



The FairTax and Charitable Giving

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Table of Contents

Executive Summary	3
I. Introduction	5
II. Background on Charitable Giving and Taxes	5
A. Sources of Charitable Gifts	5
B. Program Service Revenue	5
C. Earned Income from Investments	6
D. Gifts by Corporations, Government, and Individuals	6
III. The Concepts and the Literature	7
A. Price of Giving	7
B. The Price of Volunteering	9
C. Altruistic vs. Non-Altruistic Motivations	10
D. Price Effect and Income Effect	10
E. Charitable Giving by the Wealthy	13
IV. Charitable Giving and the Value of Charitable Giving under the Fair Tax	13
A. Non-Itemizing Scenario	14
B. Itemizing Scenario	15
V. The Beacon Hill Institute Model of Charitable Giving	16
A. How the BHI Model Works	16
B. Analysis of Results	17
VI. The FairTax's Effect on Distribution of Giving to Various Charities	20
A. Current Recipients of Charitable Giving	20
B. Recipients of Charitable Giving Under the FairTax	20
VII. Volunteering	22
A. Voluntarism Statistics	22
B. Who Volunteers and Why?	23
C. Voluntarism and the FairTax	24
VIII. Conclusions	25
References	27

Table of Tables and Figures

Table 1. Source and Allocations of Private Philanthropy (\$ billions)	6
Table 2. Effects of ERTA81 and TRA86 on Income and Price Elasticities	12
Table 3. Tax Deductibility of Charitable Contributions for Non-Itemizing Taxpayers, 1982 - 1987.	12
Table 4. 2007 Estimates of Rates and Shares	14
Table 5. Ted's Price of Giving	15
Table 6. Fred's Price of Giving	16
Table 7. Estimates for BHI Charitable Giving Regression	17
Table 8. 2007 Giving Changes Breakdown (\$ billions)	18
Table 9. Increase in Charitable Giving by Households due to the FairTax, Relative to Baseline Counterfactual using -1.674 Average Price Elasticity	18
Table 10. Robustness of Results: Increase in Giving Relative to Base Counterfactual using Different Coefficients on the Price of Giving.	19
Table 11. Robustness of Results: Increase in Giving Relative to Base Counterfactual using Different Income Growth Rates.	19
Figure 1. Charitable Giving by Charitable Organization Recipients, 2004	20
Table 12. Predicted Giving by Category, 2007	21
Table 13. Predicted Giving Shares by Category and Distributions, FairTax 2007	22
Figure 2. Share of Volunteer Hours by Type of Charitable Organization, 2004	23
Table 14. FairTax Effect on Giving Summary, 2007	25

Executive Summary

The U.S. federal tax code has undergone major changes since the last important attempt at tax simplification in 1986. The result is over 60,000 pages of tax code, rules, and rulings that can confuse even the most adept tax professionals.

As Congress continues to consider reforming the federal tax system, several groups and legislators have stepped forward with proposals. The FairTax plan is one such proposal. Essentially, the proposal seeks to replace most current federal taxes with a national retail sales tax. In 2007, Representative John Linder introduced legislation in the form of H.R. 25, the Fair Tax Act of 2007.¹ Senator Saxby Chambliss is expected to introduce companion legislation in the Senate, as he did in the previous Congress.

How would a consumption tax-based plan like the FairTax affect taxpayer behavior, particularly those who itemize a charitable giving income tax deduction on their tax return? According to *Giving USA*, charitable contributions totaled \$240.7 billion in 2003.² Of this amount, according to one report, 61 percent or \$145.7 billion was claimed by the 30 percent of individual taxpayers who itemized deductions on their 2003 federal tax returns.³ Would H.R. 25, which calls for the elimination of the federal income tax, discourage charitable giving when taking away a popular deduction?

Charitable organizations play an essential role in the economic system. The work of these organizations helps sustain cultural, educational, and social institutions that benefit all citizens, particularly the poor. Individuals practice charitable giving in part because of a “warm glow” associated with helping the poor or for religious reasons, as a sacrifice on behalf of the Church and its mission. Economic incentives also play a role. Under the current tax system, some donors reap tangible benefits for charitable giving.

A dramatic change to the tax code, such as the FairTax, may have a significant effect on charitable giving. Many taxpayers and the charitable organizations they support are anxious over the fact that the FairTax would eliminate the federal income tax and associated deductions for charitable giving.⁴ They fear that the FairTax would cause a decline in charitable contributions and threaten the viability of many nonprofit organizations.

To address the question of how the introduction of the FairTax would affect charitable giving, we consider its effects on the behavior of taxpaying donors to charitable organizations. The individual taxpayer/donor can donate time, money, or goods to charity. For most of our analysis, we consider that monetary donations are financed by wages, i.e., proceeds from work.

We divide the donor’s choice calculus into two parts: first, the decision whether to volunteer or to work and donate the proceeds of work; and, second, the decision whether to donate the proceeds of work directly to charity or to buy a good and give the good to charity. The first decision hinges on the effect of the FairTax on the price of volunteering and the second on the price of giving. Owing to the paucity of data on volunteering, we present estimates that are

¹ In the 109th Congress the bills were H. R. 25 and S. 25. In the 110th Congress the Fair Tax Act is H. R. 25 in the House but as of February 1 was not yet reintroduced in the Senate.

² American Association of Fundraising Counsel (2004).

³ Parisi and Hollenbeck (2005).

⁴ Clotfelter and Schmalbeck (1996): 237. The authors examine the effects of a business-transactions tax on nonprofits’ ability to deliver services at past levels.

limited to how the FairTax would affect income and the price of giving and how changes in both would affect the amount of giving.

If giving is a “normal good,” in economic terms, then people will give more the greater their real income. People will also give more the lower the price of giving and the higher the price of volunteering.

If we separate these effects and consider only the price of giving, we find that adoption of the FairTax would have mixed results. As the tax incentives for those in the highest marginal tax brackets decrease, their giving decreases as their price of giving rises. On the other hand, for the majority of taxpayers (those who currently do not itemize or those who fall into the lower tax brackets), the price of giving would decrease under the FairTax. The decrease in the price of giving would therefore cause the majority of taxpayers to increase their giving.

Ignoring changes in incomes, charitable giving under the FairTax would decrease by 5.24 percent in the first year. However, several studies show that the FairTax would increase GDP, and thus real income.⁵ The effect of this rise in real income would more than offset the negative effect of the price change. When the effect of the increased income is combined with the effect of the increased price of giving, our analysis shows that charitable donations would increase under the FairTax by 0.89 percent immediately, by 2.40 percent within 10 years of its introduction, and by 4.99 percent after 20 years. This analysis is based on the comparison of a baseline scenario of no FairTax (or the continuation of the current tax regime).

It is important to note that while *total* charitable giving would increase under the FairTax, this increase would not be distributed proportionately across charitable organizations. As a result of differences in preferences for type of charitable organizations between itemizers and non-itemizers, religious charities stand to gain under the FairTax, while education, health, and cultural charities stand to suffer a small loss.

In our analysis of the effect of the FairTax on charitable giving, there is a further question concerning the importance of charitable giving to charitable organizations. In summary, we find the FairTax would not decrease charitable giving. To the contrary, the FairTax would serve to increase charitable contributions, subsequently strengthening the vitality of the charitable organizations that play such an important role in U.S. society. This increase would be based on the fact that among its benefits, the FairTax would increase income and generate more giving.

⁵ The following research estimates the macroeconomic effects of moving from the current federal income tax system to a broad-based consumption tax, such as the national retail sales tax plan called for by HR 25: Laurence J. Kotlikoff and Sabine Jokisch, “Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax,” NBER Working Paper 11858, December 2005; Arduin, Laffer & Moore Econometrics, “A Macroeconomic Analysis of the FairTax Proposal, Final report to Americans For Fair Taxation, July 2006; David G. Tuerck and Jonathan Haughton, “The Economic Effects of the FairTax: Results from the Beacon Hill Institute CGE Model,” The Beacon Hill Institute at Suffolk University, (February 2007); Alan Auerbach, “Tax Reform, Capital Allocation, Efficiency, and Growth,” *Economic Effects of Fundamental Tax Reform*, Henry Aaron and William Gale, eds. (Washington: Brookings Institution Press, 1996), p. 58; Michael Boskin, “A Framework for the Tax Reform Debate,” testimony before the Committee on Ways and Means, U.S. House of Representatives, June 1, 1995; Dale W. Jorgenson, “The Economic Impact of the National Retail Sales Tax,” May 1997; Laurence J. Kotlikoff, “The Economic Impact of Replacing Federal Income Taxes with A Sales Tax,” *Cato Institute Policy Analysis* 193, April 15, 1993; Laurence J. Kotlikoff, “Replacing the U.S. Federal Tax System with a Retail Sales Tax – Macroeconomic and Distributional Impacts,” Report to Americans For Fair Taxation, December 1996; Gary and Aldona Robbins, “Looking Back to Move Forward: What Tax Policy Costs Americans and the Economy,” *Policy Report* 127, Institute for Policy Innovation, (September 1994); Joint Committee on Taxation, “Tax Modeling Project and 1997 Tax Symposium Papers,” JCS-21-97, November 20, 1997.

