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DESIGNING AN EFFECTIVE AND MORE UNIVERSAL CHARITABLE DEDUCTION

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Because of the small share of the population currently eligible for itemized tax deductions for charitable giving, many charities have argued that a more universal charitable deduction or tax credit should exist. A more universal subsidy could (but would not necessarily) increase significantly the resources made available for charitable purposes and would symbolize the nation's commitment to giving as a strong societal goal. In this brief, we show that whatever the revenue cost associated with a more universal deduction, policymakers should consider how to maximize the amount of goods and services that can be provided efficiently and equitably to charitable recipients for the subsidies it provides. Setting a floor contribution level above which some tax subsidy would be provided is a primary way of achieving that objective. Other approaches, such as allowing deductions up to the time of tax return filing (as with deductions for contributions to individual retirement accounts) and strengthened reporting, can also increase the amount of resources flowing through charities to beneficiaries for each dollar of subsidy provided.

As a result of the Tax Cuts and Jobs Act of 2017 (TCJA), the share of households claiming an itemized deduction for charitable contributions is estimated to have fallen from about 26 percent to about 9 percent in 2019. Correspondingly, the TCJA reduced the estimated average federal income tax subsidy for all dollars of giving by 30 percent, from about 20 cents a dollar to 14 cents a dollar. Put another way, the government took away about 6

cents of subsidy on average across all charitable contributions.[1] These changes have pushed onto the national agenda the search for a more universal deduction that would provide an incentive to a much larger share of the population.[2] [3]

In designing a more expanded incentive, however, it's easy for a charitable deduction to provide more symbol than substance when it comes to increasing giving. For example, Congress devoted about $1.5 billion in the Coronavirus Aid, Relief, and Economic Security (CARES) Act to create a one-year charitable deduction of $300 for the 90 percent of taxpayers who claim the standard deduction (JCT 2020). However, this provision shows the danger of enacting a more universal deduction with little attention to principles of public finance. As designed, the incentive may add to giving by only a tiny amount and thereby provide recipients with as little as $100 million, compared with the $1.5 billion in costs from forgone federal income tax revenue.[4] The bulk of the cost simply reduces taxes for those nonitemizers who will claim the deduction without significantly changing their overall amount of giving.

Why does the CARES ACT type of charitable deduction provide so little benefit to charitable recipients for the cost? First, by providing no minimum amount of giving above which the subsidy is available, it concentrates deductions on donations that people will make anyway. Second, the law creates no way for the Internal Revenue Service (IRS) to track newly deductible gifts, and those who misrepresent their contributions will be among the biggest winners. Finally, the CARES Act provision caps at a very low level the amount of giving eligible for the new tax subsidy. Because most donors already contribute more than that amount, they get no extra incentive for any additional gifts because their deduction is limited to an amount that is less than their normal annual giving without a tax deduction.

A primary purpose of the charitable deduction is to encourage more giving to organized charities so that more services can be provided to the beneficiaries of those organizations.[5] If Congress builds on the CARES Act precedent in creating a more universal deduction, those who benefit from the work of nonprofits could lose out on tens of billions in services annually, not just the close to $1.5 billion of income tax revenue effectively foregone with the $300 deduction. For instance, Congress could replace the existing itemized deduction with a capped universal deduction that even loses revenues, yet generates much less charitable giving than current law tax incentives. Or it could create a more universal deduction that could cost $30 billion per year in foregone income tax revenue, yet generate only $9 billion to $18 billion per year in additional goods and services available to charitable beneficiaries. Either way it could have used those forgone tax revenues in ways that would add much more to the output of charitable organizations. In this brief, we examine how to do much better for charitable beneficiaries.

Note that almost no matter how a "more universal" incentive is designed, it can still leave a significant number of households without a subsidy: those who do not owe taxes, those who do not give, and those who do not give more than a minimum amount if the new law sets one. Still, we must distinguish between being more universal (in the sense

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[1] See "How large are individual income tax incentives for charitable giving?" in the *Tax Policy Center Briefing Book,* accessed January 22, 2021, https://www.taxpolicycenter.org/briefing-book/how-large-are-individual-income-tax-incentives-charitable-giving.

[2] In 2020, only married couples with at least $20,800 of itemizable deductions would prefer to itemize rather than take the standard deduction.

[3] It then extended that provision through 2021in the Taxpayer Certainty and Disaster Relief Act of 2020 and expanded the deduction to $600 for joint tax filers in 2021.

[4] "New Charitable Deduction in the CARES Act: Budgetary and Distributional Analysis," Penn Wharton Budget Model blog, March 27, 2020, https://budgetmodel.wharton.upenn.edu/issues/2020/3/27/charitable-deduction-the-cares-act.

[5] A charitable deduction also attempts to create some equity between taxpayers who give more and those who give less. Consider three taxpayers. Two of them earn $100,000 and differ in no other characteristic except that one gives away $20,000 and the other gives away nothing. The third taxpayer earns $80,000 and gives away nothing. Suppose all three face a flat tax rate of 25 percent on all income. A deduction treats the donating taxpayer as having remaining income of $80,000 for its household's own consumption and then owing $20,000, the same as the non-giving taxpayer with $80,000 of income. The nondonating taxpayer with $100,000 pays more than the donating taxpayer, $25,000 versus $20,000, to support government services, but provides fewer services to others than the donating taxpayer, who, even with a deduction, devotes $40,000 to taxes and contributions combined.

that everyone except nontaxpayers gets a tax break from the proposed charitable provision) and being more "universally available" for all (meaning one has to give or give enough and be taxable in absence of any giving to qualify for the tax benefit). Even a universal deduction with no floor would benefit only about 4 percent of households in the lowest income quintile and 24 percent of households in the second-lowest income quintile, because most of them do not have a federal income tax liability, and some taxpayers with a positive tax liability make no charitable contributions.

