TAX POLICY AND CHARITABLE CONTRIBUTIONS

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The intersection of tax policy and charitable contributions is a subject of immense social importance in the United States. Philanthropic activity and the nonprofit sector are unusually large and of great consequence in supporting activities that include medical and other scientific research, education, the arts, the environment, the poor, and organized religion. The most consequential government actions regarding this sector are tax policies: the charitable contribution deduction from income and estate taxation and tax-exempt status for nonprofit operations and endowments. Much research and advocacy has addressed many issues in this domain.

The central subject to be explored in this paper is one that has been almost entirely neglected: How does favorable treatment of philanthropy fit into the framework for optimal income taxation that has been developed over the past half century? Systematic examination of charitable giving using this framework generates fresh insights and calls into question some important features of conventional wisdom. Given the richness and complexity of this subject, the analysis is far from comprehensive, but it offers a useful complement to other lines of research.

To give a flavor of some of the analysis to be presented, consider the following sequence, moving from the specific to the general. First, observe that charitable giving is a species of giving, the most prevalent form involving gifts within families, often flowing from parents to children. There are several differences, which will be highlighted, but there are also many similarities, and the subject of private voluntary transfers has received a great deal of attention, particularly in recent decades, including from an optimal income tax perspective. Hence, one would like to leverage that work to better understand optimal policy toward charitable giving.

Next, any form of giving is but one of many ways that individuals can spend their disposable income. As an aside, much income is saved, but those savings are ultimately spent or bequeathed, and much charitable giving is from savings or through bequests. Stepping back, the different uses of disposable income have themselves been a subject of study in the field of optimal taxation. Starting with Ramsey, the possible optimality of differential taxes and subsidies has been examined. In the last half century, however, much work links this question to the optimal income tax framework, the seminal contribution being Atkinson and Stiglitz (1976). There are also extensions regarding expenditures that involve externalities, which is a central issue with charitable giving. Once again, it seems useful to use the teachings of these bodies of research to better understand optimal policy toward charitable giving.

The key advance in this literature is the explicit integration of differential taxation – and subsidization – of different forms of expenditure with Mirrlees (1971) optimal income tax framework. As one traces through each of the foregoing steps, as this investigation will so (in a nontechnical manner), one should expect that most effects that arise along this path, and the analysis thereof, will prove to be relevant. And indeed, that is the case.

But this exploration will do much more than identify many pieces of the puzzle, some of which are new or have different shapes from the familiar ones. Instead, the aim will be to create a synthesis that enables analysts to focus on the most distinctive features of charitable giving, but understood in the context of this general optimal income taxation framework.

One lesson from such a project is that it turns out to be most useful to separate the redistributive features of the subsidization (if any) of charitable giving from the effects of giving as such and the activities of the organizations that are funded. The core reason is that one can adjust the overall income tax and transfer system to neutralize the distributive effects of either more or less generous charitable provisions, which implies that optimal overall policy toward philanthropy is largely independent of distributive concerns. (But not entirely, because of distributive concerns relating to the circumstances of beneficiaries.)

Another indication of the difference in perspective can be seen from considering empirical work that has studied the elasticity of charitable giving with respect to how the charitable deduction changes one's taxes owed, an inquiry launched in particular by Boskin and Feldstein (1977). A common benchmark is that the deduction is efficient if and only if this elasticity exceeds one. Yet, in analysis that embeds the deduction in an optimal income tax framework, the result for optimal treatment in the most basic model does not even have this elasticity in the formula. In modern parlance, not only is it not a sufficient statistic for welfare analysis; it is not even relevant. Going further, if one relaxes the most pertinent assumption, in which case the elasticity does matter, the sign of the effect is a priori ambiguous: that is, a higher elasticity may well favor a lower rather than a higher subsidy rate.

Embedding the standard policy question regarding the optimal subsidization of charitable giving in an optimal income tax framework delivers important lessons. Although this analysis does not cover all policy-relevant considerations, it does offer a substantial complement to our existing understanding of tax policy in this important realm.