How Charitable Is the Charitable Contribution Deduction?

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Section 170 of the U.S. Internal Revenue Code is known as the "charitable contribution deduction." This Article explores the section's rationale as well as its effect on income/wealth distribution. It reaches the conclusion that the deduction can be justified on efficiency (mitigating the free-riding on public goods and asymmetric information problems) and democracy grounds, but is not "charitable," as its distributive effects are neutral or even regressive.

Introduction

Section 170 of the U.S. 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 socioeconomic issues such as "community deterioration and juvenile delinquency."

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1 *See* I.R.C. § 170 (2013).

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

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However, *inequality* in general and *income or wealth inequality* in particular are not explicitly stated.[3] In this Article, I argue that the term "charitable" may somewhat overstate the connection between the deduction and promotion of distributive justice, which generally refers to decreasing income or wealth inequality, 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 for their donors to qualify under the section.[5] 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 an appreciated asset is contributed, 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*.[8] The higher their income, the more likely taxpayers are

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3 *Id.*

4 *See* John D. Colombo, *The Role of Access in Charitable Tax Exemption*, 82 Wash. U. L.Q. 343, 343 (2004).

5 *See* Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 Wash. U. L. Rev. 505, 555 (2010).

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 *infra* Section I.A.

7 The marginal tax rate is the income tax rate applying to the last dollar of taxable income.

8 Under U.S. tax law, taxpayers can choose between deducting a standard amount, per person, from their adjusted gross income to arrive at their taxable income, or to deduct specific deductions from a list of allowable items. Taxpayers, who choose to deduct specific deductions instead of the standard amount, are said to be itemizing their deductions.

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 expenditures, 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 Article, I try to understand what could justify the charitable contribution deduction, once we realize that it is not necessarily "charitable," 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 wellbeing of all members of society. I find that although the charitable contribution deduction may be labeled "charitable," it is mostly justified on efficiency grounds.

In Part I, 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 II discusses the justification for the charitable contribution deduction as a form of payment for outsourced provision of public goods. The government intervenes in the market to overcome a market failure known as free-riding 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 nonprofits, the government may reimburse them through tax subsidies. The charitable contribution deduction benefits the nonprofits by lowering their capital financing costs. Part III 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. In Part IV, 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 V discusses the distributional impact of the charitable contribution deduction. Finally, I conclude.

I. When a Charitable Contribution Deduction Is Required to Accurately Calculate Taxable Income

The government employs an income tax (as well as consumption tax, which is the same as taxing income but excluding the income from savings) to finance public goods. One could think of more efficient taxes, such as a uniform head tax, namely, a tax stated in fixed dollars. Such a tax is more efficient than income tax (or consumption tax) because lump-sum taxes do not affect the taxpayer's behavior, as each taxpayer's liability is fixed.[9] The modern policymaker does 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. 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.

A. 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.[10] These expenses reduce her ability to consume; accordingly,

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9 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 involves.

10 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.

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. This is why the deduction is commonly thought to be *charitable*, namely to promote distributive justice.

In reality, however, charitable contributions often have the same effect as advertising 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.[11]

Business motives are less obviously present with respect to contributions made by individual donors. However, 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 as a business expense. Making charitable contributions is often a necessary prerequisite for becoming a member of the boards of prestigious nonprofit 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 nonprofit boards, are more likely to do so for social status 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

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11 *See* Nancy J. Knauer, *The Paradox of Corporate Giving: Tax Expenditures, the Nature of the Corporation, and the Social Construction of Charity*, 44 DePaul L. Rev. 1 (1994); Linda Sugin, *Encouraging Corporate Charity*, 26 Va. Tax Rev. 125 (2006).

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 Section, is that it has to be deducted when computing taxable income. According to this interpretation, section 170 is not a subsidy given to taxpayers to induce them to privately provide public goods and to engage in redistribution. Section 170 merely measures the taxable income accurately, as disallowing the deduction of business expenses would be akin to overtaxing the income.

