

Federal Tax Policy and Charitable Giving

Charles T. Clotfelter



National
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**A National Bureau
of Economic Research
Monograph**

Federal Tax Policy and Charitable Giving

Charles T. Clotfelter



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CHARLES T. CLOTFELTER is professor of public policy studies and economics and vice-provost for academic policy and planning at Duke University.

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(Resolution adopted October 25, 1926, as revised through September 30, 1974)

**To my parents
James and Caroline Clotfelter**

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Preface

In answer to a question about the possible effects of eliminating the charitable deduction in the nation's income tax, Ronald Reagan replied that Americans "are the most generous people on earth" and that they would remain so without a deduction (*Wall Street Journal*, 7 July 1982, p. 4). The question was prompted by one of several major proposals for reforming the U.S. tax system, a low-rate comprehensive income tax. Indeed, concern over economic incentives, the effects of inflation, tax compliance, and distributional equity appears to have reached a new level in the United States. From 1976 to 1983 an average of one major tax bill was enacted every two years, and there is mounting discussion of comprehensive tax reform. As the question to the president suggests, one source of concern amid these actual and potential tax changes is the effect they will have on charitable giving. This question is a particularly important topic now, following recent cuts in federal social-welfare expenditures. In fact, the philanthropic sector has long shown a keen interest in tax provisions affecting their support and operation.

This book concerns the relation between federal taxes and charitable giving. Its objective is to present and discuss econometric evidence on this relationship in order to assist in the evaluation of tax policy. The aim of the book is not to make policy recommendations, however, but rather to provide evidence and a framework for analysis of policy. I attempt to review the body of applied econometric analysis in the area and to extend that analysis in several areas using four basic sets of data. One of these data sets has been used previously to study charitable giving. Two others have been adopted for the present study to include the most recent data on contributions. A fourth has not previously been analyzed for this purpose. In addition to this statistical estimation, I present results based on computer simulations of charitable giving, one of which is a revised

version of a model used in a previously published paper. Because of the technical nature of many of the issues dealt with, some parts of the text cannot be made fully accessible to all readers. Where such technical topics are unavoidable, I have attempted to include more generally comprehensible discussion in hopes that the book can be of use to those not trained in economics and statistical methods.

The National Bureau of Economic Research provided the major support for this book. I am also grateful for the support I received from Drake University, where I am employed, and from the University of North Carolina, where I spent a sabbatical semester. Throughout the project, I have benefited from the able and industrious research assistance of Susan Cowan and from the skillful manuscript preparation of Dante Noto and Patsy Terrell. In addition, I received assistance from Richard Bostic, Mark Gallo, William Long, Mayre Loomis, Stan Paskoff, and Allyson Tucker. Karl-Heinz Paqué, Thomas Petska, Thomas Rosen, and Roy Wyscarver provided me with useful unpublished data. For helpful comments and discussions, I am grateful to Elizabeth Boris, Arthur Clarke, Daniel Feenberg, Daniel Frisch, Pamela Gann, H. Gregg Lewis, Ralph McCaughan, Richard Schmalbeck, John Siegfried, B. J. Stiles, Emil Sunley, and members of the tax group at the National Bureau. In addition, I have benefited from many discussions I have had over the past decade with my coauthors on papers dealing with individual charitable giving: Martin Feldstein, Lester Salamon, and Eugene Steuerle. Finally, I am grateful to Lucile, James, and John Clotfelter for their indulgence over the period I have worked on this project.

1 Tax Policy and Support for the Nonprofit Sector: An Overview

The nonprofit sector—as distinct from government and the for-profit sector—plays a more important role in the United States than in any other industrialized economy. Encompassing such institutions as colleges and universities, not-for-profit hospitals and research institutions, churches and other religious organizations, museums and cultural institutions, and charitable organizations of many varieties, this sector historically has performed many functions that in other countries are the primary responsibility of government. It employs over 10 percent of the labor force and over twice the number of federal-government employees (Weisbrod 1980, p. 26). At the same time, the United States is distinctive in the degree to which it subsidizes the nonprofit sector through its tax system. Its provisions for the deductibility of charitable gifts in addition to the tax exemptions accorded to nonprofit institutions are unparalleled in scope. Although the interrelationships that have evolved between government, nonprofit institutions, and the legal structure are the result of hundreds of years of complex social development, it seems by no means accidental that this special reliance on nonprofit institutions and these favorable tax provisions have developed side by side.

