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CHARITABLE DEDUCTION FOR TAXPAYERS WHO DO NOT ITEMIZE Proposal Raises Concerns About Effectiveness And Cost

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Senators Joseph Lieberman and Rick Santorum recently introduced faith-based legislation (S. 1924) that contains tax incentives for charitable giving. The centerpiece of these tax proposals is a provision that would allow non-itemizers — tax filers who do not itemize their deductions and instead use the standard deduction — to deduct the cost of charitable gifts up to a limit, or cap, of \$400 for singles and \$800 for married couples. The proposed deduction would cost about \$4 billion a year, making it by far the most expensive provision in the legislation.

Under the bill, the non-itemizer deduction would be in effect for only two years, 2002 and 2003. Once in place, however, it almost surely would be extended, as so many “temporary” tax provisions are; allowing this provision to expire would be viewed as favoring middle-class tax increases and opposing charity (see box on page 3). If extended permanently, it would likely cost \$40 billion over the next ten years — a cost that is difficult to justify given the deterioration in the long-term budget outlook.

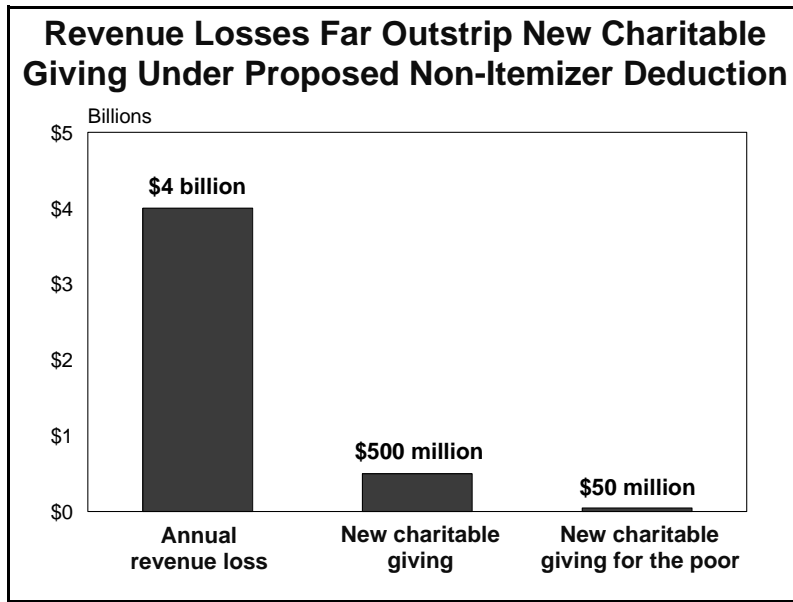
Summary

The stated objective of the Lieberman-Santorum legislation is “to promote charitable giving.” To achieve this goal, the bill must create incentives to increase charitable donations, not simply reward people’s existing level of generosity. The capped deduction for non-itemizers that the bill contains is poorly designed, however, to meet the objective of boosting charitable giving, as are capped deductions proposed by the Administration and adopted last year by the House.

- Joint Tax Committee estimates indicate that in recent years non-itemizers have made annual charitable contributions in excess of \$20 billion a year. The proposed capped deduction would reward non-itemizers for making donations to charity that they would have made anyway without the tax break. This results in a large revenue loss without increasing charitable giving.
- In a new analysis, the Congressional Research Service estimates that the charitable deduction for non-itemizers in the Lieberman-Santorum legislation would yield only *12 cents* of additional giving for every dollar of revenue lost to

¹ The authors would like to thank Robert Reischauer, Eugene Steuerle, William Gale, Leonard Burman, Gary Bass, Iris Lav, and Isaac Shapiro for their comments on earlier drafts of this analysis.

the Treasury.² CRS reached this conclusion for three reasons: because the deduction would provide a tax cut for substantial contributions that would have been made anyway, because the deduction would provide no incentive for new giving in excess of the \$400 and



\$800 caps, and because the current research in the field finds that non-itemizers are unlikely to increase their giving sharply in response to a deduction of this nature. CRS concludes that the vast majority of the cost of the deduction would go toward subsidizing existing donations rather than generating new gifts.

- CRS estimates imply that, at an estimated annual cost of about \$4 billion a year, the deduction would generate only about \$500 million of new donations — an increase of just over 2 percent in the total amount of giving by non-itemizers and an increase of less than 0.5 percent in all individual giving.
- CRS estimates further indicate that new charitable donations that would directly benefit the poor would increase under the proposed deduction by only about \$50 million a year — or one to two cents for every dollar of foregone tax revenue.
- The deduction could be made much less expensive and more effective if it were redesigned. A study by the Urban Institute found that providing a deduction only for contributions *above* a threshold amount could sharply reduce the revenue losses — in part, because many fewer existing donations would get a tax break — while substantially increasing the measure’s “bang for the buck” in terms of generating more new contributions for each dollar of lost revenue.

Finally, in an analysis released on March 18 of the tax proposals in the President’s budget, the Joint Committee on Taxation concluded that a charitable deduction for non-itemizers would “add complexity for millions of taxpayers. Adding the deduction for non-itemizers would

² Jane Gravelle, “Economic Analysis of the Charitable Deduction for Non-Itemizers,” Congressional Research Service, March 13, 2002.

Would A Two-Year Charitable Deduction For Non-Itemizers Be Made Permanent?

The charitable deduction for non-itemizers in the Lieberman-Santorum legislation would be in effect for two years, 2002 and 2003. Over these two years, the estimated cost of the deduction is approximately \$8 billion. Some who are accustomed to ten-year cost estimates have misinterpreted this \$8 billion cost figure to reflect a smaller deduction rather than simply a shorter effective period. If the non-itemizer deduction did not expire after two years and were repeatedly extended or made permanent, its ten-year cost would be approximately \$40 billion.