I. Introduction

The U.S. federal tax code has undergone major changes since the last important attempt at tax simplification in 1986. In subsequent years, Congress has enacted legislation to raise and then lower income tax rates, reduce the tax rates on capital gains and dividends, increase deductions for IRA contributions, create Roth IRAs and medical savings accounts, increase the earned income tax credit for the working poor, and make other changes. The result is over 60,000 pages of tax code, rules, and rulings that can confuse even the most adept tax professionals.

With the prospect of federal tax reform continuing to be a major issue, several groups and legislators have proposed alternative plans. The FairTax plan is one such proposal. It aims to replace most current federal taxes with a national retail sales tax. In 2007, Representative John Linder filed legislation in the form of H.R. 25, the Fair Tax Act of 2007.⁶ Senator Saxby Chambliss is expected to introduce companion legislation in the Senate, as he did in the previous Congress.

The purpose of this report is to assess the impact that the FairTax would have on charitable giving. An important question arises over the effect that the FairTax would have on the behavior of taxpayers who currently deduct charitable giving on their income tax returns. In 2003, individual taxpayers claimed \$145.7 billion in charitable deductions on their federal tax returns.⁷ Would the elimination of the federal income tax, as mandated by H.R. 25, discourage charitable giving currently encouraged by the existing tax code?

II. Background on Charitable Giving and Taxes

A. Sources of Charitable Gifts

Charitable organizations account for an important share of U.S. economic activity. The gross value added provided by charitable organizations that serve households accounted for almost 6 percent of U.S. national income in 2004.⁸ Charitable organizations are widely acknowledged for their role of filling gaps in the provision of goods and services not provided by government or the for-profit sector. These include health, cultural enrichment, and educational programs. Charitable organizations draw funds from a number of different sources; among them are program service revenues and income from investments, as well as contributions by private individuals, corporations, and government.

B. Program Service Revenue

In 2002, program service revenue accounted for 72 percent of revenue for charitable organizations.⁹ This represents an increase from 1995, when program service revenue accounted for 67 percent. Program service revenue is comprised of fees collected from the programs, services, and other activities conducted in support of a charitable organization's tax-exempt purposes. Familiar examples of program service revenue include tuition and fees at schools and

⁶ In the 109th Congress the bills were H. R. 25 and S. 25. In the 110th Congress the Fair Tax Act is H.R. 25 in the House. As of February 12, 2007, it has 54 sponsors and co-sponsors but the bill has not yet been reintroduced in the Senate.

⁷ Parisi and Hollenbeck (2005).

⁸ Freeman (1997): 140-166. The 2004 figure was calculated by dividing NIPA Table 1.35, line 7 by NIPA Table 1.13, line 1.

⁹ Arnsberger (2005): 263-272.

admission charges at museums. In general, nonprofit organizations increase their reliance on program service revenues as they grow larger. In turn, program service revenue has become a more important source of revenue to charitable organizations. In tax year 2002, nonprofit charitable organizations reported a total of over \$691.3 billion in program service revenue to the IRS.¹⁰ In 1995, program service revenue was \$413.3 billion.¹¹

C. Earned Income from Investments

Charitable organizations also rely on earned income from investments as a source of funds to support their activities. As organizations grow in size, they also tend to rely more on investment income and less on contributions.

D. Gifts by Corporations, Government, and Individuals

While corporations often make a big splash with widely publicized charitable gifts, the aggregate amount of charitable gifts by corporations is small relative to other sources.

In 2002, charitable giving totaled \$234.1 billion, with corporations and corporate foundations accounting for 6 percent and 12 percent of that total, respectively.¹²

Donor by Type	1995	%	2002	%
Individuals	95.4	77%	175.0	75%
Foundations	10.6	9%	27.0	12%
Corporations	7.4	6%	12.9	6%
Charitable bequests	10.7	9%	19.2	8%
Total Funds	124.0		234.1	

Source: Statistical Abstract of the United States, 2007, Table 567.

Government transfers to charitable organizations increased over the decade. Government assistance accounted for 52 percent of all contributions in 2002.¹³ In 1995, government accounted for 42 percent of all contributions.¹⁴

Charitable organizations rely heavily on private contributions as a revenue source. These contributions consist of both cash and non-cash donations (i.e., donations of stock, artwork, land, etc.). Seventy to eighty percent of Americans contribute annually to at least one charity.¹⁵ The IRS Statistics of Income (SOI) Division reports that in 2003, 38.6 million filers who itemized contributed \$145.7 billion.¹⁶

Under the current U.S. income tax system, taxpayers who file itemized tax returns can deduct their charitable contributions from their taxable income (up to 50 percent of their adjusted gross

¹⁰ See Table 1 in Arnsberger (2005): 267.

¹¹ Meckstroth and Arnsberger (1998).

¹² American Association of Fundraising Counsel (2002).

¹³ Arnsberger (2005): 263-272.

¹⁴ Meckstroth and Arnsberger (1998).

¹⁵ American Association of Fundraising Counsel (2004).

¹⁶ Internal Revenue Service, Statistics of Income (2003).

income). About 30 percent of taxpayers file itemized returns. Because the remaining 70 percent do not report their charitable giving to the IRS, it is more difficult to determine the amount they contribute. One source of data on charitable giving by individuals is the Independent Sector's surveys, *Giving and Volunteering in the United States*. These surveys provide valuable and detailed information on levels of charitable giving and on demographics. However, charitable giving is probably underreported in these surveys because the incentive to recall charitable giving is weaker for a person completing a survey than it is for a person completing a tax return.

BHI estimated giving by non-itemizers in 2001 by subtracting estimated giving by itemizers from estimated total giving. The American Association of Fundraising Counsel (now the Giving Institute) reports that charitable giving by individuals in 2001 totaled about \$182 billion.¹⁷ As stated previously, the IRS reports approximately \$114 billion in charitable contributions by itemizers in 2001. If we subtract giving by itemizers from total giving, we get \$68 billion in giving by non-itemizers in 2001, representing 37 percent of the total.

Itemizing taxpayers (who generally have higher incomes than non-itemizers) make the majority of charitable contributions, yet the contributions by non-itemizers are far from negligible. This is significant in determining the effect the FairTax would have on charitable giving.

III. The Concepts and the Literature

A. Price of Giving

The economic literature on the motives for charitable giving is extensive. A central concern of this literature is the affect of policy changes on the "price" of giving, which is to say the sacrifice, somehow measured, that the individual must make to give a dollar to charity, taking into account any tax incentives for giving that may be in place. There are a number of ways to measure this sacrifice.

To illustrate the concepts it is always useful to set up a generalized and simplified economic framework, so let us do just that. Let us, for now, assume that only one product is produced in the economy: pizza. Let us also assume, for simplicity, that the only cost of production is labor and that the gross wage rate is \$15.38 an hour. Let us consider that the payroll tax rate (*PT*) is 10 percent and the marginal personal income tax rate (*MTR*) is 25 percent. We assume, for now, that the charity would spend the money it receives to buy pizza to give to the less fortunate members of society. Finally, we assume that it takes 0.65 hours to make a pizza, so the price of pizza is \$10.00.

One approach is to define the price of giving as the consumption that must be sacrificed to give \$1.00 to charity. This equals \$1.00 minus any reduction in the contributor's tax burden that results from giving \$1.00. For giving that is deductible, the reduction in the tax burden is close to \$1.00 times the individual's marginal income tax rate, because the personal income tax has a deduction for giving and, hence, there is a reduction on the burden there. Since in our example *MTR* is 25 percent and *PT* is 10 percent, a gift of \$1.00 reduces his tax burden by $\$0.25 / (1 - 0.10) = \0.28 . The taxpayer must earn \$1.11 ($= 1 / 0.10$) in order to have \$1.00 left over to give to charity after he pays the payroll tax on that \$1.11. However, if he were to use the proceeds of

¹⁷ American Association of Fundraising Counsel (2001).

that \$1.11 to buy goods, he could only buy \$0.72 worth of goods.¹⁸ This means that by donating to charity he saves $\$1.00 - \$0.72 = \$0.28$ in taxes.

