Reforming the Charitable Deduction

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social capital project

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American civil society has long recognized that to whom much is given, much is required. Amidst rising living standards and improving material conditions, Americans have impressed foreign observers, all the way back to Alexis de Tocqueville, with their altruism and commitment to social causes beyond themselves. Complementing this generosity has been Americans' can-do attitude of self-reliance. Tocqueville was struck by how, in the absence of an aristocracy or government administration capable of improving their communities, Americans united to do so themselves.

In other words, Americans have been able to support their communities because of their material success, and they have had to because no other institution could do so. Both tendencies of so much of America's associational life—generosity and self-reliance—are particularly manifest in American philanthropy, of which Tocqueville wrote, "I often saw Americans make great and genuine sacrifices for the public, and I remarked a hundred times that, when needed, they almost never fail to lend faithful support to one another."[1] Americans' charity has allowed nonprofits and other voluntary institutions to play a central role in American life by caring for basic needs and providing public goods ranging from education to the arts.

However, as our report "What We Do Together" illustrates, the U.S. is suffering from long-term declines in its associational life.[2] As we wrote in "The Wealth of Relations," "Our institutions of civil society have weakened and withered, and our relationships have become more circumscribed."[3]

Reversing these trends and rebuilding civil society will require capitalizing on the strengths of America's associational life to address its weaknesses. One way of doing so is to reform policy so that less of the charitable giving of Americans is subject to taxation. Doing so would be more consistent with the principle that people should not be taxed on money they give away.

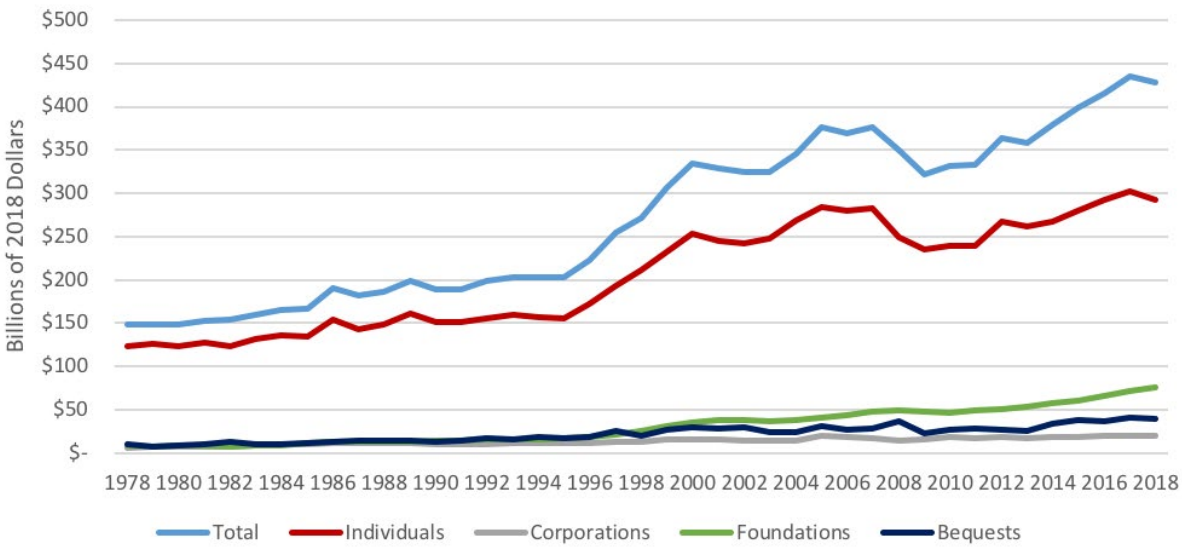
The U.S. tax code has long had a charitable deduction for these reasons. However, current policy has a number of flaws that limit its impact and are in need of reform. The decline in civil society only strengthens the importance of protecting charitable institutions and giving from undue taxation.

Reforming the charitable deduction captures the spirit of the Social Capital Project's approach to policymaking. As we noted in "The Wealth of Relations," rebuilding civil society will require promoting subsidiarity, the principle of pursuing our goals at a local, decentralized level where possible. An improved charitable deduction would recognize that individuals and the institutions they support can often fulfill their purposes more effectively, and be more attuned to the particular needs of each person or community, than can any government agency. To that end, this paper considers trends in charitable giving and their implications for civil society, discusses the flaws of the current charitable deduction, and proposes reforms to make tax policy fairer toward charitable giving and civil society.

BACKGROUND: TRENDS IN U.S. CHARITABLE GIVING

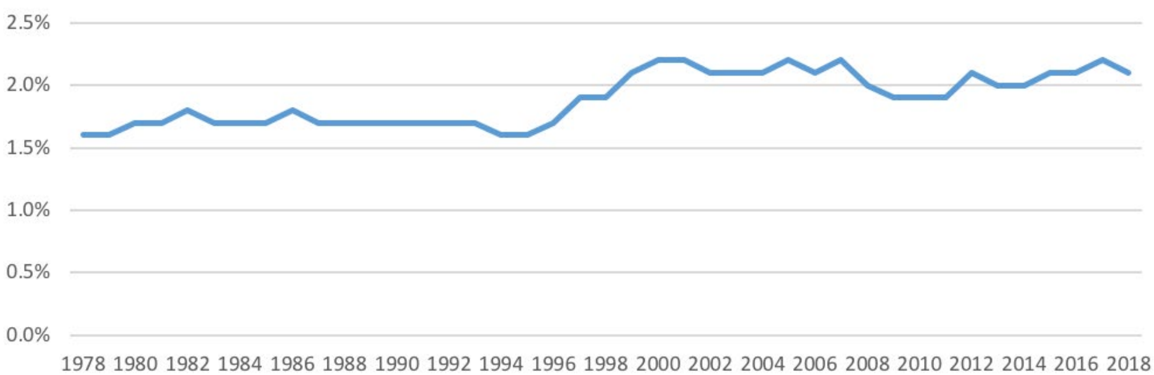
When it comes to charitable giving, Americans have much to celebrate. In 2018, the U.S. ranked fourth in the Charities Aid Foundation's *World Giving Index*, and total annual giving has risen in most years for the last half century, to $428 billion in 2018, as shown in Figure 1.[4] Giving as a percent of GDP has also risen, from 1.6 percent in 1978 to 2.1 percent in 2018, as shown in Figure 2.

