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A Deduction From Charity

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President Obama's proposal to limit the tax deductibility of charitable contributions would effectively transfer more than $7 billion a year from the nation's charitable institutions to the federal government. But the high-income taxpayers affected by the rule change are likely to cut their charitable giving by as much as the increase in their tax bills, which would, ironically, leave their remaining income and personal consumption unchanged.

In effect, the change would be a tax on the charities, reducing their receipts by a dollar for every dollar of extra revenue the government collects. It is hard to imagine a rationale for taxing schools, hospitals, medical research budgets and arts organizations in this way. I suspect that the administration officials who drafted this proposal did not understand that it would have this perverse effect.

The proposed tax change would apply to married couples with incomes of more than $250,000 (and single people with incomes greater than $200,000). Under current law, such couples can deduct the value of their charitable gifts from their taxable income. While no one makes a charitable contribution to get a tax deduction, the deductibility of charitable gifts reduces the cost of giving and therefore increases the amount that individuals give.

Consider: A high-income person paying taxes at a 35 percent marginal rate lowers his tax bill by 35 cents for every dollar that he contributes to a charitable organization. The net cost to the individual is 65 cents for every dollar received by the charity. A substantial body of economic research shows that, on average, each 10 percent reduction in the cost of giving raises the amount that a person gives by about 10 percent. So, the 35 percent reduction implied by current deductibility rules raises the amount of charitable giving by about 35 percent.

The administration's plan would limit the amount that high-income individuals could deduct to 28 percent of their gifts, down from 35 percent, even though their incomes would still be taxed at a higher marginal rate. This raises the cost per dollar of giving from 65 cents to 72 cents, an increase of 10.8 percent that can be expected to reduce the total giving of these donors by about 10 percent.

What would this mean in practice? Suppose someone would give $10,000 to a university if that amount were deductible at 35 percent. That deduction would reduce the individual's tax bill by $3,500. Limiting the deduction to 28 percent would lower the individual's tax saving on a $10,000 gift to $2,800.

This is where things get interesting: If the 10 percent increase in the cost of giving caused the person to reduce his gift by 10 percent, to $9,000, his tax savings would be 28 percent of $9,000, or $2,520. The government's revenue loss would be reduced by $980 (from $3,500 to $2,520). The person's gift to the university would be reduced by $1,000, almost the same amount. Since this high-income person would

pay $980 more in taxes but give away $1,000 less, he would end up with an extra $20 for personal consumption.

This is a hypothetical example, but the responsiveness of giving and tax revenue reflects the evidence regarding how people respond to changes in tax rates. The congressional Joint Committee on Taxation estimated that in 2007 the charitable deductions of those with incomes over $200,000 reduced government revenue by some $23 billion. If the 28 percent limit had been in effect that year, the $23 billion would have been cut by about $6.5 billion, and charitable giving would have been reduced by an approximately equal amount.

By 2011, the year in which the Obama administration proposes to start the new tax rule, the projected decrease in giving would surpass $7 billion. With the endowments of charitable institutions sharply reduced by the fall in stock prices, this loss of gifts would make an already bad situation worse.

Many tax features of the Obama budget should be changed to stimulate the near-term recovery of demand and to strengthen long-term incentives for productivity and growth. But the proposed tax on charitable gifts hits at the foundation of our pluralistic society. The administration should recognize its mistake and withdraw this proposal.

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