Under this interpretation, the price of giving is $\$0.72 / \$1.00 = 0.72$ which corresponds to the following formula: $1 - MTR / (1 - PT)$. If giving, in the parlance of economics, is a “normal good,” then itemizers will give more the higher both their *MTR* and *PT* rates, since that would bring the price of giving down.¹⁹

Non-itemizers do not benefit from the income tax deduction that itemizers do. Therefore, to give \$1.00 to charity, they would have to sacrifice \$1.00 from consumption. Consequently, their price of giving would be $\$1.00 / \$1.00 = 1$.

A second approach measures the price of giving according to the amount a donor must receive in before-tax income in order to contribute \$1.00. This approach, in effect, measures the price of giving in terms of the amount of work in which the donor must engage in order to give \$1.00 to charity. In our example we will do it on the basis of \$10.00, which is the price of a pizza, instead of \$1.00.

If the taxpayer itemizes his deductions, then he would need to receive only \$11.11 ($= \$10.00 / 0.10$) to ensure that he could place \$10.00 in the hands of the charity of his choice, not the full gross wages of \$15.38 that he would need to consume \$10.00 worth of pizza. In effect, the taxpayer would have to work 72 percent ($= \$11.11 / \15.38) as hard to ensure that a charity has the \$10.00 that it needs to buy a pizza. So the price of giving is, again, $1 - MTR / (1 - PT)$ or 0.72.

A non-itemizer must earn \$15.38 in order to donate \$10.00 to charity. This means that the taxpayer must make the same effort as he would need to have \$10.00 for his own consumption, which means that the price of giving for non-itemizers, under current law, is 1 ($= \$15.38 / \15.38).

Finally, we can measure the price of giving as the cost of giving a dollar’s worth of goods or services to a charity. In this instance the donor is, in effect, purchasing a certain quantity of goods and services, whether it is relief supplies to the victims of a natural disaster, the services of the minister at a local church, or food and shelter for the homeless.

To follow the previous example, an hour of work would give both an itemizer and a non-itemizer \$10.00 worth of consumption of goods and services. The itemizer would be able to give \$13.84 worth of pizza to the charity, using the proceeds of one hour of work.²⁰ Hence, he would “sacrifice” \$10.00 worth of consumption for every \$13.84 he gives to charity, so his price of giving, again, is 0.72 ($= \$10.00 / \13.84). Once more, we see that for an itemizer the price of giving is $1 - MTR / (1 - PT)$. The non-itemizer can give only \$10.00 after an hour of work, since he does not get tax relief as a reward for his giving. He would, then, “sacrifice” \$10.00 worth of

¹⁸ This number is calculated thus: $\$1.11 \times (1 - 10\% - 25\%) = \0.72 .

¹⁹ Giving can be deductible at the state as well as the federal level, and state income taxes are deductible against federal income taxes. For a taxpayer who itemizes and whose marginal tax rate is 25 percent at the federal level and 5 percent at the state level, the price of giving is $\$1.00 - (0.25 + .05 - 0.25 \times .05) / (1 - 0.10) = 0.6805$.

²⁰ The number is calculated thus: $\$15.38 \times (1 - 0.10) = \13.84 .

consumption for every \$10.00 he gives to charity. His price of giving is 1. All three methods of measuring the price of giving yield the same result.

We would like to note that, because all nonprofit spending is indirectly taxed under the current system, the spending habits of these organizations will have no impact on the measure of the price of giving under current law. This is not the case under the FairTax, because the FairTax does not tax wages paid by nonprofits to their employees. When calculating the price of giving under the FairTax, the composition of spending by nonprofit organizations should be taken into account to estimate the price of giving then. In section IV, when presenting the examples of a non-itemizer and an itemizer, we estimate the prices of giving for each under current law and under the FairTax. We refer the reader to those estimations to see how we have taken into account this issue when estimating the price of giving under the FairTax.

B. The Price of Volunteering

In contrast to the price of giving, there is virtually no literature on what may be called the “price of volunteering.” The price of volunteering can be thought of as how much income a donor would have to sacrifice over how much his or her volunteering produces for the charity. In order to volunteer, the donor must sacrifice time diverted from work or leisure. The price of volunteering is different depending on whether it is work or leisure that is sacrificed.

If we consider that the individual is sacrificing work, we can consider the price of volunteering as how much the giver could provide the charity by giving the net proceeds of an hour of work (the sacrifice), relative to how much he would be able to give by volunteering one hour.

Suppose, again, that an hour of work pays \$15.38 and that it takes 0.65 hours of work to produce one pizza. Assuming, for simplicity, that there is only labor involved, this means that the price of a pizza is \$10.00 and the gross wage is \$15.38 an hour, as before.

Under the current tax system, a non-itemizer could provide only \$10.00 to the charity per hour worked, whereas if he volunteered for that hour he would be able to produce 1.538 pizzas worth \$15.38. Therefore, the price of volunteering for a non-itemizer would be 0.65, which is $1 - MTR - PT$ ($= 1 - 0.25 - 0.10$).

The itemizer, on the other hand, could provide \$13.84 to charity, since he would not have to pay the income tax on that hour worked. At the same time, if he volunteered for an hour, he would be able to produce 1.538 pizzas worth \$15.38, the same as the non-itemizer. Therefore, the price of volunteering for an itemizer would be 0.90, which is $1 - PT$.

We can see that changes in income tax rates would affect the price of volunteering for non-itemizers, but not for itemizers, since giving for them would be deductible. However, changes in payroll taxes under the current tax system would affect the price of volunteering for both. We conclude that when the price of volunteering increases, making volunteering less attractive than financial contributions, monetary donations will increase.

If we consider that the donor is sacrificing leisure instead of working effort, tax changes don't change the price of volunteering directly. This is because, in the tradeoff between leisure and volunteering, there are no taxes involved. It is just an issue of the marginal benefit that each option, volunteering and leisure, represents.

Unfortunately, it is impossible to determine whether a volunteer gives up work effort or leisure. This, together with the lack of appropriate data on volunteering by tax filers, makes it impossible to determine the effect that the FairTax would have on the price of volunteering. It, nonetheless, presents an excellent opportunity for future research.

C. Altruistic vs. Non-Altruistic Motivations

The literature distinguishes between pure altruism (a desire to contribute with no expectation of a return for a contribution) and impure altruism (a desire to contribute with the expectation of a return of some kind, tangible or intangible). Charitable contributions by non-itemizing taxpayers may be motivated more by altruism than are contributions made by itemizing taxpayers.

The distinction between pure and slightly less pure altruism is key in determining the effect the FairTax would have on charitable giving. If itemizers were purely altruistic (meaning that they would give the same amount to charity regardless of the price of giving), the FairTax would have no effect on their giving.

We can assume, however, that not all itemizers are purely altruistic in their charitable giving. When a tax law change is announced, taxpayers respond in one of two ways, depending on the nature of the change: 1) they quickly act to take full advantage of a current tax benefit that is about to expire, or 2) they “save up” for future years when the tax rules will be more beneficial. In any respect, they are tax sensitive and alert to changes in laws.

There is both anecdotal and statistical evidence of this timing on the part of itemizing taxpayers. For example, when a new administration took over the White House in 1992, high income taxpayers anticipated that the top marginal tax rate would increase. Subsequently, the Omnibus Budget Reconciliation Act of 1993 raised the rate from 31 percent to 39.6 percent. By postponing charitable contributions in 1992 and opting to wait instead for 1993, individuals in the top bracket capitalized on the lower cost of giving that came with the new, higher marginal tax rates. Data from this period support this theory: the average amount of giving for those in the top bracket fell from 6 percent of average income in 1991 to 4.4 percent in 1992, as taxpayers postponed charitable contributions they might have made in 1992 to 1993. Charitable giving then increased to 6.3 percent in 1993, demonstrating that many taxpayers in the top bracket indeed increased their tax deduction for charitable giving by moving their contributions to the tax year with the lower price of giving.²¹

This is just one example from the literature of conscious timing of charitable giving based on tax law changes, but it demonstrates the fact that itemizing taxpayers are motivated to some degree by non-altruistic (i.e., tax benefit) factors.

D. Price Effect and Income Effect

The effect of tax code changes on giving can be measured by estimating price elasticities (E_p) and income elasticities (E_i), each of which has a transitory and a persistent component. Price elasticity measures the effect that a 1 percent change in the price of giving has on the quantity of giving, and income elasticity measures the effect that a 1 percent change in income has on the quantity of giving.