In terms of assessing the proposal's fiscal impact, it is more realistic to assume that it will be extended repeatedly or made permanent and that the budget will have to absorb the full \$40 billion cost over the next decade. Congress routinely extends a number of so-called temporary tax breaks before they are allowed to expire, and it is highly unlikely that Congress would allow a charitable deduction for non-itemizers to expire after two years. Those who supported the expiration of the non-itemizer deduction after two years would surely be accused of raising taxes on the middle class, who would be the primary beneficiaries of the deduction, and of being hostile to charity. Overall, the chances that this provision would be allowed to expire are very small.

Some point out that a non-itemizer deduction was allowed to expire the last time it was in effect, arguing that this precedent indicates that the two-year deduction in the Lieberman-Santorum bill could expire on schedule. This comparison has little merit, however, since the previous non-itemizer deduction was allowed to expire as part of the overhaul of the tax code made by the Tax Reform Act of 1986. That law eliminated a number of deductions and tax preferences while sharply increasing the standard deduction and reducing marginal tax rates in an effort to broaden the income tax base and simplify the tax code. Average low-, moderate-, and middle-income taxpayers came out even or with a small tax reduction. In the absence of compensating changes to ensure that ending the non-itemizer deduction would result in no net tax increase for middle-class taxpayers, it is hard to imagine that Congress would allow it to expire.

require that millions more taxpayers keep records of small contributions, and would lead to more disputes with the IRS on audits.” The Joint Committee added that deductions for non-itemizers “threaten to undermine one of the principal purposes of the standard deduction — that of simplifying returns for those with a low level of itemized deductions by eliminating the need for record keeping and accounting for these deductions by allowing instead the standard deduction. As the exceptions multiply, all taxpayers in effect become itemizers, which leads to more complicated tax return preparation and administration.”³

Cost of Deduction a Larger Factor in More Constrained Fiscal Environment; Programs for the Poor More Likely to Suffer than Benefit

The goal of stimulating more charitable giving is laudable. Furthermore, a deduction for non-itemizers — which would largely benefit the middle class — would have been preferable to

³ Joint Committee on Taxation, “Description of Revenue Provisions Contained in the President’s Fiscal Year 2003 Budget Proposal,” JCS-3-02, March 18, 2002.

many of the tax cuts included in the tax package enacted last June. But the proposed deduction would now come on top of those enacted tax cuts. Concerns about its cost and effectiveness take on far more urgency in light of the marked deterioration in the fiscal outlook.

- A year ago, the Congressional Budget Office was projecting that the budget outside Social Security would be in surplus for as far as the eye could see; now it is projecting that the non-Social Security budget will be in deficit through 2009. Some \$3.9 trillion over ten years has been lopped off the projected surplus.
- Even these CBO projections are likely to be much too optimistic, as they do not take into account a number of items that are virtually certain to be enacted now or in the not-too-distant future — from the farm bill and increased expenditures for defense and homeland security, on the spending side; to the extension of a number of popular tax breaks that are routinely extended before they expire, as well as tax relief to ensure that the number of taxpayers subject to the individual Alternative Minimum Tax does not skyrocket from fewer than 2 million today to 39 million by 2012, on the revenue side.
- Urban Institute president and former Congressional Budget Office director Robert Reischauer testified in January that “[r]arely have the policies underlying the baseline projections been as disconnected from the policy makers’ agendas as they are today.”⁴ Using “more realistic assumptions,” Reischauer has estimated that the budget outside Social Security will remain mired in deficit throughout the decade. Reischauer also has calculated that a continuation of current policies together with likely legislative actions would wipe out any remaining surpluses on the unified budget over the next ten years. Furthermore, as the cost of the retirement of the baby boom generation begins to mount in the years outside the ten-year budget window, deficits threaten to grow to unsustainable levels, a point emphasized in recent testimony by U.S. Comptroller General David Walker, the head of the General Accounting Office.⁵

The deficits projected under these more realistic assumptions indicate that the nation faces a far more constrained fiscal environment in coming years. They also lead to another significant point: Unless the country is willing to tolerate deficits for an indefinite period, proposals that involve sizeable expenditure increases or tax reductions — including the proposed charitable deduction for non-itemizers — will eventually have to be paid for.

⁴ Robert Reischauer, “Statement Before the Senate Budget Committee,” January 29, 2002. Reischauer’s “more realistic estimates” have not yet been formally published, but he has used them in a number of recent presentations.

⁵ David Walker, “Long-Term Fiscal Challenges,” General Accounting Office Testimony before the Senate Budget Committee, February 27, 2002.

With this deterioration in the budget outlook, ensuring adequate funding for programs that assist low-income families will be a particular challenge. A poorly designed charitable deduction for non-itemizers is more likely to exacerbate such problems than to offer a meaningful alternative through the provision of services by private charities.

- While the new charitable donations generated by the deduction will support many worthy causes, the Congressional Research Service estimates that “no more than 10 percent of all charitable giving directly benefits the poor.”⁶
- If, as the CRS estimates suggest, the Lieberman-Santorum deduction would yield \$500 million a year in new donations, then only about 10 percent of this total, or \$50 million a year, would be directed to services supporting poor families. This translates into an increase in services to poor households of one to two cents for every dollar of revenue lost under the proposal.
- If the approximately \$4 billion annual cost of the new deduction ultimately were offset by cuts in programs, there would be fewer resources for domestic programs in the years ahead. In the end, low-income families and individuals would be likely to come out behind.⁷

Equity Rationale for Deduction is Flawed

Some view the proposed deduction as addressing an inequity in the current tax system, believing it is inequitable for non-itemizers not to receive the same tax treatment for charitable donations as is extended to those who itemize their deductions. This view is not widely shared by tax policy experts, however, because it overlooks the role of the standard deduction in the tax code. In lieu of itemizing their deductions, non-itemizers reduce their taxable income by taking the standard deduction, which is set at \$4,700 for singles and \$7,850 for couples in 2002 and is adjusted annually for inflation. The standard deduction is specifically designed to substitute for individual itemized deductions, including the deduction for charitable donations, and to reduce the administrative burden associated with tracking small deductions.

