EXPLORING THE RATIONALE FOR THE CHARITABLE CONTRIBUTION DEDUCTION

Yoram MARGALIOTH*

Resumen

En este trabajo se analizan las posibles justificaciones de la charitable contribution deduction y se sostiene que, a pesar de su nombre, ésta desempeña un rol eficiente. Es posible asimismo que mejore la democracia, empujando a la mayoría a gastar una parte de la recaudación fiscal en bienes públicos que satisfacen las preferencias de las minorías. Sin embargo, liberando una parte de la recaudación que de otra forma se hubiera requerido para financiar algunos bienes públicos, incrementa el bienestar social al reducir las distorsiones introducidas por los impuestos, o al permitir, al mismo nivel de carga tributaria, una provisión adicional de bienes público o transferencias del Estado de bienestar. Los bienes públicos son equivalentes a las transferencias universales en especie. Por tanto, si bien la charitable contribution deduction tiene efectos regresivos en el conjunto del sistema tributario estadounidense, y las entidades que contribuye a financiar tienen un efecto neutro sobre la desigualdad, la deducción puede tener un efecto redistributivo positivo total.

Palabras clave

Deducción por aportación a entidades benéficas, redistribución, eficiencia, bienes públicos, desigualdad.

Abstract

In this paper, I have examined the possible justifications for the charitable contribution deduction and found that, in spite of its name, it serves an efficiency role. It may also enhance democracy, by forcing the majority to spend some tax revenue on public goods that satisfy minorities' preferences. However, by freeing up some tax revenue that would have been otherwise required to finance some public goods, it increases social well-being by reducing distortive taxes, or by allowing, at the same level of taxes, additional provision of public goods or transfer (welfare) payments. Public goods are equivalent to universal transfer payments in-kind. Hence, even though the charitable contribution deduction has a regressive effect on the tax structure, and the tax-exempt entities it finances have a neutral effect on inequality, the deduction may have an overall positive redistributive effect.

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Key words

Charitable contribution deduction, redistribution, *efficiency, public goods, inequality.*

I. INTRODUCTION

SECTION 170 of the US Internal Revenue Code, known as the «charitable contribution deduction,» allows taxpayers to deduct, from their adjusted gross income (AGI), voluntary transfers of cash or property made to organizations formed for religious, educational, medical, scientific and other charitable purposes (1).

The regulations define the term «charitable» as «in its generally accepted legal sense, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of charity as developed by judicial decisions» (2).

The term includes «relief of the poor and distressed or of the underprivileged» and a long list of other purposes, some of them related to socio-economic issues such as «community deterioration and juvenile delinquency.» However, *inequality* in general and *income or wealth inequality* in particular, are not explicitly stated (3).

Indeed, the term «charitable» may somewhat overstate the connection between the deduction and promotion of distributive justice, for the following reasons.

Gifts made to individuals, even when clearly justified on distributive justice grounds, cannot be deducted under section 170. Moreover, organizations whose donors benefit from section 170 are not required to engage in income redistribution (4). Hospitals, for example, are not required to offer their services for free or at reduced rates to low-income patients in order that their donors qualify under the section (5).

(1) See I.R.C. § 170 (2013).

(2) See 26 C.F.R. § 1.501(c)(3)-1 (2014).

(3) *Id.*

(4) See Colombo, J. D., «The Role of Access in Charitable Tax Exemption», *Washington University Law Review*, Vol. 82, No. 2, 2004, pp. 343-343.

(5) See Perry Fleischer, M., «Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice», *Washington University Law Review,* Vol. 87, N.º 3, 2010, pp. 505-555.

The charitable contribution deduction has regressive features on the donor's side as well. The deduction, just like any other deduction not provided for expenses incurred in the production of income, is an upside-down subsidy (6). The size of the subsidy depends on the taxpayer's marginal tax rate (7): high-income donors receive greater subsidies than low-income donors.

In addition, when contributing an appreciated asset, the built-in gain is exempt from capital gains tax and the asset's fair market value is deducted under section 170. This makes the contribution of assets even more tax-favored than donating cash, which is regressive because wealthy people have more assets and therefore donate more assets than the non-wealthy.

Finally, taxpayers can choose between claiming *standard deductions* or *itemized deductions*. The higher their income, the more likely taxpayers are to accumulate enough itemized deductions to make the total larger than the standard deduction. The charitable contribution deduction is available only to taxpayers who claim itemized deductions on their tax returns. This means, in effect, that when it comes to individual donors it is mostly homeowners who profit from the deduction. This is because they are the only class of individuals likely to have sufficient deductions for other expenditure, primarily home mortgage interest payments and property taxes, to justify giving up on the standard deductions.

This, as well as the upside-down structure of this subsidy, is important because by deducting the amount donated from their AGI, the donors reduce the taxes they pay by the sum they donate multiplied by their marginal tax rate. The taxes that they do not pay decrease government revenue available for other projects. The deduction is, in effect, a government grant positively correlated with their income level. Unlike non-donors, they have the power to affect the allocation of government spending according to their own preferences, in addition to whatever influence they have due to the democratic process.

In this paper, I try to understand what could justify the charitable contribution deduction and conduct a normative analysis based on the presumption that the policymaker's goal is to maximize social welfare, which is some function of the well-being of all members of society. I find that although labeled «charitable,» the charitable contribution deduction is mostly justified on efficiency grounds.

In Part A, I discuss two possible justifications for the charitable tax deduction as an essential feature of any income tax system: viewing the donation as an expense incurred in the production of income; and viewing the donations as resources outside the control of the taxpayer, and hence not her income. These two justifications have nothing to do with redistribution. They are neutral in that respect.

Part B discusses the justification for the charitable contribution deduction as a form of payment for outsourced provision of public goods and redistribution. The government intervenes in the market to overcome a market failure known as free-rid-

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(6) A deduction of expenses incurred in generating taxable income is not a subsidy. It is required for the tax to function as income tax, not turnover tax. Income tax is imposed on the increase in the taxpayer's ability to consume goods and services. Expenses incurred in the production of income must be accounted for, otherwise the taxpayer would be taxed on an illusionary income. For a discussion of the possibility that charitable contributions are expenses incurred to generate income, see Part A.1. below.

(7) Marginal tax rate is the income tax rate applying to the last dollar of taxable income.

ing over public goods. Government intervention is required to finance the public goods and redistribution. It can, however, outsource their provision. When the provision is carried by non-profits, the government may reimburse them through tax subsidies. The charitable contribution deduction benefits the non-profits by lowering their capital financing costs. Like the justifications for the charitable contribution discussed in Part A, this justification too has nothing to do with redistribution.