²¹ Auten et al. (2002): 371-382.

A number of studies using cross-sectional data have found the absolute value of price elasticity of charitable giving to be greater than one, implying that a percentage decrease in the price of giving leads to a higher percentage increase in the quantity of giving. Others have found the value to be slightly less than one, implying that a 1 percent decrease in the price of giving leads to a less than 1 percent increase in giving. These studies suggest that the tax price is an important determinant of giving.²²

Econometric models used to determine the elasticities of giving are fairly similar throughout the literature. Typically, the models take the form of Equation (1), although use of demographic variables such as marital status varies from study to study.

$$(1) \quad \ln(CG) = E_i \times \ln(HHI) + E_p \times \ln(P_{CG}) + \gamma_1 \times \text{Dummy}(M) + \gamma_2 \times \text{Dummy}(C) + \gamma_3 \times \text{Dummy}(W) + \varepsilon$$

Here:

- CG*: Charitable giving
- HHI*: Household income
- P_{CG}*: Price of giving
- M*: Married
- C*: Children
- W*: Widowed

Using a model such as this, Laura Tiehen examined 1989 – 1991 taxpayer panel data and estimated E_p (the price elasticity of charitable giving) to range from -0.94 to -1.15 and E_i (the income elasticity of charitable giving) to range from 0.24 to 0.35.²³ These results imply that charitable giving is responsive to tax incentives. Tiehen also incorporated into her analysis data from the Independent Sector survey on self-reported motivations for charitable giving. The more tax-motivated the respondent, the higher the E_p would be. For those who report not being tax-motivated, E_p was not statistically different from zero.

In a 2001 article, Amy Broman used panel data from 1979 – 1982 to estimate E_p and E_i based on a first-differenced model.²⁴ The results of this model imply that giving adjusts to a new long-run equilibrium level within two years after a price change. In other words, while taxpayers are unlikely to make substitutions between charitable giving and other goods in the short run, they will make substitutions between charitable giving and other goods in the long run, as they take advantage of anticipated future changes in tax rates.

²² Joulfaian, and Rider (2004). The authors cite a number of studies determining price elasticities including: Charles T. Clotfelter and C. Eugene Steuerle, “Charitable Contributions,” *How Taxes Affect Economic Behavior*, Henry J. Aaron and Joseph A. Pechman, eds., (Washington, D.C.: Brookings Institution, 1981); Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* (Chicago: University of Chicago Press, 1985); William C. Randolph, “Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions,” *Journal of Political Economy* 103, no. 4 (August, 1995): 709-38; Jon Bakija. “Consistent Estimation of Transitory and Permanent Price and Income Elasticities: The Case of Charitable Giving,” Williams College, mimeo, 1999. See also Auten et al. (2002): 371-382. The elasticities cited range from -0.42 to -1.34 with income elasticities ranging from 0.67 to 1.23.

²³ Tiehen (2001): 707-723.

²⁴ Broman (1989).

Using another model and panel data from 1979 to 1990, Gerald Auten, Charles Clotfelter, and Richard L. Schmalbeck examined the effects of the Economic Recovery Act of 1981 and the Tax Reform Act of 1986 (“ERTA81” and “TRA86”).²⁵ ERTA81 and TRA86 dramatically reduced marginal tax rates for most individuals and broadened income tax brackets, particularly at the top levels. This resulted in a reduction in the number and range of brackets, and hence created a more uniform distribution of tax rates. The results are shown in Table 1. These results imply that taxes do have a permanent price effect, though not as large as reported in previous studies.

Table 2. Effects of ERTA81 and TRA86 on Income and Price Elasticities

E_p ERTA 1981	-0.52
E_i ERTA 1981	0.43
E_p TRA 1986	-0.95
E_i TRA 1986	0.41

Source: Gerald E. Auten, Charles T. Clotfelter, and Richard L. Schmalbeck, 2000.

In 2001, David Eaton used panel data to estimate elasticities of giving for non-itemizers.²⁶ As discussed previously, non-itemizers typically account for two-thirds of all taxpayers in any given year, and little data and analysis exist regarding charitable giving by non-itemizers because the IRS collects data on charitable giving only from itemizers. Eaton’s analysis was based around a five-year window in the 1980s, when tax law allowed non-itemizers to deduct charitable contributions from their income to varying degrees (Table 2).

Table 3. Tax Deductibility of Charitable Contributions for Non-Itemizing Taxpayers, 1982 – 1987.

1982 – 1983	Non-itemizers could deduct 25% of their first \$100 in charitable giving
1984	Non-itemizers could deduct 25% of their first \$300 in charitable giving
1985	Non-itemizers could deduct 50% of all charitable giving, no ceiling
1986	Non-itemizers could deduct 100% of all charitable giving
1987	Deduction for non-itemizers expired

For the period 1982 – 1986, Eaton found that non-itemizers attempted to increase their tax deduction for charitable giving by increasing their charitable giving amounts from year to year, as the tax benefit for charitable giving increased.

Finally, it is important to note that under President Ronald Reagan, the top marginal tax rate decreased from 70 percent in 1980 to 28 percent in 1986. This decrease in tax rates markedly increased the price of giving for most taxpayers. Nevertheless, charitable contributions increased dramatically during this period, from \$48.7 billion in 1980 to \$93.7 billion in 1988.²⁷ This increase in charitable contributions, which occurred despite the increase in the price of giving for itemizing taxpayers, is attributable to several causes, one being the vast economic stimulus caused by the reduction in tax rates. Taxpayers had more disposable income due to the tax cuts, of which they chose to contribute a significant portion to charities even though the tax benefit for giving was greatly reduced for many. In addition, the lower marginal tax rates allowed taxpayers, especially those who did not itemize their deductions, to keep more of their after-tax income and thus have more available to contribute to charity.

²⁵ Auten et al. (2000). See Chapter 12.

²⁶ Eaton (2001): 431- 442.

²⁷ Bailey (1988).

Other external economic factors and events contributed to the increase in charitable giving during the Reagan years. Although the U.S. experienced a major recession in the late 1970s that lingered into 1982, the economy rebounded by 1984 and entered a period of sustained growth that continued throughout the decade. Inflation fell during this period, due to a tightening of monetary policy by the Federal Reserve. The stock market soared. Despite a crash in October 1987, the Dow Jones Industrial Average (DJIA) almost tripled between 1980 and 1988. GNP grew at an average rate of 4 percent per year during this period. Finally, the U.S. created approximately 13 million new domestic jobs during this economic boom.

Reagan's tax policies contributed to a dramatic increase in wealth for Americans during the 1980s, which, despite the increased price of giving brought about by the reduction in marginal tax rates, appears to have induced Americans to increase spending – whether on charity or other goods. In summary, the Reagan years offer two important pieces of evidence regarding tax policy and its effects on charitable giving. First, Americans give more as their incomes rise, regardless of the tax benefits associated with giving. Second, a change in tax policy that spurs economic growth and, consequently, wealth creation, can lead to an increase in giving even when it increases the price of giving.

E. Charitable Giving by the Wealthy

In Chapter 12 of *Does Atlas Shrug? The Economic Consequences of Taxing the Rich*, Auten, Clotfelter, and Schmalbeck examine taxes and charitable giving by the wealthy.²⁸ This is an important topic, considering that the top 1 percent of U.S. households in terms of income contributed over 16 percent of total charitable gifts in 1994. The authors conclude that the charitable giving preferences of the wealthy are vastly different than those of the non-wealthy. The wealthy tend to concentrate their contributions on cultural, educational, and health-related charities. The less wealthy tend to give to religious charities. Since the wealthy prefer large gifts to cultural charities, some have questioned the effectiveness of providing a government tax subsidy since such giving tends not to accrue to the poor.

Another distinction between giving by the wealthy and non-wealthy is that giving by the wealthy has been shown to be more sensitive to changes in tax rates. This is likely because the wealthy, because their deductions enable a lower cost of giving, stand to gain the most from arranging (or manipulating) their charitable contributions. It is important to note also that although tax incentives may affect the timing of gifts, they may not change the total amount of an individual's lifetime giving. Finally, it is worth noting that the wealthy contribute more non-cash items than the less wealthy, and that the wealthy often exceed charitable deduction limits.