⁶ According to the CRS study, the single largest beneficiary by far of individual donations is religious institutions. CRS estimates that approximately six percent of donations to religious institutions go to assist poor households, with the remainder going to support the operation of churches, synagogues, and the like and to provide other services to congregation members.

⁷ The Lieberman-Santorum proposal also includes an increase for the Social Services Block Grant of nearly \$1.4 billion over two years. Past experience suggests that this provision, unlike the tax measures in the bill, would be unlikely to become a permanent part of the fiscal landscape. The long-term trend in funding for this block grant has been flat or downward. Past efforts to raise funding for this block grant, as the Lieberman-Santorum bill would do, have proved short-lived, with scheduled funding increases generally being cancelled before they took effect or failing to be sustained after the term of the increase expired. This program has proven to be a target both for budget cuts when deficits have been present and for reductions to generate savings used as offsets for other programs.

In fact, non-itemizers are treated preferentially for their charitable contributions and other deductible expenditures as long as those expenditures total less than the standard deduction. In effect, non-itemizers receive more than a dollar's worth of deduction for every dollar they have in deductible expenses. As the recent Joint Tax Committee analysis notes, "the standard deduction more than compensates the donor for the income he or she has foregone even when they have made substantial charitable contributions."⁸ Once their charitable donations and other deductible expenditures exceed the standard deduction, tax filers will generally itemize their deductions. The Treasury Department has previously argued that allowing a deduction for non-itemizers would itself raise equity concerns, because it would create a "double deduction" for charitable contributions — first through the standard deduction, which is only available to non-itemizers, and then through the additional charitable deduction.⁹

Setting equity issues aside, therefore, the debate over the non-itemizer deduction should center on two key issues: First, given all the competing demands facing a tight budget, is it a policy priority to provide tax filers who do not itemize their deductions an incentive to give more to charity? Second, would the proposed deduction be an effective means of achieving this goal?

Deduction Would Benefit from Better Design

A number of proposals in the Lieberman-Santorum legislation have significant merit. The cost of the measure, however, is dominated by the charitable deduction for non-itemizers. Based on an examination of the research on this issue, this analysis concludes that the proposed capped deduction is poorly designed to achieve the objective of increasing charitable giving by non-itemizers and, given its cost, should be rejected. If policymakers nonetheless place a high priority on encouraging charitable giving by non-itemizers, then the deduction proposed in the Lieberman-Santorum legislation should be redesigned to make it significantly more effective and less costly.

Not all cost-saving changes to the proposed charitable deduction for non-itemizers would improve its effectiveness. For instance, the House of Representatives passed a less expensive version last year as part of H.R. 7. Although that deduction would cost \$6 billion over ten years — well below the approximately \$40 billion cost of the Lieberman-Santorum proposal if extended — it achieved this lower cost purely by setting a lower cap. When fully in effect, the cap in the House bill would be \$100 for singles and \$200 for married couples, as compared to \$400 for singles and \$800 for couples in the Lieberman-Santorum bill. With such a low cap, an even greater share of the cost would go toward rewarding donations that would have occurred anyway. Moreover, the low cap would reduce the incentive for additional giving, because amounts above \$100 for singles and \$200 for couples would receive no tax benefit. CRS

⁸ Joint Committee on Taxation, JCS-3-02, March 18, 2002.

⁹ Treasury Department, "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985.

estimates that the House-passed deduction would yield only *three cents* of additional giving for every dollar of revenue lost.

A better approach would be to set a floor, allowing only donations above this floor to be deductible. The floor ensures that less of the cost of the deduction would go toward providing a tax break for donations that would have occurred anyway. Rather, the cost would go toward rewarding donations above the floor, more of which are likely to reflect new giving. As a result, a deduction with a floor would be more effective at encouraging additional donations. An analysis by the Urban Institute concluded that a deduction with a floor would have more “bang for the buck” than if the deduction were available for the first dollar of donations.

The cost and overall effectiveness of such a proposal would obviously depend on where the floor is set and the degree to which donations above the floor are deductible. For instance, the CRS estimates that a deduction for charitable donations above \$500 for singles and \$1,000 for married couples would yield about 64 cents of new giving for each dollar of revenue lost. If 50 percent of the donations above such a floor were deductible, the annual cost would be about \$2 billion per year.¹⁰ Of course, policymakers would still need to decide whether a deduction that cost approximately \$20 billion over ten years to generate new contributions of about \$13 billion — only about \$1.3 billion of which would likely go to assist poor families and individuals — represented sound policy given the current budget outlook and long-term fiscal challenges.

The following sections of this analysis examine in more detail the non-itemizer deduction; a review of the other proposals in the Lieberman-Santorum bill is beyond the scope of this paper. Other tax provisions in the package are briefly described in the Appendix.

Reviving A Charitable Deduction For Non-Itemizers

For a few years in the mid-1980s, a deduction for charitable contributions was available for tax filers who used the standard deduction. In 1982 through 1985, a portion of charitable donations were deductible for non-itemizers and, in 1986, they were fully deductible. The decision not to extend the deduction after 1986 was made as part of the 1986 tax reforms. These reforms — which included eliminating a number of deductions and tax preferences, increasing the standard deduction, and reducing marginal tax rates — were intended to simplify the tax code in a way that individual taxpayers as a whole came out even or received a modest net tax reduction.

Both the Administration and Senators Lieberman and Santorum propose to revive the deduction for non-itemizers. In addition, the House approved legislation last year that included a non-itemizer deduction. All of these proposals would cap the amount that could be deducted.

¹⁰ More “bang for the buck” could be achieved for the same cost by setting a higher floor and allowing all donations (rather than only half) above the floor to be deductible.

