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Policy Analytics of the Tax Treatment of Charitable Contributions

Benjamin Zycher*

Summary

Charities and other nonprofit institutions perform a vast array of altruistic works yielding benefits for both the direct beneficiaries and for society writ large. Current proposals to change the favorable tax treatment of private giving, and larger proposals to reform the federal tax system, would have important effects on such giving and thus on the benefits that private charitable institutions yield.

The analytic case for public financial support for private giving is longstanding, comprising four basic observations:

- Underprovision of collective goods by the private sector.
- Underprovision of collective goods by the public sector.
- Distortions in the public provision of collective goods.
- The strengthening of the institutions of civil society as a buffer between the citizenry and the state.

A change in the tax treatment of charitable giving is likely to have significant effects on the level of such giving. Prominent proposals to change the way that the current tax system treats charitable donations would be likely to reduce such giving by $5-10 billion per year, an effect equal to significant percentages of the operating budgets of major charitable organizations in the U.S. Moreover, the central proposals to reform the U.S. tax system either cannot be reconciled with public support for private charity, or would require changes likely to reduce such giving.

These central proposals have varying effects. Perhaps a tax reform that results in substantially greater economic growth in the aggregate would compensate for these impacts. Or, perhaps, tax reform may be sufficiently important to justify them. But the public discussion of changes in the tax treatment of charitable giving should consider not only the narrow effects on contributions, but also the more subtle but larger implications for the substantial benefits that the institutions of civil society yield in terms of the protection of our freedoms. To the extent that private charity---giving that passes a crude market test---yields increases in both altruistic endeavors and the strengthening of the institutions of civil society, it would be wise for policymakers to keep these important effects and factors in mind.

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I. Introduction

Tax reform is back in the news, in substantial part because of a political stalemate in Washington over the specific mix of spending reductions and "higher revenues"---narrowly, increases in tax rates---appropriate for a resolution of the adverse short- and long-term fiscal outlook confronting the federal government.[1] At a broader level, the "higher revenues" dimension comprises two alternative approaches: an increase in tax rates on the one hand, versus a reduction in rates combined with a closing of some or all of the many tax preferences (or "loopholes") that have been inserted into the income tax code over time by Congress. The latter approach often is promoted in combination with a revenue "neutrality" constraint, that is, no change in the projected revenue stream; but that projection usually is made on the basis of "static" tax models that assume away an increase in economic activity (the tax base) attendant upon a reduction of both tax rates and the distortions introduced by the tax code.[2]

As an aside, an increase in rates is likely to engender increased political pressures for an increase or expansion of preferences. Such preferences usually take the form of various deductions from taxable income or, alternatively, tax credits, both of which have the effect of reducing tax liabilities for the taxpayers deemed eligible in the tax code. The elimination of tax preferences sometimes is characterized as a movement toward a "flat tax," but there is no necessary conceptual link between a reduction or elimination of tax preferences and a movement away from a graduated (or "progressive") rate structure; a "flat tax" more accurately is a tax with a single rate applied to a tax base that may or may not contain a large number of tax preferences, as specified in the income tax code.

The justifications for the preferences found in the income tax code are many and varied, particularly in terms of their analytic rigor. Unsurprisingly, defenses of given preferences often are made most strongly by those who receive large perceived benefits from them; but the mere fact of self-interest does not automatically refute any given argument defending a particular preference. Some tax preferences have been embedded in the U.S. tax code for a period of time sufficiently long that simple inertia may be hypothesized as the central source of their longevity, although "inertia" is likely to be a shorthand term for the long term growth of a class of bene-

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1 Within the "spending reduction" component of this policy choice is the issue of the appropriate composition of the federal budget, that is, the mix of reductions allocated across defense, other "discretionary" programs, and entitlement spending. These issues lie outside the scope of this paper, as does the issue of the efficient mix of policies to address federal fiscal problems.

2 Other than this cursory observation, I ignore here the issue of static versus dynamic analysis of the revenue effects of changes in marginal tax rates, that is, the possibility that a reduction in tax rates would engender an increase in economic activity (the tax base) yielding additional revenues offsetting the reduced rates either partially or wholly, relative to the case under the higher tax rates imposed *ex ante*. The assumption here is that a "revenue-neutral" reduction in tax rates would require a broadening of the tax base, that is, elimination of some or most tax preferences, and the specific focus is on various proposals to limit or eliminate the deduction of charitable contributions from taxable income. However, for nontechnical summaries of recent evidence on this question of net revenue effects, see Martin Feldstein, "The Tax Reform Evidence From 1986," *Wall Street Journal*, October 24, 2011, at http://online.wsj.com/article/SB10001424052970204002304576629481571778262.html; and Martin Feldstein, "Romney's Tax Plan Can Raise Revenue," *Wall Street Journal*, August 28, 2012, at http://online.wsj.com/article/SB10000872396390444327204577617421727000592.html?KEYWORDS=martin+feldstein. With respect to the political incentives for policymakers to opt for tax rates higher than those that would maximize the present value of the revenue stream, see James M. Buchanan and Dwight R. Lee, "Tax Rates and Tax Revenues in Political Equilibrium: Some Simple Analytics," *Economic Inquiry*, Vol. 20, No. 3 (July 1982), pp. 344-354. For a useful discussion of the distortions introduced by the tax code, see Alan D. Viard, "Tax Policy and Growth," in The Kauffman Task Force on Law, Innovation, and Growth, *Rules for Growth: Promoting Innovation and Growth Through Legal Reform*, Kansas City: Ewing Marion Kauffman Foundation, 2011, pp. 179-207. The emphasis in the Viard discussion is on improved efficiency in resource allocation in the private sector; he does not delve into the complex issue of how tax policies affect the efficiency of resource allocation between the private and public sectors, or in the public sector specifically.

ficiaries opposed politically to a change in the status quo. One important such preference is the deduction of charitable contributions from income subject to the income tax.

This paper discusses in section II four central policy justifications for the tax preference enjoyed by those making charitable contributions, or, more rigorously, the rationales for public support of private charity through the tax code. These justifications are driven by standard economic analysis and by the modern analysis of the behavior of policymakers and government agencies under democratic institutions; and by central principles and observations on the role of the institutions of civil society as a buffer between the citizenry and the state. Section III summarizes the peer-reviewed empirical literature on the effect of changing tax rates and deductibility on the level of charitable giving. Section IV discusses briefly how the tax preference for charitable giving might be incorporated into a tax reform effort striving toward a "flat" income tax or a consumption tax. Section V offers concluding observations.

II. The Analytic Case for Public Support of Private Charity

What is "charity"? For purposes of the analysis developed here, charity is the private provision or financing (or both) of activities (or goods and services) that yield benefits not only for the direct beneficiaries, but also for society writ large (or for third parties).[3] That is, obvious benefits accrue to the direct beneficiaries of, for example, charitable hospital services; but those financing or providing the services derive a benefit in the form of satisfaction (or "utility" in economic jargon) that the services are being provided for, as an example, those less fortunate.[4] The discussion that follows offers several rationales for public support of charitable activity---in the form of the tax preference for charitable giving---that are consistent, as noted above, with standard economic analysis, with the modern analysis of the behavior of policymakers and government agencies, and with the buffering role of the institutions of civil society.