To illustrate the issues around a more universal tax incentive for charitable contributions, we begin by describing the incentives to give and the distribution of charitable giving by income class. We then discuss some of the economic factors that can be employed to make a tax incentive more effective.

INCENTIVES TO GIVE

People often know about their average or effective tax rate, which is simply their total taxes divided by their total income. For instance, a worker might note on a pay stub the share of his or her take-home pay reduced by taxes. The incentive for itemizing taxpayers to increase their charitable contributions, however, depends less on that average tax rate than on the marginal income tax rate, typically the rate applied on the last dollar on which income taxes are assessed.

When taxpayers itemize their deductions, an extra dollar of charitable contributions typically reduces taxable income by a dollar, which then reduces federal income tax. For example, if an itemizing taxpayer with a top tax rate of 12 percent increases his or her charitable contributions by one dollar, that person's taxable income goes down by one dollar and the government collects 12 cents less. The "price" to the taxpayer of an extra dollar of giving in this case is only 88 cents. Similar to a reduction in the price of a consumer good, a reduction in the price of giving provides an incentive for the taxpayer to increase contributions, and the revenue loss to the government is 12 cents for each dollar contributed. If the taxpayer uses the standard deduction, then an extra dollar of contributions does not reduce taxable income, and the price to the taxpayer of giving one dollar to charity is one dollar.

Like all deductions, such as the itemized deductions for mortgage interest and state and local taxes, the subsidy for charitable giving works by subtracting expenditures from taxable income. Because those with more taxable income face higher tax rates, the subsidy for charitable giving provides larger incentives for those with higher incomes. For example, a married couple who itemizes and has $60,000 of taxable income reduces their federal taxes by 12 cents for every extra dollar they give away. An itemizing couple with $150,000 of taxable income reduces their taxes by 22 cents for every extra dollar of contributions, and a similar couple with $450,000 of taxable income reduces their taxes by 35 cents for every extra dollar contributed. Cash contributions are only deductible, however, up to 60 percent of adjusted gross income (AGI).[6]

The incentive to contribute (at least for the years 2018 through 2025) changed dramatically when the Tax Cuts and Jobs Act of 2017 was passed. Although it modestly lowered income tax rates (and thus reduced the incentive for itemizers to contribute), its most pronounced effect came through an increase in the standard deduction and a simultaneous elimination of the personal exemption for both taxpayers and dependents. In 2017, the personal exemption was $4,050, meaning that $4,050 could be deducted when computing taxable income for the taxpayer and each of his or her dependents. The standard deduction in 2017 was $6,350 for single filers and $12,700 for married couples filing jointly. For 2019, the personal exemption was $0, while the standard deduction increased to $12,200 for singles and $24,400 for married couples filing jointly. Also, some other itemizable deductions were limited, particularly by imposing an

[6] There are additional rules for other types of contributions. For example, noncash contributions to qualified organizations are limited to 50 percent of AGI minus cash contributions, while most contributions of capital assets are limited to 30 percent of AGI. The CARES Act lifted the limit to 100 percent of AGI for cash contributions made in 2020.

annual cap on all state and local tax deductions at $10,000. Consequently, the number of households itemizing their charitable deductions fell dramatically, from 25 percent in 2017 to about 10 percent in 2018. (IRS 2019; 2020b).

How a marked decrease in the incentive to contribute actually affects total contributions depends not just on the number of households affected but also on how those households respond to those incentives.[7] One debate centers on whether contributions increase by less than, the same as, or more than the revenue loss to government.

That debate often is stated in terms of government costs and taxpayer benefits. However, there is third party to these transactions: charitable recipients. When a tax reform increases charitable contributions by the same amount as the government revenue loss, charitable beneficiaries are the net winners. In that special case, donors end up with the same net income after the tax subsidy as they would have had if there was no subsidy, since they transfer their extra tax saving to charitable recipients through a charity. But whatever the response rate, the change in benefits to charitable beneficiaries equals the change in contributions made, but the net income of contributors equals the change in taxes less the change in contributions made.

Early studies estimated that the response of donors to tax incentives was larger than that estimated by later studies, which, starting in about 1995, began to focus on the difference between the long-run effects of a change in the tax price versus the immediate, short-run effects.[8] Also, the rate reductions in 1981 and 1986 did not seem to reduce charitable giving as much as would be predicted by the earlier studies. Some studies also found that higher-income taxpayers are more responsive to the incentive. Also worthy of note for our analysis of the alternative deduction proposals later in this brief, nonitemizers tend to have a lower response level than itemizers at the same income level. That is, at any income level, the more-responsive-than-average donors are more likely to move into itemization status because they tend to give more. xxx

For the purposes of this brief, we use the response rate found in later studies, partly because most of the incentive expansion being discussed would not be of benefit to those more generous givers (at any income level) whose responsiveness has already yielded them a deduction as an itemizer. However, all of our conclusions about how to increase the effectiveness of charitable contributions tend to hold at any level of responsiveness.