- The Lieberman-Santorum legislation would provide a deduction for charitable donations by non-itemizers up to a limit of \$400 for single filers and \$800 for married couples. The deduction would be available for two years, 2002 and 2003. No official cost estimates of the proposal are available, but previous estimates of similar proposals indicate that it would cost about \$4 billion a year or \$8 billion over the two years it would be in effect. If it were extended repeatedly or made permanent — which seems highly probable, as discussed in the box on page 3 — its ten-year cost would likely equal or exceed \$40 billion.
- The Administration’s budget includes a proposal for a permanent non-itemizer deduction that would phase in gradually. The deduction would be capped at \$100 for singles and \$200 for couples in 2002 through 2004, \$300 for singles and \$600 for couples between 2005 and 2011, and \$500 for singles and \$1,000 for couples in 2012 and the years thereafter. The Joint Committee on Taxation estimates that this proposal will cost \$29.5 billion between 2002 and 2012. It would cost about \$5 billion a year once fully in effect.
- The House passed legislation last year (H.R. 7) that includes a deduction for non-itemizers. Under the House bill, the deduction would initially be capped at \$25 for singles and \$50 for married couples, with the cap subsequently rising to \$100 for singles and \$200 for couples. As a result of these low caps, the Joint Tax Committee has estimated this deduction would cost \$6.3 billion over ten years.

Treatment Of Charitable Donations Under Current Law

Under current law, filers who itemize their deductions are allowed to deduct fully their charitable contributions, with some limitations. These deductions reduce taxable income.

The actual reduction in taxes depends both on the size of the donation and the marginal income tax rate that the filer faces. For instance, a tax filer who has income sufficiently high to be in the 35 percent bracket has his or her taxes reduced by \$35 for a \$100 charitable donation. A filer with a lower income who faces a 10 percent or 15 percent marginal income tax rate has his or her taxes reduced by only \$10 or \$15 for the same \$100 donation. This tax deduction lowers the cost of charitable giving at the margin — that is, for the filer in the 35 percent bracket, it “costs” only \$65 dollars to give an additional \$100 to charity because of the tax break. By lowering the cost of giving at the margin, the deduction available to tax filers who itemize creates an incentive to make more charitable donations than they otherwise would.

In 1999, according to the latest IRS data, 32 percent of tax filers itemized their deductions and thus were able to deduct the cost of charitable donations (see table below). The remaining 68 percent of filers used the standard deduction. In 2002, the standard deduction reduces taxable income by \$4,700 for a single filer and \$7,850 for a married couple.

Tax Filers Using the Standard Deduction, 1999

Adjusted Gross Income	Tax filers using the standard deduction (in millions)	Percent in each income category using the standard deduction
Below \$25,000	56.2	93.1%
\$25,000 to \$50,000	21.3	67.5%
\$50,000 to \$100,000	7.5	30.3%
\$100,000 to \$200,000	0.7	9.4%
Above \$200,000	<u>0.2</u>	<u>7.3%</u>
Total, all incomes	85.8	67.5%

Source: IRS Statistics of Income

Tax filers generally use the standard deduction if they spend less on deductible items — such as state and local taxes, home mortgage interest, high medical expenses, and charitable donations — than the standard deduction amount. The standard deduction more than compensates non-itemizers as long as their deductible expenditures — including gifts to charity — are less than the amount of the standard deduction. Once their charitable donations and other deductible items exceed the level of the standard deduction, tax filers will typically itemize their deductions. Either way, they effectively get to deduct their charitable donations.

The fact that there is not a separate deduction that non-itemizers can take for their charitable donations has prompted some to argue that, as a matter of equity, non-itemizers should be given such a deduction. Tax experts generally do not regard this different treatment as an equity issue, because the tax code fully takes into account charitable donations for both itemizers (through itemized deductions) and non-itemizers (through the standard deduction). Moreover, if they wish to do so, tax filers with deductible expenditures that are less than the standard deduction can itemize their deductions and thereby receive the same treatment as itemizers. (This would result in higher taxes for such tax filers, however, and if it is discovered, the IRS treats it as an error and corrects the “error” by giving the filer credit for the full amount of the standard deduction.)

Furthermore, if valid, the equity argument for the charitable deduction for non-itemizers would also apply to all other itemized deductions, such as mortgage interest expenses and state and local taxes. Virtually no one argues that non-itemizers should be allowed to deduct the cost of these items in addition to the standard deduction, because the standard deduction more than compensates non-itemizers for these deductible expenses.

Rather, the key distinction between these two categories of tax filers is the type of incentive their respective tax reductions create for additional charitable giving. Tax filers who itemize their deductions see their tax liability fall as their charitable giving increases, so the deduction creates an incentive for additional giving. For filers using the standard deduction, the deduction remains the same regardless of the level of giving and consequently does not provide an incentive for additional contributions.

With the incentive effects — rather than the equity issue — as the key concern, the criterion for assessing a proposed charitable deduction for non-itemizers is the degree to which it can spur additional giving by this group of tax filers. As an Urban Institute analysis prepared by Joseph Cordes, John O’Hare, and Eugene Steuerle succinctly states: “The case for extending the charitable deduction to non-itemizers is thus not so much an issue of equity, since these taxpayers are indirectly allowed to deduct charitable contributions as part of the standard deduction. Rather, the question is whether it is good public policy to make tax incentives for charitable giving available to more persons.”¹¹

Charitable Giving By Non-Itemizers

Although they receive no tax incentive for giving, non-itemizers nonetheless make substantial charitable donations each year. The exact amount is not known precisely, but in all likelihood it exceeds \$20 billion a year. According to the Joint Committee on Taxation, between 1995 and 1999, charitable deductions claimed by tax filers who itemized deductions averaged about \$98 billion a year, while total contributions by individuals averaged about \$120 billion a year over this period. Although the difference — \$22 billion — would appear to be the amount contributed by non-itemizers, the Joint Committee concluded that this amount would "underestimate actual donations by non-itemizers" because evidence from audits and taxpayer compliance studies show that many tax filers who itemize overstate their actual charitable contributions.¹²

If non-itemizers — who already make substantial contributions to charity — were given a separate deduction for charitable donations, any contributions they are currently making would lower their taxes without increasing their giving. Under the Lieberman-Santorum bill, single tax filers who are already making donations of up to \$400 and married couples already giving up to \$800 would simply receive a windfall tax cut for charitable gifts they would make even without the new tax break. While this results in a substantial cost to the Treasury in terms of lost revenue, it does almost nothing to increase charitable giving. (In addition, a number of tax filers who currently itemize would pay lower taxes if they were to use the standard deduction in

¹¹ Joseph Cordes, John O’Hare, and Eugene Steuerle, “Extending the Charitable Deduction to Nonitemizers: Policy Issues and Options,” Urban Institute, May 2000.