Underprovision of Collective Goods by the Private Sector.

Suppose that nonparticipants---individuals other than those financing, providing, or receiving charitable goods and services---receive the same kind of satisfaction benefits from charitable activities, at least qualitatively.[5] These individuals are third parties. More generally, third-party beneficiaries of charitable activity benefit from that activity, but cannot be denied the benefits that result merely because of a failure to contribute.[6] This would mean that the nonparticipants would receive benefits that others finance; but those bearing

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3 For a brief discussion of motivations and other dimensions of charitable activity, see Russell Roberts, "Charity," in David R. Henderson, ed., The Concise Encyclopedia of Economics, Indianapolis: Liberty Fund, 2008, pp. 63-66, available online at http://www.econlib.org/library/Enc/Charity.html.

4 Those providing the services are contributing to the charitable endeavor if the price (or wage) that they accept is lower than the market price for the given services. An example is the donation of medical services to the poor by physicians.

5 Unlike such indirect benefits as the satisfaction of knowing that the poor are receiving more hospital services than otherwise might be the case, the benefits enjoyed by third parties can be direct. An example is the (possible) reduction in crime yielded by a neighborhood watch program implemented by a subset of the neighborhood.

6 The usual example of such a collective or public good is national defense services. While defense may seem very different from charity, both exhibit the central characteristics underlying the normative theory of government subsidies for or provision of collective goods: All individuals must consume the same quantity (although different individuals may place differing values on the common amount provided), consumption of the satisfaction or security benefits of charity or defense services, respectively, by one individual does not reduce the amount available for others to consume, and those not contributing toward the financing or provision of charitable

the costs are likely to consider only the satisfaction that they receive themselves when making decisions about the (dollar) amount of charity to provide. At least in principle, they do not consider the satisfaction benefits that the nonparticipants receive.[7] The efficient amount of such charitable giving is that amount equating the marginal benefits and marginal costs of the activity for society as a whole, that is, summed across all individuals. But because of the decision dynamic just described---those actually financing or providing the services consider only the satisfaction benefits to themselves---the amount of charity actually provided is smaller than that socially optimal; the marginal benefit of charity is greater than the marginal cost, so that charity is "underprovided."[8]

This prediction of a systematic underprovision of collective (or public) goods by the private sector is the classic economic justification for provision or subsidization of such goods by government.[9] In simple terms, the private sector offers too little provision or financing of collective goods from the social perspective because those deriving benefits while not contributing enjoy a "free ride" on the efforts of others, and as a practical matter cannot be denied the benefits.[10] A subsidy for private provision, in the standard analysis, has the effect of inducing the market to increase its provision to the level that is efficient socially. In the case of government provision, again in the standard analysis, that efficient provision is achieved through government acting as a sort of *deus ex machina*.

In short, one traditional rationale for the tax preference bestowed upon charitable giving is the corrective that results in terms of the incentive for the private sector to provide a level of charitable giving or provision too small from the social perspective. This rationale is accepted broadly, but by itself does not offer a set of principles delineating the relative virtues of subsidized private provision and public provision, a topic discussed below in the context of charitable activities.[11] Moreover, the current approach for support of private giving---the tax deductibility of contributions---does not address well the external benefits of activities supported disproportionately by those who do not itemize deductions on their tax returns.

Underprovision of Collective Goods by the Public Sector.

The discussion to this point has not addressed the important distinctions between subsidies for the private provision of collective goods, and the provision of such goods by government agencies using financing au-

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or defense services cannot be denied its benefits. See Benjamin Zycher, "Defense," in David R. Henderson, *op. cit.*, fn. 3 *supra.*, at 107-111, available online at http://www.econlib.org/library/Enc/Defense.html.

7 Again in economic language: Those providing the financing (or the services themselves) contribute an amount of charity that equates the marginal cost of doing so with the perceived marginal benefit *to themselves*; the latter parameter excludes the marginal benefits perceived by third parties.

8 For a new critique of this standard analysis, see C. M. Lindsay and William R. Dougan, "Efficiency in the Provision of Pure Public Goods by Private Citizens," *Public Choice*, online May 9, 2012, at http://www.springerlink.com/content/d57x5404t44r8151/.

9 For a summary discussion see Dennis C. Mueller, Public Choice III, Cambridge: Cambridge University Press, 2003, pp. 9-63.

10 For a useful summary discussion, see Tyler Cowen, "Public Goods," in David R. Henderson, *op. cit.*, fn. 3 *supra.*, at 431-432, available online at http://www.econlib.org/library/Enc/PublicGoods.html.

11 However, there is a significant literature on the conditions that would induce the private sector to provide amounts of collective goods that are optimal or even greater than optimal. See C. M. Lindsay and William R. Dougan, *op. cit.*, fn. 8 *supra.* See also, e.g., Earl A. Thompson, "The Perfectly Competitive Production of Collective Goods," *Review of Economics and Statistics*, Vol. 50, No. 1 (February 1968), pp. 1-12; and Harold Demsetz, "The Private Production of Public Goods," *Journal of Law and Economics*, Vol. 13, No. 2 (October 1970), pp. 293-306.

thorized by Congress.[12] With respect to the latter, the implicit assumption in the traditional literature is that government in fact has incentives to increase the provision of such goods to the efficient level.

That assumption is inconsistent with the modern literature on the behavior of political decisionmakers under democratic institutions. Consider a democracy operating under a simple majority decision rule for a spending choice on a given program. For such a decision, the median voter---the voter whose preference on the spending level lies at the median among the preferences of all voters---is the marginal member of the majority coalition.[13]

Consider now a government that provides two goods, one a collective good (e.g., defense) that yields benefits for all voters and the second a private good (e.g., transfer payments) yielding benefits only for members of the majority.[14] Because the median voter decides the spending levels for the two goods, he has an incentive to reduce spending on the collective good in favor of spending on the private good until two dollars of spending on the private good yield the same marginal value as one dollar of spending on the collective good, *to members of the majority*.[15] In short, just as the traditional analysis predicts in a simple model that market competition will result in an underprovision of collective goods, so does the modern analysis of democratic behavior predict that government itself will underprovide collective goods.[16]

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12 For the classic analysis of the supply behavior of government agencies producing an aggregate output bundle in exchange for a "lumps-sum" budget (as distinct from a per-unit price), see William A. Niskanen, *Bureaucracy and Representative Government*, Chicago: Aldine, 1971. See also William A. Niskanen, "Bureaucracy," and Kelly H. Chang, Rui J.P. de Figueiredo, Jr., and Barry R. Weingast, "Rational Choice Theories of Bureaucratic Control and Performance," in William F. Shughart II and Laura Razzolini, eds., *The Elgar Companion to Public Choice*, Northampton: Edward Elgar, 2001, pp. 258-270 and 271-292, respectively; and Mueller, *op. cit.*, fn. 9 *supra.*, at 359-405.

13 The details of this and similar voting models lie outside the scope of the discussion here, but one necessary assumption is that voters' preferences are "single peaked," that is, among alternatives smaller than their preferred spending level, they would choose the largest, and among alternatives larger than their preferred spending level, they would choose the smallest. Under this reasonable assumption, the median voter provides the deciding vote.