IV. Charitable Giving and the Value of Charitable Giving under the Fair Tax

Opponents of the FairTax allege that churches and other charitable organizations will suffer under a consumption tax system, because charitable giving will no longer be deductible and itemizers will see a reduction in their tax incentive for giving. This argument ignores the fact that the higher incomes made possible by the FairTax would encourage giving. It also ignores the fact that the FairTax rate of 23 percent is very close to being revenue neutral. This implies that the rate takes into account the lower revenue raised by the federal government due to the current

²⁸ Auten et. al. (2000): 392-424.

deductions and, consequently, the rate reflects the current benefits enjoyed by those deductions. Such criticism fails to take into account the fact that the FairTax imposes no tax on the wages of persons working for charitable organizations (i.e., on the output of charitable organizations).

The FairTax would affect both the amount given to charities and the value that charities would derive from any amount of giving. The net effect of the FairTax on giving depends, as shown, on two offsetting effects – the change in the price of giving for itemizers and the increase in real income that would result from the transition from current law to the FairTax. The effect on the value derived from a particular amount of giving stems from a feature of the FairTax whereby the FairTax would reduce labor costs faced by charities. We begin our estimation of these effects with data presented in Table 3. For reasons mentioned above, these estimations do not take into account changes in the price of volunteering. They follow the more traditional analysis.

Table 4. 2007 Estimates of Rates and Shares	
Tax	Average Tax-Inclusive Rate
<i>Personal Income Tax</i>	
Overall	16.93%
Itemizers	23.67%
Non-Itemizers	13.45%
<i>Payroll Tax</i>	12.86%
<i>FairTax</i>	23.82%
Giving Benchmarks	
	Percent of Total
Itemizers	62.60%
Non-Itemizers	37.40%
Non-Profit Expenditures	
	Percent of Total
Labor	51.73%
Other	48.27%
<i>Source: Author's estimates based on IRS public use file for 2001 and NIPA and CBO 2004 data.</i>	

A. Non-Itemizing Scenario

Under the current tax system, taxpayers who do not itemize their income tax deductions (non-itemizers) donate to charities using after-tax dollars. Consider a simple economy that consists of a non-itemizing taxpayer named Ted, a nonprofit institution called “Charity,” and the federal government, nicknamed “the Feds.” We have estimated the average income tax rate paid by non-itemizers in 2007 to be 13.45 percent and the average payroll tax paid by all workers to be 12.86 percent, as presented in Table 3. Bachman et al. estimated the revenue-neutral, static, and inclusive FairTax rate to be 23.82 percent.²⁹ We assume that the average hourly wage rate is \$10.00, that it takes an hour to produce a pizza, and that producing pizza only requires labor. This puts the price of pizza at \$10.00. There is also a professional counselor named Shirley who is paid the same wage rate, \$10.00 an hour.

Under the current taxation system, Ted has a choice: He could buy pizza and give it to needy children or he could give the net proceeds of his wages to Charity, who could then buy the pizza and give it to the children. An hour of Ted’s work leaves him with \$7.37 after income and

²⁹ Bachman et al. (2006).

payroll taxes. If Ted uses these funds to buy pizza, he would be able to buy 0.737 pizzas. Since he does not get a tax deduction, he can give only \$7.37. Charity then uses that amount to buy 0.737 pizzas. Therefore, his price of giving a pizza is 1.

Ted could also donate counseling to Charity. If he were to hire Shirley as a counselor, he would have to pay her \$10.00 an hour, so with his \$7.37 he can buy 0.737 hours of her time. If he were to give the money directly to Charity, it could hire Shirley to give 0.737 hours of counseling to the children. So his price of giving counseling is also 1.

Since both prices of giving for the non-itemizer are 1 under current law, the price of giving for a non-itemizer is 1. This simply means that Ted would have to sacrifice \$1.00 in consumption for each \$1.00 he gives to charity. The figures for this example are presented under the Current Law side of Table 5.

Table 5. Ted's Price of Giving				
	Current Law		FairTax	
	Ted	Charity	Ted	Charity
Net Revenue	\$ 7.37	\$ 7.37	\$ 7.62	\$ 7.62
Available to Give	\$ 7.37	\$ -	\$ 7.62	\$ -
Quantity of Pizza	0.737	0.737	0.762	0.762
Quantity of Counseling	0.737	0.737	0.762	1.000
Price of Giving	1.0000		0.8768	

Let us now consider what Ted's situation under the FairTax would be, as shown on the FairTax column of Table 5. Assuming that the monetary authorities do not "accommodate" the imposition of the FairTax by allowing market prices to rise above their current level, and following Bachman et al., wages would drop to \$7.62 an hour, while the tax-inclusive price of pizza remained the same.³⁰ This means that Ted would now be able to buy 0.762 pizzas or give the money to Charity to buy 0.762 pizzas. The price of giving pizza would remain equal to 1. However, the taxation of Shirley's services would change. If Ted were to hire her services, she would have to charge him the FairTax, and he would still have to pay \$10.00 an hour. However, Charity could hire her and, since it is a nonprofit, it would not have to pay the FairTax on those wages. This means that Ted could buy 0.762 hours of Shirley's counseling, whereas Charity can buy a full hour with the same \$7.62, which means that the price of giving counseling is now 0.762.

Overall, given the share of nonprofit spending on labor reflected in Table 4, we estimate that the price of giving for a non-itemizer would be 0.8768 ($= 1 \times 48.27\% + 0.762 \times 51.73\%$) under the FairTax, which represents a decrease when compared against the current taxation system, making giving more attractive for non-itemizers under the FairTax than it currently is.

B. Itemizing Scenario

Now consider Fred, who itemizes his deductions. Under current law, Fred's disposable income from an hour of work is \$6.35, insofar as he faces a larger income tax rate than Ted. With that income he can buy 0.635 pizzas. However, because he itemizes he does not have to pay income

³⁰ Ibid.

taxes on income given to Charity. Hence, he can give \$8.71 to Charity and it can buy 0.871 pizzas. Therefore, Fred's price of giving pizza is 0.7284 (= 0.635 / 0.871). If he wanted to hire Shirley, he would face the same situation. He could only hire 0.635 hours of Shirley's counseling, whereas if he gave the money to Charity, it could buy 0.871 hours of Shirley's counseling. So Fred's price of giving counseling to Charity is also 0.7284. This means that we estimate the price of giving of an itemizer to be 0.7284 under current law in 2007. The numbers for this estimation (rounded) are collected under the Current Law side of Table 6.

Table 6. Fred's Price of Giving				
	Current Law		FairTax	
	Fred	Charity	Fred	Charity
Net Revenue	\$ 6.35	\$ 8.71	\$ 7.62	\$ 7.62
Available to Give	\$ 8.71	\$ -	\$ 7.62	\$ -
Pizza	0.635	0.871	0.762	0.762
Counseling	0.635	0.871	0.762	1.000
Price of Giving	0.7284		0.8768	

We now consider Fred's situation under the FairTax and see how it is identical to Ted's. Because Fred's wages are now \$7.62 an hour, he can either buy 0.762 pizzas or 0.762 hours of Shirley's counseling. Charity, however, can buy 0.762 pizzas or a full hour of Shirley's counseling when it hires her as labor; this is because nonprofits do not have to pay the FairTax on wages. Therefore, Fred's price of giving under the FairTax is the same as Ted's: 0.8768 (= 1 × 48.27% + 0.762 × 51.73%). This means that the price of giving increases for itemizers under the FairTax.

V. The Beacon Hill Institute Model of Charitable Giving

A. How the BHI Model Works

To measure the effect of the FairTax on charitable giving, we used the IRS public-use microdata tax sample for 2001, the most recent year for which these data are available. The sample covers 143,221 "taxpayers," chosen by a method of stratified sampling that over-samples high-income households. In order to preserve confidentiality, the IRS "blurs" the data, so that each observation represents a possible, rather than actual, taxpayer. When working with the data, the measures have to be weighted in order to adjust for the sampling procedure.

How will the introduction of the FairTax affect the amount of charitable giving? There are two main effects that need to be taken into account: an income effect and a price effect.

The income effect reflects the observation that households with more income also give more in charitable contributions. To the extent that the FairTax would boost economic growth, and hence incomes, it would also raise the amount of charitable giving. The price effect would capture how much giving would change because it has become cheaper or more expensive.