B. 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 a taxpayer's ability to consume during that year. Some influential legal scholars have argued that donations are not consumption, and therefore should not be taxed.[12] This view has since been broadly rejected.[13] Indeed, it is difficult to understand how, as a technical matter, the voluntary use of one's own resources would not be considered

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12 William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 Harv. L. Rev. 309, 314-15 (1972) ("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* Boris I. Bittker, *Charitable Contributions: Tax Deductions or Matching Grants?*, 28 Tax L. Rev. 37, 58-59 (1972) (arguing that charitable donations should not be considered consumption because they "discharge moral obligation"); Johnny Rex Buckles, *The Community Income Theory of the Charitable Contributions Deduction*, 80 Ind. L.J. 947, 952 (2005) (arguing that assets donated to charity should more properly be considered "community income").

13 *See* Dana Brakman Reiser, *Dismembering Civil Society: The Social Cost of Internally Undemocratic Nonprofits*, 82 Or. L. Rev. 829, 882-83 & n.199 (2003) (noting the literature's rejection of this argument); John D. Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 Wake Forest L. Rev. 657, 661 (2001) (same); Brian Galle, *The Role of Charity in a Federal System*, 53 Wm. & Mary L. Rev. 777, 787 (2012) (same); Perry Fleischer, *supra* note 5, at 517; David E. Pozen, *Remapping the Charitable Deduction*, 39 Conn. L. Rev. 531, 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

as consumption.[14] 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 a technical, straightforward interpretation would point in a different direction. However, there 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.

II. 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.[15] 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.[16] 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. The motive of redistribution was not explicitly stated. 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.[17]

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the ultimate well-being of society. That is, the deduction is widely viewed as a government subsidy . . . .").

14 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* Amartya Sen, *Rational Fools: A Critique of the Behavioral Foundations of Economic Theory*, 6 Phil. & Pub. Aff. 317 (1977).

15 The possibility that a 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 11.

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

17 *See* James J. Fishman & Stephen Schwarz, Taxation of Nonprofit Organizations: Cases and Materials 594 (3d ed. 2010); John A. Wallace & Robert W. Fisher, *The Charitable Deduction Under Section 170 of the Internal Revenue Code*

This motive was stated again when the provision, initially available only to individuals, was amended during the Great Depression to include corporate donors.[18] The charitable organizations that qualify under section 170 are a corporation, trust, or community chest, fund, or foundation, created or organized in the United States and under U.S. 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 involves the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals. These organizations are nonprofit. No part of their net earnings contributes 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.

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 a market failure explains why the market does not provide the goods and services at the desirable level in the absence of government

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(1975), *reprinted in* 4 Research Papers Sponsored by the Commission on Private Philanthropy and Public Needs 2131 (Dep't of Treasure ed., 1977).

18 *See* Colombo, *supra* note 13, at 682 ("[T]he federal government sought voluntary transfers from the private sector (i.e., nontax revenue) to fund needed social programs.").

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?[19] 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 nonprofit firms.

The government decides which 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 will 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.[20] 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 minimizes the tax obligation of the service provider. The tax revenue forgiven is the 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.[21]

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

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19 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 nonprofit organizations chosen by the government on the basis of efficiency.

20 For example, the Israel Supreme Court disallowed the privatization of prisons for these reasons. See Hila Shamir, *The Public/Private Distinction Now: The Challenges of Privatization and of the Regulatory State*, 15 Theoretical Inquiries L. 1 (2014) (criticizing this line of argument).

21 See Part V below, for a detailed analysis of why using tax subsidies could be efficient.

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 nonprofit 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, and choosing the lower-cost option.

One form of tax subsidy provided to nonprofit organizations is section 170: the charitable contribution deduction. It allows donors to deduct their donations, thereby lowering the financing costs of nonprofit 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.[22] The nonprofit benefits from it, and thus the deduction can be construed as a form of government payment for its services. The charitable tax deduction is, therefore, used to finance the provision of public goods. It promotes redistribution to the extent that the public goods provided by the nonprofits to which donors contribute do, but as I argue in this Article, they do not necessarily do so.

III. Partial Funding of Public Goods Preferred by Minorities and of Unknown Preferences

A. 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.[23] 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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22 Jeff Strand, *The Charitable Contributions Deduction: A Politico-Economic Analysis*, *in* The Economics of Nonprofit Institutions 265, 273 (Susan Rose-Ackerman ed., 1986).

23 Burton A. Weisbrod, *Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*, *in* The Economics of Nonprofit Institutions, *supra* note 22, at 21, 24-25. 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 fifty percent of AGI.[24] This means that individual donors who donate more than fifty percent of their AGI do not receive any subsidy for the surplus. Contributions of appreciated property are capped at thirty percent of AGI.[25] 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.[26]

B. 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 — on 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; hence their contribution signifies a strong preference for the provision of the specific public goods they choose to contribute to.