14 Note that for the collective good (defense), all voters must consume the same quantity, but they may value the good differently. Also, excluding the kinds of transfers that reasonably could be deemed "charitable," transfers are a private good because not all individuals or interest groups necessarily receive the same amount of transfers, because a dollar transferred to one individual or interest group cannot be transferred to another, and any individual or group can be excluded from a given transfer program. See fn. 6, *supra.* One could argue that *a policy* of making transfer payments among interest groups itself is a collective good, but that is a subtlety ignored here.

15 The median voter may be a different individual for the two programs, but in that case a side payment can be arranged to achieve the equilibrium described here. Since the majority is half the voters plus the median voter, each reduction in spending on the collective good of one dollar per voter yields an increase in spending on the private good of two dollars per member of the majority in any polity with more than a trivial number of voters. As dollars are shifted from the collective good toward the private good, the marginal value of the former rises to members of the majority, while the marginal value of the latter falls. For a detailed discussion of this fiscal choice dynamic in a polity producing coconuts (a private good) and mosquito abatement (a collective good), see James M. Buchanan, *The Demand and Supply of Public Goods*, Chicago: Rand McNally, 1968. See also James M. Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy*, Ann Arbor: University of Michigan, 1971, pp. 131-145.

16 For a discussion of how governments and other "groups" might achieve the efficient output of collective goods, see Mancur Olson, *The Logic of Collective Action*, Cambridge: Harvard University Press, 1973. One problem with Olson's hypothesis of a bundling of private and collective goods is an implicit requirement that the group has a comparative advantage in the production of the private good; were that not the case, another group or entity could produce the private good without bearing the costs of producing the collective good. But such bundling may be a realistic outcome for some outputs; consider, for example, the collective financing of national defense services characterized in part by creating private goods in the form of defense bases and contractor facilities in particular Congressional districts. Accordingly, some defense "waste" actually may be an efficient response to the problem of the underprovision of public goods by government. For a discussion of such "efficient pork" in the counterterrorism context, see Benjamin Zycher, *A Preliminary Benefit/Cost Framework for Counterterrorism Public Expenditures*, RAND MR-1693-RC, 2003. See also Omar Azfar, "The

The analysis of fiscal choice obviously is more complex in a representative democracy with multiple branches of government. But the central prediction of underprovision of collective goods---and overprovision of transfers---by government under democratic institutions holds even in a more realistic model of government decisionmaking.[17] In substantial part this result obtains because those financing government programs---the taxpayers---are a large and diffused group in which opposition to the expansion of government spending itself is a public good afflicted with a free rider problem. This diffusion phenomenon is true as well for the beneficiaries of government programs supplying such public goods as charity for the poor; those beneficiaries by definition are a group comprising every voter (although the value of a given public good is almost certain to vary across voters). In contrast, the beneficiaries of such transfer programs as agriculture subsidies are more concentrated as an interest group and so face fewer inherent obstacles in terms of organizing political support and lobbying efforts. Accordingly, there are reasonable analytic grounds to question whether the direct provision by government of such public goods as charitable endeavors would yield an efficiency improvement relative to market behavior even in the narrow context of the amount of public goods provided.

Because of private incentives to underprovide public goods, the tax preference for charitable giving, by increasing the amount of such activity, at a minimum engenders a change in the provision of public goods in the appropriate direction. If the existing tax preference (deductibility for purposes of calculating income tax liabilities) is too small from the social standpoint, proposals to eliminate or to limit it are unlikely to yield allocational improvement. Moreover, there is no obvious reason to hypothesize that the current tax preference yields private charitable giving that is too large socially; after all, interest-group competition for budget dollars is intense, and Congress has incentives not to waste (potential) revenues that otherwise could be used to satisfy the demands of other interest groups.[18] As discussed in the next section, an increase in marginal tax rates would increase the incremental subsidy for charitable giving, but would yield a reduction in economic growth.[19] It is far less clear as to how to change the political dynamics inherent in democratic institutions that yield inefficiently low public provision of collective goods through the appropriation process, unless the solution is a crude increase in the budgets of the relevant agencies, but that "solution" simply assumes away the underprovision problem.

Logic of Collective Action," in Shughart and Razzolini, eds., *op. cit.*, fn. 12 *supra.*, at 59-82.

17 See, for example, Mueller, *op. cit.*, fn. 9 *supra.*, at 230-263. See also Robert B. Ekelund, Jr., and Robert D. Tollison, "The Interest-Group Theory of Government," in Shughart and Razzolini, eds., *op. cit.*, fn. 12 *supra.*, at 357-378; and Albert Breton, *The Economic Theory of Representative Government*, Chicago: Aldine, 1974, pp. 99-120 and 179-193.

18 See Niskanen, *op. cit.*, fn. 12 *supra.* (1971 and 2001), for a discussion of the incentives of Congress to create competitive "duplication" of given programs among agencies attempting to maximize their (discretionary) budgets so as to force greater efficiency in the production of government outputs.

19 The empirical evidence for the U.S. is that a 1 percent increase in GDP per capita yields an increase in charitable giving of 0.9 percent. For a summary discussion, see Arthur C. Brooks, *Who Really Cares: The Surprising Truth about Compassionate Conservatism*, New York: Basic Books, 2006, pp. 147-148. On the relation between marginal tax rates and economic growth, see Christina D. Romer and David H. Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," *American Economic Review*, Vol. 100, No. 3 (June 2010), pp. 763-801; Andrew Mountford and Harald Uhlig, "What Are the Effects of Fiscal Policy Shocks?," *Journal of Applied Econometrics*, Vol. 26, No 6 (September/October 2009), pp. 960-992; and Alberto F. Alesina and Silvia Ardagna, "Large Changes in Fiscal Policy: Taxes Versus Spending," in Jeffrey R. Brown, ed., *Tax Policy and the Economy, Volume 24*, Chicago: University of Chicago, 2010. Romer and Romer find that tax increases of 1 percent of GDP reduce real GDP by almost 3 percent. Mountford and Uhlig find that for the U.S. tax reductions yield a maximum of five dollars of additional GDP per dollar of reduced government revenue in present value terms. Alesina and Ardagna find in a survey of ninety-one policy shifts in the OECD since 1970, tax reduction is more likely than increased spending to increase GDP growth. See also Martin Feldstein, *op. cit.*, fn. 2, *supra.*

Distortions in the Public Provision of Collective Goods.

The identity (or characteristics) of those "worthy" of charitable support obviously is highly subjective, but one central normative principle underlying a market economy can be stated as follows: *Individual preferences determine value*. It is individual preferences as aggregated and signaled in market prices that determine the "efficient" allocation of resources.

