



# Do tax incentives affect charitable contributions? Evidence from public charities' reported revenues



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## ABSTRACT

This paper estimates the effect of the charitable contribution tax deduction on charities' donation revenue from charities' tax filings. A one percent increase in the tax cost of giving causes charitable receipts to fall by about four percent, an effect three times larger the consensus in the literature. Further analysis reveals substantial heterogeneity in the tax response by subsector: health care and home care are more tax-sensitive than other charities, while higher education and arts are less tax-sensitive. The results are consistent with substantial tax response heterogeneity within the sample and between sampled and unsampled charities, implying that the mean tax elasticity of charitable contributions is a poor predictor of tax incentive effects for individual charities.

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## 1. Introduction

Private nonprofit organizations provide many crucial services in the U.S. They grant 30% of bachelor's degrees, make 69% of hospital admissions, and supply almost 100% of religious services. Private nonprofits constitute 71% of museums and 89% of homeless shelters and soup kitchens. These organizations receive substantial donor support – in 2014, charitable giving was equal to 2.1% of gross domestic product.<sup>1</sup>

American governments also support nonprofits by exempting them from many income and property taxes levied on for-profit firms. Additionally, organizations which serve particular causes can be registered as public charities under section 501(c)3 of the Internal Revenue Code, and donations to public charities can be taken as

itemized deductions on households' tax returns.<sup>2</sup> This reduces the donors' income tax and creates an incentive for increased giving that grows more valuable as the donor's marginal tax rate increases.

Over time, a consensus has emerged that the elasticity of charitable giving with respect to its tax cost is about  $-1$ , so that the deduction induces about as much additional giving as the US Treasury forgoes in revenues. However, there is wide disagreement around this consensus: *Pelozo and Steel (2005)* analyze 70 studies of the tax elasticity of charitable giving, and their tabulated estimates range from a zero effect to about seven additional dollars given per dollar of foregone tax revenue. Results differ for many reasons, not least of which is a dearth of credible instruments for the after-tax cost of charitable giving. Most studies distinguish between income and price effects from changes in the schedule of marginal federal tax rates using panel fixed-effects models that use households at different income levels as counterfactual comparison groups for each other, a strategy that is likely to be flawed if the price elasticity varies by income. In addition to challenges formulating estimation

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<sup>1</sup> Sources: U.S. Department of Education, National Center for Education Statistics, *The Condition of Education 2013*; American Hospital Association, *AHA Hospital Statistics (2012)*; Institute of Museum and Library Services, *Exhibiting Public Value: Government Funding for Museums in the United States (2008)*; U.S. Bureau of the Census, National Survey of Homeless Assistance Providers and Clients (1999); *Giving USA (2015)*; Bureau of Economic Analysis. Homeless shelters are termed "emergency shelters" in the NSHAPC data.

<sup>2</sup> Public charities are a subset of nonprofit organizations. Other types of nonprofit organization enjoy a wide variety of tax subsidies, such as exemption from most income and property taxes paid by for-profit firms, while only public charities and private foundations can receive tax-deductible contributions. Examples of tax-exempt nonprofit organizations that cannot accept tax-deductible contributions include social welfare groups, political organizations, homeowners' associations, and some professional sports leagues. See *Hopkins (2007, §1.2–1.3)*.

strategies, households' incentives to misreport giving can lead studies using individual income tax return data to underestimate the tax sensitivity of giving (Slemrod, 1989). How much the charitable contribution income tax deduction affects charitable giving therefore remains an open question.

Moreover, this literature has largely focused on *total* charitable giving. Giving by cause or organization is not disaggregated in machine-readable individual tax return data. Survey data such as the new PSID/COPPS files allows for some examination of heterogeneous tax responses by type of charity, but are often limited by the nature of the questions and the size and type of households surveyed.

This paper instead asks the slightly different, but related question, of how tax incentives for donors affect contributions to the service providing organizations themselves. Responses to tax incentive changes are examined using a panel of reported contributions from nonprofit organizations' Internal Revenue Service (IRS) filings, the federal form 990. It is estimated that a one percent increase in the tax cost of giving following the TRA86 causes about a four percent decline in charities' contribution receipts. Such elasticities imply a much larger tax-sensitivity of charitable giving than has been reported by most studies using household data. Unlike household data from tax returns or surveys, the form 990 data comprises a long panel with no privacy restrictions for high-income households (who make up a large share of charitable giving) and no incentives for the reporting entity to overstate contributions.

The effect of tax incentives on charities' donation revenue is credibly identified by exploiting unintentional variation across states in the effects of the Tax Reform Act of 1986 (TRA86). Preexisting differences among state income tax laws interacted with the TRA86 in ways that created substantial variation in the value of tax incentives for potential donors across states. The evidence shows that interstate changes were not foreseeable by charities, donors, or policy makers, nor were they correlated with the tax cost of giving before the federal reform, supporting the internal validity of this empirical methodology. Additionally, because these changes were driven by state-federal legal interactions, it is unlikely that other changes in the national law drove observed differences across the states.