In recent years, however, there has been evidence of increasing concern about the vitality of the nonprofit sector and the adequacy of federal tax provisions affecting charitable giving. One source of concern has been the standard deduction, introduced as a simplification into the income tax system over forty years ago, but blamed for reducing incentive to make contributions. Public commissions in the 1960s and 1970s investigated the role of tax policy in philanthropic giving and made their recommendations to Congress. One of those—the Commission on Private Philanthropy and Public Needs, known as the Filer Commission—began its report by recommending several basic changes in the tax treatment of contribu-

tions (Commission on Private Philanthropy and Public Needs 1977, pp. 3–21). For its part, Congress has responded with changes in tax provisions affecting charity, most recently passing a law that would extend the charitable deduction to nonitemizers by 1986. Even so, there is widespread concern about the adequacy of support for the nonprofit sector. Proposals to eliminate the corporation income tax or to replace the income tax with a “flat-rate” comprehensive tax would have implications for charitable giving. In addition, cuts in federal spending for social programs under President Reagan reduced an important revenue source for nonprofit organizations at the same time it increased the demand for many of their services. Rising labor costs and other developments within the nonprofit sector combined with slow growth in private support have caused one commentator to conclude that the sector as a whole “is in serious and growing difficulty” (Nielson 1979, p. 3). Needless to say, such concerns have heightened interest in the role of the tax system in influencing the level and distribution of private support for charitable and other nonprofit organizations.

The purpose of the present study is to examine one important aspect of the relationship between the tax structure and the nonprofit sector: how federal taxes affect charitable giving. Specifically, it examines the effect of tax provisions on contributions by individuals, corporations, and estates, on grants by foundations, and on volunteer work. The focus is on the connection between policy variables and behavior as observed in econometric analysis and other empirical study. To give the reader perspective for this investigation, it is useful to begin by providing, first, an overview of the nonprofit sector and the role of charitable giving in it and, second, a brief description of the major federal tax provisions affecting charity. The chapter concludes with an outline of the remaining chapters.

1.1 Charitable Giving and the Nonprofit Sector

Before focusing on charitable organizations and contributions made to them, it is useful to have a general sense of the size and function of the nonprofit sector as a whole. Table 1.1 presents data for major categories within the nonprofit sector based on returns for tax-exempt organizations in 1975. The organizations are divided according to whether contributions made to them are generally deductible in calculating federal income taxes. Of the 220,000 nonprofit organizations filing returns in 1975, the largest single group was in fact charitable organizations. Often referred to by the Internal Revenue Code section applying to them, such “501(c)3 organizations” include religious, educational, cultural, scientific, and social-welfare organizations. This category represented over a third of all nonprofit organizations, based on number of returns, and over a half of total receipts of the sector, although these figures are probably underestimates

since some religious groups do not submit returns. Charitable organizations represented an even larger share of contributions received—some 83 percent based only on 1975 returns and almost 90 percent counting all organizations.¹ The most important other category, based on receipts, was civic clubs such as Lions and Rotary. Other significant categories included voluntary employee beneficiary associations, labor and agricultural groups, business groups, and life insurance associations. As numerous as these other nonprofit organizations were, however, table 1.1 makes clear that charitable organizations account for a sizable portion of the entire nonprofit sector.

Measured in terms of dollars contributed, charitable giving in 1982 amounted to about \$60 billion. Table 1.2 provides estimates of giving from four sources for selected years between 1955 and 1982. The estimates are published in the annual volume *Giving U.S.A.*, a widely cited source of data on charitable contributions. Worth noting, however, is that the estimation procedures underlying these figures are not described in print and should be taken as rough approximations only. For 1982, contributions by living individuals accounted for about four-fifths of the total, some \$49 billion. The remaining one-fifth was shared by bequests from estates (about \$5 billion), corporations (\$3 billion), and foundations (\$3 billion). These numbers involve some double counting since foundations act as intermediaries, as is discussed below, but these figures serve to give a general idea of relative magnitudes. Over the period 1955 to 1982, the real level of total giving has almost tripled, from \$11 to \$29 billion in 1972 dollars. This growth has also tended to exceed that of national income; total giving rose from 2.0 percent of national income in 1955 to 2.5 percent in 1982. Over this period, individual donations have averaged about 80 percent of the total. Contributions by corporations have declined slightly in importance, and foundation grants have dropped significantly. Bequests have fluctuated over time, being particularly sensitive to large gifts.