Figure 1. Giving by Source, 1978-2018



Source: Giving USA. Estimates of individual giving include itemized and non-itemized charitable contributions.

Figure 2. Giving as a Percent of GDP, 1978-2018

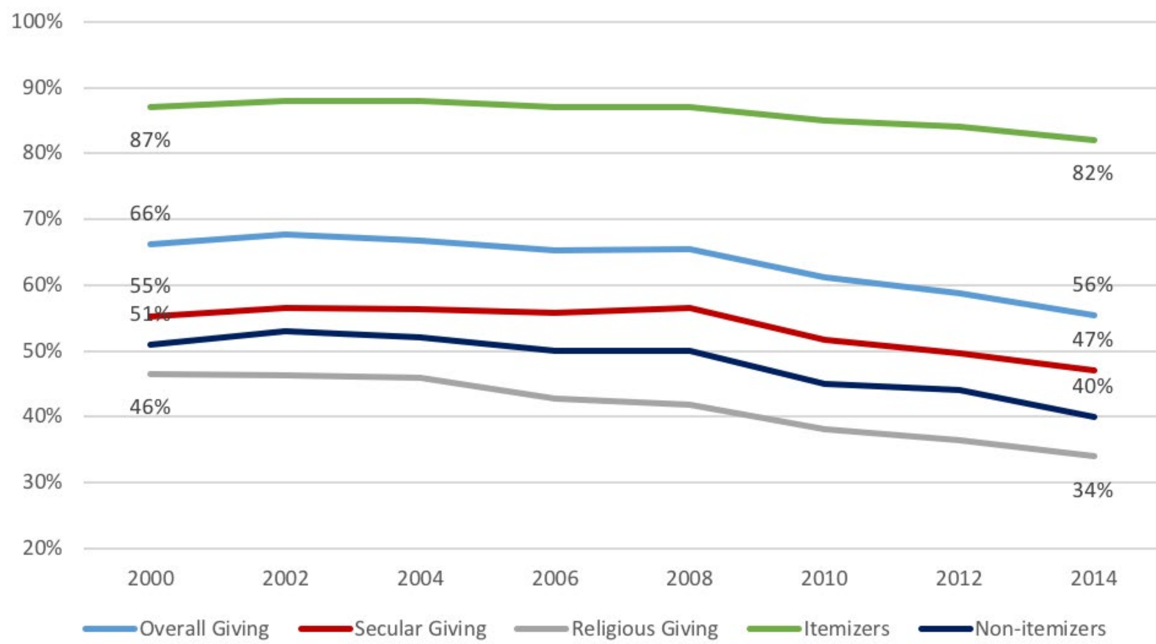


Source: Giving USA.

However, behind these figures lie two disconcerting trends.

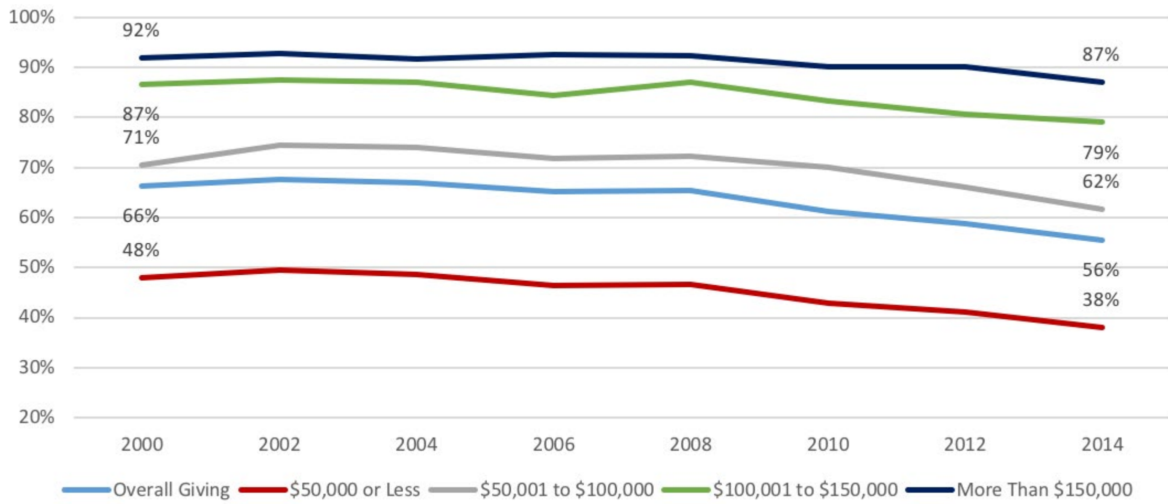
First, while total giving has increased, the percent of Americans giving has decreased, from 66 percent in 2000 to 56 percent in 2014. In other words, growing donations are coming from a shrinking share of the population. As Figures 3 and 4 illustrate, the drop has been particularly pronounced among non-itemizers, those giving to religious causes, and lower-income Americans, although the trend is also apparent for itemizers, those giving to secular causes, and higher-income Americans.

Figure 3. Percent of Households Giving to Charity by Itemizing Status and Cause, 2000-2014



Source: Nonprofit Quarterly and United Way analyses of University of Michigan's Philanthropy Panel Study. Estimates of itemizers include those who gave but did not claim the deduction or did not know if they claimed the deduction.