¹² Joint Committee on Taxation, JCS-3-02, March 18, 2002.

combination with a separate deduction for charitable donations. In other words, simply by switching filing status, this group of tax filers — which would be large — would receive a tax break.¹³ This is another example of how the proposed deduction would result in a cost to the Treasury without increasing charitable giving.)

This phenomenon of the tax cut benefitting taxpayers regardless of whether they increase charitable giving, sometimes called “buying out the base,” significantly reduces the effectiveness of this tax proposal. It raises the question of how much of the cost of a deduction that rewards the *first dollar* of donations — as the Lieberman-Santorum bill, the Administration’s proposal, and the House provision would do — would simply provide a tax cut for donations that would have occurred anyway, rather than encourage non-itemizers to increase their contributions.

Sensitivity Of Charitable Contributions To Tax Incentives

There is considerable debate in the economics literature about how changes in tax policy affect charitable giving. Some studies in the past concluded that charitable giving is fairly sensitive to tax incentives, implying that a deduction for non-itemizers would stimulate more in additional charitable donations than it would cost the Treasury in terms of lost revenue. Many recent studies, however, have challenged these conclusions, finding that charitable giving is likely to be less sensitive to permanent tax changes than previously assumed.¹⁴ These findings cast doubt on whether the Lieberman-Santorum deduction for non-itemizers would come close to meeting a basic test of stimulating more in donations than it would lose in revenue.

At Lower Incomes Typical of Non-Itemizers, Proposed Deduction is Less Valuable

Moreover, most studies rely on data that reflect the sensitivity of taxpayers who itemize their deductions, rather than those who use the standard deduction. Non-itemizers are likely to be less responsive to a tax deduction than itemizers, in large part because non-itemizers have

¹³ CBO analysts Pamela Greene and Robert McClelland estimate that if a charitable deduction with no cap were available to non-itemizers in 1997, between 2.25 million and 2.7 million itemizers (or about 7 percent of all itemizers in that year) would have received a tax benefit simply by switching to become non-itemizers. See their article “Taxes and Charitable Giving,” *National Tax Journal*, September 2001. No estimates are available for the number of tax filers that would switch status under a capped deduction.

¹⁴ For a discussion of the shift in research findings, see Joseph Cordes, “The Cost of Giving: How Do Changes in Tax Deductions Affect Charitable Contributions?” from a Seminar on Emerging Issues in Philanthropy hosted in April 1999 by the Urban Institute’s Center on Nonprofits and Philanthropy and Harvard University’s Hauser Center for Nonprofit Organizations, March 2001. Also see Pamela Greene and Robert McClelland, “Taxes and Charitable Giving,” *National Tax Journal*, September 2001; and William Randolph, “Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions,” *Journal of Political Economy*, Vol. 103, No. 4, August 1995. Even those analyses that continue to show a higher degree of sensitivity acknowledge that it is still lower than previous studies had shown. See, for instance, Gerald Auten, Holger Sieg, and Charles Clotfelter, “The Distribution of Charitable Giving, Income, and Taxes: An Analysis of Panel Data,” July 13, 2000.

lower incomes, on average, than itemizers. As shown in the table above, while there are non-itemizers at all income levels, there is a much greater likelihood that tax filers at lower income levels will use the standard deduction. Virtually all filers with income under \$25,000 and two-thirds of filers with incomes between \$25,000 and \$50,000 use the standard deduction. Some 90 percent of tax filers using the standard deduction have incomes under \$50,000.

At lower levels of income, families typically have less disposable income, making it more difficult for them to afford additional charitable donations. Further, at lower income levels, the tax deduction is worth less — and thus creates a much smaller incentive for additional giving — than at higher income levels.

- According to IRS data, one-third of tax filers who used the standard deduction in 1999 had no taxable income (after their total income was reduced by allowable deductions and exemptions). *None* of these filers would benefit from the proposed deduction.
- Of the remaining two-thirds of non-itemizers who are eligible for the deduction, the vast majority would be in the 10 percent and 15 percent income tax brackets. For every \$100 of charitable contributions, these tax filers would receive a \$10 or \$15 reduction in their tax liability.
- By comparison, the tax break is considerably larger for filers in higher tax brackets — ranging from \$27 to nearly \$40 for each \$100 in donations.
- For a single filer in the 10 percent bracket, the benefit from the maximum \$400 donation that could be deducted would be a \$40 tax reduction. For a single filer in the top bracket, the maximum benefit from the same donation would be nearly four times as large.

Even at Same Income, Non-Itemizers Expected to Give Less than Itemizers

Some argue that the deduction would nonetheless create a strong incentive to boost giving even at lower levels of income. They point to data that show itemizers making substantially larger average charitable contributions than non-itemizers in the same income ranges, arguing that itemizers give more because of the tax incentive available to them.¹⁵ The implication is that providing the deduction to non-itemizers would encourage them to boost their giving to the level of itemizers. These claims do not hold up under scrutiny.

A recent study published in the *National Tax Journal* found that while non-itemizers would increase their giving in response to a tax incentive, they would be unlikely to be as

¹⁵ See, for instance, “Statement Submitted to the House Ways and Means Committee on Behalf of the Independent Sector on the Bush Administration’s Proposal to Create a Charitable Deduction for Non-Itemizers,” February 27, 2001.

responsive as taxpayers who itemize their deductions.¹⁶ Reviewing the period in the mid-1980s when a separate charitable deduction was available to non-itemizers — including 1986 when both itemizers and non-itemizers had the same charitable deduction — the study found that the proportion of non-itemizers taking advantage of the deduction was “considerably smaller” than the proportion of itemizers using it. Moreover, even among those who made donations, the non-itemizers gave less at all income levels than the itemizers. The findings of this study “imply diminishing returns from extending the itemizers-only deduction to non-itemizers.”