Two forms of charitable giving are not shown in table 1.2. The most important is volunteer work. In 1980 as many as 80 million Americans did some volunteer work, spending the equivalent of about 8 billion hours in such activity. The market value of this time has been estimated to be on the order of \$60 billion, suggesting that estimates of giving such as those shown in table 1.2 measure about half of the economic resources contributed to charitable organizations (Weitzman 1983, p. 270). In addition, the dollar amounts in table 1.2 do not directly reflect contributions made on fiduciary income tax returns for trusts and estates. Representing for the most part gifts not otherwise reflected on personal income or estate tax re-

1. Total receipts by charitable organizations were some \$28 billion in 1975 (see table 1.2, netting out foundation grants). Adding the \$11 billion yields 89 percent for contributions to 501(c)3 organizations.

Table 1.1 Tax-Exempt Organizations, 1975

Type of Organization	Number of Returns	Receipts in Millions of Dollars		Applicable Code Section
		Total	Contributions, Gifts, and Grants	
<i>Tax-Deductible Contributions Generally Allowed</i>				
Corporations organized under act of Congress	665	527	11	501(c)1
Charitable, religious, educational, and scientific organizations	82,048	65,544	17,110	501(c)3
Cemetery companies	1,518	255	5	501(c)13
War-veterans organizations	1,921	130	7	501(c)19
<i>Tax-Deductible Contributions Generally Not Allowed</i>				
Title-holding companies for exempt organizations	3,263	490	23	501(c)2
Civic leagues, social-welfare organizations, and local associations of employees	28,064	19,558	681	501(c)4
Labor, agricultural, and horticultural organizations	28,258	5,028	120	501(c)5
Business leagues, chambers of commerce, and real estate boards	17,530	3,890	230	501(c)6

Social and recreational clubs	18,228	2,535	32	501(c)7
Fraternal beneficiary societies	12,066	2,134	46	501(c)8
Voluntary employees' beneficiary associations	4,285	6,806	1,926	501(c)9
Domestic fraternal societies	4,674	507	21	501(c)10
Teachers' retirement-fund associations	49	100	6 ^a	501(c)11
Local benevolent life insurance associations	4,975	3,725	17	501(c)12
State-chartered credit unions	1,610	2,259	1 ^a	501(c)14
Mutual insurance companies or associations	864	59	0 ^a	501(c)15
Farmers cooperatives organized to finance crop operations	36	54	18 ^a	501(c)16
Supplemental unemployment-benefit trusts	496	959	244	501(c)17
Employee-funded pension trusts	42 ^a	13 ^a	7 ^a	501(c)18
Other organizations ^b	9,605	309	62	—
TOTAL	220,197	114,890	20,565	

Source: Sullivan and Coleman 1981, pp. 7–8, figure 1; p. 10, table 1.

^aEstimates based on small samples.

^bOrganizations not specified included trusts for prepaid group legal services (covered in section 501(c)20), black lung trusts (501(c)21), religious and apostolic associations (501(d)), farmers' cooperative associations (521(a)), cooperative hospital service organizations (501(e)), and cooperative service organizations of operating educational organizations (501(f)). Contributions to the last two types of organizations are generally tax deductible.

Table 1.2 **Estimated Charitable Giving by Source, Selected Years**

Year	Individuals	Corporations	Bequests	Foundations	Total	Total in 1972 Dollars	Total as Percentage of National Income
<i>Amounts in Billions</i>							
1955	\$ 5.71	\$0.42	\$ 0.24	\$ 0.30	\$ 6.67	\$10.96	2.0
1960	7.63	0.48	0.57	0.71	9.39	13.67	2.3
1965	10.36	0.79	1.02	1.13	13.30	17.89	2.3
1970	15.92	0.80	2.13	1.90	20.75	22.69	2.6
1975	24.24	1.20	2.23	1.65	29.32	23.31	2.4
1980	39.88	2.60	2.86	2.81	48.15	26.95	2.3
1982	48.69	3.10	5.45	3.15	60.39	29.14	2.5
<i>Percentage of Total Giving</i>							
1955	85.6	6.3	3.6	10.6	100.0	—	—
1960	81.3	5.1	6.1	7.6	100.0	—	—
1965	77.9	5.9	7.7	8.5	100.0	—	—
1970	76.7	3.9	10.3	9.2	100.0	—	—
1975	82.7	4.1	7.6	5.6	100.0	—	—
1980	82.8	5.4	5.9	5.8	100.0	—	—
1982	80.6	4.5	9.0	5.2	100.0	—	—

Sources: *Giving U.S.A.* 1983, p. 36; U.S. Council of Economic Advisers 1983, p. 186.