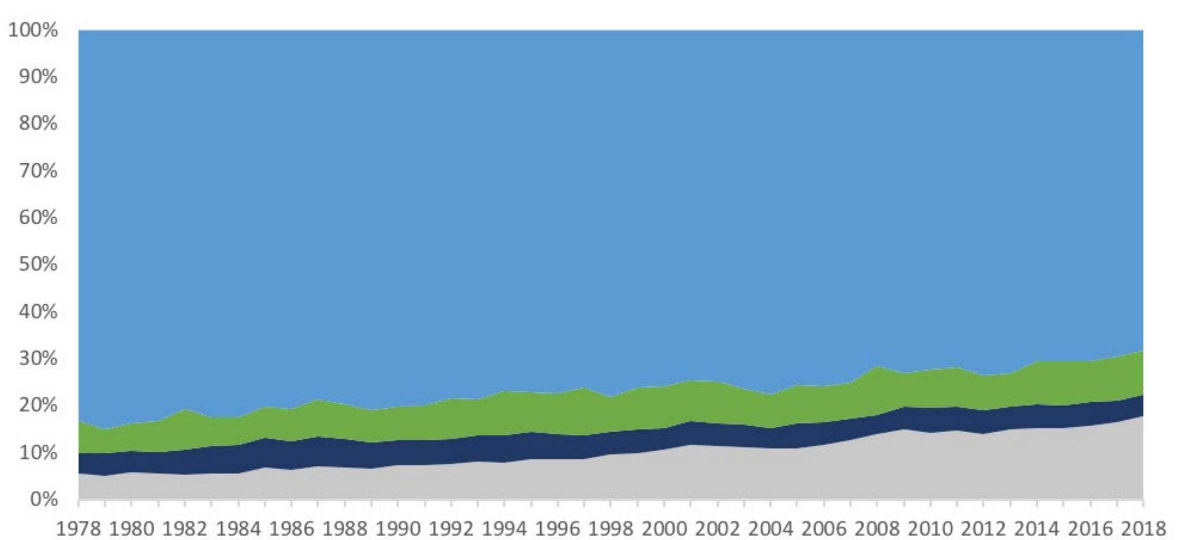
Figure 4. Percent of Households Giving to Charity by Income, 2000-2014



Source: The Chronicle of Philanthropy analysis of University of Michigan's Philanthropy Panel Study.

Second, while total individual giving has increased over time, its *share* of total giving has decreased by 18 percent, from 83 percent in 1978 to 68 percent in 2018. Meanwhile, the share of giving coming from corporations, bequests, and especially foundations has increased, as shown in Figure 5. In other words, the relative importance of individuals' giving has fallen, and the relative importance of other sources has risen.

Figure 5. Composition of Giving by Source, 1978-2018



Source: Giving USA. Estimates of individual giving include itemized and non-itemized charitable contributions.

As total giving is increasing, one might wonder whether the declines in the percent of Americans giving and in the share of giving from individuals are really worrisome trends. Perhaps what matters is not the *source* of giving, but the *amount*; and by that standard, American giving is thriving like never before.

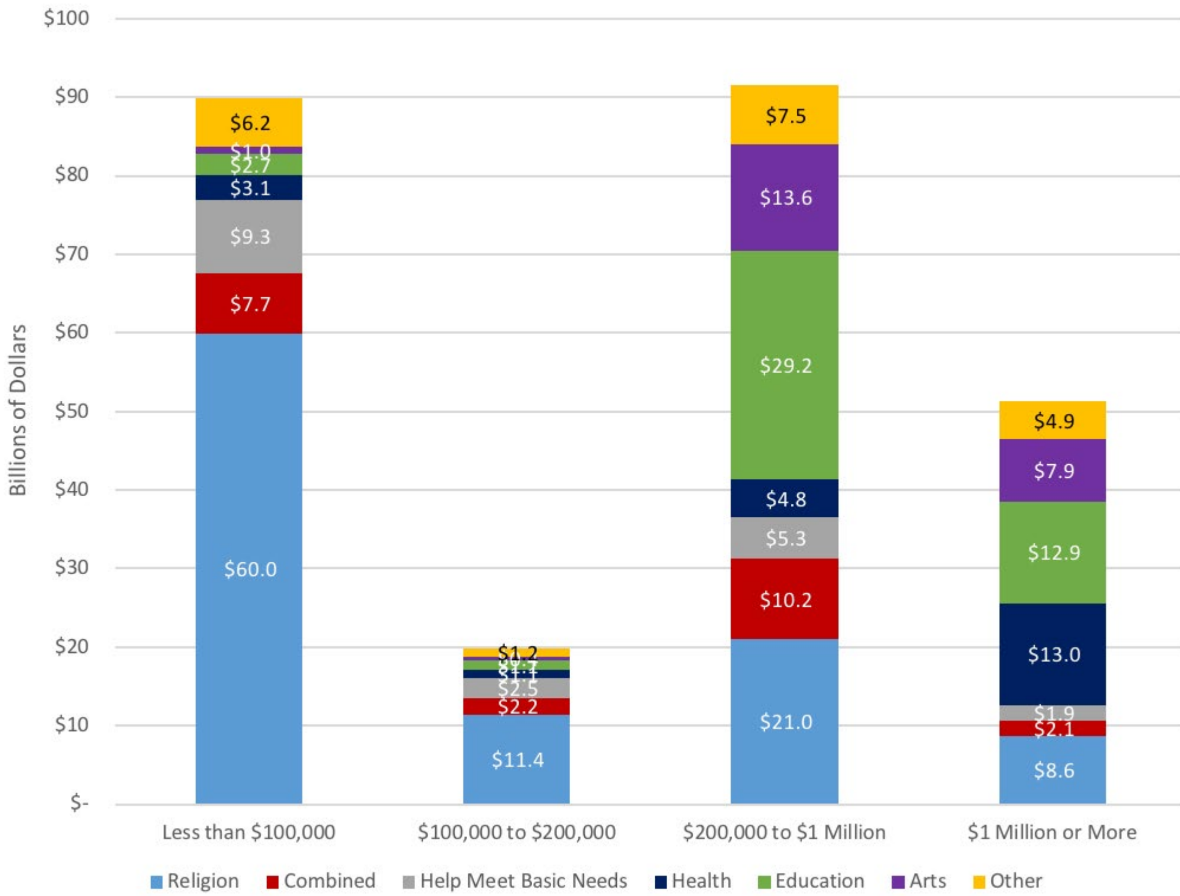
However, with regard to social capital, it is not enough to look simply at the financial support that makes possible the caring for basic needs, the stability of community institutions, the provision of public goods, and so on. As we wrote in "The Wealth of Relations," "Individual investment in social capital often creates benefits for the entire community, such as norms of trust and reciprocity."[5] Such benefits to our associational life come in addition to the material benefits that individual investments or contributions provide, and they require widespread buy-in. A shrinking share of donors, no matter how generous, cannot replace widespread altruism and commitment to improving a community.

