

Right Way to Extend Charitable Deductions to Nonitemizers, The

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In his fiscal 2001 budget submission, President Clinton proposed a plan to extend the charitable deduction to those taxpayers who currently do not itemize deductions on their tax returns. Another proposal to extend the deduction has come out of the presidential campaign of George W. Bush, whose principal economic advisor, Larry Lindsey, has written on this subject in the past.

If designed carefully, the extension of a charitable deduction to nonitemizers can increase giving moderately, while avoiding losses in revenues, increases in administrative burdens for taxpayers, and compliance problems for the IRS. How to achieve that type of design is the subject of this column.¹

When taxpayers are allowed to deduct their contributions on tax returns, they effectively get back a rebate equal in value to their deductible contributions times their marginal tax rate. For example, for taxpayers in the 15 percent bracket, giving away a dollar effectively costs them 85 cents, with the government chipping in the remainder. The 85 cents in this example is labeled the "price" of giving away a dollar. For someone in a higher tax bracket, the price would be lower.

Currently, the price of giving away a dollar is less than a dollar only to those who itemize on their tax returns. For the majority of taxpayers, a standard deduction is allowed in lieu of itemized deductions—the standard deduction covers not only charitable contributions but state and local taxes, some sources of interest payments, medical expenses, and miscellaneous itemized expenses. In recent years, all of those other sources of itemized deductions have been pared down and separate floors have been put under both medical and miscellaneous itemized expenses, with deductions allowed only for amounts in excess of the floor involved.

Because a standard deduction can be chosen by the taxpayer in lieu of itemizing deductions—and, when taken, is almost always more valuable than the itemized deductions—the denial of a charitable deduction to nonitemizers is not necessarily "unfair." By the same token, it is eminently "fair" to consider allowing all taxpayers to take a charitable deduction and for a standard deduction to apply to the other items that are itemized. That type of system is consistent with the belief that the appropriate tax base should be income left over for consumption after charitable contributions are made.

Extending a charitable deduction to nonitemizers treats as equals those with equal amounts of income after charitable giving has taken place; whereas under current law, the nonitemizer who does give to charity pays the same tax as one who does not, all other things being equal. Of course, if enough is given to charity, then the taxpayer automatically moves into "itemizer" status, so very large givers are seldom denied any charitable deduction.

Whatever the ambiguity of the equity case, extending the charitable deduction to nonitemizers is usually justified on the grounds that it will encourage more giving and that charitable giving is good for society. More is involved than simply the charitable activity that might be sponsored or the amount of income that might be transferred to those with needs; a more giving society may be one that, overall, is a better society.

How much additional giving would be generated by extending the charitable deduction to nonitemizers? The answer depends largely on how responsive taxpayers are to the tax incentives, and the econometric or statistical evidence is quite mixed.

If one simply extends the charitable deduction and does nothing else, there is a revenue cost. Moreover, the revenue cost can easily be more than the amount of charitable giving generated, unless the response rate to the incentive is fairly high. If a dollar of revenue would be equally well spent as a dollar of giving, then some would argue that the extension is not revenue efficient. However, the matter is much more complicated.

What one really wants to do is compare revenue-neutral systems and see which one is superior. Some may believe that it would still be better to have a system with slightly higher tax rates, yet some additional charitable deduction that provides a broader distinction between givers and nongivers. (Remember also that for those who can deduct contributions the tax rate on the decision to earn an extra dollar and give it to charity is zero.)

Fortunately, however, resolving the charitable contribution/revenue loss trade-off at this level is not required. To the extent a tax deduction is believed to provide an incentive, it is for the last dollars of giving, not the first. For example, a person might provide \$500 of giving without an incentive and \$550 with an incentive. If the tax rate can be lowered mainly for the last \$50 of giving, rather than all or some of the first \$500, then the revenue loss can be lowered considerably without having much effect on the amount of giving generated.

Because of these considerations of the marginal effectiveness of the incentive, many proposals contain a floor under the amount of giving that will be eligible for a subsidy. Once a floor becomes available as a policy tool, it is possible to design a charitable giving subsidy that provides a bigger "bang per buck." In fact, even if the responsiveness of giving to a subsidy is fairly low, a floor under the nonitemizer deduction can be used effectively to practically ensure that the net increase in giving is greater than the revenues lost. If taxpayers are even more responsive than at first expected, then giving will go up even more (although revenue losses will also be a bit higher).

Indeed, a floor can be used to avoid almost all revenue loss or even pick up revenue. The same logic that applies to nonitemizers extends to itemizers. A floor under their itemized giving would increase revenues with almost no loss in their charitable giving. In fact, a common floor under both itemizers and nonitemizers is far superior as a matter of tax policy to separate rules applying to each. Not only would a common floor provide for greater simplification for the same amount of revenue loss, it generally would induce more charitable giving than would separate rules.

In effect, a floor under itemizers raises revenues that can be spent more efficiently on providing a lower floor for nonitemizers than might otherwise be required. For example, a \$200 floor under both itemizers and nonitemizers would be superior to a \$500 floor under nonitemizers and no floor at all on itemizers—assuming that these are the levels at which equivalent revenue losses are attained.

Floors are also extremely valuable in solving other problems. The standard deduction simplifies recordkeeping for a great many taxpayers and tax enforcement for the IRS. It is well-known that it is difficult for the IRS to audit small amounts of charitable contributions, and it is not cost-effective for the IRS even to try. Simply extending an open deduction to nonitemizers raises serious questions of complexity and compliance. Fortunately, with the use of a floor, it is possible to minimize any increased complexity by continuing to remove small givers from itemizing any of their giving. And a floor minimizes enforcement problems for the IRS.

In sum, it is possible to extend a deduction to nonitemizers that could either increase giving by more than the revenue loss or increase giving without any revenue loss at all, and at the same time minimize or even reduce tax complexity and administrative burdens on the IRS. None of the recent proposals has really tried to strike such a balance, but they have put the charitable deduction for nonitemizers on the table. Given that some enactment is likely when both parties are presenting proposals, significant attention is required now to issues of proper tax design and policy.

Footnote

1. The analysis here summarizes some research being performed at the Urban Institute with Joseph Cordes and John O'Hare.

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