That normative premise raises a rather obvious question: In precisely what sense is "efficiency"---the satisfaction of individual preferences---compelling as a normative goal? Why should individual preferences matter? Indeed, there are those who argue that individual preferences are the artificial result of various kinds of manipulation.[20] The traditional answer, driven by the central normative principle just stated, is that allocational efficiency allows the greatest possible satisfaction of individual preferences in a world in which resources are scarce. If we shunt aside those preferences when making social choices among institutions or allocational outcomes, whether in a bottom-up or top-down fashion, then we necessarily substitute the preferences of elites in place of those of individuals; after all, *someone's* preferences must decide the basic question of resource allocation. That substitution of elite decisionmaking in place of individual choice is a central---indeed, a defining---characteristic of autocracy.[21] Accordingly, to the extent that the preservation of individual freedom is a goal enjoying approximate unanimity, the pursuit of "efficiency"---"happiness" in the formulation of the Founders---is appropriate normatively.
That efficiency principle underlies the "underprovision" analytic prediction for a market equilibrium level of charitable giving---there is "underprovision" because decisions on charitable giving exclude the preferences of free riders---and that principle also is the central normative basis for the philosophical argument for self-government under a rule of law constrained by a constitution enjoying an approximation of unanimity in terms of popular acceptance at the time of adoption.[22] Public decisions, crudely, reflect in principle "the will of the people," that is, they are assumed to be consistent with constitutional constraints on the powers of government and with the laws duly enacted by the representatives of the people; and choices among alternative uses of tax revenues as determined under the institutions of representative democracy are assumed to reflect the preferences of that same body politic, as determined by a majority or other decision rule.

Just as the traditional field of welfare economics examines the implications of conditions that lead market competition to result in "inefficient" allocational outcomes in the private sector, the modern field of public choice examines the impact that incentives in political markets have on allocational outcomes in the public sector, or, more generally, in nonmarket settings.[23] In simple terms: Policymakers are likely to have incentives to allocate public resources in ways not reflecting in full the preferences of the taxpayers, and government agencies are likely to have incentives to administer programs in ways that, again, do not reflect faithfully the preferences of either the taxpayers or of the legislators.[24]

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20 See, e.g., John Kenneth Galbraith, *The New Industrial State*, Princeton: Princeton University Press, 2007.

21 For a discussion of the incentives of autocrats, see Gordon Tullock, *Autocracy*, Boston: Kluwer Academic Publishers, 1987, pp. 115-129. See also Mueller, *op. cit.*, fn. 9 *supra.* at 9-63 and 406-426.

22 See Buchanan and Tullock, *op. cit.*, fn. 15 *supra.*, at 63-116; and Geoffrey Brennan and Alan Hamlin, "Constitutional Choice," in Shughart and Razzolini, eds., *op. cit.*, fn. 12 *supra.*, at 117-139.

23 See, e.g., Mueller, *op. cit.*, fn. 9 *supra.*, at 1-6.

24 Both of these effects are examples of the standard principal/agent problem, in which the agent has marginal incentives to sacrifice

Consider as an example the classic U.S. program of aid to the poor: the traditional federal/state "welfare" program (Aid to Families with Dependent Children or AFDC), established in 1935 and then replaced in 1996 legislation establishing a new Temporary Assistance for Needy Families (TANF) program. AFDC had the clear (and incontrovertible) effect of inducing generations of individuals and families to remain on public assistance, to hinder family formation, and to encourage childbearing out of wedlock. That these perverse incentives were a prominent effect of the program was virtually undisputed, and it is no secret that an important group of beneficiaries comprised the program administrators (i.e., the bureaucracy writ large) and the numerous academics, consultants, and experts the demand for whose professional services was tied to the program. Tanner notes more generally:

In addition, whatever the intention behind government programs, they are soon captured by special interests. The nature of government is such that programs are almost always implemented in a way to benefit those with a vested interest in them rather than to actually achieve the programs' stated goals. … [T]he political power necessary to transfer income to the poor is power that can be used to transfer income to the nonpoor, and the nonpoor are usually better organized politically and more capable of using political power to achieve their purposes. Among the nonpoor with a vital interest in antipoverty programs are social workers and government employees who administer the programs and business people, such as landlords and physicians, who are paid to provide services to the poor. Thus, anti-poverty programs are usually more concerned with protecting the prerogatives of the bureaucracy than with actually fighting poverty.[25]

In short, the clear effect of funding and delivering "charity" through government often is the creation of a large class of direct recipients permanently enmeshed in the system and confronted with powerful short-term incentives to reject options (e.g., low-wage employment) that would lead over time to independence, as well as a class of indirect beneficiaries that an equivalent private charitable endeavor funded by voluntary contributions almost certainly would not support.[26] Moreover, the direct beneficiaries often are made worse off by long term dependency in ways that, again, private charity would not allow and in fact does not display as a crude generalization.[27]

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the principal's interests in favor of his own. In this context, the principal is the taxpayers (as a group) relative to the legislature as the agent, and the legislature as a principal relative to the agency as the agent.

25 See Michael Tanner, "The American Welfare State: How We Spend Nearly $1 Trillion a Year Fighting Poverty---and Fail," Cato Institute Policy Analysis No. 694, April 11, 2012, at http://www.cato.org/pubs/pas/PA694.pdf.

26 For an example of bureaucratic support for expansion of the Supplemental Nutrition Assistance Program ("food stamps"), see Jason DeParle and Robert Gebeloff, "Food Stamp Use Soars, and Stigma Fades," *New York Times*, November 28, 2009, at http://www.nytimes.com/2009/11/29/us/29foodstamps.html. For a useful discussion of the relative costs of private charity and public income transfers, see James Rolph Edwards, "The Costs of Public Income Redistribution and Private Charity," *Journal of Libertarian Studies*, Vol. 21, No. 2 (Summer 2007), pp. 3-20.

27 Note as well that the combination of the income tax system and the means-tested transfer programs had the effect of confronting those who otherwise would choose to opt out of the welfare system with very high implicit marginal tax rates, which under some conditions approached or exceeded 100 percent. The classic discussion of the perverse incentives and human degradation engendered by the traditional American (welfare) system of income redistribution is Charles Murray, *Losing Ground: American Social Policy 1950-1980*, New York: Basic Books, 1984. The 1996 replacement of AFDC with TANF, implementing a more rigorous work requirement and time limit for welfare recipients arguably occurred at a time when the growth of AFDC spending at the state level was creating budget stringencies for other constituencies. Perhaps more centrally, the Republican takeover of Congress in 1995 changed the relative positions of the relevant constituencies, although that takeover obviously cannot be viewed as exogenous. For useful histories of the 1996 reform, see Hugh Heclo, "The Politics of Welfare Reform" and Lawrence M. Mead, "The Politics of Conservative Welfare Reform," in Rebecca Blank and Ron Haskins, eds., *The New World of Welfare*, Washington: Brookings Institution, 2001, pp. 169-200 and 201-221, respectively.