In the same report, we also wrote, "When the federal government expands the provision of goods and services on offer through social policy, it runs the risk of 'crowding out' civil society—another potentially counterproductive effect of public policy. Increased reliance on government to address needs weakens the selfish rationale for community members to invest in social capital."[6]

The same concern can be raised about foundations and corporations. Just as government might be able to provide goods or services typically provided by civil society, but fail to foster community attachment as the latter does, so other large-scale entities like foundations and corporations may support important causes without providing the community spillover effects that result from individual contributions. To the extent that individual charitable giving both evinces and contributes to social capital, declines in the percentage of Americans giving and in the share of giving coming from individuals are causes for concern and relevant policy matters.

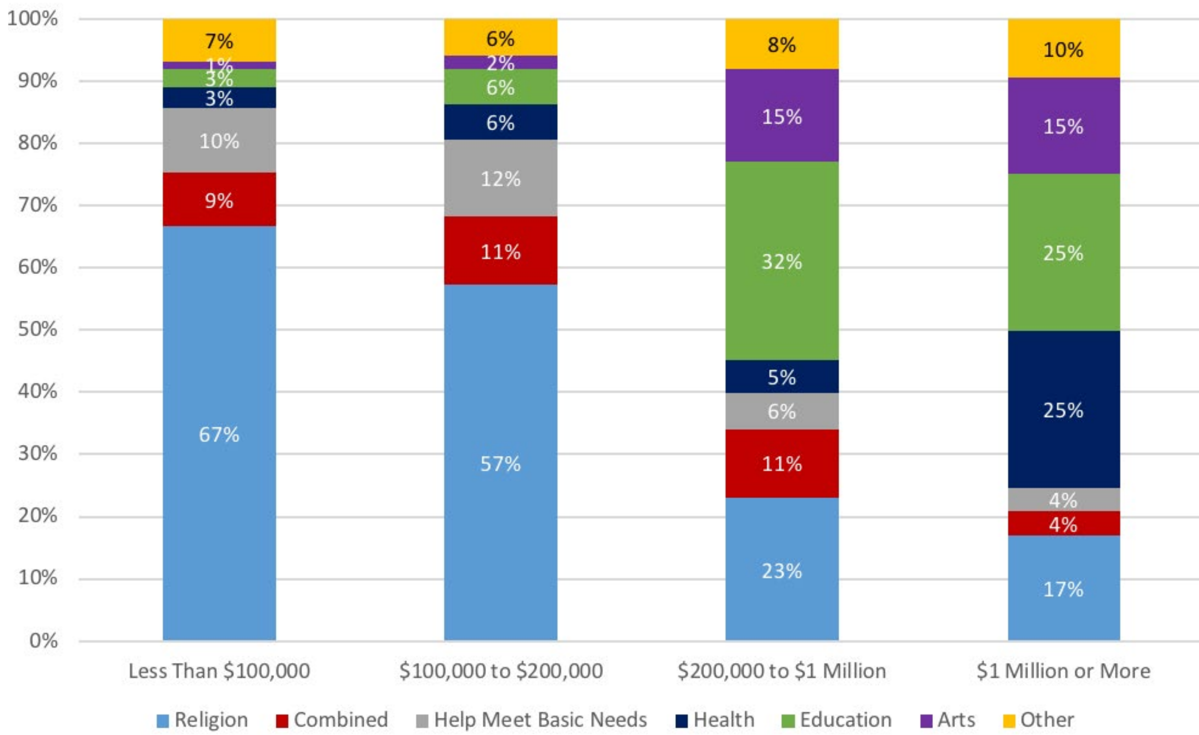
A final reason for the significance of changes in the composition of givers is that the causes people support vary with income, as illustrated in Figures 6 through 9. For example, people making under $200,000 devote a greater share of their giving to religion and meeting basic needs, while people making $200,000 or more devote a greater share of their giving to education and the arts.[7]