This study suggests that, more than the availability of a tax deduction, other distinguishing characteristics that differentiate itemizers from non-itemizers influence their level of giving. For example, those who itemize at low levels of income are likely to have considerably more in accumulated assets, such as a home, and thus would be in a better position to make charitable donations. In 1999, more than three-quarters of tax filers who itemized their deductions and had incomes below \$50,000 claimed a deduction for home mortgage interest payments, including nearly 65 percent of itemizers with incomes under \$25,000. Analyses that compare donations by itemizers and non-itemizers in the same income ranges ignore the significant differences in wealth that evidently characterize these groups.

Finally, as will be discussed in more detail below, the overall response to a tax incentive is affected by the design of the provision. If the goal of the non-itemizer deduction is to boost charitable giving, the tax incentive must focus on promoting each additional dollar of giving. Proposals such as the Lieberman-Santorum deduction that place a dollar limit on the amount of donations that can be deducted necessarily weaken the overall incentive effect of the deduction, since any giving above the cap would not receive the benefit of the tax reduction and thus would not be affected by the incentive.

In sum, non-itemizers will surely increase giving in response to a tax incentive. The key issue is how much giving will increase. There is ample evidence to question the belief that non-itemizers would substantially increase charitable giving in response to the proposed deduction in the Lieberman-Santorum bill.¹⁷

¹⁶ Christopher M. Duquette, “Is Charitable Giving by Nonitemizers Responsive to Tax Incentives? New Evidence,” *National Tax Journal*, June 1999.

¹⁷ In arguing that non-itemizers would be quite responsive to a tax incentive, some supporters of a deduction for non-itemizers have pointed to the increase in giving by non-itemizers between 1985 and 1986 when the deduction rose from 50 percent to 100 percent of charitable donations. Reported giving by non-itemizers rose by 40 percent between these two years. However, claims this 40 percent increase is an indication of how responsive non-itemizers would be to a new deduction are unwarranted. There are strong reasons to believe that only a portion of this reported increase in donations by non-itemizers reflected new giving stimulated by the expanded deduction.

Part of the increase in 1986 reflected timing shifts, as tax filers moved some donations they otherwise would have made in 1985 or 1987 into 1986 to take advantage of the tax benefits available only in that year. Non-itemizers had an incentive to delay donations from 1985, when the deduction was equal to only 50 percent of the gift, until

(continued...)

Proposal Could Lead To More Revenue Losses Than Additional Giving

As noted, the Congressional Research Service estimates that for every dollar of lost revenue, the capped non-itemizer deduction included in the Lieberman-Santorum package would generate only 12 cents of new charitable giving. At an estimated cost of about \$4 billion a year, the Lieberman-Santorum deduction thus would yield approximately \$500 million of additional giving annually. And with non-itemizers currently contributing more than \$20 billion a year to charities, that would represent an increase in giving among this group of about 2 percent.

This low level of new giving reflects several factors: Consistent with most of the current research, CRS concludes that non-itemizers are not likely to increase their charitable giving dramatically in response to a tax incentive. Second, CRS concludes that the overall effectiveness of the proposal is weakened by the imposition of the cap. According to the CRS analysis, a non-itemizer deduction without a cap would yield about 50 cents of additional giving for every dollar of revenue lost — or four times the amount of additional giving generated by the proposal with the cap. Of course, without the cap, the cost of the deduction would increase substantially.

¹⁷ (...continued)

1986, when the full contribution was deductible. A non-itemizer who simply delayed a gift from late December 1985 to early January 1986 would have doubled his or her deduction. Delaying gifts in this manner can have a particularly strong impact on the year-to-year percentage change. If, for example, a taxpayer who normally contributed \$200 a year to charity shifted only \$40 of 1985 contributions into early 1986 to take advantage of the larger tax break, this shift alone would make it appear that this taxpayer's giving increased by 50 percent between 1985 and 1986 (from \$160 to \$240).

In addition, studies have shown that after enactment of the 1986 Tax Reform Act, there was sufficient time left in the year for many taxpayers to shift certain transactions *forward* into 1986 to take advantage of the more favorable tax treatment available in that year before the reforms took effect. Many taxpayers accelerated into 1986 the realization of capital gains to take advantage of the lower capital gains tax rate then in effect before that rate increased to 28 percent in 1987. Similarly, there was an incentive to accelerate some planned charitable contributions into 1986 while the non-itemizer deduction was still in effect.

Another part of the increase in charitable donations by non-itemizers in 1986 reflected the impact of taxpayers who previously itemized deductions switching to the non-itemizer category; these taxpayers were able to reduce their taxes in 1986 simply by switching filing status. These were taxpayers who had high levels of charitable giving but more modest expenditures for other deductible items, so that combining the standard deduction with the expanded charitable deduction for non-itemizers that became available in 1986 resulted in a larger overall deduction for them. While the donations made by these taxpayers helped push up the year-to-year increase in total giving by *non-itemizers*, those donations did not represent an increase in charitable giving *overall*.

Finally, some tax experts believe that some non-itemizers who already were making charitable contributions took the deduction and thereby reported their giving for the first time in 1986. Tax filers who use the standard deduction rather than itemizing their deductions are less accustomed to looking out for tax breaks and may have been unaware of the charitable deduction for non-itemizers prior to 1986, in part because it was considerably smaller in those years. To the extent that some non-itemizers may have first become aware of and used the deduction in 1986, their giving would have been newly reported, but much of it would not have represented an increase in giving.

The CRS estimates are generally consistent with recent studies of the responsiveness of charitable giving to changes in the tax code. An Urban Institute report, for example, examined the effects of a non-itemizer deduction without a cap.¹⁸ (Only the CRS study has examined the effects of a non-itemizer deduction *with* a low dollar cap, which is the type of approach reflected in the Lieberman-Santorum bill.) Its estimates reflect three different scenarios of the sensitivity of charitable contributions to tax changes. Under the first two scenarios, which the study considered the more likely, the Urban Institute analysis found that a non-itemizer deduction without a cap would yield 41 cents to 89 cents of additional charitable giving for each dollar in lost revenue. The CRS estimate of 50 cents of new giving per dollar of revenue loss for a non-itemizer deduction without a cap lies in this range.

In general, both the CRS and Urban Institute analyses highlight the problems with any proposal that allows a deduction for the first dollar of charitable contributions, which will lose substantial revenues from providing a tax break for charitable donations that would have been made in any event. The CRS study also shows that the cap in the Lieberman-Santorum proposal would further lower the “bang for the buck” of the deduction, reducing the amount of new giving relative to the deduction’s cost.

In contrast to these analyses, Independent Sector, a coalition of non-profit organizations advocating for the Lieberman-Santorum legislation, has argued that the proposed deduction “would likely stimulate at least \$1.15 of charitable giving for every \$1.00 it costs.”¹⁹ This claim is very optimistic, given the findings of the CRS and Urban Institute studies. The Independent Sector estimate is similar to the Urban Institute projection of what would occur if *both* a high level of taxpayer responsiveness to the deduction is assumed — a level above what most current research supports — and there was no cap on the amount of the deduction. Because the proposal has a cap, the \$1.15 estimate is inconsistent even with the estimates at the high end of the range the Urban Institute study examined. As the CRS study found, the cap in the Lieberman-Santorum proposal that would allow a deduction only for donations up to \$400 for singles and \$800 for couples would significantly reduce the amount of new giving generated by the deduction.

¹⁸ Cordes, O’Hare, and Steuerle, Urban Institute, May 2000. The Urban Institute study implicitly caps the non-itemizer deduction at the level of the standard deduction, as tax filers with donations above the amount of the standard deduction would be able to itemize their deductions anyway. In its fiscal year 2002 budget, submitted in early 2001, the Bush Administration proposed a non-itemizer deduction that was capped at the standard deduction level.

¹⁹ See <http://www.independentsector.org/programs/gr/nonitemizer.html>, “Issue Brief.” Although the estimate is provided in a fact sheet available on the Independent Sector web site, other Independent Sector documents imply that it is not possible to estimate precisely the increase in giving generated by the deduction. For instance, “An Open Letter to the Nonprofit Community” from the Independent Sector president and chairman states: “No one can estimate precisely how much new giving will be generated by this tax deduction, but there is broad agreement that there will be an increase in donations.”

Proposed Deduction Would Create Administration Problems

In addition to issues concerning the effectiveness of the proposed deduction, both the CRS and Urban Institute analyses find that a deduction for non-itemizers raises significant administration concerns. The Joint Committee on Taxation, in its review of the Administration's capped non-itemizer deduction, also concluded that it would add complexity to the tax law. The standard deduction eases the complexity of preparing tax returns for those who have relatively small deductible expenses, sparing them the need to maintain records of these transactions. Just as the standard deduction eases the record-keeping burden for taxpayers, it also makes the Internal Revenue Service's task of ensuring compliance with the tax rules simpler. Adding a new deduction for non-itemizers that covers even the smallest charitable contributions imposes new burdens on both tax filers and the IRS.²⁰

Administrative concerns were at the heart of the Treasury Department's critique of the non-itemizer deduction in 1985:

“[T]he allowance of a charitable deduction for non-itemizers is administratively burdensome for the Internal Revenue Service and complicated for taxpayers. In particular, it is extremely difficult for the Internal Revenue Service to monitor deductions claimed for countless small donations to eligible charities; the expense of verification is out of proportion to the amounts of tax involved. Dishonest taxpayers are thus encouraged to believe that they can misrepresent their charitable contributions with impunity.”²¹

Given that the IRS is now auditing fewer than 0.5 percent of all returns — a 70 percent decline in the audit rate since 1996, according to the GAO²² — it seems even less likely that the IRS will be in a position to administer a non-itemizer deduction effectively.

Deduction Could Be Made Less Costly and More Effective

With the worsening of the budget outlook, there is likely to be pressure to reduce the cost of many policy initiatives that Congress considers this year. The Lieberman-Santorum faith-based package already reflects the effects of this pressure, as the bill's tax provisions would be in effect for only two years. Yet this sunset does not represent real cost savings; supporters of these tax incentives will push to hard to ensure that they are continued on a permanent basis.

²⁰ In an apparent acknowledgment of the administrative burden created by small donations, for instance, the IRS does not currently require taxpayers to have a statement from a charity for donations of less than \$250 or to provide substantiation of the estimate of fair market value for gifts of property of less than \$500.

²¹ Treasury Department, May 1985.

²² “IRS Audit Rates: Rate for Individual Taxpayer Has Declined But Effect on Compliance Is Unknown,” General Accounting Office, April 2001.

If policymakers determine that a non-itemizer deduction for charitable contributions should be provided, they can do so at a substantially lower permanent cost than the proposal in the Lieberman-Santorum bill. There are two major approaches to such cost reduction. These approaches differ substantially in their ability to generate new charitable giving.

The first approach is the one taken in H.R. 7, which passed the House last year. The House deduction for non-itemizers cost \$6 billion over ten years, less than the expected two-year cost of the Lieberman-Santorum deduction. The low cost is achieved primarily by reducing the amount of charitable donations that can be deducted. Under the House bill, the cap would phase in gradually, reaching a maximum of \$100 for singles and \$200 for couples, only one-quarter of the levels in the Lieberman-Santorum proposal. As a result of this low cap, the House deduction would overwhelmingly go toward “buying out the base” — that is, providing a tax reduction for gifts that would have been made without the deduction. CRS estimates that the House proposal would generate only *three cents* of additional giving for each dollar of lost revenue.