Part C discusses two additional efficiency justifications for the charitable contribution deduction: The tax subsidy reveals to the policymaker the unknown preferences of citizens with respect to public goods. In addition, according to public choice theory, it creates an avenue for minority groups to receive some government funding for their preferred public goods.

Part D discusses the positive emotional sensation, known as «warm glow,» that most individuals experience when giving gifts or donating to charitable organizations. The existence of warm glow would justify the charitable contribution deduction only if taxpayers derive warm glow not only from their out-of-pocket donation, but also from the part of the donation that is financed by the tax subsidy.

In Part E, I provide a detailed explanation of the concept of *excess burden*. I then go on to discuss how subsidizing donations may be part of an optimal tax and transfer system.

Part F discusses the distributional impact of the charitable contribution deduction. This section is comprised of three sub-sections. The first sub-section discusses the possible welfare-reducing effects that the deduction might have, due to the nature of social status being a zero-sum game. The second sub-section discusses the specific structure of the subsidy, namely as a deduction instead of a credit. The third sub-section discusses the distributional impact of the outputs of the non-profit organizations. Finally, I conclude.

II. WHEN A CHARITABLE CONTRIBUTION DEDUCTION IS REQUIRED TO ACCURATELY CALCULATE TAXABLE INCOME

Lump-sum taxes such as a uniform head tax are more efficient than the taxes we currently employ, such as income or consumption taxes. This is so because lump-sum taxes do not affect the taxpayer's behavior, as each taxpayer's liability is fixed (8). We do not rely on such taxes because in addition to efficiency, we also care about distributive justice. Social policy decisions ought to be based on personal attributes –such as the ability to earn– which lump-sum taxes completely ignore.

The ability to earn is one of the relevant attributes that cannot be directly observed. Income is thought to be a relatively good proxy for ability. Clearly this is not a perfect proxy, because it does not account for effort level. However, by taxing income, as a representation of the taxpayer's ability to consume goods and services, we believe that we come closer to the ideal tax base.

(8) We generally do not intend taxes to distort taxpayers' behavior (the excess burden of taxation) with the exception of our relatively limited use of taxes (or subsidies) to change taxpayers' behavior in the presence of externalities, causing taxpayers to internalize the social harm (or benefit) their behavior involve.

The above description of an income tax may justify the deduction of charitable contributions, not as a subsidy to promote distributive justice or other goals, but as a fundamental element of the system necessary to calculate taxable income, in the following two cases:

2.1 THE CHARITABLE CONTRIBUTION AS A BUSINESS EXPENSE

In order for income to represent the taxpayer's ability to consume, we must deduct whatever expenses that are incurred by the taxpayer in order to generate her income (9). These expenses reduce her ability to consume; accordingly, disallowing their deduction would result in overstating the taxpayer's ability to consume, thereby taxing her on an illusionary income.

Charitable contributions are not considered as expenses incurred in the production of income. In fact, the IRS has interpreted the phrase «contribution or gift» in section 170 as requiring a transfer from the donor to the donee «without adequate consideration» in return. This is known as the «quid pro quo» test whereby, in order for a contribution to qualify for deduction under section 170, it must occur without a direct quid pro quo from the donee in exchange for the putative contribution.

In reality, however, charitable contributions often have the same effect as advertisement and lobbying, expenses incurred in the production of income and thus generally allowed as deductibles under IRC section 162. This is clearly the case with respect to corporations engaging in corporate social responsibility (CSR), a term that includes charitable giving by corporations. Corporations use section 170 to deduct charitable contributions they have made, but could probably deduct much of this under section 162 instead (10).

Business motives are less obviously present with respect to individuals. But, if we consider networking as sometimes serving as a form of business marketing –a plausible assumption to make– then charitable contributions by individual donors could be regarded a business expense. Making charitable contributions is often a necessary prerequisite for becoming a member of the boards of prestigious non-profit organizations such as museums or the opera, as well as receiving invitations to galas and other high-profile social events. Such forums are ideal for self-promotion and making the useful social connections that may lead to job offers or work commissions.

To the extent that networking expenses are recognized as deductible business expenses, charitable contributions could qualify as such in certain situations. This would be rare in the case of individual donors who, even when networking at charity events and sitting on non-profit boards, are more likely to do so for social status

(9) These include the costs of material input; wages, salaries, social security contributions and benefits for employees; costs of repairs; depreciation of productive equipment and buildings; advertising costs; interest paid on borrowed capital used to generate income; and many other miscellaneous expenses.

(10) See Knauer, N. J., «The Paradox of Corporate Giving: Tax Expenditures, the Nature of the Corporation, and the Social Construction of Charity», *DePaul University Law Review*, Vol. 44, N.º 1, pp. 1-99; Sugin, L., «Encouraging Corporate Charity», *Virginia Tax Review*, N.º 26, 2006, pp. 125-183.

and other psychological reasons. However, personal business motives should not be ruled out automatically.

To sum up, corporations often deduct their charitable contributions under the provisions of section 170; but in fact, in many cases these contributions should have been deducted under section 162, as business expenses. To a lesser degree, the same is true with individuals, assuming that the networking aspect is significant and that the tax system allows for the deduction of expenses incurred whilst soliciting work through networking.

The policy meaning of characterizing charitable contributions as a business expense, as suggested in this sub-chapter, is that it has to be deducted when computing taxable income. Its effect on taxpayer behavior is neutral. It is not a subsidy, and hence does not promote distributive justice or any other policy goal.

2.2 CHARITABLE CONTRIBUTIONS ARE OUTSIDE THE NORMATIVE DEFINITION OF «INCOME»

As noted above, income tax should ideally be imposed on annual consumption, as well as on the increase in ability to consume of a taxpayer during that year. Some influential legal scholars have argued that donations are not consumption, and therefore should not be taxed (11). This view has since been broadly rejected (12). Indeed, it is difficult to understand how, as a technical matter, the voluntary use of one's own resources would not be considered as consumption (13). It could be interpreted as such under a legal interpretation method that looks to policy and reads the law in line with the desired policy, even in cases where technical, straightforward interpretation would point in a different direction. However, there

(11) Most notably Andrews, W. D., «Personal Deductions in an Ideal Income Tax», *Harvard Law Review*, Vol. 86, N.º 2, 1972, pp. 309-385 («A good argument can be made that taxable personal consumption should be defined to include divisible, private goods and services whose consumption by one household precludes enjoyment by others, but not collective goods whose enjoyment is non-preclusive or the nonmaterial satisfactions that arise from making contributions.»). See also Bittker, B. I., «Charitable Contributions: Tax Deductions or Matching Grants?», *Tax Law Review*, No. 28, 1972, pp. 37-63 (charitable donations should not be considered consumption because they «discharge moral obligation»); Buckles, J. R., «The Community Income Theory of the Charitable Contributions Deduction», *Indiana Law Journal*, N.º 80, 2005, pp. 947-986 (assets donated to charity should more properly be considered «community income»).