Figure 6. Allocation of Charitable Dollars by Income Group, 2005



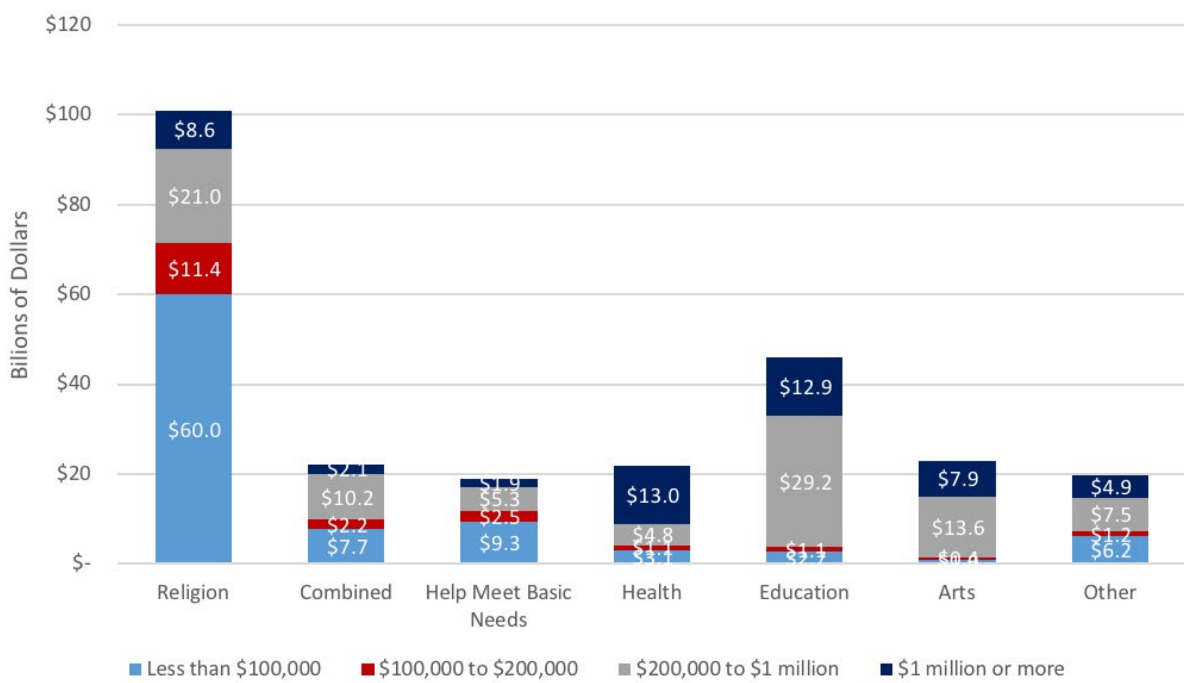
Source: Center of Philanthropy at Indiana University.

Figure 7. Share of Allocation of Charitable Dollars by Income Group, 2005



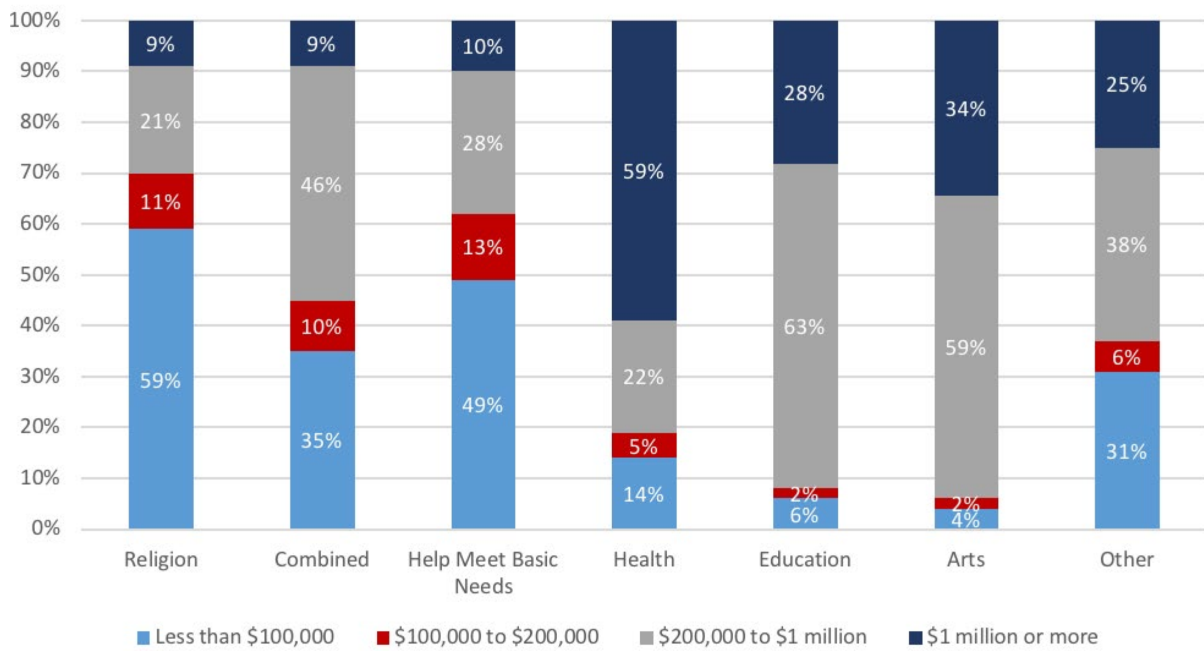
Source: Center of Philanthropy at Indiana University.

Figure 8. Allocation of Charitable Dollars by Cause, 2005



Source: Center of Philanthropy at Indiana University.

Figure 9. Share of Allocation of Charitable Dollars by Cause, 2005



Source: Center of Philanthropy at Indiana University.

Increased individual giving among a shrinking share of the population, and an increase in the average annual charitable gift, suggest that higher-income Americans are increasingly driving individual giving.[8] The variation in giving is even more pronounced among the very richest Americans, as Ken Stern has noted in *The Atlantic*:

> Of the 50 largest individual gifts to public charities in 2012, 34 went to educational institutions, the vast majority of them colleges and universities, like Harvard, Columbia, and Berkeley, that cater to the nation's and the world's elite. Museums and arts organizations such as the Metropolitan Museum of Art received nine of these major gifts, with the remaining donations spread among medical facilities and fashionable charities like the Central Park Conservancy. Not a single one of them went to a social-service organization or to a charity that principally serves the poor and the dispossessed. More gifts in this group went to elite prep schools (one, to the Hackley School in Tarrytown, New York) than to any of our nation's largest social-service organizations, including United Way, the Salvation Army, and Feeding America (which got, among them, zero).[9]

It is not just that the social benefits of giving are endangered when fewer people maintain the norm of giving, then; the very causes being supported are likely to change as higher-income Americans increasingly drive individual giving.

That worsens the problem of crowd-out of civil society because lower-income and middle-class Americans are more likely to direct their giving toward service and assistance to the poor—an area where government crowd-out has been especially severe. Figure 10 replicates Figure 6, but with giving divided into all giving to the poor and all other giving. The former category includes not only meeting basic needs, but also giving towards other sectors that support those in poverty, such as church food banks and donations to private schools to provide financial aid. Those making $200,000 or more give a smaller share of their donations to support the poor—29.1 percent of those making between $200,000 and $1 million and 22 percent of those making over $1 million, versus 35.6 percent for those making less than $100,000 and 37.5 percent for those making between $100,000 and $200,000. Those in lower income groups, then, give greater support—both in absolute terms and as a percent of their total giving—to a sector in which charity lowers the need for government support and therefore reduces the risk of civil society becoming crowded out.

Figure 10. Allocation of Charitable Dollars to Poor by Income Group, 2005

Source: Center of Philanthropy at Indiana University.

For several reasons, then, not only the amount of giving, but the source, matter for the health of philanthropy and civil society.

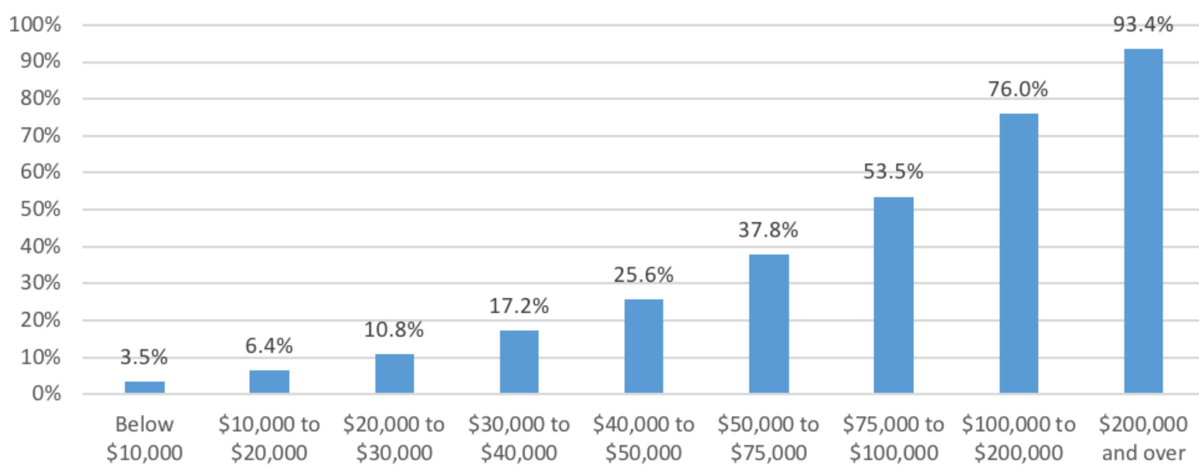
It is important to emphasize that these trends have been developing for some time and thus do not depend on the Tax Cuts and Jobs Act's (TCJA) impact on giving. A number of reforms, particularly the near-doubling of the standard deduction and the reduction of marginal tax rates, have led to predictions or concerns that the TCJA would reduce charitable giving, including charitable deductions.[10] If such immediate concerns prove unfounded, the longer-term trends discussed above would remain causes for concern. If the TCJA does prove to harm giving, the case would only be stronger for reforming policy affecting philanthropy. The most prominent such policy—the charitable deduction—offers much room for improvement.

OVERVIEW OF THE CHARITABLE DEDUCTION

The charitable deduction allows itemizers to deduct the value of their charitable contributions to qualifying tax-exempt organizations, up to 60 percent of adjusted gross income (AGI). In 2018, the charitable deduction for individuals reduced federal revenue by $54.1 billion.[11] Under its current design, however, the charitable deduction is not available to all taxpayers. As a "below-the-line" deduction, reported on a line that comes after a tax return's AGI calculation, it is available only to itemizers.

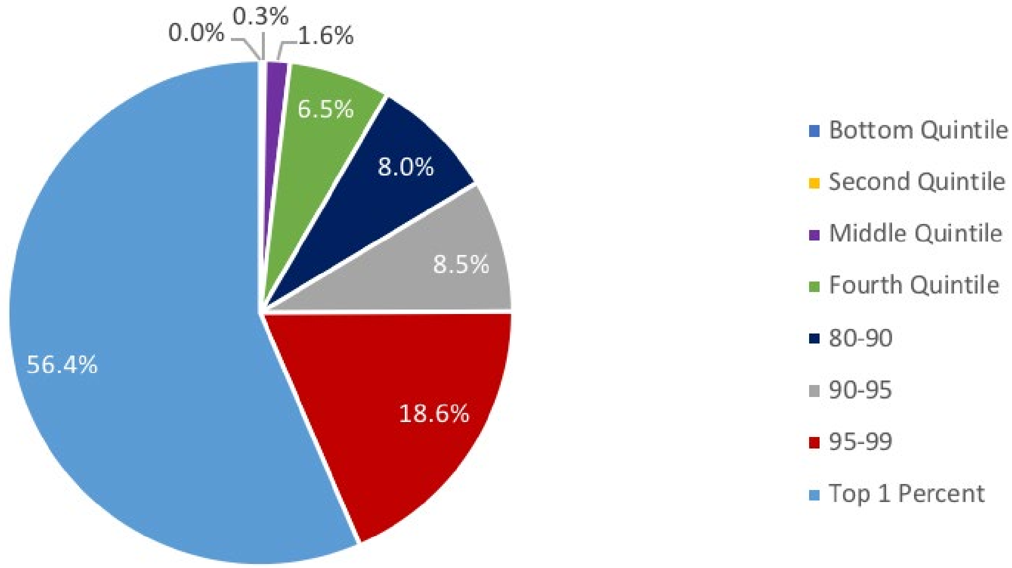
Because itemizers tend to have higher incomes, as shown in Figure 11, the charitable deduction overwhelmingly goes to higher-income taxpayers. Only 9 percent of the charitable giving that avoided taxation because of the deduction occurred within the bottom four quintiles in 2018, while more than half came from the top 1 percent of Americans, as Figure 12 illustrates.

