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Case Study #11: Deduction for Charitable Contributions

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These results are part of an eleven-part series, *The Economics of the Blank Slate*, created to discuss the economic effects of repealing various individual tax expenditures. In these reports, Tax Foundation economists use our macroeconomic model to answer two questions lawmakers are considering:

1. **What effect does eliminating these expenditures have on GDP, jobs, and federal revenue?**
2. **What would be the effect on GDP, jobs, and federal revenue if the static savings were used to finance tax cuts on a revenue neutral basis?**

Key Points:

Eliminating the deduction for charitable contributions would:

- Increase tax revenues by $39 billion on a static basis;
- Reduce GDP by $40 billion; and
- Generate slightly less revenues ($30 billion) on a dynamic basis;
- Reduce employment by the equivalent of approximately 131,000 full-time workers; and
- Reduce hourly wages by 0.2 percent.

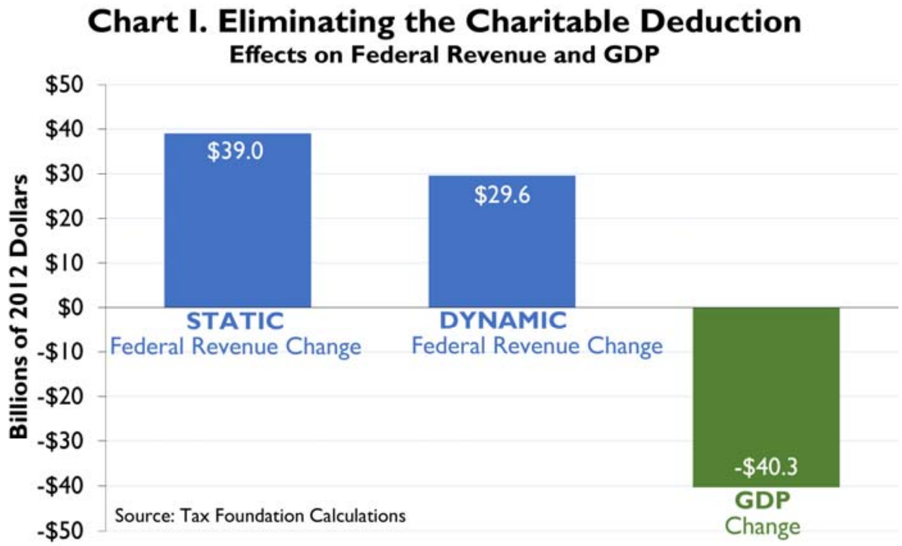
Eliminating the deduction for charitable contributions and trading the static revenue gains for individual rate cuts would:

- Allow for an across-the-board rate cut of 3.7 percent;
- Boost GDP by $19 billion per year; and
- Boost federal revenues by $4.5 billion on a dynamic basis;
- Increase employment by the equivalent of approximately 200,000 full-time workers; and
- Reduce hourly wages by 0.1 percent.

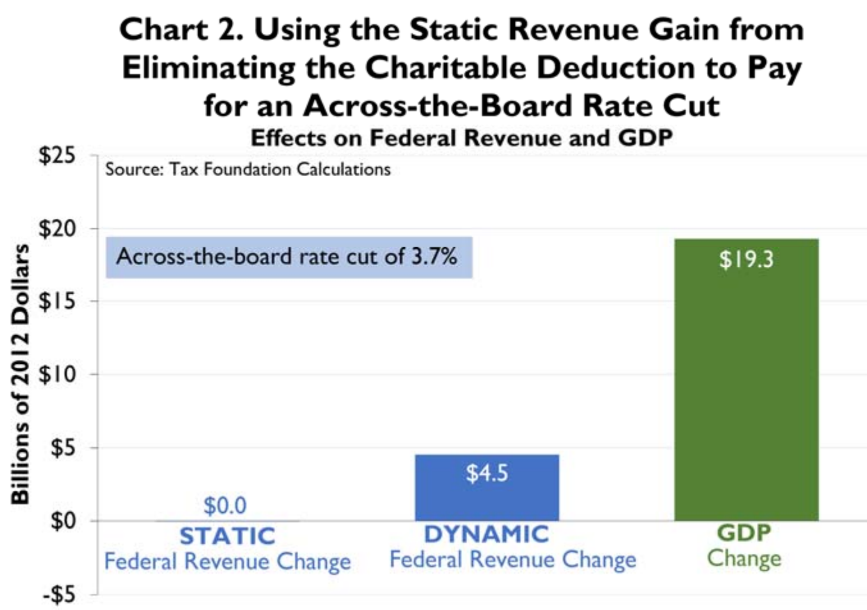
The income tax's charitable deduction serves the valuable purpose of encouraging private giving. Private charities are often more cost conscious, responsive, better targeted, and invite greater citizen participation than government outlay programs. The deduction also recognizes that people contributing to charities are transferring part of their incomes to others, which reduces their ability to pay taxes out of what remains. The

Joint Committee on Taxation and the Treasury, however, classify the charitable deduction as a tax expenditure because it would not be included in what they regard as a normal, broad-based income tax.

In a conventional static revenue estimate that holds total economic activity constant, the Tax Foundation's model estimates that repealing the charitable deduction would raise federal income tax receipts by $39 billion. (See Chart 1.)



In the dynamic simulation that includes growth effects, our model also estimates that disallowing the charitable deduction would lower GDP by $40 billion, which would trim the revenue gain to $30 billion. The growth slowdown occurs in the model because the loss of the deduction increases people's taxable incomes, pushing more of them into higher tax brackets. This may understate the harm because the model does not estimate the benefits mentioned above for charitable activities, some of which may have a favorable impact on growth.



The model was run a third time under the assumption that the static estimate of the revenue gain is plowed back into an across-the-board cut in individual tax rates. The lower marginal rates would soften the tax system's biases against investment and work effort, which would expand the quantities of labor and capital inputs and, thereby, lead to more production. The model estimates that the combined effect of trading the charitable deduction for a uniform cut in marginal rates would add $19 billion to GDP and, due to the positive revenue feedback, provide a net gain of $5 billion in federal revenue. (See Chart 2.) The difficult policy question, of course, is weighing these benefits against the social desirability of the charitable deduction.

Finally, we determined the impact of these scenarios on employment and wages. We found that eliminating the charitable deduction would decrease employment by the equivalent of about 131,000 full-time workers and cut hourly wages by 0.2 percent. With the rate cut offset, employment would increase by the equivalent of about 200,000 full-time workers but hourly wages would fall by about 0.1 percent.

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About the Tax Foundation
The Tax Foundation is a 501(c)(3) non-partisan, non-profit research institution founded in 1937 to educate the public on tax policy. Based in Washington, D.C., our economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability.