



Revised March 31, 2009

PROPOSAL TO CAP DEDUCTIONS FOR HIGH-INCOME HOUSEHOLDS WOULD REDUCE CHARITABLE CONTRIBUTIONS BY ONLY 1.9 PERCENT Would Help to Finance Universal Health Coverage

By Paul N. Van de Water

The President's 2010 budget proposes to limit the tax subsidy for deductible expenses of the most affluent Americans and to use the additional revenue to help finance national health reform, including universal coverage. This proposal has been attacked on the grounds that it would lead to substantial reductions in charitable contributions and hit charities at a time when they face increased need and decreased contributions due to the recession. Careful examination indicates that these criticisms are greatly exaggerated or wrong.

- New analysis by the Urban-Brookings Tax Policy Center shows that the proposal would affect *only 1.4 percent* of U.S. households — those in the top two tax brackets. The other 98.6 percent of households would not be affected.¹
- Total charitable contributions would decline — but only by an estimated 1.9 percent. Offsetting this decline, the proposal would help finance universal health coverage, which would greatly reduce burdens on the charitable sector to provide uncompensated health care to millions of Americans who lack insurance. It would also make it easier for many small non-profit organizations to obtain health insurance for their own employees.
- The proposal would be unlikely to hit charities during the recession, because it would not take effect until nearly two years from now — January 2011 — by which time the economy is expected to be recovering. If the economy is still weak at that time, Congress and the President almost certainly will delay implementing the proposal. In fact, under those circumstances, it would be difficult politically for them *not* to do so.

What the Proposal Is

Currently, middle-income Americans receive an individual income tax subsidy equal to 10 cents or 15 cents for each dollar of their deductible expenses (if they itemize deductions), while affluent

¹ The estimates in this paper have been revised based on new data from the Urban Institute-Brookings Institution Tax Policy Center (TPC). The new data reflect updates to TPC's model and economic assumptions.

Americans get a subsidy of 35 cents for each dollar of deductible expenses. The Administration's proposal would cap the subsidy at 28 cents on the dollar for those with incomes over \$250,000 — the same rate at which those expenses could be deducted during the Reagan years, when the top tax rates were lower. As a result, the incentive to incur those expenses would be the same as under President Reagan.

Effect of Proposal on Total Charitable Contributions

The proposal would lead to some decline in charitable giving. That reduction would be quite small, however, for several reasons.

First, a substantial portion of charitable giving derives from foundations, estates, and corporations and from individuals who do not itemize their contributions on their tax returns. Itemized contributions represent only 62 percent of total charitable giving.²

Second, the proposal would affect only the 1.4 percent of tax filing units that are in the top two income tax brackets. Tax Policy Center data indicate that these taxpayers account for only 28 percent of the charitable contributions that are reported as itemized deductions.³ Thus, only about 17 percent of total charitable giving would be affected.

Reducing the tax subsidy for charitable giving increases the after-tax price of a dollar of contributions. Someone who is now in the 35-percent federal income tax bracket and lives in a state with a top income tax rate of 6 percent pays 59 cents after taxes for each dollar contributed to a tax-exempt charitable organization. Under the proposal, which would limit the federal deduction to 28 percent, that person would face an after-tax cost of 66 cents — an increase in cost of 12 percent. (The increase in the cost of giving would be 8 percent for those in the 33-percent income tax bracket.) Based on research on the effect of tax incentives on charitable giving, this change would be expected to reduce total charitable giving in the U.S. by about 1.9 percent, or \$6 billion.⁴ (The technical appendix explains the calculations.)

Other Budget Proposals Benefit Charitable Sector

The Obama Administration's health reform proposal aims to provide health coverage to most or all of the 45 million Americans who are now uninsured. Currently, people without health insurance receive some free care from hospital emergency rooms, neighborhood health clinics, and other charitable organizations. Health reform will greatly reduce the burden on non-profit organizations

² Giving USA Foundation, *Giving USA 2008: The Annual Report on Philanthropy for the Year 2007*.

³ Urban Institute-Brookings Institution Tax Policy Center. *Charitable Contributions by Statutory Tax Rate, 2011*, Table T09-0175, March 25, 2009. The unrevised data may be found at Table T09-0122, February 26, 2009.

⁴ The Tax Policy Center has calculated that the limitation on deductions would reduce giving by 2 percent. (See Len Burman, "Would Obama's Plan to Curb Deductions Hurt Charities?," *Tax Vox: The Tax Policy Center Blog*, March 3, 2009.) That estimate is based on TPC's unrevised data and reflects the Obama Administration's proposal to raise the top two marginal income tax rates (from 33 percent and 35 percent today to 36 percent and 39.6 percent in 2011), while our estimate reflects the effect of limiting itemized deductions under *today's* income tax rates. We chose this approach to avoid confounding the effects of the proposed limit on deductions and the proposed increase in tax rates, since the latter would by itself increase the incentive for giving.

to provide free health care, thereby offsetting to a significant extent the overall drop in contributions.

Finally, the Administration's budget also proposes to make permanent the estate tax as it stands in 2009, rather than to allow the estate tax to be repealed or shrink further, as would occur under a number of other proposals that have been advanced on Capitol Hill and in political campaigns. The estate tax operates as a powerful incentive for charitable giving. Giving by estates would be significantly higher under the Obama proposal than under competing proposals that would further curtail the tax.

The projected loss of about 1.9 percent of total charitable contributions from the cap on itemized deductions should thus be weighed against the beneficial effects on the charitable sector of both universal health coverage and maintaining the current estate tax. Overall, the effect of the budget proposals on charities is probably a very small negative at worst — and quite likely a net positive.

**TECHNICAL APPENDIX:
ESTIMATING THE EFFECT OF THE ADMINISTRATION'S
PROPOSAL ON TOTAL CHARITABLE GIVING**

$$\begin{array}{r} \text{Itemized deductions as a fraction of total charitable giving (0.616)} \\ \quad \times \\ \text{Fraction of itemized charitable contributions affected by proposal (0.278)} \\ \quad \times \\ \text{Increase in after-tax price of giving for those affected by proposal* (0.113)} \\ \quad \times \\ \text{Elasticity of giving with respect to a change in its price** (-1.000)} \\ \quad = \\ \text{Reduction in total charitable giving (-0.019)} \end{array}$$

* This figure is a weighted average of the percentage increase in the after-tax price of giving for those in the 35-percent tax bracket (a 12-percent increase) and those in the 33-percent bracket (an 8-percent increase.)

** This assumption reflects recent studies of the effect of marginal tax rates on charitable giving among high-income people. See Jon Bakija and Bradley Heim, "How Does Charitable Giving Respond to Incentives and Income," National Bureau of Economic Research Working Paper No. 14237, August 2008.