Such politicization is inevitable and separate from the underprovision problem discussed above: Elected officials who bear the political costs of taxes inevitably are driven to shape spending programs that maximize or at least increase the political benefits of the outlays, and there is no particular reason to predict that this dynamic serves to increase the alignment of program outcomes with the charitable preferences of taxpayers. This dynamic is reinforced by the relatively greater ability of concentrated interests to exert political pressures upon policymakers, as discussed above. This is why a substitution of direct government subsidies to private charities in place of the current tax preference in the income tax code reasonably can be predicted to yield a greater degree of politicization.[28]

The general problem of distortion in the public provision of collective goods is exacerbated by the incentives shaping the behavior of the agencies administering the various programs. One useful assumption about the goals of agencies is a maximization of the discretionary budget, that is, the difference between the actual budget and the minimum cost of producing the amount of output preferred by the legislature.[29] In particular, this discretionary budget can be used to increase salaries and promotions among the agency staff, among other incentives. Since the agency is likely to have better information than the legislature about the minimum cost of producing the output preferred by the legislature, the agency can threaten to revert to an output level lower than that preferred by the legislature if the legislature refuses a budget funding the agency's (still higher) preferred output, including some level of discretionary spending. In effect, the agency presents the legislature with an approximation of an "all-or-nothing" threat: The legislature prefers the agency's high output/higher budget proposal to the threatened low output/lower budget (the reversion budget), but both are inferior to the legislature's preferred budget/output combination. This threat can take the form of cutting the most valuable outputs first, a budget tactic known informally as "the Washington Monument Game."[30] In the context of the public production of charitable services, this dynamic would yield cuts in those services valued most highly by the taxpayers instead of, say, a reduction in the size of the bureaucracy. In a survey of 71 studies comparing the cost performance of similar services provided by private firms and public agencies, 56 found greater efficiency for private provision, 10 found no difference, and 5 found greater efficiency for public provision.[31]

Preservation of the Institutions of Civil Society.

As a further adverse effect of a substitution of public charity in place of private giving, consider the role of the institutions of civil society as a buffer between the citizenry and the state. Government by its very nature is coercive: Taxes cannot be voluntary, compliance with regulations by definition is mandatory and necessarily creates winners and losers, and spending choices inexorably generate wealth transfers among groups. Private organizations, on the other hand, by definition are voluntary. To the extent that political opposition to the growth of government and the coercion that it necessarily entails is a collective good subject to a standard free-rider problem, the existence of voluntary organizations competing with government agencies in the

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28 For several detailed discussions of such effects, see "HHS and the Catholic Church: Examining the Politicization of Grants," Hearing before the Committee on Oversight and Government Reform, House of Representatives, December 1, 2011, at http://www.gpo.gov/fdsys/pkg/CHRG-112hhrg73939/pdf/CHRG-112hhrg73939.pdf.

29 See Niskanen (2001), *op. cit.*, fn. 12 *supra.*

30 Agencies operating national parks threaten to close the Washington Monument before less-popular attractions, libraries threaten to close during the most popular hours, etc.

31 See Mueller, *op. cit.*, fn. 9 *supra.*, at 373-380.

provision of charitable services engenders an ancillary benefit: Such voluntary organizations in effect are concentrated interest groups with incentives to protect their prerogatives---freedoms---in the face of efforts by government to expand its powers.[32] The current efforts by the Catholic Church and other religious organizations to challenge the contraception/abortifacient mandate in the Patient Protection and Affordable Care Act (ACA)---an obvious attempt by federal policymakers to transform important institutions of civil society into agents of the government---is a prominent example of this phenomenon.[33] The tax preference for charitable giving thus can be viewed as a corrective for the incentive of the private sector to offer too little resistance to the expansion of the state because of the collective nature of any such effort; the institutions of civil society receiving such support help to protect freedoms from government coercion in ways that individual citizens might find difficult to undertake.[34] A brief observation from Tocqueville may be appropriate:

> Despotism, which by its very nature is suspicious, sees in the separation among men the surest guarantee of its continuance, and it usually makes every effort to keep them separate. … The Americans have combated by free institutions the tendency of equality to keep men asunder, and they have subdued it.

…..

As soon as several of the inhabitants of the United States have taken up an opinion or a feeling which they wish to promote in the world, they look out for mutual assistance; and as soon as they have found one another out, they combine. From that moment they are no longer isolated men, but a power seen from afar, whose actions serve for an example and whose language is listened to.[35]

III. Evidence on the Tax Preference and the Level of Charitable Giving

The deduction from taxable income for charitable contributions was implemented in the War Revenue Act of 1917, and has remained a feature of the U.S. income tax system since then.[36] Charitable giving in 2011 was

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32 Whether through the tax system, regulatory machinery, or spending programs, government actions must have the effect of inducing individuals and groups to find routes around the legal requirements, wealth transfers, and other constraints attendant upon public policies. This yields incentives for policymakers to impose further conditions and requirements, and so on. Thus does government grow through this dynamic, among others. See, e.g., Fred S. McChesney, "Rent Seeking and Rent Extraction," in Shughart and Razzolini, eds., *op. cit.*, fn. 12 *supra.*, at 379-395. See also Mueller, *op. cit.*, fn. 9 *supra.*, at 333-358.

33 See, e.g., Joe Carlson, "CHA Joins Opposition to Reform Law's Birth-Control Rule," June 15, 2012, at http://www.modernhealthcare.com/article/20120615/NEWS/306159974#.

34 The term "social capital" often is used to describe the large benefits of civil society and its institutions in the protection of individual freedom, democratic processes, and the rule of law. For an analysis of the economic effects of differences in the level of social capital, see Stephen Knack and Philip Keefer, "Does Social Capital Have an Economic Payoff? A Cross-Country Investigation," *Quarterly Journal of Economics*, Vol. 112, No. 4 (November 1997), pp. 1251-1288, at https://hec.unil.ch/docs/files/21/280/knack_keefer_1997.pdf.

35 Alexis de Tocqueville, *Democracy in America*, Vol. 2, Part 2, Chapter IV, "That the Americans Combat the Effects of Individualism By Free Institutions," and Chapter V, "Of the Use Which the Americans Make of Public Associations in Civil Life," at http://books.google.com/books?id=inSGAAAAMAAJ&pg=PA106&lpg=PA106&dq=Public+Associations+in+Civil+Life&source=bl&ots=t9g-G-9u6J&sig=lJ_8Ia3eVoOp7Su31UzgMwmhjnI&hl=en&sa=X&ei=0k05ULndN4SWiALLooHQBg&ved=0CC8Q6AEwAA#v=onepage&q=Public%20Associations%20in%20Civil%20Life&f=false.

36 For a history and detailed description of the features of the charitable deduction, see Joint Committee on Taxation, *Present Law and Background Relating to the Federal Tax Treatment of Charitable Contributions*, JCX-55-11, October 14, 2011, at https://www.jct.gov/

about $298 billion, by individuals, foundations, estates, and businesses.[37] From the viewpoint of a taxpayer who itemizes deductions on his income tax return, the marginal tax rate reduces the perceived cost of a contribution by that percentage in most cases. For example, a taxpayer contributing $100 to a charity and subject to a marginal tax rate of 28 percent would reduce his tax liability by $28, thus reducing the perceived cost of the $100 donation to $72. Table 1 illustrates the effects of past and proposed marginal tax rates as applied to charitable contributions in terms of the percent change in the perceived cost (or "price") of a given contribution.

Table 1: Change in Perceived Cost of Contributions (percent)

Tax Policy	Tax Rate Before	Tax Rate After	Cost Change
Deduction cap 2012 rates	35	28	10.8
2001 tax reduction	39.6	35	7.6
1993 tax increase	31	39.6	-12.5
1990 tax increase	28	31	- 4.1
1986 tax reduction	50	28	44.0
1981 tax reduction	70	50	66.7

Source: Tax Foundation at http://taxfoundation.org/article/us-federal-individual-income-tax-rates-history-1913-2011-nominal-and-inflation-adjusted-brackets; and author computations.
Note: Deduction cap is notional. See Roger Colinvaux, Brian Galle, and Eugene Steuerle, "Evaluating the Charitable Deduction and Proposed Reforms," Urban Institute, June 2012, at http://www.urban.org/UploadedPDF/412586-Evaluating-the-Charitable-Deduction-and-Proposed-Reforms.pdf.

