EXPANDING MODELING CAPACITY ON TAX EXPENDITURES FOR CHARITABLE CONTRIBUTIONS

Technical Methodology Report
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Until now TPC’s basic distributional analysis did not separately examine charitable contributions. As part of this research project, we have created a new module that extends the capacity of our microsimulation model to simulate the effect of proposed policy changes on charitable contributions. This brief includes an explanation of the technical methodology behind the chartbook, “Tax Incentives for Charitable Contributions,” released on November 12, 2019.

OVERVIEW

Reforming the current-law itemized deduction for charitable contributions has increasingly become a topic of discussion following the late 2017 enactment of the Tax Cut and Jobs Act (TCJA). This tax overhaul temporarily limits the availability of a deduction for charitable giving to a small share, about 9 percent, of individual taxpayers. Moreover, high income taxpayers dominate the remaining set of beneficiaries of the deduction. Consequently, political support for a deduction applied to such a narrow base of taxpayers is tentative, and several groups such as the Independent Sector, have begun to analyze and advocate for a reformed deduction or a completely different tax incentive. We expect these debates to continue and intensify particularly when Congress starts considering future tax policy changes—which they must at some point, given the temporary nature of many individual income tax provisions in the TCJA, including those that have significant effect on charitable contributions.

Any future tax incentive for charitable contributions can take one of many forms; for instance, it can be a deduction or a credit, and it could contain a floor under which, or a cap above which, no deduction is allowed. Also, reforms to other tax provisions, such as the home mortgage interest deduction or the standard deduction, could affect the number of taxpayers who can take a deduction for charitable contributions, depending on how it is structured. Each of these reforms, by changing incentives, affects both federal tax revenues and the extent to which people donate to charity.
In the past, developing estimates of the effect of tax reforms on charitable contributions, whether through provisions aimed directly or indirectly at the charitable deduction, required substantial work in addition to the individual microsimulation tax model setup. The basic distributional analysis would not reveal what was happening to the amount of charitable contributions. As part of this research project, we developed a tax expenditure module for charitable contribution that provides an extended capacity to estimate a wide variety of proposals, and, at the same time, has automated how additional information on charitable giving will be shown as addendums to our conventional distributional tables.

**CAPACITY TO ESTIMATE A WIDER VARIATION OF PROPOSALS**

*Cash and In-Kind Contributions*

Taxpayers can deduct both cash contributions and other gifts of property or equipment. A donation of appreciated property receives a special preference under current law in that the taxpayer can deduct both the full market value of the donated property and avoid paying any tax on income earned on that property in the form of appreciation (because the asset was not sold and a capital gain not realized). The revised charitable deduction module has added the capacity to simulate proposals that differentiate cash and non-cash contributions. For example, we now have the capacity to estimate a proposal that restrict the charitable deduction to cash donations only.

*More Universal Charitable Tax Benefits*

To deduct a charitable contribution under current law, a taxpayer must itemize deductions on Schedule A. Policy makers and researchers have been exploring alternative tax incentives that have effects along three different dimensions: overall amount of charitable giving, federal revenue cost, and progressivity. The most common proposal being discussed is a universal charitable deduction or credit that potentially provides tax benefits to all taxpayers with positive income tax liability who contribute to charities. Limitations can be added to the basic proposal to remove taxpayers who only give modest amounts. The module has added the capacity to simulate proposals that offer forms of universal tax deductions or universal tax credits that would be available to people who claim the standard deduction on their tax return (as well as people who itemize).

*Limitations on Charitable Tax Benefits*

Economists generally believe that incentives for the first dollars of giving have little effect on the overall amount of giving and, accordingly, that floors under allowable deductions can help reduce the ultimate revenue cost of a more universal charitable deduction. Floors can also limit noncompliance and ease the administrative costs of such a reform by reducing the number of taxpayers affected. A floor can be a fixed dollar amount or a percentage of a specified income measure, such as a fraction of Adjusted Gross Income (AGI). The module has parameters that can be chosen to specify the contours of a contribution floor without requiring new programming for each new proposal. For example, our model can easily estimate the proposal of replacing the current law itemized deduction for charitable contributions with a 15 percent non-refundable universal credit for contributions above 1 percent of AGI.

**AUTOMATION OF MODEL OUTPUTS**

*Last-dollar Tax Prices of Contribution*

Most econometric estimates of the effect of a charitable tax incentive relate that incentive to the tax benefits related to the last dollars given (the marginal contribution), rather than the first dollars given. To simulate the effect of proposals on charitable giving, therefore, we have also standardized the calculation of “last-dollar” marginal tax benefits and marginal tax prices resulting from an increase in current-law contribution. The TPC tax model for years has been able to
calculate the effective marginal tax rate (EMTR) on wages and salaries as well as several forms of capital investment. This module now extends this capability to calculate the marginal tax benefits of charitable contributions.

For the households in the tax model database, we determine the marginal tax benefits on contributions by first calculating the household’s individual income tax based on the household’s actual levels of income and charitable contribution. We then add $100 to the original contribution level and recalculate the household’s individual income tax liability. The marginal tax benefit is the resulting change in income tax divided by the $100 increase in contribution. For instance, if an additional $100 of contributions would decrease taxes by $20, the marginal tax benefit is 20 percent.

When calculating the average effective marginal tax benefit within each income class or for all income classes, we weight each household by the original amount of charitable contribution levels. If taxpayer A has a marginal tax benefit of 20 percent and gives away $1,000 currently and taxpayer B has a marginal incentive of 40 percent and gives away $3,000, their average effective marginal tax benefit is estimated as .35 (that is, [(.20 x .$1000) + (.40 x $3000)]/$4000).

The marginal tax price of contribution is defined as the after-tax cost per $100 of contribution, i.e., (1 - marginal tax benefit) x100.

Charitable Addendum Distribution Tables

The module now includes a regular tabulation routine that produces addendum charitable tables along with the standard distribution tables. These addendum tables show how a proposal will affect charitable contributions compared to current law and contain the following additional information: a) number of tax units with a tax benefit from charitable contributions; b) average benefit from charitable contributions; c) weighted-average marginal tax prices of giving; and d) implied change in charitable contributions associated with alternative price elasticities for giving. The last item allows us to provide a range of estimates given the uncertainty in the economic evidence on the precise incentive effect of the charitable contribution deduction.

CHARTBOOK DEMONSTRATION OF HOW THE NEW CHARITABLE CONTRIBUTION MODEL CAN BE USED

To demonstrate how this new module can be used, TPC has released the chartbook, “Tax Incentives for Charitable Contributions,” that shows the impact of several variations of universal charitable contribution incentives, including both floors and credit alternatives to a deduction.

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