Figure 11. Share of Itemizing Taxpayers by Income Group, 2016



Source: Internal Revenue Service.

Figure 12. Share of the Charitable Deduction Going to Income Quantiles, 2018

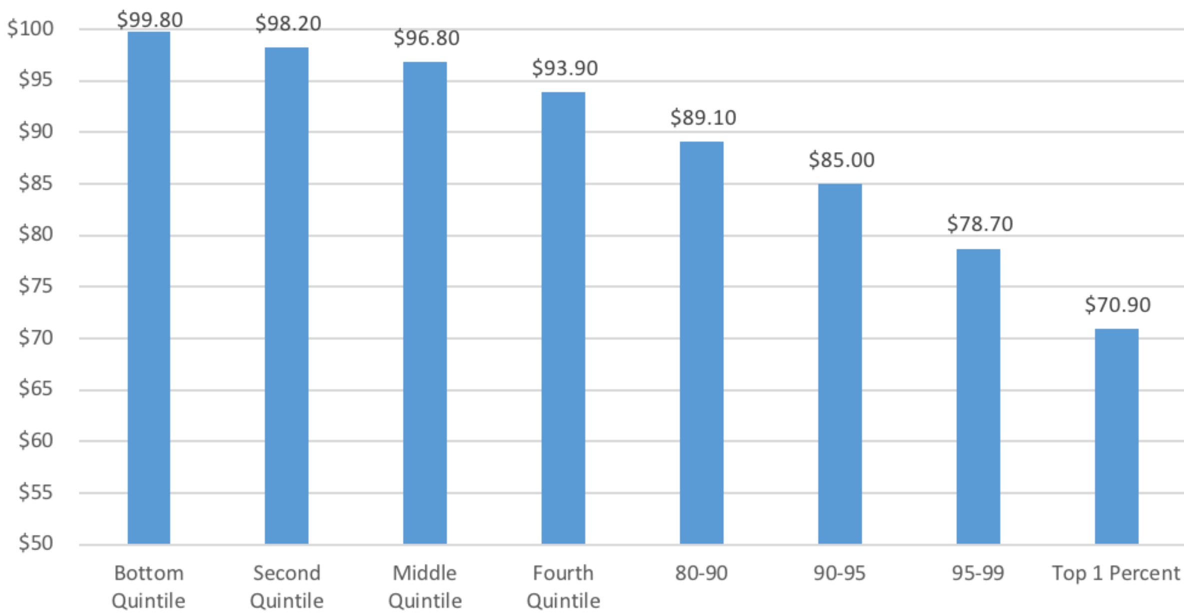


Source: Tax Policy Center.

One might respond that this is exactly the distribution to expect; higher-income Americans have more money to give, so are responsible for a greater share of total giving, so naturally receive a greater share of the deduction.

It's true that even with a charitable deduction that applied equally to all taxpayers, a higher-income person who donated more would see a greater absolute reduction in tax liability than would a lower-income person who donated less. Even so, the after-tax price of giving (the value of donations minus the deduction) declines with income—in other words, the dollar-for-dollar cost of donating falls. This is the case both because higher-income taxpayers generally have higher tax rates and because they are more likely to itemize. Thus, even if low- and high-income taxpayers donated the same amount and itemized, the latter would still receive a greater charitable deduction, as shown in Figure 13.

Figure 13. Average After-Tax Price of $100 Donation by Income Percentile, 2018



Source: Tax Policy Center.

To be clear, the drawback is that the deduction does not apply to all taxpayers; that the deduction disproportionately goes to higher-income taxpayers is a consequence of its design but not itself an intrinsic flaw. Giving ought to be safeguarded against taxation among lower-class Americans as much as among upper-class Americans.

Indeed, giving among lower-income Americans is if anything more important, for two reasons. First, as noted previously, Americans in lower income brackets give a greater share of their donations to the poor—in fact, those making $100,000 or less are responsible for 49 percent of all giving to meet basic needs (Figure 9)—and it is those donations that are more likely to prevent government crowding out. If the deduction is effectively unavailable to lower-income taxpayers, tax policy is penalizing much of the giving that holds back government intervention.

Second, to the extent that lower-income people are often less attached to their communities, as Timothy P. Carney has argued in his book *Alienated America*, the salutary spillover effects of contributing to civil society by giving to charity are needed even more dearly there.[12] And yet it is among lower-income Americans that the percent of people giving has fallen most (Figure 3).

REFORMING THE CHARITABLE DEDUCTION

Under current policy, non-itemizers are fully taxed on income that they give away to charitable causes (and itemizers are taxed on some of that income). This treatment is unfair, discourages giving, and weakens civil society. One reform option is to make the charitable deduction more widely available. Perhaps the most common proposal for reform is moving the deduction "above the line," making it available to both itemizers and non-itemizers. Other above-the-line deductions already exist, such as those for retirement account contributions and student loan interest payments; this reform would simply give the same treatment to the charitable deduction.

Moving the deduction above the line would increase total giving but reduce federal revenue. A 2018 study by Alex Brill and Derrick Choe at the American Enterprise Institute (AEI) estimated that replacing the current charitable deduction with an above-the-line deduction would increase giving by $21.5 billion in 2018 and reduce revenue by $25.8 billion.[13]

While an above-the-line deduction would treat lower-income donors more fairly with respect to their charitable giving, it would still result in their having a higher after-tax price of giving compared with today's itemizers. Because higher-income taxpayers generally have higher tax rates, the effective cost of their donations would still be lower.