The first step is to estimate the effect of income and of the price of giving on the amount of giving. The basic regression is of the form of Equation (2).

$$(2) \quad \ln(\text{Giving}/\text{Pop}) = \alpha + \beta \ln(\text{Income}/\text{Pop}) + \gamma P_G + \varepsilon$$

where:

Giving/Pop: Charitable giving per capita

Income/Pop: Adjusted gross income per capita

P_G: Price of giving

However, the price of giving, $1 - MTR$, is negatively correlated with the log of income, thus making it difficult to isolate econometrically the effect of the price of giving.³¹ Our solution has been to “instrument” the price of giving. We construct an “instrumental variable” that is correlated with the observed price of giving but has been purged of the element of correlation with the log of income. The instrumental variable in our case was constructed by first regressing the price of giving on the number of household members, the marital status of the filer, and whether the household was receiving a pension. The predicted value of the price of giving, taken from this subsidiary equation, was used instead of the actual price of giving in estimating Equation (2).

The results of estimating Equation (2) in this fashion are shown below in Table 7. The regression was estimated using 89,688 observations on households that itemized their taxes and had non-negative income in 2001. The adjusted R^2 for the equation was 0.11, which, although low, is consistent with other estimates in the literature.

	Coefficient	t-statistic	p-value
Dependent variable: Log of charitable giving per capita			
Independent variables:			
Log of adjusted gross income per capita (in thousands)	0.7936	103.4	0.00
Price of giving (using instrument)	-1.7005	-12.3	0.00
Constant	4.4972	42.9	0.00

Source: Based on IRS public use file for 2001 federal income tax returns, for itemizers with non-negative income.

The second step is to quantify the effect of the introduction of the FairTax on giving. Under current law, itemizers will give an estimated \$145.3 billion in charitable contributions, equivalent to 3.9 percent of their adjusted gross income, in 2007. As we have seen in section IV, the price of giving for itemizers will increase with the FairTax from 0.7284 to 0.8768, which, as indicated by the -1.7005 coefficient in Table 7, would put downward pressure on the amount that this group would give under the FairTax. Non-itemizers, on the other hand, find their price of giving decreasing from 1.000 to 0.8768 with the FairTax, which would put upward pressure on their giving under the FairTax. The net effect would depend on the combined effect of the change in the price of giving and the change in income per capita that the FairTax would cause.

B. Analysis of Results

To determine the net effect, we used our estimated equation, along with the changes in the price of giving for itemizers and non-itemizers estimated in section IV, to calculate how much

³¹ The price of giving under current law for itemizers is $1 - MTR / (1 - PT)$ if the money comes from wages (as in the estimations in section IV) and $1 - MTR$ for giving that comes from capital revenue. The difference between both is very small and $1 - MTR$ can serve as a good measure for the regression.

charitable giving would change for each itemizing household in the sample. In Table 8 we present estimations of the changes in giving based on price changes only, income changes only, and both changes simultaneously (as would be the actual case).

Based on the price effect alone, itemizers are expected to reduce their giving by \$32.40 billion in 2007 from \$145.30 to \$112.90 billion, or by 22.3 percent. For taxpayers who do not itemize their deductions, the price of giving is 1.00 under the current rules but would fall to 0.8768 under the FairTax. With the introduction of the FairTax, these taxpayers are expected to donate more to charity; a dollar now stretches further when given to charity than when used for some other purpose, making charitable giving relatively more attractive. In 2007, we estimate non-itemizers to make \$86.8 billion in charitable contributions. If this group of households responds to the price of giving in the same way itemizers do – a plausible enough assumption – then their giving would rise by \$20.23 billion from \$86.80 to \$107.03 billion (i.e., by 23.31 percent) with the introduction of the FairTax, when we account only for the effect of the price of giving.

	Itemizers	Non-Itemizers	Total
Benchmark	145.30	86.80	232.10
Price Effect	112.90	107.03	219.93
Income Effect	154.70	92.42	247.12
Total Effect	120.20	113.96	234.16

In short, looking only at the price effect, total charitable giving would decrease by 5.24 percent from \$232.10 billion to \$219.93 billion with the introduction of the FairTax (levied at a tax-inclusive rate of 23.82 percent), when we consider only the effect of the change in the price of giving.

This is not the end of the story, however, because as discussed in *The Economic Effects of the FairTax: Results from the Beacon Hill Institute CGE Model*, the introduction of the FairTax would boost GDP by 7.9 percent in 2007 and by 10.90 percent within 10 years, as compared with a benchmark of no FairTax (i.e., current law).³² As discussed above, higher levels of income produce higher levels of charitable giving.

	Baseline (billions)	FairTax (billions)	Difference (billions)	Percentage Increase
2007	\$ 232.10	\$ 234.16	\$ 2.06	0.89%
2016	\$ 382.70	\$ 395.40	\$ 12.70	3.32%
2026	\$ 630.60	\$ 649.47	\$ 18.87	2.99%

Source: Authors' estimates based on IRS public use sample for 2001.

We start by looking at the effects that this change in income has in 2007 by itself. Itemizers would increase their giving by \$9.40 billion from \$145.30 to \$154.70 billion (by 6.47 percent). Non-itemizers, on the other hand, would increase their giving by \$5.62 billion from \$86.80 to \$92.42 billion (6.47 percent). Overall, when looking at the effect that the increase in income

³² Tuerck et al. (2007).

would have by itself on giving, it would increase total giving by 6.47 percent from \$232.10 to \$247.12 billion.

When the price effect is combined with the income effect, the FairTax would increase charitable donations by 0.89 percent immediately, by 3.32 percent within 10 years of its introduction, and by 2.99 percent once it has been in place for 20 years, again compared to the baseline situation of no FairTax (and hence the continuation of the current tax regime).

It is appropriate to ask how robust these results are. To examine this issue, we re-ran the simulation of the effects of the FairTax on the assumption that the coefficient on the price of giving was -0.4521 (a quarter of the estimated coefficient) and -0.8503 (half of that same estimated coefficient), in addition to the value of -1.7005 that we found in our estimations.

		Itemizers		Non-Itemizers		Total	
P _G Coeff.	Year	\$ billions	%	\$ billions	%	\$ billions	%
-1.7005	2007	(25.10)	-17.27%	27.16	31.29%	2.06	0.89%
	2016	(36.61)	-15.28%	49.31	34.45%	12.70	3.32%
	2026	(61.38)	-15.55%	80.24	34.03%	18.87	2.99%
-0.8503	2007	(8.93)	-6.15%	15.82	18.23%	6.89	2.97%
	2016	(9.31)	-3.89%	30.17	21.08%	20.85	5.45%
	2026	(16.55)	-4.19%	48.81	20.70%	32.26	5.12%
-0.4251	2007	(0.06)	-0.04%	10.59	12.20%	10.53	4.54%
	2016	5.68	2.37%	21.32	14.90%	27.00	7.06%
	2026	8.08	2.05%	34.28	14.54%	42.36	6.72%

The effects are summarized in Table 10. In all cases, the introduction of the FairTax would continue to increase charitable donations within all timeframes considered. In fact, we find that the less sensitive that giving is to the price of giving, i.e., the smaller the absolute value of the coefficient, the more that giving will increase. This is because the lower coefficient causes itemizers to not decrease their giving by more than it causes non-itemizers to not increase theirs as much.

		Itemizers		Non-Itemizers		Total	
Growth Rate	Year	\$ billions	%	\$ billions	%	\$ billions	%
7.90	2007	(25.10)	-17.27%	27.16	31.29%	2.06	0.89%
10.90	2016	(36.61)	-15.28%	49.31	34.45%	12.70	3.32%
10.50	2026	(61.38)	-15.55%	80.24	34.03%	18.87	2.99%
2.90	2007	(29.77)	-20.49%	22.73	26.18%	(7.05)	-3.04%
4.80	2016	(46.20)	-19.28%	40.21	28.10%	(5.98)	-1.56%
7.90	2026	(68.19)	-17.27%	73.79	31.29%	5.60	0.89%

To further test the robustness of the results, we conducted the simulation with different rates of increased economic growth resulting from the implementation of the FairTax. We assumed a growth of 2.90 percent in 2007, 4.80 percent by 2016 and 7.90 percent by 2026. In order to give

a sense of how conservative these figures are, please note that the rate we have assumed the FairTax to grow the economy within 20 years is in fact the one that is estimated to be in place in the first year of the FairTax implementation. In Table 11 we present the comparison with the original simulation.