PATTERNS OF GIVING

The largest share of contributions comes from those in the highest income quintile (figure 1). Those in the bottom income quintile (the 20 percent of households with the lowest annual income) are estimated to have contributed about $6 billion in 2019, while those in the top quintile contributed an estimated $192 billion. This is, of course, largely because of the higher incomes of those in progressively higher income quintiles, who both have more to contribute and tend to spend smaller shares of their income on the consumption of other goods and services. Another factor is the structure of the tax incentive: higher-income taxpayers are more likely to get an incentive and, because tax rates rise with income, the highest-income itemizers face the lowest after-tax prices for giving. The combination of higher income and lower after-tax prices for charitable giving for those in progressively higher quintiles leads them to contribute progressively larger shares of their income (figure 2).

[7] Economists measure this responsiveness as an 'elasticity," which in this case is the percent change in charitable giving from a 1 percent change in the tax-subsidized price of giving. An elasticity of -1 holds a special significance because a decrease in the price of giving will lead to additional contributions exactly equal to the forgone tax revenue. If taxpayers have an elasticity of -1.2, the additional contributions will exceed the revenue loss, while if the elasticity is -0.8, the additional contributions are less than the forgone tax revenue.

[8] The long-run effects in one often-cited study were found to be about half the size of the previous estimates, while the short-run effects were larger.

These patterns can create a tension in designing reform between maintaining the progressivity of the tax incentive considered by itself and getting the most value in terms of charitable output per dollar of revenue loss. Additional contributions are often maximized by encouraging giving among those who already tend to give. Because much giving, regardless of any incentive, comes from the highest-income households, this often means providing them with the largest tax breaks.

How a charitable deduction that reduces taxes most for higher-income taxpayers affects progressivity, however, is a complex issue. For instance, extending lower-income taxpayers a higher standard deduction can be more progressive than extending a charitable deduction to them.

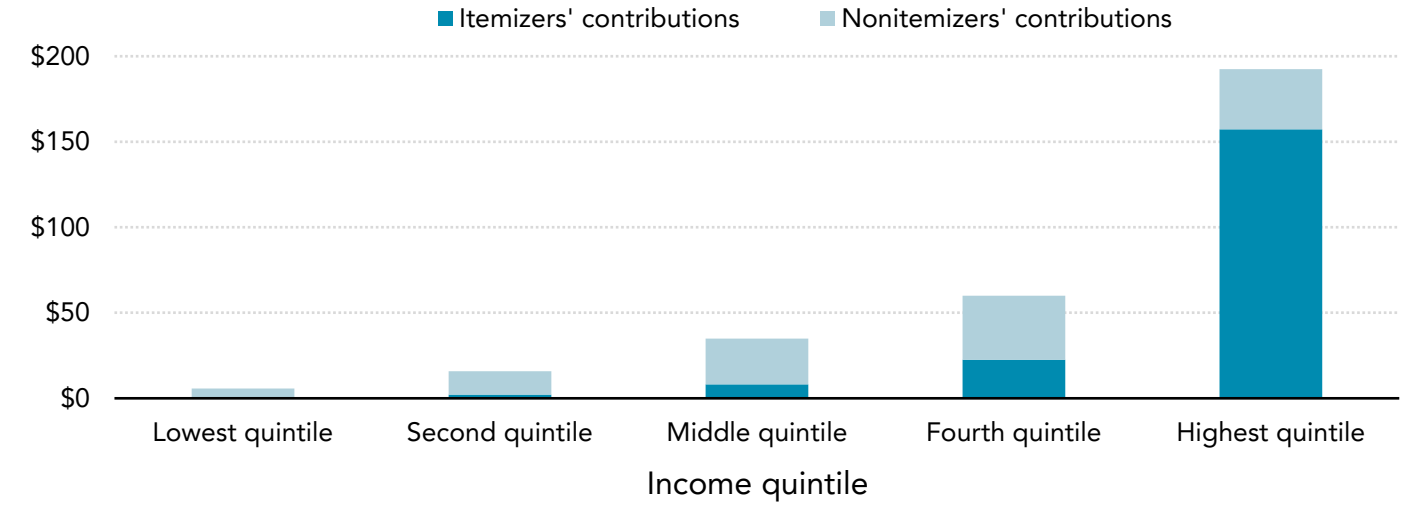
To make matters more complex, when people give away their income, the monetary gains from the gifts accrue to charitable recipients. Is it the progressivity of the tax system or of the combined tax and contribution system that is of concern? If the latter, then almost no matter how generous the deduction, donors bear a much heavier burden than nondonors with the same income. Further, if donors cut back on their giving because their incentives are reduced, then charitable beneficiaries bear some or all (or in some cases, more than all) of the loss. Suppose a taxpayer gives away $10,000 under the tax system before reform and, because of a policy change causing a $2,000 loss in tax benefits from a deduction, now only gives away $8,000. That taxpayer's economic situation has not changed (in both cases the gift costs $8,000 after accounting for tax consequences), but charitable beneficiaries have lost out on $2,000 of benefits.