In short: Changes in marginal tax rates or other possible changes in the tax deductibility of charitable contributions can have substantial effects on the perceived cost of private giving. The empirical question to be addressed is straightforward: Do such changes in perceived costs attendant upon shifts in tax policies have effects on charitable giving that are large or small? That is: What is the elasticity of charitable giving with respect to changes in marginal tax rates?[38] There exists a large literature on this question, the more-recent findings reported in which are summarized in Table 2.[39]

publications.html?func=startdown&id=4371.

37 The Center on Philanthropy at Indiana University, *Giving USA 2012*, at http://www.nxtbook.com/nxtbooks/galvin/givingusa_execsummary2012/index.php#/0.

38 This elasticity is the percent change in charitable contributions induced by a 1 percent change in the perceived cost of giving. This can be predicted to be a negative number, as an increase (decrease) in the perceived cost of giving should yield a decline (increase) in charitable contributions, *ceteris paribus*. An elasticity lower than -1.0---say, -1.5---is a higher demand elasticity, implying a greater response to given change in the perceived cost of giving.

39 The citations for the analyses summarized in Table 2 are listed in the appendix to this section. The literature findings summarized here begin with work published in 1990; the findings in earlier work are summarized in John Peloza and Piers Steel, "The Price Elasticities of Charitable Contributions: A Meta-Analysis," *Journal of Public Policy and Marketing*, Vol. 24, No. 2 (Fall 2005), pp. 260-272.

Table 2: Estimated Elasticities Reported in the Literature

Author	Elasticity
Bakija and Heim (2011)	< -1
Karlan and List (2007)	0 above 1:1 match
Bradley, Holden, McClelland (2005)	- .78 to -2.56
Joulfaian and Rider (2004)	-1.14 to -2.15
McClelland (2004)	-1.85 to -2.14
Bakija, Gale, Slemrod (2003)	- .162
Auten, Clotfelter, Schmalbeck (2002)	- .52 to -.95
Auten, Sieg, Clotfelter (2002)	- .4 to -1.26
Greene and McClelland (2001)	- .54
Newsome, Blomquist, Romain (2001)	- .27 to -.58
Tiehen (2001)	- .02 to -2.41
Bakija (2000)	- .2 to -2.52
Joulfaian (2000)	- .74 to -2.58
Duquette (1999)	- .64 to -1.24
Wu and Ricketts (1999)	.12 to -.2
Barrett, McGuirk, Steinberg (1997)	- .47
Dunbar and Phillips (1997)	-3.36
Auten and Joulfaian (1996)	-1.1 to -2.5
O'Neil, Steinberg, Thompson (1996)	- .47 to -2.24
Randolph (1995)	- .51 to -1.55
Choe and Jeong (1993)	-2.45
Greenwood (1993)	- .43
Ricketts and Westfall (1993)	-1.06
Auten, Cilke, Randolph (1992)	-1.11
Brown and Lankford (1992)	-1.62 to -1.79
Barrett (1991)	-1.09
Joulfaian (1991)	-3.0
Auten and Rudney (1990)	- .14 to -1.4
Christian and Boatsman (1990)	-2.0
Christian, Boatsman, Reneau (1990)	- .99 to -1.56
Robinson (1990)	-1.43 to -7.07

Sources: See the Appendix to this section.

The findings summarized in Table 2 are reported in published analyses that vary substantially in terms of the permanence of the tax changes analyzed, the use of cross-sectional versus time-series data, the type of survey employed, the types of donations examined, and the specifics of the underlying models. Accordingly, some of the findings are not directly comparable with some of the others; nonetheless, this literature is sufficiently

large and robust to allow some conclusions to which a reasonable amount of confidence can be attached. With the exception of one outlying finding in the Wu and Ricketts study (1999), all of the estimated elasticities are negative as expected, ranging from -.02 to -7.07. Among these thirty-one studies, twenty-three report elasticities of -1.0 or less, either as a point estimate or within a range of estimates. ("Less" in this context means an estimate lower than -1.0, that is, a higher demand elasticity.) Five of the studies report elasticities of -0.4 to -1.0, again as point estimates or within a range. If we ignore the estimates that can be viewed as outliers, the various estimated elasticities lie, broadly speaking, in a range of about -0.5 to -1.5. Accordingly, an elasticity estimate of -1.0 is reasonable for purposes of discussion and the derivation of rough estimates with respect to various proposals to change the tax treatment of charitable deductions.[40] From Table 1 above, a 28 percent cap on the marginal tax rate assumed for charitable deductions would raise the perceived cost by about 10.8 percent for those affected; the elasticity assumption of -1.0 yields a simple predicted decline in giving of about that percentage for those affected by this tax change.

However, the analysis is complicated by differences in tax status among donors, the income effects of changes in the tax treatment of charitable contributions, the distinction between transitory and permanent price effects, and other factors. Gravelle and Marples estimate that a 28 percent cap on the value of itemized deductions would raise the perceived cost of donations by about 18.3 percent under 2011 law, and would reduce total donations under their "central elasticity" (-0.5) assumption by 1.44 percent. For their "high elasticity" assumption (-0.79), the latter figure is 2.27 percent.[41] If we apply those figures to the $218 billion donated by individuals in 2011, we arrive at a decline ranging from about $3 billion to about $5 billion.[42] Cordes estimates that the 28 percent cap, under an assumed price elasticity of -1.0, would reduce deductible contributions by 3.2 percent, or about $5.6 billion annually.[43] The Congressional Budget Office estimates that other proposals would reduce charitable giving by about $8-10 billion per year, a reduction greater than, or equal to significant percentages of, the operating budgets of major U.S. charitable organizations.[44] Note that some proposals for changes in the tax treatment of charitable contributions are components of broader tax reforms that might yield increases in GDP growth (or national wealth). Three such proposed tax reforms are discussed in the next section. Since giving grows with wealth, an increase in the cost of giving might be offset partial-

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40 More detailed analyses can be found in Jane G. Gravelle and Donald J. Marples, "Charitable Contributions: The Itemized Deduction Cap and Other FY2011 Budget Options," Congressional Research Service Report for Congress R40518, March 18, 2010, at http://www.scribd.com/doc/52962518/R40518; and "Options for Changing the Tax Treatment of Charitable Giving," Statement of Frank J. Sammartino, Congressional Budget Office, before the Committee on Finance, United States Senate, October 18, 2011, at http://www.cbo.gov/sites/default/files/cbofiles/attachments/10-18-charitableTestimony.pdf.

41 See Gravelle and Marples, *op. cit.*, fn. 40 *supra.*, at Tables 2 and 3, respectively.

42 See The Center on Philanthropy at Indiana University, op. cit., fn. 37 supra., at 9.

43 Joseph J. Cordes, "Re-Thinking the Deduction for Charitable Contributions: Evaluating the Effects of Deficit-Reduction Proposals," *National Tax Journal*, Vol. 64, No. 4 (December 2011), pp. 1001-1024, at Table 2.