(12) See Galle, B., «The Role of Charity in a Federal System», *William and Mary Law Review*, Vol. 53, No. 3, 2012, pp. 777-851 (noting literature's rejection of this argument); Colombo, J. D., «The Marketing of Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption», *Wake Forest Law Review*, Vol. 36, No. 3, 2001, pp. 657-703 (same); Perry Fleischer, op. cit., as in note 5, p. 517; Brakman Reiser, D., «Dismembering Civil Society: The Social Cost of Internally Undemocratic Nonprofits», Oregon Law Review, N.º 82, 2003, pp. 829-900, at pp. 882-83 & n. 199 (same); Pozen, D. E., «Remapping the Charitable Deduction», *Connecticut Law Review*, N.º 39, pp. 531-601, at pp. 552-53 (2006) («In Congress, the courts, the media, and now academia, the deduction is widely viewed not as a means to reify the ideal tax base ... but as a tax expenditure used to promote charitable giving and thereby the ultimate well-being of society. That is, the deduction is widely viewed as a government subsidy ...»).

(13) But to assume that the benefits of an altruistic act are always at least as great as the costs, as in a market transaction, is to disregard some forms of giving such as sacrificial giving or acting out of commitment. See Sen, A., «Rational Fools: A Critique of the Behavioral Foundations of Economic Theory», *Philosophy & Public Affairs*, Vol. 6, N.º 4, 1977, pp. 317-344, at p. 317.

is no need in this case to force the interpretation of the legal text to achieve the policy goal, as we can simply argue that the deduction is an intentional subsidy.

III. THE CHARITABLE CONTRIBUTION DEDUCTION AS A GOVERNMENT PAYMENT FOR OUTSOURCED SERVICES

The leading rationale in the literature is that the charitable contribution deduction is meant to encourage potential donors to finance the activities of charitable organizations (14). This interpretation is also supported by legislative history.

The charitable income tax deduction became part of the Internal Revenue Code in 1917, a mere four years after the Sixteenth Amendment made the imposition of income tax constitutional. It was enacted as part of a tax bill that raised federal tax rates, to help finance the costs of entering World War I (15).

Excerpts from the floor debate reveal that the original purpose of the charitable contribution deduction was to encourage continued philanthropic giving, thought to be an efficient alternative to the government's support of nonprofit organizations providing a public benefit. Proponents of the charitable contribution deduction thought the deduction was necessary, on policy grounds, to insulate philanthropic giving from the high income-tax rates that began to emerge during World War I, fearing that otherwise the flow of private philanthropy would dry up (16).

This motive was again explicitly stated when the provision, initially available only to individuals, was amended during the Great Depression to include corporate donors (17).

The charitable organizations that qualify under section 170 are corporation, trust, or community chest, fund, or foundation, created or organized in the United States and under US law. They are organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of their activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals. These organizations are non-profit. No part of their net earnings contribute to the benefit of any private shareholder or individual.

As we can see, these organizations provide goods and services at a community level. The individuals who found and contribute to these organizations receive a tax subsidy in the form of a deduction, and the organizations are subsidized by being tax-exempt.

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(14) The possibility that charitable contribution, especially when the donor is a corporation, is a business expense, has been mostly ignored; and in any case both sections 162 and 170 allow for deductions. Thus, the policy implications are limited. But see Sugin, *supra* note 10.

(15) War Revenue Act, ch. 63, § 1201(2), 40 Stat. 300, 330 (1917).

(16) See Fishman, J. and Schwarz, S., *Taxation of Nonprofit Organizations: Cases and Materials*, Foundation Press, Minnesota, 3d ed., 2010, at p. 594; Wallace, J. A. and Fisher, R. W., «The Charitable Deduction Under Section 170 of the Internal Revenue Code», in *Research Papers Sponsored by the Commission on Private Philanthropy and Public Needs*, Vol. IV, US Department of the Treasury, 1977, pp. 2131-2161.

(17) See Colombo, *supra* note 12, at p. 682 («the federal government sought voluntary transfers from the private sector (i.e., nontax revenue) to fund needed social programs»).

It is reasonable to presume that there must be a market failure that prevents the market from providing the goods or services that these organizations provide. The most likely market failure in this context is the non-exclusivity of public goods, which results in free-riding. A public good has two characteristics: it is non-excludable, in that individuals cannot be effectively excluded from using it even if they did not participate in financing the good; and it is non-rivalrous, meaning that the use by one individual does not reduce availability of the good to others. National defense, for example, is a public good. Once supplied, everyone benefits from it.

Charitable organizations often supply healthcare and education. These may be made available only to individuals who have paid for the service, but health and education nevertheless have an important public good feature: the benefits that everyone living in a country enjoys by being part of an educated and healthy population. In such conditions, society in general is more pleasant, less dangerous and more prosperous, as educated healthy people tend to have a higher level of work productivity. The same is true of another service offered by charitable organization: support for the poor. Decreasing poverty improves the quality of life of all residents for the same reasons that providing health and education do.

The existence of market failure explains why the market does not provide the goods and services at the desirable level in the absence of government intervention. But why does the government provide a tax subsidy to charitable organizations and to their donors, rather than solving the market failure by imposing taxes, raising revenue and providing the public goods and services either directly or via outsourcing? (18).

Indeed, the government imposes taxes to finance public goods and to promote distributive justice. Such government intervention in the market is required because, without coercion, people will tend to avoid participation in the financing of public goods and redistribution, seeking instead to free-ride on the contributions of others. This does not mean, however, that the government has to provide the public goods and redistributive social services itself. It can outsource their provision to for-profit as well as to non-profit firms.

The government decides what goods and services to outsource and to whom. The main consideration is efficiency. The government outsources the provision of the goods or services to the organization that would provide the public goods or services at the highest ratio of quality to cost. In rare cases, the government provides the goods and services itself –even when it is not the most efficient provider– if privatization is thought to be immoral, or in cases where it is too difficult for the government to monitor quality (19).

Usually the government pays the providers of public goods and services with money. However, it may provide them with a tax subsidy instead. The tax subsidy minimises the tax obligation of the service provider. The tax revenue forgiven is the

(18) Government intervention is required to solve the problem of financing the public goods due to free riding. When it comes to provision of the public goods, there is no market failure. Hence, the government will provide the goods by itself or outsource their provision based on an assessment of comparative advantages only. The public goods will be supplied either by the government, or by for-profit or non-profit organizations chosen by the government on the basis of efficiency.

(19) For example, the Israel Supreme Court disallowed the privatization of prisons for these reasons.

government's payment for the provision of services. The policymaker chooses between direct government payments and tax subsidies, selecting the form of payment that incurs the least cost.