The progressivity of the tax system is determined largely by all provisions, including any charitable deduction and a tax rate structure. That overall burden can be shared in a progressive way in a system that still allows tax incentives for charitable contributions. For instance, suppose the degree of desired progressivity of the tax system includes a constraint that two people each making $200,000 per year should pay a total of $80,000 in taxes. Each can pay $40,000 in income taxes and the progressivity constraint is met. Or a charitable deduction can be allowed that reduces the taxes paid by one who is more generous so that, say, the more generous donor pays $35,000 in taxes and the less generous donor or nondonor pays $45,000. Again, the progressivity constraint is met. Similarly, if a charitable deduction is expanded as part of a larger tax-reform effort, it is the total reform that will eventually affect the degree of progressivity, not the design of just one provision.

Finally, and most relevant here, a more universal charitable deduction can be designed that limits gains for higher-income taxpayers while still encouraging giving at other income levels. As we shall see, universal deductions without floors provide substantial benefits to the highest-income taxpayers who already itemize, even when they give no more (and sometimes even when they give less) in response.

FIGURE 1

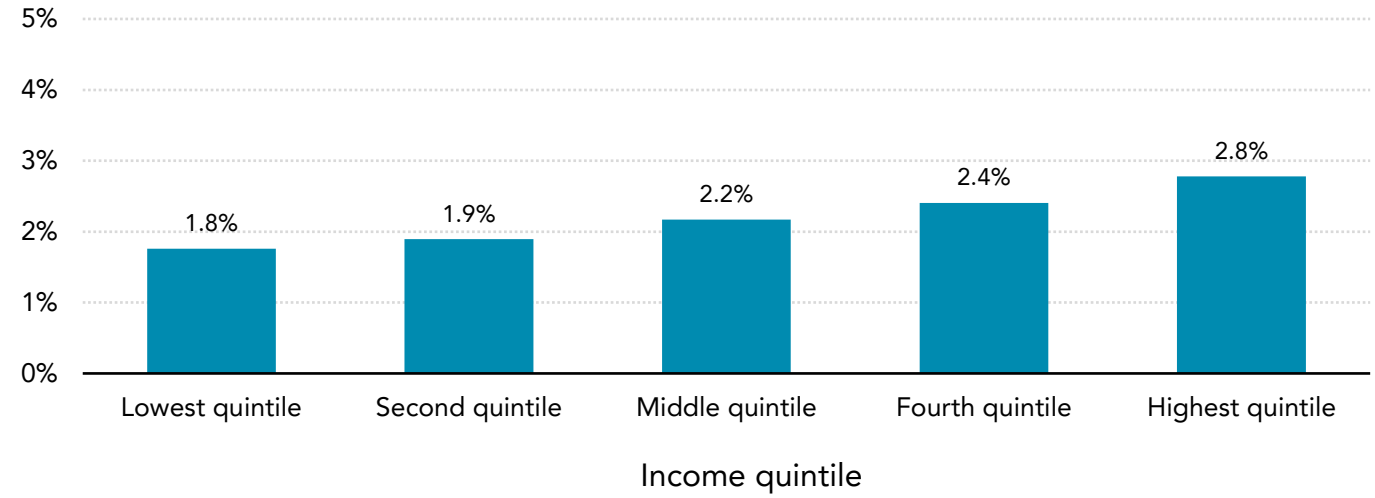
Charitable Contributions, 2019



Source: Tax Policy Center Microsimulation Model (version 0319-2).
Note: Income quintiles are based on expanded cash income. For a description of the income measure see "Income Measure Used in Distributional Analyses by the Tax Policy Center," accessed January 22, 2021, http://taxpolicycenter.org/taxmodel/income.cfm.

FIGURE 2

Charitable Contributions, 2019



Source: Tax Policy Center Microsimulation Model (version 0319-2).
Note: AGI = adjusted gross income. Income quintiles are based on expanded cash income. For a description of the income measure see "Income Measure Used in Distributional Analyses by the Tax Policy Center," accessed January 22, 2021, http://taxpolicycenter.org/taxmodel/income.cfm.

Most households that make contributions give away more than 1 or even 2 percent of their income (table 1), though it appears that about half of all households either do not make contributions or do not report doing so. Lower-income households usually do not have positive income tax liability and generally would not be affected by any reform of the charitable deduction. We estimate that 82 percent of those in the highest income quintile make contributions, but only

55 percent contributed more than 1 percent of their AGI. However, one needs to be a bit careful in making comparisons across income classes at a given point in time. Such comparisons do not account for how families may give over many years and how their incomes fluctuate significantly over their lives according to their employment and other economic circumstances.

TABLE 1

Shares of households with charitable contributions by income
2019

Expanded Cash Income Quintile	Share among all households			Share among households that donate	
	With contributions	With contributions greater than 1% AGI	With contributions greater than 2% AGI	With contributions greater than 1% AGI	With contributions greater than 2% AGI
Lowest quintile	23%	21%	21%	91%	88%
Second quintile	40%	39%	29%	96%	72%
Middle quintile	57%	52%	32%	92%	56%
Fourth quintile	71%	57%	34%	80%	48%
Highest quintile	86%	55%	33%	63%	38%
All returns	**51%**	**42%**	**29%**	**83%**	**57%**
80–90th percentiles	83%	56%	34%	67%	41%
90–95th percentiles	88%	55%	33%	63%	38%
95–99th percentiles	92%	53%	31%	58%	33%
Top 1%	93%	49%	28%	52%	30%
Top 0.1%	94%	44%	27%	47%	29%

Source: Tax Policy Center Microsimulation Model (version 0319-2).