44 See Statement of Frank J. Sammartino, "Options for Changing the Tax Treatment of Charitable Giving," before the Committee on Finance, United States Senate, October 18, 2011, at http://www.cbo.gov/sites/default/files/cbofiles/attachments/10-18-charitableTestimony.pdf. One proposal would convert the current deduction into a 15 percent tax credit for all taxpayers, but impose a floor of 2 percent of adjusted gross income for eligibility. That combination would reduce contributions by an estimated $10 billion or more. A similar proposal for the conversion to the 15 percent credit, but without the floor, would reduce giving by about $8 billion. See also The American Red Cross, "2011 Annual Report," at http://www.redcross.org/images/MEDIA_CustomProductCatalog/m6340455_2011AnnualReport.pdf.; and Catholic Charities USA, "2010 Annual Report," at http://www.catholiccharitiesusa.org/document.doc?id=2776.

ly or wholly (or even more than wholly) by an increase in GDP per capita.[45] This possible net increase in charitable giving would not remove the free-rider problem discussed above, and thus the rationale for the tax preference given charitable donations, unless the benefits enjoyed by those not donating (the free riders) were to become sufficiently small relative to the benefits perceived by the donors as to be "inframarginal," that is, irrelevant in terms of the aggregate demand for giving relative to its cost.

Appendix to Section III: Citations for Table 2

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45 See Brooks, *op. cit.*, fn. 19 *supra.*, and Gravelle and Marples, *op. cit.*, fn. 40 *supra.*, at 11.

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IV. Observations on Tax Reform Proposals and Public Support for Private Giving

Reform of the U.S. tax system in the face of all of its complexities and distortions is a perennial topic among scholars and policymakers alike, and many proposals to change the tax treatment of charitable contributions are part of broader efforts to design a federal tax system that generates more revenue and/or that is simpler, less distorting, more conducive to economic growth.[46] As a crude generalization, most proposals to reform the federal tax system can be classified either as efforts to preserve the basic taxation of income and wealth, but with far fewer distortions and tax preferences, or as efforts to shift taxation away from income and wealth toward consumption.

As noted at the beginning of section I, the serious problems attendant upon current federal fiscal policies have increased the prominence of proposals to change or to reform the tax system, and so one question to be addressed is how the favorable treatment of charitable contributions, appropriate in principle for the reasons outlined in section II, might be preserved under alternative reform proposals. We offer brief observations on that question with respect to three well-known reform frameworks: the original (1985/1995) Hall-Rabushka Flat Tax, the recent Heritage Foundation "New" Flat Tax, and the well-known proposal for a progressive consumption ("X") tax.

The original Hall-Rabushka flat tax proposal was for a tax system that subjects almost all income to taxation once and at the same rate, with first-year expensing of all capital investment.[47] It is straightforward to show that such a tax applied to all income is equivalent to a tax on consumption.[48] In any event, the deduction for charitable contributions would be eliminated under the flat tax, but Hall and Rabushka argue that the greater economic growth that would result from this tax reform would induce additional giving compensating either

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46 The "excess burden" of the tax system is a measure of the distortions that the system imposes upon the economy; in brief, because of the tax system, the private sector must become smaller by more than a dollar in order to send a dollar to the federal government. This excess burden, therefore, is a hidden cost of all federal spending. There exists a substantial literature on the magnitude of the economic distortions engendered by the federal tax system; a useful discussion is provided by Feldstein in two recent papers, and by Conover in a recent summary review of the literature. See Martin Feldstein, "The Effect of Taxes on Efficiency and Growth," *Tax Notes*, May 8, 2006, pp. 679-684; and Christopher J. Conover, "Congress Should Account for the Excess Burden of Taxation," Cato Institute Policy Analysis No. 669, October 13, 2010. See also William A. Niskanen, "The Economic Burden of Taxation," in Mark Wynne, Harvey Rosenblum, and Robert Formaini, eds., *The Legacy of Milton and Rose Friedman's Free To Choose: Economic Liberalism at the Turn of the 21st Century*, Dallas: Federal Reserve Bank of Dallas, 2004; and the *Report of the President's Advisory Panel on Federal Tax Reform*, November 1, 2005, p. 36, at www.taxreformpanel.gov/final-report/.

47 See Robert E. Hall and Alvin Rabushka, *The Flat Tax*, Stanford: Hoover Institution Press, 2nd ed., 1995. The "flat" description of this proposal is not quite correct, in that an exclusion from taxation would be applied to some level of (initial) income for each taxpaying unit (e.g., a family). Accordingly, because the marginal tax rate would be constant (at 19 percent in the proposal) above the exclusion level, there would be some graduation (or "progressivity") in the income tax structure; but the average tax rate would decline as income rises. This means that in any such proposal there is an important tradeoff between the size of the exclusion (the implicit support given those with lower incomes) and the marginal tax rate applied to income above that exclusion (the disincentive for work and investment). Moreover, it is not obvious that such a flat tax devoid of preferences can be a political equilibrium, in that the interests that would benefit from the introduction of such preferences are concentrated, while those who would have to bear the resulting higher tax burdens are a diffused group.

48 See Harvey S. Rosen, *Public Finance*, Boston: Richard D. Irwin, 3rd ed., 1992, pp. 274-304. For a less-technical discussion, see *The Annual Report of the Council of Economic Advisers*, February 2004, pp. 103-116, at http://www.gpo.gov/fdsys/pkg/ERP-2004/pdf/ERP-2004.pdf.

partially or fully for the elimination of the tax subsidy.[49] They point out that almost half of all giving (as of 1991) was not deducted on federal income-tax returns,[50] and argue as well that the elimination of the tax deduction would affect giving by upper-income taxpayers disproportionately, and thus the charities that they tend to favor, in particular "universities, symphonies, opera companies, ballets, and museums… No compelling case has ever been made that these worthy undertakings should be financed by anyone but their customers."[51]

Whether the activities of that class of nonprofit organizations yield external benefits for nonpayers is an issue outside of the scope of the discussion here. One problem with the Hall-Rabushka analysis is straightforward: Even if the increased economic growth yielded by a flat tax reform were sufficient to compensate fully for the reduced incentive to give caused by the elimination of the tax preference, the external benefit/free rider problem remains. The higher national wealth attendant upon the tax reform by assumption would increase the demand for giving (that is, for charitable activity); but it would not address the underprovision problem discussed in section II.[52] At the same time, as noted in section II, the current approach for support of private giving---the tax deductibility of contributions---does not address well the external benefits of activities supported disproportionately by those who do not itemize deductions on their tax returns. In any event, it is difficult to see how government can distinguish among varying charities (e.g., soup kitchens versus operas) in terms of external effects, and an effort by government to make such choices would erode the conceptual basis of the flat tax, that is, the taxation of all income at a constant rate. In short: The Hall-Rabushka framework, whatever its larger virtues, cannot be reconciled with a tax preference for private giving, unless a tax credit for charitable donations is inserted, which would be inconsistent with the "spirit" of the proposal. Alternatively, a substitution of government funding in place of private charity carries its own set of likely distortions, as discussed in section II above.