Payment for outsourced services to a non-profit organization can either take one of two forms, or a combination of the two: (a) subsidizing charitable contribution to the non-profit organization; or (b) providing the non-profit organization with a direct government grant. The subsidy, as well as the grant, are both financed by the government, using revenue collected via the tax system.

Let us assume, for example, that the government wishes to provide private tuition to underprivileged children. It could provide this service through government employees, or outsource the provision of the service to for-profit or non-profit firms. Assuming it decides to outsource the provision of tutoring, the government must decide how to pay the provider for its services. It will do so by comparing the cost of a direct grant with the cost of a tax subsidy, choosing the lower cost option.

One form of tax subsidy provided to non-profit organizations is section 170: the charitable contribution deduction. It allows donors to deduct their donations, thereby lowering the financing cost of non-profit organizations. The tax subsidy given to donors lowers the «price» of donation, resulting in greater donations. This deduction is, in effect, a government matching-grant given to donors. (20) The non-profit benefits from it, and thus the deduction can be construed as a form of government payment for its services.

IV. PARTIAL FUNDING OF PUBLIC GOODS PREFERRED BY MINORITIES AND OF UNKNOWN PREFERENCES

4.1 PUBLIC CHOICE

According to public choice theory, a majority voting system will select the outcome most preferred by the median voter. A government will therefore fund and provide, either directly or via outsourcing, only the public goods that it believes would meet the preferences of the median voter (21).

Individuals whose preferences differ significantly from those of the median voter are, by definition, minorities. They may form coalitions to demand that the government fund and supply their preferred public goods. The charitable contribution deduction can be interpreted as a compromise between a coalition of minorities and the majority.

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(20) Strnad, J., «The Charitable Contributions Deduction: A Politico-Economic Analysis», in S. Rose-Ackerman (ed.), *The Economics of Nonprofit Institutions*, Oxford University Press, New York, 1986, pp. 265-296, at p. 273.

(21) Weisbrod, B. A., «Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy», in S. Rose-Ackerman (ed.), *The Economics of Nonprofit Institutions*, Oxford University Press, New York, pp. 21-44, at pp. 24-2. The public choice literature recognizes that majority votes do not always determine political outcomes but uses the majoritarian model for simplicity and as starting point for the argument.

The government partially funds the public goods preferred by minorities by allowing them to deduct from their taxable income the amounts they contribute to the preferred charitable organizations that supply their chosen public goods.

The charitable contribution deduction is capped at 50% of AGI in the case of individual donors, and 10% for corporate donors. This means that individual donors who donate more than 50% of their AGI do not receive any subsidy for the surplus. Contributions of appreciated property are capped at 30% of AGI (22). Carry-forwards for unused deductions are allowed, but only with restrictions.

Viewing the charitable contribution deduction as a compromise between the majority and the minority coalition over government funding of public goods provides a possible explanation for this cap on charitable contribution deduction. The minorities are allowed to deduct their charitable contributions to their preferred public goods, allocating in this way the tax revenue forgone according to their preferences. However, they are still required to pay taxes on at least half of their gross income. The revenue from this tax is allocated according to the majority's preferences (23).

4.2 ASYMMETRIC INFORMATION REGARDING PREFERENCES

The government cannot know its citizens' exact preferences for public goods. As it often delegates responsibility to local governments to finance and distribute public goods –making the presumption that local governments have superior knowledge about the needs of the local residents– similarly the government relies on donors to target the government provision of some public goods. Reliance on donors may be justified, given that the tax deduction does not fully compensate them.

The charitable deduction essentially casts the government as a financing partner, with taxpayer-donors serving as intermediaries or agents who choose the providers of –or indeed the very existence of– certain services (24). When residents contribute to charitable organizations, they channel tax revenue to their preferred charitable organizations, tax revenue that could otherwise be allocated elsewhere by the government. In addition, they provide the government with information about their preferences for direct government spending. This information consists not only of the identity of the charitable organization and the preferred public good, but also the intensity of the preference, reflected in the amount they contribute.

The charitable contribution deduction is therefore justified on efficiency grounds. It solves the failure of asymmetric information, and makes the whole sys-

(22) Contributions made to a private foundation which is a charitable organization funded by a single individual, a corporate source or a close-knit family group. A private foundation makes grants to other charities instead of conducting its own charitable activities. Cash contributions to a private foundation are capped at 30% of AGI, and property contributions are capped at 20%. See Fishman and Schwarz, *supra* note 16, at p. 472.

(23) See Perry Fleischer, M., «Generous to a Fault? Fair Shares and Charitable Giving», *Minnesota Law Review*, N.º 93, 2008, pp. 165-230.

(24) Levmore, S., «Taxes as Ballots», *University of Chicago Law Review*, Vol. 65, N.º 2, pp. 387-431.

tem of financing and providing public goods for the satisfaction of the citizens more competitive.

V. **THE EXISTENCE OF WARM GLOW**

Donors are sometimes purely altruistic, caring only about the end-result, which is that the goods or services should be supplied. In that case, there is no advantage to subsidizing donations over the regular taxation and provision method.

However, more usually, donors derive some personal satisfaction from being in the position to finance the provision of the public goods or services through a process that allows them to choose those goods or services to be provided, and even possibly be involved in their provision by assuming various functions (such as being board members) in the charitable organizations.

The good feeling that most donors derive from being the ones to choose the charitable organization and being involved in the actual provision of goods is termed *warm glow* (25). Donors are part of society; hence, the policymaker may prefer to provide the public goods by subsidizing donors to create the warm glow, thereby increasing overall social welfare (26).

It is unclear whether a tax subsidy can increase the warm glow derived by donors. It depends on the extent to which donors view themselves as donating the gross or the net amount. Let us clarify this by using the following simple example.

Assume that a donor, whose marginal tax rate is 35%, donates $100,000 to a charitable organization and deducts this donation under section 170. Her out-of-pocket cost is only $65,000. Does she derive from the donation the same level of warm glow as she would have in a world with no section 170, donating $65,000 or $100,000?

The subsidy may be justified for increasing social welfare in the form of warm glow, but only if she feels as if she donated $100,000, or at least more than $65,000.

VI. **REDUCING THE EXCESS BURDEN OF TAXATION**

Another reason why the provision of a tax subsidy to charitable organisations and their donors –rather than imposing taxation to raise revenue for the provision of services, directly or via outsourcing– is that it allows the government to raise funds for public goods (and income redistribution) without incurring the *excess burden* of taxation, in part or at all. Excess burden, also known as deadweight loss,

(25) The term was coined by Andreoni. See Andreoni, J., «Giving with Impure Altruism: Applications to Charity and Ricardian Equivalence», *Journal of Political Economy*, Vol. 97, N.º 6, 1989, pp. 1447-1458; Andreoni, J., «Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving», *The Economic Journal*, 1990, pp. 464-477.