The other approach would be to restrict a non-itemizer deduction to donations *above* a certain threshold. This approach would yield considerably more new charitable giving for each dollar of revenue lost. The Urban Institute analysis found that a deduction with a floor can be both less costly and more cost-effective than a first-dollar deduction. Allowing a deduction only for donations above a specified floor has the effect of eliminating part of the “buying out the base” phenomenon associated with first-dollar deductions, and this reduces the overall revenue loss of the deduction. It also has the effect of focusing the tax break on amounts above the floor — which are more likely to be additional charitable donations — thereby increasing its bang for the buck. As a result, more of the revenue loss would be going toward new giving.

For instance, the Urban Institute analysis looked at the impact of providing a deduction for donations over \$250 for single tax filers and \$500 for married couples. Assuming that the sensitivity of these tax filers to the new deduction is low to moderate, the Urban Institute predicted that setting such a floor would reduce the revenue loss by about 30 percent relative to a first-dollar deduction without a cap, but the new charitable giving stimulated by the tax incentive would fall by less than 5 percent.²³ (A deduction with a floor set this low, however, would still be quite costly and would be unlikely to generate enough new giving to justify the cost.)

Where a floor is set — as well as the level of tax reduction given to donations above the floor — are issues that would have to be resolved when developing such a proposal. For example, the Clinton administration proposed a non-itemizer deduction with a floor in its 2001 budget. When fully in effect, that deduction would have allowed non-itemizers to deduct 50

²³ Even greater levels of charitable giving for each dollar of lost revenues can be achieved, according the Urban Institute study, if the floor were applied to donations by itemizers as well as to those made by non-itemizers. Although this would reduce the tax break currently available to those that itemize their deductions, it would not significantly reduce the incentive to give more, because the tax reduction for each additional dollar of giving above the floor would remain unchanged. This approach also would be simpler than applying a floor to donations by non-itemizers only.

percent of charitable donations above \$500 for singles and \$1,000 for married couples, at a cost of about \$2 billion a year.²⁴ CRS estimates that this floor would generate about 64 cents of new charitable giving for every dollar of revenue lost — or more than five times the effectiveness of the Lieberman-Santorum proposal. A deduction with a floor still might not achieve the goal of generating more in charitable giving than it would lose in revenue, but it would be more effective than a first-dollar deduction and far more effective than a first-dollar deduction with a low or modest dollar cap.²⁵

The Urban Institute study also points out that setting a floor addresses some of the administrative concerns associated with a first-dollar deduction. Tax filers making small contributions would not be eligible for the deduction, which means they would not be required to maintain records documenting their donations. This, in turn, would help to simplify the IRS's job of ensuring compliance. At the same time, the floor for non-itemizers adds some complexity for tax filers making charitable donations, because these donations would not be treated uniformly for itemizers and non-itemizers.

Conclusion

A key provision in the faith-based legislation introduced by Senators Lieberman and Santorum would reestablish a charitable deduction for non-itemizers. The bill's capped deduction — an approach that has also been proposed by the Administration and adopted by the House — is not well designed to encourage new charitable giving. The Congressional Research Service estimates that the Lieberman-Santorum proposal would generate only 12 cents of new giving for every dollar of foregone revenue, with the bulk of the revenue loss going to reward non-itemizers for making contributions that they were predisposed to make without the tax break. Such ineffective tax policy at a cost of \$4 billion a year should be avoided, especially in the current budget climate. Such a low level of effectiveness would likely not be tolerated for a proposed new government program.

Analyses by the Urban Institute and CRS make clear that, by setting a floor, it is possible to design a deduction for charitable giving that is considerably more effective and less costly than a capped deduction. A redesigned deduction with a floor would be a superior way to achieve the goal of increasing charitable deductions. The question would remain, however, as to whether even a redesigned deduction would be sufficiently effective to justify its cost, given the deterioration in the fiscal outlook.

²⁴ Estimates of the Clinton proposal by the Treasury Department and Joint Committee on Taxation differed somewhat. If the proposal were fully in effect in 2002, the Treasury estimates implied a cost of about \$1.5 billion in that year, while the Joint Tax estimates implied a cost of about \$2.5 billion. The \$2 billion estimate shown above is an average of these 2002 estimates.

²⁵ Placing a floor under the deduction would improve its effectiveness regardless of what one assumes about the overall responsiveness of non-itemizers to tax incentives. If one believes that non-itemizers would be fairly responsive to a deduction, including a floor still would lower its cost and improve its “bang for the buck.”

APPENDIX

Other “Faith-Based” Tax Proposals

Beyond allowing non-itemizers to deduct charitable contributions, both the Lieberman-Santorum and the Administration’s faith-based packages include other, smaller tax breaks related to charitable giving. In total, the Administration’s faith-based tax proposals would cost \$40.2 billion between 2002 and 2012. Of this total, \$29.5 billion — or nearly three-quarters — reflects the cost of the deduction for non-itemizers. The remaining proposals cost \$10.6 billion over 11 years. The Lieberman-Santorum package contains very similar proposals, although they would be in effect for two years under that package, rather than permanently. The sponsors estimate the cost of all of these tax provisions to be \$8 billion to \$10 billion. In addition to the charitable deduction for non-itemizers, the Lieberman-Santorum package would:

- Allow tax-free distributions from Individual Retirement Accounts for charitable donations for account holders who are age 67 or older;
- Reduce from two percent to one percent the excise tax that private foundations pay on their net investment income;
- Expand the deduction for food donations to charitable organizations;
- Raise the share of income that subchapter C corporations can contribute from 10 percent to 13 percent in 2002 and 15 percent in 2003, and expand incentives for subchapter S corporations to make donations; and
- Modify the unrelated business income tax for charitable remainder trusts.

In addition, the Lieberman-Santorum package includes a tax credit to expand the use of Individual Development Accounts for low-income working families. Under that proposal, banks or community organizations sponsoring IDAs could receive a dollar-for-dollar tax credit for matching up to \$500 annually of account-holder contributions to these savings accounts. The tax credit would be available through 2009, and the Joint Committee on Taxation estimates that it would cost \$2.1 billion over ten years. (This is in addition to the \$8-10 billion noted above.) The Administration’s budget also includes this IDA tax credit.