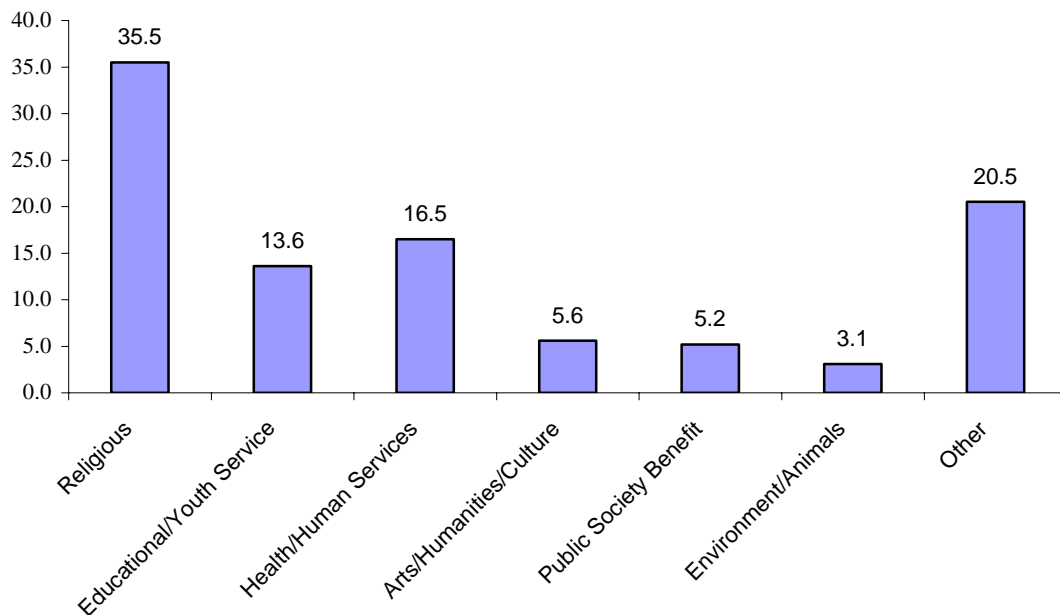
We observe that even with such low growth rates in the economy, in the longer term the FairTax would cause overall charitable giving to increase, even though it would decrease in the shorter term.

VI. The FairTax’s Effect on Distribution of Giving to Various Charities

A. Current Recipients of Charitable Giving

Another important issue to examine is how the FairTax will affect the current distribution of giving to different types of charities, if at all. Figure 1 displays a breakdown of the charitable giving in the U.S. in 2004 by type of charitable recipient. We observe how religious nonprofits obtain the largest share of giving (35.50 percent) while environmental and animal-related charities have the smallest piece of the pie (3.1 percent).³³

Figure 1. Charitable Giving by Charitable Organization Recipients, 2004.



Source: Giving USA

B. Recipients of Charitable Giving Under the FairTax

In section V we estimate that under a FairTax of 23.85 percent, charitable giving in 2007 would increase by 0.89 percent, or \$2.06 billion, from \$232.10 billion to \$234.16 billion. At first glance, one might simply assume that each of the types of charitable organizations in Figure 1 would gain proportionately from the total increase in charitable giving, and the distribution of giving to the various types of charities would not change.

³³ Giving USA (2004).

However, the increase in the supply of charitable giving under the FairTax is not proportionate across the population. Therefore, determining the quantity of the change in giving toward each type of charitable organization is not as straightforward as just proportionately increasing giving across all types of charities. In order to accurately predict which charities will gain and lose under the FairTax, we must look at *who* comprises the increase in charitable giving.

The estimated net increase in charitable giving of \$2.06 billion under the FairTax is comprised of a decrease of \$25.10 billion, or 17.27 percent, by itemizers and an increase of \$27.16 billion, or 31.29 percent, by non-itemizers (who are generally less wealthy and have lower incomes than itemizers).

As noted in section III D., wealthier people tend to contribute to cultural, educational, and health-related charities, while the less wealthy tend to give to religious charities. Based on the BHI estimate that non-itemizers' aggregate charitable giving will increase under the FairTax, the assumption that non-itemizers are less wealthy, and taking into account the fact that the less wealthy tend to give disproportionately to religious organizations, we conclude that religious charities will benefit disproportionately more than other charities under the FairTax.

Conversely, the BHI estimate of a significant decrease in charitable contributions by itemizers (who are generally wealthier than non-itemizers), coupled with evidence that the wealthy tend to give to cultural, educational, and health-related charities leads us to believe that these cultural, educational, and health-related charities will see at least a small decrease in their receipts of charitable contributions under the FairTax, relative to other charities.

Table 12. Predicted Giving by Category, 2007

Category	Current Law		FairTax		Difference	
	\$ billions	%	\$ billions	%	\$ billions	%
Religious	82.40	35.50%	101.35	43.28%	18.96	7.78%
Educational/Youth Service	31.57	13.60%	25.06	10.70%	(6.50)	-2.90%
Health/Human Services	38.30	16.50%	30.41	12.99%	(7.89)	-3.51%
Arts/Humanities/Culture	13.00	5.60%	10.32	4.41%	(2.68)	-1.19%
Public Society Benefit	12.07	5.20%	12.10	5.17%	0.03	-0.03%
Environment/Animals	7.20	3.10%	7.21	3.08%	0.02	-0.02%
Other	47.58	20.50%	47.71	20.37%	0.13	-0.13%
Total	232.10	100.00%	234.16	100.00%	2.06	0.00%

Specifically, we extrapolated the effects on each of the charitable recipient organizations as follows: we assumed that 80 percent of all taxpayers fall into the conventional categories of giving based on their itemizing status (i.e., 80 percent of non-itemizers' charitable gifts are made to religious charities and 80 percent of itemizers' gifts are made to educational, health, and cultural organizations). The total net initial increase in charitable giving of \$2.06 billion under the FairTax breaks out into a gain of approximately \$18.96 billion for religious charities. It also implies a loss of \$6.50 billion, \$7.89 billion, and \$2.68 billion for educational, health, and cultural charities, respectively. Percentage-wise, religious charities increase their piece of the pie from 35.5 percent (Figure 1) to 43.28 percent under the FairTax. Health-related charitable organizations decrease their take of charitable gifts from 16.5 percent of the total to 12.99 percent, educational organizations decrease their take from 13.6 percent to 10.70 percent, and the take of cultural organizations diminishes from 5.6 percent to 4.41 percent under the FairTax. These figures are collected in Table 12.

The assumption of an 80 percent “loyalty” to the conventional categories is made in the above estimations since there is no factual estimate. In order to be thorough, we ran a sensitivity test to see how different assumptions about this rate would affect the distribution of giving by categories under the FairTax. In particular, we estimated what the shares of giving by the different categories would be under assumptions of 60 percent and 70 percent of individuals falling into their conventional categories, in addition to the original estimation under the assumption of 80 percent. In Table 13 we present the different shares of giving by categories that would be in place under the FairTax under the different conventional share assumptions. We observe that the differences are nominal between the different assumptions, but not directional. This means that for any of the assumptions, religious charities’ share of total giving increases under the FairTax while the rest of the charities lose part of their share. We also observe that the lower the conventional share the lower the share of giving to religious charities, while the rest of the categories gain some share.

Category	Conventional Share		
	80%	70%	60%
Religious	43.28%	41.53%	39.78%
Educational/Youth Service	10.70%	11.36%	12.01%
Health/Human Services	12.99%	13.78%	14.57%
Arts/Humanities/Culture	4.41%	4.68%	4.94%
Public Society Benefit	5.17%	5.17%	5.18%
Environment/Animals	3.08%	3.08%	3.09%
Other	20.37%	20.40%	20.43%
Total	100.00%	100.00%	100.00%

VII. Volunteering

A. Voluntarism Statistics

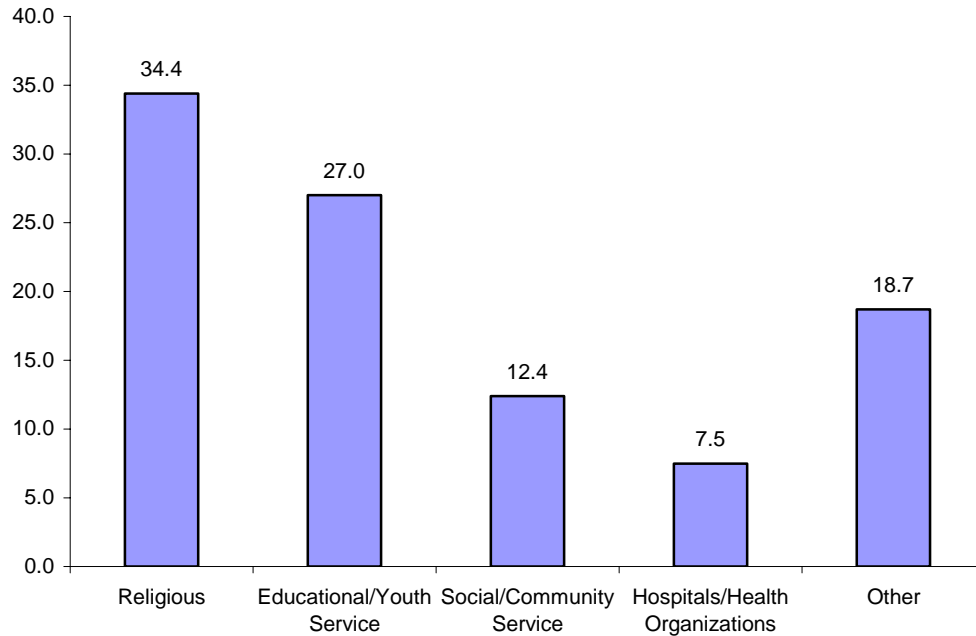
As previously noted, the IRS currently tracks itemizers’ tangible contributions to charity, both cash and non-cash.³⁴ A third type of charitable giving needs addressing: voluntarism. Volunteer activity consists of individuals working for no pay. Americans volunteer their time to a wide variety of charitable organizations, including schools, hospitals, churches, museums, and other cultural organizations (Figure 2).