(26) There are arguments against including warm glow in social welfare. See discussion below.

is the inefficiency of the tax system, namely, the loss of welfare above and beyond the tax revenues collected.

Because not all readers are familiar with tax policy, I will briefly provide the basic background necessary to understand the argument, and then connect it to our discussion of tax incentives offered to donors.

As mentioned above, the government is supposed to correct market failures and promote distributive justice using tax and regulation. Taxes that correct market failures such as externalities –say, a tax on pollution– are efficient.

Once market failures are corrected and the market becomes competitive, individuals and firms are thought to be the best judges of the goods and services they value. Accordingly, they make spending decisions to maximize their well-being and in line with their own preferences. The result, as Adam Smith observed over two hundred years ago, is known as the invisible hand of the market, and is assumed to maximize social efficiency.

The use of taxes other than Pigovian taxes –namely, other than taxes that correct externalities– interferes with this efficiency, because the taxes induce firms and individuals to shun taxed activities in favor of relatively untaxed ones, keeping us from making the best use of our resources.

In other words, it is a net welfare loss, caused by reducing the welfare of taxpayers by taxing them, without generating revenue that could be used to enhance welfare through government actions such as the provision of public goods or redistribution.

A significant part of the inefficiency cost of taxation derives from administrative costs such as compliance and enforcement. Empirical research estimates these costs to be about 20%, meaning that in order to finance one dollar of transfer payment to promote distributive justice, the government needs to raise in tax not just one dollar but one dollar and twenty cents (27).

Some inefficiency is caused by tax avoidance activity, because taxpayers engage in transactions that are not optimal from a business perspective, and which therefore do not generate the highest possible yield. These transactions include tax evasion, which is illegal, as well as tax planning, which is legal. Both can involve huge transaction costs, such as the incorporation of a company abroad, the use of shell companies, etc. It may also include relatively small and legitimate actions, which because many millions of people also engage in these actions amount to significant aggregate sums at the national level.

This is a cost to society, since the production factors are not being optimally used to produce the maximum yield. The people who work in facilitating tax planning or evasion, such as lawyers and accountants, as well as those who work on the government side to enforce the taxes, do not create any added value to society. They do not increase the standard of living. They merely engage in the distribution of income generated by others within the society. Ultimately, they pull in opposite directions.

(27) Slemrod, J. and Bakija, J., *Taxing Ourselves*, MIT Press, Cambridge (MA), 2004, at. pp. 158-161. It is important to note that soliciting donations for non-profits is also wasteful. It is an open empirical question whether charitable fundraising costs are lower than tax compliance and administrative costs.

But the *term excess* burden is often used to describe one specific cost of taxation: the effect that taxes have on relative prices.

It would be easier to explain using an example. American examples often involve the neighbor's teenager coming over to babysit, or to mow our backyard lawn, or to shovel snow from our front yard.

Let us imagine babysitting.

You want to go out for 5 hours to, say, a movie and dinner. You have a baby, and your neighbor's teenage daughter is willing to babysit.

Her reservation price is $15 an hour. By reservation price (also known as the opportunity cost of her time), we mean what her leisure time is worth to her, assuming that leisure is her alternative to taking the babysitting job.

Let us assume this is the competitive price, at least in the area you are living in. Namely, this is what babysitters charge per hour. You would not find a less expensive option.

You are happy to pay $20 per hour. Hence, both of you would benefit from a transaction at a price that is anywhere between $15 and $20 per hour.

As we have assumed 5 hours of work, there is a social surplus generated by this voluntary transaction of 5 X $5 = $25.

If the transaction were set at $20 per hour, then the entire surplus of $25 would go to the babysitter.

If the transaction were set at $15 per hour than the entire surplus of $25 would go to you.

Suppose now that there is a 26% income tax. You are willing to pay up to $20 per hour, but the potential babysitter will not take the job unless she receives $15 per hour, which is more than the $14.80 that will be her after-tax income if you pay her $20 (28).

So, assuming she does not evade taxes, you will not go out to see a movie and she will stay at home and will not benefit from having some extra cash.

Please note that no one in this example has benefited from this tax. Both participants in the aborted transaction lost an opportunity to increase personal happiness, but because no tax was paid, no one benefited from any use of tax revenue.

The loss to society is the social surplus that was not created. Assuming, in our example of 5 hours of work, that this would have been 5 X $5 = $25. $5 per hour, being the difference between the babysitter's reservation price of $15, and what you were willing to pay, $20 per hour.

More often, a transaction does take place, but due to the tax-induced increase in prices, a smaller quantity is purchased; some potential social surplus will nonetheless be lost.

Now, let us move on to the topic of this paper –tax incentives provided to donors– and examine the excess burden the incentive saves or involves.

One important aspect of financing public goods and redistribution through donations is that unlike taxes, donations are voluntary. The easiest way to understand the argument I am about to present would be to view charitable contribution as consumption good with positive externalities (29). Donors purchase a warm

(28) $20 X (1-0.26) = $14.80.

(29) For such modeling, see Saez, E., «The Optimal Treatment of Tax Expenditures», *Journal of Public Economics*, N.º 88, 2004, pp. 2657-2684.

feeling, derived from doing a good deed; social status and prestige; political power; or even the belief that they have secured a place in heaven.

When donations fund public goods and promote distributive justice, they improve the overall efficiency of the system by replacing taxes that involve excess burden. The problem, however, is that donations confer positive externalities and therefore are undersupplied. This is obviously true when financing public goods, but it is even so when the donation is a gift to one recipient.

Let us look at the following simple example. An individual will donate up to the point at which the marginal benefit to the individual just equals the marginal cost. A donation that costs the donor $1, makes the donor happier by more than $1. She will continue to make such donations until the marginal benefit she derives from donating $1 is lower than $1. Let us assume for example that the benefit to her from donating $1 is only $0.75. In that case, she does not make the donation. From a social point of view, this is inefficient if the recipient derives a benefit greater than $0.25. Let us assume that the benefit derived by the recipient is $1. In that case, donating $1 increases social welfare by $1.75 (30).

As in most market transactions, the price will have an effect on the quantity demanded. The charitable contribution deduction effectively reduces the price of the charitable contributions relative to non-deductible consumption to one minus the marginal income tax rate for those who claim them (31).

Assuming for ease of calculation, that the donor's marginal tax rate in our example is 50%. Deducting her charitable contribution reduces the out-of-pocket cost of the donation from $1 to $0.50. This motivates the donor to make the donation because it costs her $0.50, whereas the benefit she derives in our example is $0.75. From a social point of view, this is efficient, because at a total cost of $1, a total benefit of $1.75 was derived. For this reason, efficiency requires the subsidization of all gifts and bequests, even if no public goods are being financed (32).

