Emerging Issues in Philanthropy

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The Cost of Giving: How Do Changes in Tax Deductions Affect Charitable Contributions?

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Panelists identified several factors for judging tax deductibility that were as important as the size of any incentive effect.

Each year, millions of American taxpayers claim tax deductions for contributions to their favorite charities. The charitable tax deduction subsidizes private giving by reducing the out-of-pocket cost of making contributions. For example, a taxpayer in the 28 percent tax bracket who gives $100 to a favorite charity cuts his or her tax bill by $28 with a charitable tax deduction, in effect reducing the cost of the donation to $72. However, giving such tax incentives is not an inexpensive endeavor for the federal government. In 1999, the budgetary cost of the charitable deduction was estimated to be almost $25 billion.

In April 1999, the Urban Institute's Center on Nonprofits and Philanthropy and Harvard University's Hauser Center for Nonprofit Organizations convened the first Seminar on Emerging Issues in Philanthropy to explore whether the benefits derived from the charitable tax deduction are worth the cost. The day-long roundtable brought together researchers, government officials, and nonprofit executives and advisors to identify areas of agreement and disagreement about the effect of the deduction on private giving. Panelists also discussed our general level of knowledge about the cost of giving.

Price Elasticity of Giving

Price elasticity of giving is a measure of how responsive giving is to a change in its cost. It assesses the degree to which people give more or less depending on how expensive the donations are. A price elasticity of –1.0 indicates that reducing the cost of giving by 50 percent raises giving by 50 percent, while a price elasticity of –0.5 means that a 50 percent drop in the price of giving would increase giving by only 25 percent.

From a tax policy perspective, it matters whether the price elasticity of giving is greater (in absolute value) than 1.0. If it is, then taxpayers who claim tax deductions for charitable contributions are likely to increase their giving by more than the estimated revenue cost of the subsidy. In such a case, the subsidy would be said to be "treasury efficient." If the elasticity is smaller (in absolute value) than 1.0, the extra giving prompted by the charitable deduction is less than the revenue cost of the deduction to the U.S. Treasury; therefore, the tax subsidy would be "treasury inefficient." In principle, the government could actually increase the financial resources of nonprofit organizations by eliminating the charitable deduction and then using the extra revenue collected to make grants directly to charities. (Seminar participants were quick to note, however, that this alternative may not be realistic.)

Does the Charitable Tax Deduction Stimulate Private Giving?

In general, seminar participants agreed that people are at least somewhat sensitive to the cost of giving and will give more if it costs them less to do so. But, the presentation from researchers and the ensuing discussion also indicated much uncertainty about how much the cost of giving affects charitable contributions.

*Joseph Cordes prepared this brief based on the April 1999 meeting of the Seminar on Emerging Issues in Philanthropy. The seminar is part of the Urban-Hauser seminar series coordinated by Eugene Steuerle, Joseph Cordes, Evelyn Brody, Marion Fremont-Smith, and Sarah Wilson.

The first generation of statistical studies of private giving, conducted in the 1970s, generally found that the price elasticity of giving was equal to or greater than 1 (in absolute value), in some cases significantly so. The implication was that giving was fairly sensitive to the after-tax cost of giving and that changes in tax rates that raised or lowered the cost of giving could significantly affect the amount of charitable contributions.

Yet, tax-rate cuts enacted in the 1980s raised questions about the magnitude of these estimates. The Tax Reform Act of 1986 increased the after-tax cost of giving, often significantly. There were concerns that if private giving were as sensitive to cost as implied by the existing research, lower tax rates would cause private giving to fall by an appreciable amount. The predicted drop in giving, however, did not materialize. With the exception of taxpayers in the highest income tax brackets, charitable giving remained quite stable. The implication was that giving may not be as sensitive to price incentives as indicated by some econometric models.

Temporary Versus Permanent Changes in the Cost of Giving

What might account for the discrepancy between the observed response of taxpayers and the predictions of statistical models? One important insight among panelists was that early studies were prone to overstate the "long-run" price responsiveness of giving because these studies were forced to use data that reflected responses to temporary as well as permanent changes in the after-tax cost of giving. For example, a taxpayer who faces a higher-than-usual tax rate in a particular year might also be prompted to give more than the usual amount in that year (indeed, he or she could be advised to do so by a tax planner) because the cost of giving was temporarily low. A taxpayer's income in such a year is also likely to be higher than usual, which would further encourage giving. The implication is that the observed reaction of a taxpayer to a temporary drop in the cost of giving might overstate the change that would be prompted by a more permanent drop in the cost of giving. An opposite pattern of responses would be expected in a year in which a taxpayer's income and tax rate were lower than usual. In any given year, a sample of tax returns will likely include a number of taxpayers whose observed tax rates are temporarily higher or lower than usual.