The Heritage New Flat Tax proposal is similar to the Hall-Rabushka (traditional) proposal; it imposes a flat tax rate on all income not saved or invested, and allows the expensing of capital investment. It eliminates inheritance and estate taxes, the payroll tax, and all excise taxes not earmarked for specific trust funds.[53] It allows two nonrefundable credits, for the purchase of health insurance and the existing Earned Income Tax Credit, and three deductions, for charitable contributions, for higher-education expenses, and for interest paid on home mortgages. The deductions are justified on grounds of tax neutrality. For charitable contributions the deduction is appropriate because donations purportedly are not "consumption" for the donor, but the ensuing consumption by tax-exempt organizations would not be taxed, as under current law. Accordingly, this

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49 Hall and Rabushka, *op. cit.*, fn. 47 *supra.*, at 99-100 and 105-106.

50 The Staff of the Joint Committee on Taxation estimates that in 2008 about 25 percent of individual contributions were not claimed as itemized deductions. See Staff of the Joint Committee on Taxation, *op. cit.*, fn. 36 *supra.*, at 37-38; and The Center on Philanthropy at Indiana University, "U.S. Charitable Giving Falls 3.6 Percent in 2009 to $303.75 Billion," at http://www.philanthropy.iupui.edu/news/article/us-charitable-giving-falls-36-percent-in-2009-to-30375-billion.

51 Hall and Rabushka, *op. cit.*, fn. 47 *supra.*, at 100.

52 See fn. 19 supra.

53 See J.D. Foster, "The New Flat Tax: Easy as One, Two, Three," Heritage Foundation Backgrounder No. 2631, December 12, 2011, at http://www.heritage.org/research/reports/2011/12/the-new-flat-tax-easy-as-one-two-three.

"neutrality" argument is a bit dubious, unless the ultimate recipients of charitable services are taxed on their consumption of those services, a concept unlikely to prove workable as a practical matter.[54]

Moreover, even more than in the case for a flat tax with no preferences, a flat tax proposal that preserves some preferences on neutrality grounds is likely to engender demands from innumerable interests for similar preferences. In short, this sort of reform is unlikely to prove a political equilibrium, as the experience after the 1986 Tax Reform Act suggests.[55] Nonetheless, whatever the internal challenges and conflicts inherent in the Heritage proposal, it preserves the tax preference for charitable donations, and thus deals directly but partially with the underprovision problem discussed in section II, at least directionally. The problem of underprovision by those who do not itemize deductions might be addressed with a refundable tax credit; but that would represent an erosion of the central concept underlying the Heritage proposal

The progressive consumption (or X) tax was developed and proposed initially by the late Professor David F. Bradford, and updated recently by Robert Carroll and Alan D. Viard.[56] The proposal essentially is a consumption tax on households and a value-added tax on businesses minus their wage bills. Households (or workers) would be taxed on wages under a progressive rate schedule, but not on the income from savings and investments. Businesses would be taxed on their value added (as under an explicit value-added tax) minus their wage bills at the highest rate applied to workers. Business capital investments would be expensed. This proposal is virtually the same as the Hall-Rabushka flat tax discussed above, except that the X tax imposes a progressive (or graduated) rate structure on wages, while the Hall-Rabushka rate structure is flat after the income exclusion. The X tax therefore is a tax on consumption, analytically identical to a national sales tax.

Carroll and Viard note that "the decision of whether to provide tax relief for charitable contributions and the generosity of any such relief can be resolved separately from the decision of whether to adopt the X tax."[57] Carroll and Viard note however that the structure of such a tax preference would matter under an X tax: A deduction similar to that under current law would yield no benefit (or incentive effect) for households with wages too low to owe taxes, a condition virtually identical to that prevailing under current tax law. Such a deduction would be irrelevant also to households with only investment income, an outcome that "could significantly diminish the effectiveness of an incentive for charitable giving."[58] Carroll and Viard then suggest that a refundable tax credit for both households and businesses might be the most efficient option for public support for private charity.

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54 Perhaps purchasers of opera tickets somehow could be taxed on the implicit subsidies that they receive, but a similar approach is implausible for, say, consumers of the services of churches or soup kitchens or medical care for the indigent. In the context of tax neutrality, Foster argues as well that higher education investment (in human capital) should receive the same expensing as investment in physical capital, and that home mortgage interest should be deductible as long as interest payments by lending institutions are taxable.

55 See fn. 47.

56 See David F. Bradford, *The X Tax in the World Economy: Going Global With a Simple Progressive Tax*, Washington D.C.: AEP Press, 2004; and Robert Carroll and Alan D. Viard, *Progressive Consumption Taxation: The X Tax Revisited*, W Washington D.C.: AEP Press, 2012.

57 Carroll and Viard, *op. cit.*, fn. 56 *supra.*, at 60.

58 Carroll and Viard, *op. cit.*, fn. 56 *supra.*, at 61.

V. Conclusions

The favorable tax treatment---government financial support---given private charitable giving is longstanding and consistent in principle with standard economic and public choice analysis. That standard analysis does not provide guidance with respect to the particular level (or structure) of this financial support, but it suggests strongly that both the private and public sectors have incentives to allocate too few resources toward collective goods, that government provision of many such goods is likely to be afflicted with important distortions, and that public support for private giving provides an important ancillary benefit in terms of the preservation of the institutions of civil society as a buffer between the citizenry and the state.

Changes in the tax treatment of charitable giving---that is, changes in the after-tax "cost" of giving perceived by donors---have important effects in terms of the level of giving. For those affected by changes in this tax treatment, giving is likely to decline by roughly 1 percent for each 1 percent increase in the after-tax cost of giving. The various proposals to change or reform the tax treatment of charitable giving would yield declines in aggregate donations that would be large in terms of the operating budgets of major charitable organizations. The larger tax reform proposals now prominent in the public discussion cannot be reconciled with public support for private giving, or would be somewhat inconsistent with the larger goals of the reform, or would replace the current deduction with some form of tax credit.

One prominent proposal is for a cap of 28 percent on the marginal tax rate applied to charitable contributions by taxpayers above a given income level. That would raise the perceived cost of giving by, roughly, 18 percent for the taxpayers affected, leading to a reduction in total giving by all taxpayers of about 2 percent, or roughly $5 billion annually. In a world of trillion-dollar deficits, that may sound small; but it is 40 percent greater than the operating budget of the American Red Cross. Another proposal would convert the current deduction into a 15 percent tax credit for all taxpayers, but impose a floor of 2 percent of adjusted gross income for eligibility. That combination would reduce contributions by an estimated $10 billion or more, an amount equal to about half the operating budget of Catholic Charities. A similar proposal for the conversion to the 15 percent credit, but without the floor, would reduce giving by about $8 billion.

There are other proposals with varying effects. Perhaps a tax reform that results in substantially greater economic growth in the aggregate would compensate for these impacts. Or, perhaps, tax reform may be sufficiently important to justify them. But the public discussion of changes in the tax treatment of charitable giving should consider not only the narrow effects on contributions, but also the more subtle but larger implications for the substantial benefits that the institutions of civil society yield in terms of the protection of our freedoms. To the extent that private charity---giving that passes a crude market test---yields increases in both altruistic endeavors and the strengthening of the institutions of civil society, it would be wise for policymakers to keep these important effects and factors in mind.