Charitable contribution to non-profits usually provides positive external benefits to others besides the direct recipients. For example, a donation that finances private tutoring to underprivileged children helps not only them but also society in general, as living in a more equal society improves the overall good feeling of success and harmony. In particular, these children will later become more productive workers and contribute to society through products or services, as well as increase taxation revenue.

The effect of the charitable contribution deduction depends on its price elasticity that is the percentage change in donations caused by a 1% change in price. Allowing taxpayers to deduct their charitable contributions decreases tax revenue, but increases donation.

Let us assume that donations finance the provision of public goods and services, of similar value, that advance the maximization of the social welfare function of government. If we also assume that the government would otherwise fund such

(30) Bakija, J., «Tax Policy and Philanthropy: A Primer on the Empirical Evidence for the United State and Its Implications», *Social Research*, Vol. 80, N.º 2, 2013, pp. 557-584, at p. 577.

(31) The tax exemption of non-profit organizations, a topic outside the scope of this paper, has similar effects.

(32) See Kaplow, L., «A Note on Subsidizing Gifts», *Journal of Public Economics,* Vol. 58, N.º 3, 1995, pp. 469-477.

goods and services with tax revenue, then the policymakers' goal should be to induce the most donations possible, for a given cost in terms of tax revenues forgone.

To do so, the policymaker must know the price elasticity of charitable contributions. It also needs to assess the administrative and compliance costs of the tax system, as well as the fundraising costs of the non-profit organizations. Moreover, to evaluate the total effect on social welfare, the dollar-valued benefits from a donation to the donors (the warm glow), the direct recipients, and others should all be weighted by the marginal social welfare weights of each involved person. For example, under a utilitarian social welfare function, the value of a $1 benefit to a high-income donor or recipient would be lower than the value of the $1 benefit to a low-income donor or recipient.

The literature on optimal taxation takes all the above considerations into account and suggests the optimal subsidy structure and tax rate (33). I will not go into the detail of the optimal tax models, but will offer one, mainly unintuitive, policy insight, explaining it non-formally with a numerical example.

When the price elasticity of donations is 1 or greater (in absolute value), $1 of tax revenue is forgone due to allowing the taxpayers to deduct their charitable contributions from their taxable incomes, resulting in a donation of more than $1. In such a case, it is intuitive to think that the charitable tax deduction is warranted. Because, assuming the donation funds public good and redistribution similar to what the government provides, the charitable contribution deduction increases the funding while keeping the level of excess burden constant, or lowers the excess burden while keeping the level of funding constant.

It is, however, less intuitive to understand why even when the price elasticity of donations is lower than 1 (in absolute value), the charitable contribution deduction may be desirable from a social policy perspective.

I will try to explain this using the following example. Suppose that the marginal tax rate of a donor is 35%, and that without a tax deduction she would donate $100. Let us assume now that if she is allowed to deduct the charitable contribution from her taxable income she would donate $154 or more. This means that when the elasticity is 1 or greater (in absolute value) no tax revenue in our example is forgone (34).

Further assume that the elasticity is lower than 1 (in absolute value), but that the public good in our example is funded only by donors at a level that the policymaker views to be too low. Let us assume it is currently funded at $100 billion, but that the government would like it to be $130 billion. The problem, however, is that when the government uses tax revenue to increase the total funding for this particular public good, the donors reduce their contributions by the same amount. This phenomenon is known as «crowding out,» which is the change in private donations caused by a $1 increase in government spending (35).

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(33) See, e.g., Saez, *supra* note 29; Diamond, P., «Optimal Tax Treatment of Private Contributions for Public Goods With and Without Warm Glow Preferences», *Journal of Public Economics*, Vol. 90, N.º 4-5, 2006, pp. 897-919.

(34) $154 x (1- 0.35) = $100

(35) See Roberts, R. D., «Financing Public Goods», *Journal of Political Economy*, Vol. 95, N.º 2, 1987, pp. 420-437; Andreoni, *supra* note 25.

Assuming donors decrease their donation by $1 for each $1 the government contributes, it would cost the government $130 billion to bring the level of the public good to the desired level.

Instead, the government may offer the donors a tax incentive. Let us assume it is a tax deduction, and let us further assume that the donors' marginal tax rate is 35%. Let us also assume that the price elasticity of contribution is *lower* than 1 (in absolute value), so that the donors do not increase their donations by $154 billion or more. Let us assume they increase it only to $130 billion, satisfying the government goal.

In that case, offering the tax deduction reduced the out-of-pocket donation from $100 billion –which was the amount donors contributed with no tax deduction– to only $84.5 billion (36). However in the presence of crowding out, it allows the government to reach the $130 billion goal with an investment of $45.5 instead of $130 billion, saving it $84.5 billion (37).

To sum up, the charitable contribution deduction may increase social welfare. Its optimal structure and rate depend on: (a) the price elasticity of contribution; (b) the dollar-valued benefits from a donation to the donors, to the direct recipients, and to others, weighted by the marginal social welfare weights of each involved person, under our choice of a social welfare function; and (c) the level of crowding out.

VII. **DISTRIBUTIONAL IMPACT OF CHARITABLE CONTRIBUTIONS**

The optimal tax model described above considers the distributional impact, as maximizing social welfare requires finding the optimal balancing of efficiency and equity considerations. The previous chapter, however, elaborated on the efficiency aspect of the charitable contribution deduction, as most of the chapter was devoted to explaining and discussing the issue of elasticity. This chapter will focus on the equity consideration.

It is important to distinguish between: (a) the distributive implications of using the mechanism of donations to finance the public goods; (b) the design of tax subsidy (Why not replace the deduction with a credit? Why not offer the tax subsidy to all donors, namely, for any private provision of public goods, instead of limiting it to those who itemize their deductions?); and (c) the profile of people who donate, distinguished by income class; how progressive is the distribution of the outputs of non-profit organizations?

7.1 THE DISTRIBUTIVE IMPLICATIONS OF USING THE MECHANISM OF DONATIONS TO FINANCE PUBLIC GOODS

The warm glow effect discussed above obviously increases social welfare when we look only at its positive effects on donors. However, some of the good feeling experienced by donors is from the increase in their social status. Such an

(36) 130 x (1- 0.35) = $84.5
(37) 130 x 0.35 = $45.5

increase may create a negative externality on others, and be regarded as rent-seeking, as social status is a zero sum game (38).

This would decrease social welfare. Thus, the social desirability of providing the public good by the mechanism of subsidizing donation depends on the outcome of the trade-off between the increase in well-being of the donors due to the warm glow on the one side, and the decreased well-being of others on the other side. Donors, too, may be adversely affected by donations of other donors, as it reduces their own social status.