Note: AGI = adjusted gross income. Table excludes dependent tax units. Tax units with negative income are excluded from income categories but included in the total. Estimates of giving by non-itemizers are based on survey data. For someone in the first quintile with say, $10,000 of AGI, $101 of giving would put them above the 1 percent floor. The accuracy of survey data, particularly for relatively small amounts of giving, is much less than the accuracy of administrative data, from which more of the estimates at higher income levels are derived.

ALTERNATIVE UNIVERSAL DEDUCTION PROPOSALS

Partly because the TCJA reduced the number of households itemizing and thus reduced the number of households with a tax incentive to make charitable contributions, interest has resurged in broadening the subsidy for charitable contributions beyond those households that itemize. Allowing contributions to be deducted regardless of itemization status would introduce a new tax incentive both for many who have never itemized and for those who no longer itemize as a result of the TCJA. But offering a broad universal deduction to all taxpayers with a positive income tax liability is far from a perfect tax incentive. Without refinement, we estimate that such a proposal would have lowered federal revenue by about $27 billion in 2019.

Two factors make a completely universal deduction especially inefficient at generating more charitable output for the beneficiaries of charities.

1. Most of this revenue loss comes from giving a tax deduction to current nonitemizers for tens of billions of dollars of contributions that would have been given even without the new incentive. For a person giving away $2,000 in absence of any incentive, for instance, a universal deduction would provide a tax benefit for that initial $2,000 worth of giving, not just for the increase in giving above $2,000.

2. Second, the new deduction would grant a significant tax break to many current itemizers who can already deduct charitable contributions. A substantial number of taxpayers who already make use of a deduction can simply give away the same amount, switch to the standard deduction, and reduce their income taxes. For example, take a couple with $150,000 of taxable income, $4,000 in contributions and $22,000 in other deductions. Under 2020 tax law, they would minimize their taxes by itemizing because the $26,000 of itemizable deductions exceeds the standard deduction of $24,800. Under a system that allowed all households to deduct their charitable contributions without itemizing, this couple could now minimize their 2020 income taxes by taking the standard deduction of $24,800 and further deducting $4,000 of charitable giving with the new charitable deduction. In that case, total tax deductions equal $28,800 rather than $26,000, thus lowering their income tax liability.

There are two primary types of limits on the potential deductibility of contributions: floors and ceilings. A floor can be put on the deduction, meaning that only contributions above a certain specified amount can be deducted from taxable income. For example, if a household contributes 2.3 percent of their AGI and there is a 2 percent floor, the household may deduct contributions equal to 0.3 percent of their AGI. If the household would have contributed more than 2 percent of their AGI absent the deduction, the advantage of the floor becomes clear: it provides an incentive to the household to make additional contributions without providing a tax reduction for many of the contributions that would have been made in any case.

In theory, the maximum increase in contributions at the minimum cost could be achieved if a different floor could be set for each household at exactly how much they would contribute absent any tax incentive. Of course, no such knowledge is available, but setting the floor as a percentage of AGI is a practical alternative. It maintains incentives for contributions above the floor (a larger share of which would tend to be marginal) and it removes incentives for those contributions more likely to be made regardless of any incentive. A percentage-of-income floor, as opposed to a flat dollar floor, tends to be much more progressive as well.

The other type of limit is a ceiling. As an example, the CARES Act allows a tax deduction for contributions made by nonitemizers in 2020 up to a $300 ceiling. Although this provides little incentive to make new contributions and invites fraudulent reporting of small donations that would almost never be audited, its low level sharply limits both overall revenue cost and the opportunity for itemizers to claim the new charitable deduction and switch to the standard deduction. Another recent proposal would allow nonitemizers to deduct contributions up to one-third of the standard deduction (commonly but incorrectly described as allowing up to $4,000 in deductions for single taxpayers and $8,000 in deductions for married taxpayers filing jointly). This proposal is more costly in terms of forgone federal revenue than the $300 limited deduction in the CARES Act. Accordingly, it will incentivize more giving, but it still concentrates much of the total revenue loss on gifts that would be made anyway, especially among those who typically give more than the ceiling amounts.[9]

Although both floors and ceilings limit costs, a ceiling tends to hurt charitable recipients much more because it incentivizes fewer contributions per dollar of revenue loss. In fact, for those households contributing at or near the ceiling and currently using the standard deduction, a more universal deduction with a ceiling could provide a significant tax cut while offering little or no incentive to make additional contributions. If a universal deduction with a ceiling were to replace the ability to itemize deductions, it could reduce charitable giving altogether even if total tax subsidies rise. If offered as an option on top of itemization, as noted, many households who currently itemize would see a tax cut from switching to nonitemizer status without any change in their incentive to contribute.

[9] Note that an overall ceiling has long applied over the past half-century at very high levels. Legislation in 1969 set the ceiling at 50 percent of AGI for cash and ordinary contributions. It was raised temporarily to 60 percent in 2017 legislation and then, for 2020 only, to 100 percent in the CARES Act.

ANALYSIS

We analyze options for extending a deduction to nonitemizers through a single, universal replacement of itemized charitable deductions. These options include a universal deduction for all charitable contributions, a universal deduction with a floor equal to 1 percent of AGI, a universal deduction with a floor equal to 2 percent of AGI, and a deduction for nonitemizers capped at one-third of the standard deduction. We also develop a universal deduction with the floor set to a level where the revenue loss is close to zero. We examine these options for 2019 (to represent an economy for a typical year), but we also discuss the type of revenue-neutral floor that would apply if Congress were to restore some of the tax subsidies provided under the law in effect before the TCJA was enacted. The restoration issue will arise when Congress addresses what to do about the individual income tax provisions, many of which affect charitable giving, that expire after 2025 under the TCJA.