Eighty percent of all volunteering is in the nonprofit sector, where volunteer labor accounts for one-fourth of total labor input.³⁵ The Bureau of Labor Statistics reports that in 2004, approximately 64 million people participated in volunteer work. According to the Economic Report of the President, the assigned national hourly wage for volunteers in 2004 was \$17.55. It is clear that volunteer labor provides American society with a significantly higher level of charitable, cultural, and educational activities than would otherwise exist.

³⁴ Giving USA (2004).

³⁵ Freeman (1997): 140-166.

Figure 2: Share of Volunteer Hours by Type of Charitable Organization, 2004



Source: Bureau of Labor Statistics, 2004 data³⁶

B. Who Volunteers and Why?

Pollsters, economists, sociologists, and others have studied the question, “Who volunteers?” In general, those who volunteer tend to be people with higher opportunity costs of time. In other words, those who volunteer are disproportionately employed, highly-educated professionals who could be spending their leisure time earning more money, yet opt to spend at least some of their leisure hours volunteering for a cause.

Virtually all of the literature on voluntarism finds a high correlation between volunteering and monetary contributions to charity. Surveys of people in both the U.S. and the U.K. show that those who volunteer are more likely to contribute monetarily to charitable organizations and vice versa. In fact, individuals who contribute to charity are approximately three times as likely to volunteer as those who do not contribute to charity.³⁷

Based on six of its surveys of giving and volunteering, the Independent Sector found that 47 percent of households in 1998 who made charitable contributions also volunteered.³⁸ Further, contributing households that also contained a volunteer contributed more than twice the percentage of household income than contributing households without a volunteer. The following excerpt supports these findings:

On average, respondents who gave upwards of \$132,000 to charities and non-profits also spent more than 200 hours volunteering, compared to less than 50 hours for those who gave under \$32,000, the study found.

³⁶ U.S. Bureau of Labor Statistics (2004).

³⁷ Ibid.

³⁸ Independent Sector (1999).

Rather than seeking tax shelters, more than 86 percent of respondents said they were motivated to give by the opportunity of ‘meeting critical needs’ in society, while 82.6 percent said they were moved by a ‘feeling that those who have more should give to those with less,’ the study said.

According to researchers at Indiana University's Center on Philanthropy, wealthy donors also claimed to be far less influenced by prevailing tax policies than is often thought, researchers said. Despite dire warnings by some business groups that failure to repeal the federal estate tax will result in a decline in charitable giving by the rich, more than half of the study's respondents said the amounts they donate would stay the same regardless of any changes to the tax. An equal number also said they would continue giving even if there were no tax deductions for charitable donations at all, the study said.³⁹

Using data from the Independent Sector and the IRS for the years 1991 - 2000, the Beacon Hill Institute estimated a correlation between volunteer hours and charitable giving of between 0.48 and 0.50. This estimate supports the strong positive correlation between voluntarism and charitable contributions found throughout the literature.

C. Voluntarism and the FairTax

While there is no tax deduction for volunteering (aside from a small allotment for transportation expenses associated with volunteer work), some have raised concerns about the effect the FairTax would have on voluntarism. This section of the report will address the potential effects of the FairTax on voluntarism.

The strong correlation between charitable giving and voluntarism suggests that the FairTax's effect on voluntarism would be similar to its effect on charitable contributions. Our estimates in section V of this report conclude that the FairTax would have a positive effect on charitable giving. Estimates in the literature and our own estimates of the correlation between charitable contributions and voluntarism are as much as 0.50. Therefore, it is possible that the FairTax would increase the quantity of volunteer hours in the U.S.

A potential rebuttal to the assertion that the FairTax would increase voluntarism comes in the form of a substitution effect theory. If the cost of charitable giving decreases, as our analysis of the FairTax shows, people might substitute monetary contributions for volunteer work, as the cost of monetary contributions would decline, while (presumably) the opportunity cost of voluntarism has not changed. Relative to monetary contributions, the opportunity cost of volunteering increases under the FairTax.

This rebuttal is more compelling when taking into account our explanation in section III B. about the price of volunteering and how it would increase under the FairTax. As the price of volunteering increases, cash contributions to nonprofits become relatively cheaper, and it seems reasonable to think that there is some pressure to substitute some volunteering for cash contributions.

Based on our estimates and our analysis on the price of volunteering, it is clear that a deeper analysis on how these forces would counteract and which would dominate is needed. However,

³⁹ Loten (2006).

due to lack of data on volunteering by tax filers, both itemizers and non-itemizers, this will remain a great chance for future research.

VIII. Conclusions

Charitable giving is an important part of American society, enabling charitable organizations to play their essential role in providing goods and services to members of society who most need help. Individuals practice charitable giving in part because of culture – i.e., a “warm glow” associated with charitable giving or out of a sense of religious duty. But incentives also play a role. Many who donate to charity currently reap another, more tangible, benefit under our current tax system: a tax deduction for charitable giving.

Concerns about the effects on charitable giving of a major systemic change, such as the FairTax, are understandable. Because it would eliminate the current income tax and the associated tax deduction for charitable giving, the FairTax draws the apprehension of the nonprofit sector. Charitable organizations are worried that, if fully implemented, the FairTax would erode their base of financial support. Supporters of the current incentive system also believe a FairTax scenario, in turn, would threaten the viability of recipients.

As outlined in this paper, BHI’s research and analysis prove these fears to be unfounded. To be sure, the FairTax would cause charitable giving by those in the very highest marginal tax brackets to decrease as the tax incentives for this income group became less valuable and as the price of giving increased. However, this shortfall in charitable giving by the wealthy would be more than offset by an increase in charitable giving by other taxpayers. Under the FairTax, the majority of taxpayers (who currently do not itemize or fall into the lower tax brackets) would see the price of giving decrease. The decrease in the price of giving would provide an attractive incentive for the majority of taxpayers to increase their charitable giving under the FairTax.

It is important to note that while *total* charitable giving will increase under the FairTax, this increase in giving will not be distributed proportionately amongst the various types of charitable organizations. Due to differences in preferences for type of charitable organizations between itemizers and non-itemizers, religious charities stand to gain disproportionately under the FairTax, while education, health, and cultural charities will actually suffer a small loss.

Donor	Current		FairTax		Difference	
	\$ billions	%	\$ billions	%	\$ billions	%
Itemizers	145.30	62.60%	120.20	51.33%	(25.10)	-17.27%
Non-Itemizers	86.80	37.40%	113.96	48.67%	27.16	31.29%
Total	232.10	100%	234.16	100%	2.06	0.89%

Due to the FairTax’s effect on the price of giving, charitable giving would decrease by 5.24 percent in the first year if we ignored the rise in the income brought about by implementation of the FairTax. However, previous BHI analysis shows that the FairTax would increase GDP by 7.9 percent within 10 years and 10.50 percent within 20 years. This income effect would increase charitable contributions, as we can expect households with increased income to increase their charitable contributions. The increase would outweigh the small decrease in charitable

giving due to the FairTax's effect on the price of giving. In Table 14 we summarize the immediate effects of the FairTax in cash contributions by donor type.

In the final analysis, the adoption of the FairTax would not decrease total individual charitable contributions. To the contrary, due to the price and income effects, among its other benefits, the FairTax would induce an increase in charitable contributions, subsequently strengthening the vitality of the charitable organizations that are so instrumental in their role in U.S. society.

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