In the 1980s and 1990s, improved data have made it possible to better distinguish between temporary and permanent changes in the cost of giving. As expected, researchers using these data generally find that annual giving is less responsive to permanent than to temporary tax changes. Indeed, the results of several recent studies suggest that the price elasticity of giving may be less than 1, perhaps closer to –0.40.

The panelists, however, agreed that the issue is far from settled. A major obstacle to "pinning down" the elasticity of giving is incomplete data. One important limitation is that few data sets distinguish among different types of giving so that researchers must assume that the elasticity of giving to different types of charities is the same. In the few cases with enough data to allow this assumption to be relaxed, one generally finds that the elasticity of giving does vary by type of charitable activity.

Not many instances exist in which tax rates have been changed across the board; therefore, we can rely on few "natural policy experiments" altering the schedule of tax rates. This type of legislated change in tax rates is most likely to be interpreted as a permanent change in the cost of giving.

How Much Weight Should Go to Estimates of the Price Elasticity of Giving?

Recent research raises the possibility that charitable giving may be relatively insensitive to changes in its price. If these results are confirmed in subsequent studies, the implication is that the amount of extra giving prompted by the charitable deduction may be less than its budgetary cost.

From the narrow standpoint of treasury efficiency, such a finding would seem to do two things: challenge the view that the deduction for charitable contributions has been an effective way of increasing the financial resources of nonprofits and raise questions about the wisdom of expanding the scope of the charitable deduction. The panelists agreed, however, that drawing such conclusions gives undue weight to the price elasticity of giving in the design and evaluation of tax policy affecting charities.

In particular, the panelists identified other factors that should receive equal consideration. These include (1) the overall public benefits that are derived from the range of charitable activities that are supported by private giving, (2) who receives these benefits, and (3) whether the benefits differ according to who makes the gift.

Even if the charitable deduction encouraged less additional giving than it cost in forgone tax revenue, it seems quite unlikely that a system of direct government grants would mirror the pattern of extra giving elicited by the deduction. While the added revenue that would be garnered from abolishing or limiting the tax deduction, in theory, could be spent more efficiently by providing direct grants, there is no guarantee that the direct grants would produce a socially superior pattern of funding for different charities.

Replacing private charitable gifts with direct government grants could also have other consequences. Theoretical models of individual giving demonstrate that individuals have a stronger economic incentive to substitute government support of charities for their own giving when the government support takes the form of direct government grants instead of indirect subsidies to private giving. In other words, there is a chance that more direct support of charities through direct government grants may simply replace private gifts.

External gains that extend beyond the cash amount of the gifts may also arise from a more "giving population." For example, some studies have found that when people give money to charities they are also more likely to volunteer their time. Hence, financial incentives that encourage gifts of cash may also help charities expand and deepen their pool of volunteers in a way that direct government grants to charities will not. Increased volunteer participation in charitable activities not only provides a tangible benefit to charities but also may help foster civic virtues that are needed to help maintain a "civil society."

More Information, Other Considerations

Although our knowledge of the price sensitivity of giving has grown in recent years, it remains incomplete. The empirical evidence shows that the amount of giving is at least somewhat sensitive to the cost of giving. The evidence also suggests that giving is fairly responsive to temporary changes in the cost of giving, though few researchers agree on how sensitive giving is to more permanent price changes. But much remains to be learned. To quote one panelist, "Available data are strong in some respects and weak in others. . .so that each study's strengths reflect shortcomings in the others. Incomplete data have entailed piecemeal modeling, and alternative results contain kernels of truth."

As data improve, one can expect that some of the current uncertainties about the magnitude of the price sensitivity of giving will disappear. But, as many panelists noted, even then consideration of charitable giving will require more than estimates of price elasticity. Policy judgments about the effectiveness of the current charitable deduction—and proposals for expanding its scope—should rest not only on how much more people will give, but also on the social benefits of greater individual giving.

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