Changes in Contributions and Revenues

The universal deduction clearly provides the largest increase in giving relative to alternatives with floors or additional caps, but it does so at the greatest revenue cost (figure 3). We estimate that in 2019 the deduction would have increased funds for charitable recipients through higher contributions by $8.7 billion, at a federal revenue cost of $27.1 billion that year.[10] Even if we double the extent to which taxpayers respond to the incentive, the increase in contributions would still be significantly less than the revenue cost. Regardless of the incentive effect, the proposal forgoes substantial sums of revenue in subsidizing the contributions of those itemizers who reduce their income taxes by switching to the standard deduction, while still taking the full amount of their charitable deduction but no longer as an itemized expense.

A universal deduction that applies to contributions above 1 percent of AGI both generates fewer contributions and costs less in terms of forgone tax revenue. Although we estimate that a proposal along these lines generates about 25 percent less in contributions, it costs only one-third as much as the universal deduction proposal with no floor. This universal deduction with a floor offers a new incentive for nonitemizers who would give 1 percent or more of their AGI to charity, paid for in part by removing deductions for gifts up to 1 percent of AGI for itemizers. The floor not only reduces costs substantially but also significantly enhances progressivity.

We can also look at these numbers in reverse order by viewing the gains achieved by removing a floor from a universal deduction. Eliminating a floor of 1 percent raises charitable contributions by only about $2.2 billion ($8.7 billion minus $6.5 billion) at a cost of $17.4 billion ($27.1 billion minus $9.7 billion). Marginally, eliminating the floor raises charitable giving only by about 13 cents per dollar of federal revenue loss.

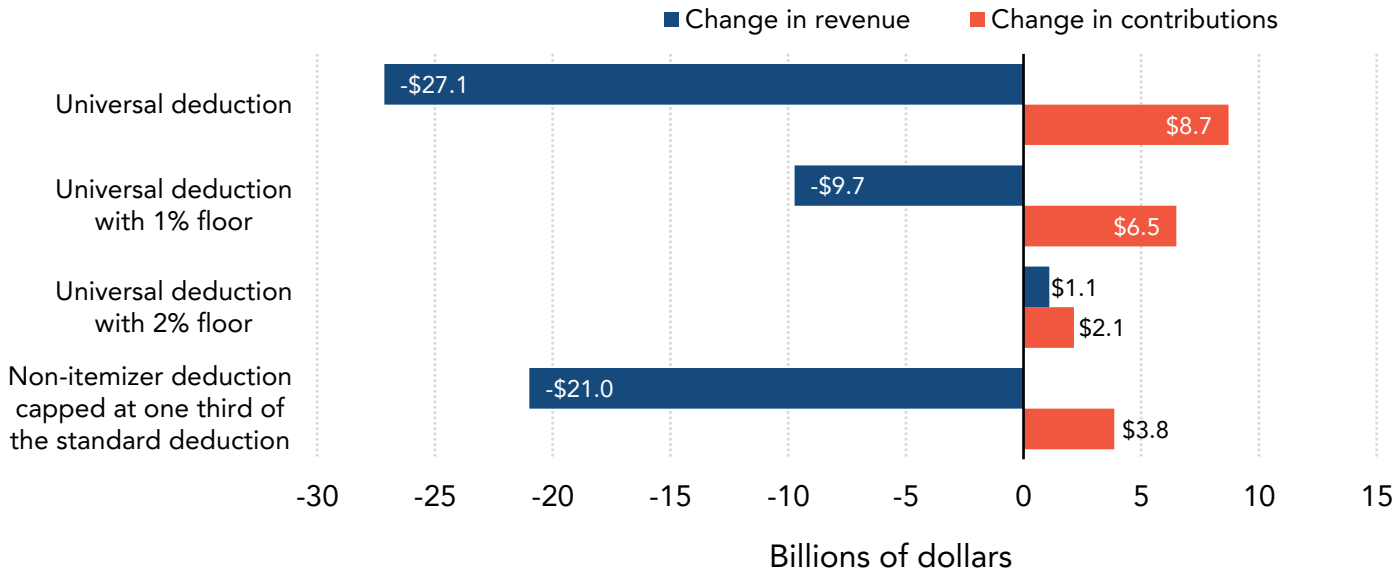
A universal deduction above 2 percent of AGI generates even less in charitable giving. We estimate that in 2019 it would have increased contributions by about $2.1 billion, less than one-third of the amount of the one percent floor. One reason for the drop in charitable giving from doubling the size of the floor is an expansion of the group receiving no incentives. For instance, even in the highest income quintile, in which the average contributions for itemizers exceed 3 percent of AGI, there are many households contributing less than 2 percent of AGI in any given year. With a 2 percent of AGI floor, someone donating amounts equal to 1.5 percent of their AGI would no longer get a deduction for their charitable giving. However, because the proposed floor of 2 percent of AGI reduces or eliminates the subsidy for giving for many households, it would actually raise revenue compared with current law.