The next section describes what we know about the history and the policy effects of the charitable contribution individual income tax deduction. This long literature has found a consensus that tax incentives matter for individual giving, but due to data limitations has said less about how such giving affects charities themselves. Section 3 describes the sample of data from IRS forms 990 used in this paper and the identification strategy for credibly isolating the effect of tax rates on giving. Section 4 presents tax elasticity results for the main sample and some robustness checks, with the finding that the sampled charities' contribution receipts are substantially more tax-sensitive than donations itemized on the average tax return. The measured tax elasticities are not only substantially larger than the  $-1$  obtained in the individual household literature but also differ substantially within the sample. Section 5 looks at heterogeneous effects of taxation on giving by type of charity. This finding can be reconciled with the individual giving literature because of substantial heterogeneity within and outside the sample; Section 6 concludes with observations about the meaning of "the elasticity of charitable giving" when organizations' responses are heterogeneous.

## 2. Charitable contributions and the US tax system

The charitable contribution deduction was added to the federal tax code by the War Revenue Act of 1917. The federal government sharply increased the burden of the federal income tax on high-income households as the US prepared to enter the First World War, increasing the top marginal rate from 15% to 67%. Senator Henry F. Hollis of New Hampshire (who also happened to be a regent of the

Smithsonian Institution) introduced an amendment allowing up to 15% of income to be given without tax to "corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals" (*Congressional Record* v. 55 pt. 7 p. S6741). Charitable giving is a luxury good, Hollis argued: "After they have done everything else they want to do... [people give] to a college or to the Red Cross or for some scientific purpose." Therefore, at the margin, high-income households will maintain their own consumption first, and "when war comes and we impose these very heavy taxes on incomes, [charity] will be the first place where the wealthy men will be tempted to economize" (*Congressional Record* v. 55 pt. 7 p. S6729).

Hollis's amendment was accepted quickly and unanimously. The brief Congressional debate on the matter, however, presaged a long scholarly one. The literature estimating individual donors' response to tax incentives is large and long, but a consensus on the effect the deduction has on charitable giving remains elusive. Because the deduction has been in the tax code continuously since 1917, its efficacy has traditionally been estimated by computing elasticities of charitable contributions relative to the "tax price" of giving when legislation alters marginal rates, and therefore the value of contribution incentives.<sup>3</sup> A meta-analysis by *Pelozo and Steel (2005)* tabulates 70 peer-reviewed studies, most estimating a tax elasticity of charitable contributions between  $-4$  and  $-0.4$ , with a median of about  $-1.2$ .

This literature finds divergent results to a large extent because there is no single elasticity of charitable giving, but a complex behavioral response which can be measured with respect to different sorts of tradeoffs. One challenge with individual tax return data is correctly distinguishing between changes in permanent giving and shifting of giving across years to maximize the tax benefit of anticipated rate changes — a problem made more difficult by the fact that marginal tax rate is a nonlinear function of income. If households strategically "bring forward" giving, comparison of contributions just before and after a tax change overstates the permanent response. Separating income and price effects can mean, for instance, comparing tax rate changes among high-income groups with low-income groups, or other not-quite-ideal approaches. See the discussion of estimation issues in *Andreoni (2006)* and *Bakija and Heim (2011)*. For example, using the same panel data but different assumptions about permanent and temporary changes, *Randolph (1995)* finds that most of the tax response is temporary shifting, with a permanent giving tax elasticity of about  $-0.5$ , while *Auten et al. (2002)* find a permanent elasticity of  $-1.2$ , with a small temporary response.<sup>4</sup>

Besides intertemporal shifting, this literature has found tax effects on behaviors that substitute for cash gifts. For example, tax incentives can encourage the replacement of gifts of labor (*i.e.* volunteering) with gifts of money. Most of the literature on this topic finds that the sensitivity of monetary contributions is greater than the total response of money plus the cash equivalent of volunteering hours (*Duncan, 1999; Feldman, 2010; Gruber, 2004*), suggesting that gifts of time and money are substitutes, although *Yörük (2013)*

<sup>3</sup> Tax rates determine the "price" of giving to charity, because giving \$1 to a charity costs an itemizing taxpayer only  $\$1 - \tau$  in after-tax personal consumption, where  $\tau$  is the marginal tax rate. For example, with a tax rate of 36%, an itemizing taxpayer can give \$1 to a public charity, or could pay the tax authority 36 cents and keep 64 cents for herself. So by reducing the top marginal rate from 50% to 28%, the TRA86 increased the federal tax cost of giving \$1 to charity among top-bracket itemizing taxpayers from 50 cents to 72 cents, the amount of after-tax income the household could otherwise keep for personal use. A tax cut is therefore equivalent to a price increase in the cost of charitable giving, and can help to identify the importance of this incentive for donors.

<sup>4</sup> Both papers use the IRS publicly available panel data. Auten et al. benefit from their later date by being able to study data ending in 1993, whereas Randolph's panel ended in 1988; however, since the 1981 and 1986 tax reforms are the major legislation spanned by the panel these additional years should not explain the substantial difference.

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