any alternatives to the charitable contribution deduction that would be compatible with a flat tax?

There are several alternatives to outright elimination of the charitable contribution deduction. Each one is better than maintaining the full deduction with a flat tax, but each one also has significant drawbacks.

Senator Dan Coats (R-IN) and other lawmakers have put forth the idea of a dollar-per-dollar tax credit for charitable donations of up to $500 for individual taxpayers ($1,000 for married persons filing jointly). The credit would be limited to contributions to human service charities. Taxpayers would have to forego the $500 but could either donate the money to a private charity and take the tax credit or simply pay the taxes, in which case the money would be spent by the federal government. In effect, taxpayers could "vote" on whether private social welfare organizations or the federal government should spend $500 of the money they currently pay in taxes.

Senator Coats has proposed this approach within the context of the current tax code. The credit would supersede the present deduction, which would be available only for contributions made above and beyond the $500 ceiling ($1,000 for married persons filing jointly). However, the $500 charitable credit could be joined with the flat tax in place of the deduction. This would be superior to maintaining the deduction but would still have several drawbacks. For example, the credit would infringe on the integrity of

29 Dale Jorgensen, "The Economic Impact of Taxing Consumption," statement before Committee on Ways and Means, U.S. House of Representatives, March 27, 1996.

a pure flat tax. Any deduction, credit, or other loophole would open the door for future deductions, credits, or loopholes.[30]

Also, unless the $500 credit was offset by equal reductions in federal welfare spending, a higher tax rate would be necessary. Such a spending reduction mechanism is not included in Senator Coats's proposal.

Another idea is to limit the income tax deduction to contributions made to human service organizations. This proposal, which is included in the Coats legislation, would have the advantage of focusing donations where they are most needed: on the sorts of private "welfare-oriented" efforts that many expect will "pick up the slack" as federal welfare programs are streamlined. At the same time, a targeted tax deduction would eliminate the subsidy by all taxpayers of activities, such as the arts and private universities, that are enjoyed primarily by the wealthy.

There are, however, several drawbacks to a targeted deduction. It would require a higher tax rate, although not as high as would be required if the full deduction were retained. All taxpayers would face a higher tax burden, with only a portion of taxpayers receiving a reduction in return. Maintaining any charitable deduction may also lead to other exemptions and loopholes. Once again, including any deduction, even the deduction for charitable contributions, conflicts with the flat tax principle of fairness and opens the door for increased government activism, perhaps not in such a desirable direction. Finally, there would have to another layer of complex regulations to differentiate between "human service" organizations and other charitable activities.

CONCLUSION

Any public policy must have a clearly defined goal. The task then becomes one of reaching that goal most efficiently and completely. In the case of the charitable contribution deduction, the goal is to encourage private giving to private organizations engaged in socially beneficial activities. It is unclear, however, that the current tax structure with a charitable contribution deduction is the most efficient way to reach that goal. Far more effective would be a flat income tax with a single low rate and no deductions. Historical evidence and statistical analysis demonstrate that giving to nonprofit organizations will not decline with passage of the flat tax. In fact, donations likely will increase slightly because of higher economic growth.

The flat tax, by increasing economic growth and removing 24 million Americans from the federal income tax rolls, itself serves as a charitable program. All Americans, especially those at lower income levels, will realize more economic opportunities and lower taxes. The flat tax will give individuals the freedom to make their own decisions on how to spend their own money without fear of being penalized through the federal income tax

30 It might be possible to remove the "welfare-voting" proposal from the income tax structure altogether by creating a system whereby taxpayers choose private charities to which they want a set donation made. This would retain the simplicity of the flat tax and also allow a partial privatization of welfare spending. However, there are several drawbacks, the most significant of which is the tremendous bureaucracy and administrative costs associated with such a plan.

structure. These benefits will do more for individual Americans than any nonprofit organization—and certainly more than any federal government program—ever can.

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31 With contributions from Gareth Davis.