[10] These values differ slightly from those in a Tax Policy Center chartbook (McClelland et al. 2019), "Tax Incentives for Charitable Contributions" (e.g., the universal deduction was predicted to reduce revenue by $26.7 billion and increase contributions by $9.2 billion) for two reasons. First, McClelland and colleagues' chartbook predictions are for 2020 rather than 2019. Second, their chartbook did not explicitly account for how changes in charitable contributions would affect overall federal income tax revenues.

A deduction for nonitemizers capped at one-third of the standard deduction would cost more than $20 billion dollars a year, according to our estimates, while increasing contributions by less than $4 billion. Again, it offers no new incentive to generous nonitemizers already giving more than one-third of the standard deduction. Remember that the most generous givers are the ones most likely to respond to incentives, so this structure reduces the tax incentives for charitable donations for those most inclined to give.

FIGURE 3

Change in Revenue and Charitable Contributions by Proposal, 2019



Source: Tax Policy Center Microsimulation Model (version 0319-2).
Note: Assumes the elasticity of charitable giving is -0.5

Proposal with a Revenue-Neutral Floor

We estimate that a universal deduction with a floor of 1.9 percent of AGI would be approximately revenue neutral relative to 2019 law and would raise charitable giving by about $2.5 billion a year. If revenue neutrality had been sought under the pre-TCJA law, a revenue-neutral floor would have been a smaller percentage of AGI than it would be today. After all, the provision of a more universal deduction would have increased incentives for a smaller set of nonitemizers under that older law. Indeed, we estimate that a floor of 1 percent of AGI in 2017 would have led to an increase in charitable contributions in excess of the revenue loss. Therefore, the revenue-neutral floor relative to that law would be less than 1 percent of AGI.

Many of the 2017 changes in the tax law are scheduled to expire after 2025. At that point, the level of floor that would achieve revenue neutrality could fall anywhere in these ranges. That is, the question arises, "revenue neutral with respect to what?" Those seeking restoration of the incentives provided before 2017 could also note that that an incentive made available to almost all taxpayers who give more than a modest amount would have a greater symbolic impact—and certainly more marketing potential—than one, as in 2020's CARES Act, that concentrated new incentives on a very small segment of the population (only those who tended to give less than $300). However, as we discuss in the next section, better information reporting would be needed to deal with compliance issues associated with any large expansion in the number of taxpayers claiming a deduction.

Table 2 shows the effect of alternative charitable subsidies on government revenues, benefits that flow through charities to recipients of their services, and net tax liabilities of charitable donors. We estimate that charities and their beneficiaries received about $309 billion in 2019. Of that amount, about $266 billion came from net contributions (contributions less tax subsidies) from households, and about $43 billion came from the federal government's tax subsidies to those households. We also estimate that replacing the itemized deduction with a universal deduction for contributions greater than 1.9 percent of AGI is about revenue neutral. This proposal would generate about an additional $2.5 billion for charities and their beneficiaries and a change in federal revenues close to zero (about $0.3 billion). Note that the main effect of a universal deduction with no floor is to give a tax benefit to taxpayers, who garner about two-thirds of the revenues forgone. Charitable beneficiaries get only about one-third. With a nonitemizer deduction capped at one-third of the standard deduction, taxpayers garner about 82 percent of the revenue loss and charitable beneficiaries only about 18 percent.

TABLE 2

Effect of Charitable Subsidies on Net Income

Under current law and proposals, 2019

	Government	Charities and their beneficiaries	Charitable donors
Current law	-$42.5	$309.1	-$266.6
Change from proposals to replace the itemized deduction for charitable contributions			
Universal deduction	-$27.1	$8.7	$18.4
Universal deduction for all giving above 1% of AGI	-$9.7	$6.5	$3.2
Universal deduction for all giving above 2% of AGI	$1.1	$2.1	-$3.2
Non-itemizer deduction capped at one third of the standard deduction	-$21.0	$3.8	$17.2
Universal deduction for all giving above 1.9% of AGI	$0.3	$2.5	-$2.8

Source: Tax Policy Center Microsimulation Model (version 0319-2).
Note: AGI = Adjusted Gross Income.

The distribution of the tax reduction among households also varies for the different universal deduction proposals. Table 3 compares the proposal with no floor to the proposal with a floor of 1 percent of AGI. The table shows the change in contributions and the average change in income taxes for households in each of five income quintiles, and separately it breaks out contributions and average change in taxes for groups of households within the top quintile.

The main thing to notice is that the universal deduction proposal provides the largest average subsidy to taxpayers in the top quintile, $570 on average, when there is no floor. With a floor of 1 percent of AGI, on the other hand, fewer taxpayers switch from itemizing to taking the standard deduction, and there is a reduction in the amount of donations eligible for a deduction by already itemizing taxpayers. As a result, the average tax reduction for that group falls to $20.

This table also reminds us that most households in the first or second income quintiles do not pay positive amounts of income tax in any given year and that a share also do not report giving to charities; therefore, the net change in revenues and contributions for these lower-income households are small under almost any universal deduction proposal. With a floor, the changes in taxes and contributions tend to concentrate in the third and fourth quintiles of the income distribution.