A second option for reform would be to transform the deduction into a credit worth some percent of the value of a taxpayer's total giving. For example, with a 25 percent credit, someone's tax liability would fall by 25 percent of the value of all donations, regardless of tax rates or the size of the donations. However, unless made refundable, the credit would apply only in as much as someone has income tax liability. The same AEI study estimated that replacing the charitable deduction with a 25 percent nonrefundable tax credit would have a greater impact on giving and a greater reduction in revenue than the above-the-line deduction: it would increase giving by $23.3 billion in 2018 and reduce revenue by $31.1 billion.[14]

A credit approach has also been estimated to have a larger positive effect on the number of new donors compared to an above-the-line deduction. A 2019 study of various ways to penalize giving less among non-itemizers while leaving the current deduction unchanged found that a 25 percent tax credit, of the options considered, would most increase the number of households giving, both overall and at all income levels except the top 1 percent.[15]

CONCLUSION

Rebuilding civil society is no small task. In some cases it will require exploring unorthodox ideas and experimenting with new approaches. But it will also require evaluating the policies we already have in place to see how they could be improved. Reforming the charitable deduction to treat donors more fairly and penalize giving less is one such opportunity.

Those who argue that but for government overreach, civil society would be flourishing, should be asking exactly which government policies need correction, and the charitable deduction should be high on the list. A reformed charitable deduction would be a means of making our tax code fairer, a precautionary defense against one obstacle to civil society, and a step towards a renewal of America's voluntary institutions.

APPENDIX: ADDITIONAL EFFICIENCY CONSIDERATIONS AND NET IMPACT ON GIVING

While people give to charity for many non-tax-related reasons, the cost of giving is certainly part of their decision-making. Therefore, when weighing the effects of changes to the charitable deduction, policymakers must consider how reforms might increase new donations, affect tax revenues, and implicate taxpayer compliance and administrative costs.

For example, if someone would donate $100 without the deduction and $150 with it, then the deduction's practical impact is concentrated in the decision to give the additional $50. To concentrate the impact on new donations, a deduction or credit could set a floor on donations, such that only giving above a certain amount qualifies. If someone would give $100 even without a tax credit or charitable deduction, then a more efficient provision would apply only to the amount above $100.

A floor could be set at either a dollar amount or a percent of AGI. For example, with a 2 percent floor, someone making $50,000 would take the deduction or credit only for giving above $1,000, while someone making $100,000 would do so only for giving above $2,000. Recent studies have generally considered floors of $500 or $1,000, or 1 or 2 percent.[16] As average giving is worth roughly 2 percent of income, a 2 percent floor would concentrate the deduction or credit at above-average giving.[17]

A tax provision with a floor, while producing more giving than the current deduction, would have a smaller effect on giving and reduce revenue by less than one without a floor. The AEI study cited earlier estimated that an above-the-line deduction with a floor of $500 for single filers and $1,000 for married filers would increase giving by $19.1 billion in 2018 and reduce revenue by $14.6 billion; a 25 percent credit with a floor of $500 for single filers and $1,000 for married filers would increase giving by $20 billion in 2018 and reduce revenue by $15.4 billion. In both cases, only with a floor would the increase in giving exceed the reduction in revenue.

A floor set to a percentage would have an advantage over a floor set to a dollar amount: it would be equally valuable at all incomes. A floor set to a dollar amount would set a high bar for low-income givers and a low bar for higher-income givers, whereas a floor set to a percent would ensure that the deduction or credit scales with income. One potential downside of a percentage floor, however, is that it could prove more complicated to taxpayers, who would have to calculate the level at which it takes effect. Any confusion could reduce the provision's impact.

There is the possibility that a floor would motivate people to bunch their donations to benefit from the provision. For example, instead of annually giving an amount that falls below the threshold, one might give twice as much every two years so that at least part of the donation passes the threshold. However, evidence suggests that with a low floor, any bunching effects would be minor.18 Additionally, even a floor that motivates some bunching would be a more efficient provision in terms of producing new charitable giving than the current deduction, with no floor at all.

A floor would be more efficient in two respects. First, simply by reducing the amount of giving qualifying for the deduction or credit, a floor would have a smaller effect on revenues. According to the AEI estimates, an above-the-line deduction without a floor reduces revenue by $11.2 billion more than a deduction with a floor, for only a $2.4 billion greater impact on giving. Similarly, a 25 percent credit without a floor would reduce revenue by $15.7 billion more than a credit with a floor, for only a $3.3 billion greater impact on giving. Only with a floor does a deduction or credit boost giving by more than it reduces revenue.

Second, a floor would reduce administrative costs associated with a provision. Applying a provision to all giving, even small donations, would greatly increase administrative complexity. As Joseph Rosenberg et al. have noted, "Even if it audited more returns, the IRS has almost no ability to determine if, say, one really put money in the collection basket or made contributions to people knocking at the door. Spending hundreds or thousands of dollars of IRS personnel time on one return to go after a few dollars of tax for a person donating moderate amounts is not economical."[19] A floor would greatly reduce the need to monitor charitable giving to ensure compliance, preventing the provision from becoming an administrative boondoggle.

A final question is whether to maintain the ceiling, or cap, that currently exists on giving. With a cap, taxpayers stop receiving any tax benefits once their donations pass some threshold. The deduction currently has a cap at 60 percent of AGI (temporarily increased from the pre-TCJA level of 50 percent), so the deduction does not apply to giving in excess of 60 percent of AGI.

Justifications for the cap tend to appeal to the desire to make the deduction more equal by limiting the value of the deduction to the wealthy, who can afford to donate more (both in absolute terms and as a percent of AGI) and therefore stand to benefit more from the deduction.[20] A cap would also reduce tax revenues less, like a floor, by reducing the amount of giving subject to the deduction or credit. But whereas a floor can encourage giving, a cap removes the incentive to give past a threshold.

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ENDNOTES

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