The negative externality created by donations, due to the zero-sum game nature of social status, reduces social welfare. It should therefore be taken into account when designing the optimal tax structure and rate of the tax incentive offered to donors. It could even lead to the conclusion that donations should be taxed.

There are reasons not to include warm glow in the social welfare perspective. People may donate due to unpleasant pressure imposed on them. In such circumstances, the warm glow does not describe an increase in social welfare but merely a decrease in disutility coming from the pressure to donate (39). Moreover, the analysis of warm glow may be too incomplete to allow basing policy recommendations on it. Warm glow is an evaluation based on the *process* of determining the final resource allocation. If we only track some uses and ignore others, the policy implications may be distorted. If we cannot account for all of the uses of resources, we may be better off not accounting for any of them, including the warm glow, at all (40).

In addition, it is very difficult to measure warm glow because of behavioral biases. Experiments find that people react differently to seemingly equivalent subsidy-schemes (41).

Finally, the policymaker may need to account for the following additional argument: relying on donors to finance public goods severs the link between processes of decision-making and the citizens these decisions are intended to benefit, and therefore erodes political engagement and its underlying notion of shared

(38) See Frank, R. H., *Choosing the Right Pond: Human Behavior and the Quest for Status*, Oxford University Press, New York (1985); Frank, R. H., «Frames of Reference and the Quality of Life», *American Economic Review*, Vol. 79, N.º 2, 1989, pp. 80-85; Frank, R. H., «Positional Externalities», in R. J. Zeckhauser (ed.), *Strategy and Choice*, MIT Press, Cambridge (MA), 1991, pp. 25-47; McAdams, R. H., «Relative Preferences», *Yale Law Journal*, N.º 102, 1992, pp. 1-104; Blumkin, T. and Sadka, E., «A Case for Taxing Charitable Donations», *Journal of Public Economics,* Vol. 91, N.º 7-8, 2007, pp. 1555-1564.

(39) See Diamond, *supra* note 33, at pp. 909, 917; Andreoni, J., «Philanthropy», in S. Kolm and J. M. Ythier (eds.), *Handbook of the Economics of Giving, Altruism and Reciprocity*, North-Holland, Amsterdam, 2006, pp. 1201-269, at p. 1225; but see Schizer, D. M., *Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals*, Tax Law Review, N.º 62, 2009, pp. 221-269, at p. 226 (arguing that it is a matter of context. People donate under pressure only in unusual settings, because usually there are painless ways to refuse a solicitation… «Obviously, many donors derive great joy from their donation, and this satisfaction should not be dismissed as irrelevant.»).

(40) See Diamond, *supra* note 33, at p. 916.

(41) See, e.g., Eckel, C. and Grossman, P., «Rebate Versus Matching: Does how we Subsidize Charitable Contributions Matter?», *Journal of Public Economics*, Vol. 87, N.º 3-4, 2003, pp. 681-701 (finding that total contributions were 1.2-2 times greater with a match than a rebate, and were more responsive to changes in the match than they were to changes in the rebate).

responsibility (42). This is so even if everyone wants the public good to be financed by donations rather than taxes. This is because when the public good is financed by donations, the citizens are giving up some political engagement and responsibility that some scholars do not believe they should be allowed to surrender (43).

7.2 THE DESIGN OF THE TAX SUBSIDY FOR DONATIONS

As mentioned in the Introduction, the charitable deduction is more valuable to high-income taxpayers than to low-income taxpayers because of the increasing marginal tax rates structure. This makes it cheaper for high-bracket taxpayers to donate.

Replacing the deduction with a tax credit, namely reducing tax liability dollar for dollar taking into account amounts given to charity, would equalize the after tax price of donation to low and high income taxpayers.

A credit would also allow the government to choose the credit rate that would maximize donations, whereas in setting the marginal tax rates the policymaker is mostly concerned with the willingness of taxpayers to work and save, not their willingness to give to charity (44).

However, if the price elasticity of giving is greater than 1 (in absolute value), it may be that the deduction amplifies the redistributive effect of the tax by encouraging the wealthy to devote more dollars to charities that benefit the poor than wealthy donors save in taxes (45).

Moreover, if high-income individuals have larger price elasticity for contributions than low-income individuals, offering high-income individuals a greater subsidy– as a deduction does– would increase overall contributions (46).

It therefore seems likely that a credit is better, but empirical findings regarding elasticity of donation may justify a deduction.

7.3 THE DISTRIBUTION OF THE OUTPUTS OF NON-PROFIT ORGANIZATIONS

Much has been written about the distributive allocation of charitable contributions (47). As a percentage of annual income, deductible contributions make a

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(42) Dorfman, A. and Harel, A., «Against Privatization as Such», (Jan. 2015) (unpublished manuscript, on file with author).

(43) The argument is presented in the text de-ontologically. It could be «translated» to welfarism to better fit the rest of this paper, by plausibly assuming that social welfare is increased when citizens are politically engaged and that they derive utility from having responsibility over the choice and quality of their public goods and can influence the way the public goods are managed. See also Diamond, *supra* note 33, at 909 («Perhaps there is resentment at the need to provide privately what is seen as a government obligation.»).

(44) See Schizer, *supra* note 39, at p. 238.

(45) See Brannon, G., «Tax Expenditures and Income Distribution: A Theoretical Analysis of the Upside-Down Subsidy Argument», in H. Aaron and M. Boskin (eds.), *The Economics of Taxation,* Brookings Institution, Washington, 1980, pp. 87-98, at. pp. 92-95.

(46) See Strand, *supra* note 20, at p. 276.

(47) See, e.g., Auten, G. E., Clotfelter, C. T. and Schmalbeck, R. L., «Taxes and Philanthropy among the Wealthy», in J. Slemrod (ed.), *Does Atlanta Shrug? The Economic Consequences of*

U-shape pattern. Low-income taxpayers contribute a relatively high percentage of their AGI. Donations as a percentage of AGI fall as AGI increases. When AGI reaches annual income of around $500,000 (in 2009) donations as a percentage of income start to increase (48). The very rich contribute about the same percentage of their income as low-income taxpayers. Because there are many more low-income taxpayers than very rich ones, much more donations, in dollar terms, are made by low-income taxpayers. Most of the contributions, in dollar terms, come from middle-income taxpayers.

The types of organizations favored by donors differ systematically according to their incomes. For individuals of modest means, religious organizations are far and away the most favored type of donee. Middle-income taxpayers donate mostly to religious organizations as well as to education. High-income taxpayers donate to higher education, health, religion and the arts (49).

Only about 7.5% of all donations go towards the satisfaction of basic needs, that is, towards relieving poverty (50). Empirical studies find diversity within the non-profit sector, with no overarching distributional impact (51). In no sub-sector of the non-profit sector is there evidence that benefits are dramatically skewed towards the rich or the poor.