TABLE 3

Distribution of Changes in Tax and Charitable Giving Under Universal Deduction Proposals

2019

Expanded cash income quintile	Universal Deduction		Universal Deduction with 1% AGI Floor	
	Change in total contributions ($ billions)	Average tax change ($)	Change in total contributions ($ billions)	Average tax change ($)
Lowest quintile	$0.0	*	$0.0	*
Second quintile	$0.4	-$30	$0.4	-$20
Middle quintile	$1.5	-$110	$1.5	-$70
Fourth quintile	$2.8	-$260	$2.6	-$160
Top quintile	$4.0	-$570	$1.9	-$20
All	$8.7	-$150	$6.5	-$50
Breakdown of top quintile				
80th–90th percentile	$1.9	-$470	$1.6	-$250
90th–95th percentile	$1.0	-$570	$0.8	-$220
95th–99th percentile	$0.6	-$650	$0.1	$40
Top 1 percent	$0.5	-$1,250	-$0.6	$3,320
Top 0.1 percent	$0.2	-$3,240	-$0.2	$17,000

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0319-2).

Note: AGI = Adjusted Gross Income. Proposals would replace the itemized deduction for charitable contributions with a universal deduction for all contributions and all contributions above 1% of AGI, respectively.

Other Options for Improving a Charitable Deduction

In this study, we have emphasized the importance of the federal government getting the maximum amount of services to beneficiaries of charitable organizations for the revenues forgone. After all, that is one of the main purposes of a charitable incentive. In addition to the adoption of a floor, however, two other options should be considered as add-ons to the proposals, especially if the charitable deduction is made more universal.

First, taxpayers could be given the option of making charitable contributions up to the date of filing their income tax returns, or April 15, whichever comes first. Congress has offered this option to those making deposits to individual retirement accounts, and the House of Representatives passed this type of provision in the America Gives More Act of 2014. This timing option makes almost no difference in terms of incentive, but there is strong evidence that the provision would prove an effective marketing tool.[11]

When people file their tax returns, they can easily see how much an additional donation can reduce their income tax liability. As opposed to thinking that the incentive is roughly equal to their average tax rate, they would learn from their

[11] Eugene Steuerle, "An April 15 Deadline for Charitable Giving Would Be a Boon to Nonprofits" *Chronicle of Philanthropy*, December 8, 2014, https://www.philanthropy.com/article/An-April-15-Deadline-for/152105.

tax preparer or tax software that an extra $100 would yield a tax saving of, say, $25 if the tax bracket on their last dollars of taxable income equaled 25 percent.

The cost of this provision in terms of forgone revenue is proportional to the increase in giving. If the average tax rate on additional contributions is 25 percent, then 25 cents of additional revenue cost comes with an additional dollar of additional giving. Contrast that four-to-one ratio with those shown previously for other proposals, where many proposals provided a ratio of less than 1:1.

Second, to avoid the threat of widespread tax cheating, Congress should consider adopting a provision for electronic reporting of charitable contributions to the IRS. Tax gap studies through the years have consistently demonstrated that third-party reporting significantly raises voluntary compliance. For instance, a significant increase in compliance for interest and dividends occurred once they became subject to an information reporting system. The net misreporting percentage for items such as capital gains, for which there is some incomplete reporting to IRS on forms 1099, is about 17 percent, whereas the net misreporting rate for items for which there is little or no information reporting is 55 percent (Johnson and Rose 2019.)

We have little idea how much charitable contributions are misreported, but we do know that the IRS audited only about 0.6 percent of tax returns in 2018 (IRS 2020a), almost inviting cheating. Even if the IRS were to audit everyone, the agency has almost no capability of checking up on all claims of small contributions.

Although some charities might be averse to the administrative cost of reporting, in theory most keep track of contributions already because taxpayers must have records for each contribution of $250 or more. And charities routinely thank donors for the amounts contributed. Some charities might well be willing to exchange such a reporting requirement for the adoption of a universal deduction or credit with the more modest floor that could be financed with the improved compliance. Charities should also recognize the threat of a non-administrable deduction not just to government revenues but to their own reputation and, more broadly, to societal respect for the rule of law.

Congress can also consider other limits, such as tackling the equity and compliance issues with many in-kind charitable contributions—a concern that would grow even larger with a more universal deduction. For the April 15 deduction previously noted, Congress might simply confine the option to cash contributions reported to IRS electronically.

Of course, in trying to help charitable recipients, Congress must also think beyond the tax system to options to provide direct spending support to charities. In this case, each dollar of revenue spent provides one dollar of services to charitable beneficiaries.

CONCLUSION

This study has shown how the money spent on a charitable incentive can significantly increase the goods and services provided to charitable beneficiaries per dollar of revenue forgone if attention is given to the efficiency and fairness of each dollar of subsidy. Primary among such efforts are using floors and avoiding low dollar caps. Closely tied to such an effort should be consideration of a better information reporting system. The enhanced revenues from better compliance could be devoted to an enhanced charitable incentive. Yet another option involves allowing deductions for the previous tax year up to the time of filing, perhaps only in cash and with electronic reports to the IRS; this option can produce very high levels of contributions per dollar of revenue cost. In contrast, forgoing tax collections to support giving below some minimum amount entails significant revenue costs, including large tax breaks to some current itemizers who simply switch to the standard deduction without increasing their giving.

A well-designed and more universal charitable incentive can send a strong signal about how we define ourselves as a society. It can have a larger effect on charitable giving than can be projected from existing statistical evidence.

Taxpayers who don't want to be seen as below average in their generosity may feel compelled to give at least above some floor amount. Tax preparers and tax software companies could promote charitable giving if made easy to market at tax filing time. Better compliance could improve the reputation of the sector. Whatever Congress decides should be done with eyes on the prize: improvements in the level and quality of giving in the building of a more generous nation.

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