TECHNICAL APPENDIX

Heritage analysts estimate that the amount of money donated to charities each year under the flat tax would be about 3.8 percent more than would have been donated under the current system. This figure assumes the following:

- ✔ A final flat income tax rate of 17 percent.
- ✔ An immediate and lasting increase in after-tax personal income of 2.3 percent. This is a static estimate based on the Internal Revenue Service public use tape from tax year 1992 (the latest year for which data were available) and does not include any increased income that may arise as the result of higher economic growth under the flat tax.[32]
- ✔ An additional increase in economic output of 9 percent annually after a two-year transition period. This is taken from testimony delivered by Harvard economist Dale Jorgenson, who estimated the effect of moving from the current income tax system to a consumption-based system.[33]
- ✔ A price elasticity of -0.44 and an income elasticity of +1.00. The price elasticity is an average of the price elasticities found in time series and panel data studies cited in the work of Richard Steinberg, Associate Professor of Economics at Indiana University. The 11 studies cited by Steinberg generated an average fall in contributions of 0.44 percent for every 1 percent increase in the "tax price" of giving faced by individuals.[34] The income elasticity was derived from historic data across the income spectrum indicating that as income increases by 1 percent, charitable donations also increase by 1 percent.[35]

An important feature of this estimate is that, unlike other work, it takes into account the use of the charitable contribution deduction for purposes of fraudulent tax evasion. For example, economist Joel Slemrod, Professor of Business Economics and Public Policy at the University of Michigan Business School, has reported that approximately 7.2 percent of reported donations in one large sample were found to be false following intensive auditing by the Internal Revenue Service.[36] The IRS data on itemized contributions are modified to reflect this finding.

Econometric studies based on a single time period were excluded from this analysis. There is a growing professional consensus that such cross-sectional studies (which examine differences in giving between individuals in a single time period) are characterized by a number of fundamental methodological flaws.

32 Daniel J. Mitchell and William W. Beach, "The Flat Tax Cuts Individual Income Taxes in Every State," Heritage Foundation *F.Y.I.* No. 86, February 7, 1996.

33 Jorgensen, "The Economic Impact of Taxing Consumption."

34 Richard Steinberg, "Taxes and Giving: New Findings," *Voluntas*, Vol. 1, No. 2 (1990), pp. 61-79.

35 Using a more "pessimistic" estimate of income elasticity (0.73) would still result in an increase in aggregate giving of approximately $630 million.

36 Joel Slemrod, "Are Estimated Tax Elasticities Really Just Tax Evasion Elasticities? The Case of Charitable Contributions," *Review of Economics and Statistics*, Vol. 71 (August 1989), pp. 517-522.

First, the suitability of these studies, which rely on evidence from a static snapshot of the economy at a single point in time, for examining the dynamic effect of changes in taxes and income on charitable contributions over a number of time periods is dubious. Time series and panel data studies examine the effect of taxes and income on giving over a number of successive time periods and hence appear more suitable in this respect.

Second, cross-sectional econometric studies fall victim to the problem of multicolinearity. Econometric regressions can separate out the individual effects of changes in tax rates and income on giving only when there are independent variations in these two variables. In a single year, the tax price (income tax rate) of giving faced by an individual is determined solely by his or her income and hence does not vary independently.[37]

Given these problems, the emerging consensus of a decade ago that changes in tax policies have significant effects on giving has been shattered. This consensus was based almost wholly on static cross-sectional (and therefore flawed) studies. Much of the new dynamic econometric evidence suggests that the link between the level of giving and tax incentives is highly questionable at best.

37 For a full discussion of this problem, see Steinberg, "Taxes and Giving: New Findings"; Steinberg, "Charitable Giving as a Mixed Public/Private Good: Implications for Tax Policy," *Public Finance Quarterly*, Vol. 14, No. 4 (October 1986), pp. 415-431; and Charles W. Christian and James R. Boatsman, "Cross-Sectional Price Elasticity Estimates of the Charitable Deduction," *Advances in Taxation*, Vol. 3 (1990), pp. 45-66.