Even in the sectors in which one might think that for-profits would have a redistributive effect, such as education (52) and healthcare (53), it appears that government-funded schools and hospitals are much more favorable to the poor and the uninsured than the non-profits. When it comes to hospitals, even for-profit hospitals are often more generous to the poor than the non-profit hospitals (54). In areas such as employment, training and income support, legal rights and advocacy, there is a strong positive correlation between reliance on government funding and servicing the poor (55).

To sum up, empirical studies support Vickrey's hypothesis that «the role of philanthropy in redistribution is relatively slight» (56).

Taxing the Rich, New York and Cambridge (MA), Russell Sage Foundation and Harvard University Press, pp. 392-424; Auten, G. E., Sieg, H. and Clotfelter, C. T., «Charitable Giving, Income and Taxes: An Analysis of Panel Data», *American Economic Review*, Vol. 92, N.º 1, 2002, pp. 371-382, at p. 371; Clotfelter, C. T., «The Economics of Giving», in J. W. Barry and B. V.Manno (eds.), *Giving better, giving smarter: working papers of the National Commission on Philanthropy and Civic Renewal*, National Commission on Philanthropy and Civic Renewal, Washington (DC), 1997, pp. 31-55.

(48) Clotfelter, C. T., «Charitable Giving and Tax Policy in the U.S.», in G. Fack and C. Landais (eds.), *Charitable Giving and Tax Policy: A Historical and Comparative Perspective*, Oxford University Press, Oxford, 2014, pp. 34-63.

(49) *Id.*

(50) *Id.*

(51) Clotfelter, C. T., «The Distributional Consequences of Nonprofit Activities», in C. T. Clotfelter (ed.), *Who Benefits from the Nonprofit Sector?*, Chicago University Press, Chicago and London, 1992, pp. 1-24.

(52) See, e.g., Schwartz S. and Baum, S., «Education», in *Who Benefits from the Nonprofit Sector?*, *supra* note 48, pp. 55-92.

(53) See, e.g., Salkever, D. S. and Frank, R. G., «Health Services», in *Who Benefits from the Nonprofit Sector?, supra* note 48, pp. 24-55.

(54) Stern, K., *With Charity for All*, New York, Doubleday, 2013.

(55) Salamon, L. M., «Social Services», in *Who Benefits from the Nonprofit Sector?*, *supra* note 48, pp. 134-174.

(56) Vickrey, W., «One Economist's View of Philanthropy», in Frank Dickenson (ed.), *Philanthropy and Public Policy*, New York, National Bureau of Economic Research, pp. 31-56.

Does it matter? Perhaps not. As detailed in the first parts of this paper, the charitable contribution deduction, or any other subsidy provided to the non-profit sector, can be justified on efficiency grounds. The non-profit sector provides pluralism; brings individuals' preferences over public goods to the government's attention; and the tax subsidy manipulates donors to contribute even more than they would have otherwise contribute (57).

One could focus on the efficiency role of the tax preference alone. To the extent it reduces the excess burden of tax and increases the provision of public goods, the tax-and-transfer system viewed as a whole becomes more progressive, namely, redistribution takes place. That is so, because we plausibly assume no correlation between individual's income and the benefit she derives from public goods. High and low income individuals may tend to benefit from different public goods, but benefit equally from public goods on the aggregate level.

Assuming that donations fund public goods at, or below, the socially optimal level, donations free-up the tax revenue that would have been otherwise required to finance those public goods. Hence, the money that would have been required to finance those public goods, minus the forgone tax revenue due to the tax subsidy, can be used for redistribution purposes. Money has no earmarks.

This is similar to the idea that legal rules should be as efficient as possible and allow the trade-off between efficiency and equity to take place at a higher level, striking a balance between efficient legal rules and the tax and transfer system (58).

Adopting this view does not relieve us from the need to assess the distributional effects of donations. However, this is done not to necessarily change the structure of incentives to make the non-profits more redistributive, but in order to adjust the level of redistribution carried through the tax-and-transfer system to offset whatever impact (regressive or progressive) donations have on overall redistribution in society.

This adjustment is required to bring the overall level of redistribution to the level that is thought to maximize our social welfare function.

One could raise an objection to the above argument by pointing out that this does not happen when the charitable contribution deduction is justified by pluralism, or on asymmetric information grounds: If the donors finance public goods that the government would not have otherwise funded, then no tax revenues are being freed-up for redistribution purposes.

I think this objection can be answered as follows. Assuming that the government should increase taxes and finance those public goods as well, that is, the government would have done so in the first place had it known the preferences of the individuals, then the private funding allows the government to increase taxes to the level they should have been and use the additional tax revenue for redistribution purposes.

To sum up. The non-profit sector does not have a significant re-distributional impact. This may call for a change in the incentives given to the organizations, as well as to the donors that finance them. To the extent that changing the incentives would decrease the efficiency of the non-profit sector in terms of pluralism, infor-

(57) I use the word «manipulate» because at least some of the subsidy's effect on donors has to do with cognitive biases.

(58) See Kaplow, L. and Shavell, S., «Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income», *Journal of Legal Studies*, N.º 23, 1994, pp. 667-683.

mation and decreased excess burden (59), it is possible that redistribution should be left to the tax and transfer system.

VIII. **CONCLUSION**

In this paper, I have examined the possible justifications for the charitable contribution deduction and found that, in spite of its name, it serves an efficiency role. It may also enhance democracy, by forcing the majority to spend some tax revenue on public goods that satisfy minorities' preferences. However, by freeing up some tax revenue that would have been otherwise required to finance some public goods, it increases social well-being by reducing distortive taxes, or by allowing, at the same level of taxes, additional provision of public goods or transfer (welfare) payments. Public goods are equivalent to universal transfer payments in-kind. Hence, even though the charitable contribution deduction has a regressive effect on the tax structure, and the tax-exempt entities it finances have a neutral effect on inequality, the deduction may have an overall positive redistributive effect.

There is no reason to think that the charitable contribution deduction is optimal. Switching to a tax credit is intuitively compelling, calling for empirical studies of elasticity to assess the intuition's validity. The same is true with respect to providing differential incentives for contribution based on the tax-exempt organizations' impact on redistribution. This calls for empirical studies that would measure the additional administrative costs of introducing differential incentives, and requires a cost-benefit analysis to see whether the outcome is indeed welfare enhancing.

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(59) Providing the tax subsidy involves forgiving tax revenue, namely, involves tax excess burden, as this tax revenue has to be collected. However, it is possible that for various psychological reasons, and due to the value that donors place on their ability to control the use of the tax revenue, the tax subsidy results in greater collection of private money to finance public goods than the tax system would collect at the same level of excess burden.

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