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.[27] When residents contribute to charitable organizations, they channel tax revenue to

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24 In the case of corporate donors, the cap is ten percent of AGI.

25 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 thirty percent of AGI, and property contributions are capped at twenty percent. *See* Fishman & Schwarz, *supra* note 17, at 472.

26 *See* Miranda P. Fleischer, *Generous to a Fault? Fair Shares and Charitable Giving*, 93 Minn. L. Rev. 165 (2008).

27 Saul Levmore, *Taxes as Ballots*, 65 U. Chi. L. Rev. 387 (1998).

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

IV. Reducing the Excess Burden of Taxation

Another reason for the provision of a tax subsidy to donors 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, 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 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 wellbeing 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 twenty percent of the net revenue raised, 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.[28] 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 nonetheless amount to significant aggregate sums at the national level because many millions of people engage in them.

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.

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 then the entire surplus of $25 would go to you.

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28 Joel Slemrod & Jon Bakija, Taxing Ourselves 158-61 (3d ed. 2004). It is important to note that soliciting donations for nonprofits is also wasteful. It is an open empirical question whether charitable fundraising costs are lower than tax compliance and administrative costs.

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.[29] 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 Article — 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. Being voluntary, they are not subject to the excess burden of tax.

The easiest way to understand the argument I am about to present would be to view charitable contribution as consumption good with positive externalities.[30] Donors purchase a warm 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 in the case of financing public goods, but it is so even 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

29 $20 X (1-0.26) = $14.80.

30 For such modeling, see Emmanuel Saez, *The Optimal Treatment of Tax Expenditures*, 88 J. Pub. Econ. 2657 (2004).

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.[31] 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 nondeductible consumption to one minus the marginal income tax rate for those who claim them.[32]

Assume, 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.[33]

It is especially justified in the case of charitable contribution to nonprofits, as they usually provide 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.

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 goods and services with tax revenue, then the policymaker's 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, i.e., 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. It also needs to

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31 Jon Bakija, *Tax Policy and Philanthropy: A Primer on the Empirical Evidence for the United State and Its Implications*, 80 Soc. Res. 557, 577 (2013).

32 The tax exemption of nonprofit organizations, a topic outside the scope of this Article, has similar effects. From the donors' point of view, exempting the nonprofits from tax is similar to providing the donors with a governmental match to their donations, and is essentially the same as providing the donors with a tax subsidy.

33 *See* Louis Kaplow, *A Note on Subsidizing Gifts*, 58 J. Pub. Econ. 469 (1995).

assess the administrative and compliance costs of the tax system, as well as the fundraising costs of the nonprofit organizations. Moreover, to evaluate the total effect on social welfare, the dollar-valued benefits from a donation to the donors (the warm glow[34]), 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 same $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.[35] I do not go into the detail of the optimal tax models, but 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 that the donation funds public goods 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 still 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.[36] 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 that it is currently funded at 100 billion dollars, but that the government would like it to be 130 billion dollars. The problem, however, is that when the government uses tax revenue to increase the total funding

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34 *See infra* Section V.A.

35 *See, e.g.*, Saez, *supra* note 30; Peter Diamond, *Optimal Tax Treatment of Private Contributions for Public Goods with and Without Warm Glow Preferences*, 90 J. Pub. Econ. 897 (2006).

36 $154 X (1- 0.35) = $100

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.[37]

Assuming that donors decrease their donation by $1 for each $1 the government contributes, it would cost the government 130 billion dollars 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 that 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 dollars or more. Let us assume they increase it only to 130 billion dollars, satisfying the government goal. In that case, offering the tax deduction reduced the out-of-pocket donation from 100 billion dollars — which was the amount donors contributed with no tax deduction — to only 84.5 billion dollars.[38] However, in the presence of crowding out, it allows the government to reach the 130 billion dollars goal with an investment of 45.5 billion dollars instead of 130 billion dollars, saving it 84.5 billion dollars.[39]

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. It can therefore be justified, even if it does not directly promote redistribution, but merely reduces the excess burden of tax, making the tax and transfer system as a whole more efficient.

V. 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 Part, however, elaborated on the efficiency aspect of the charitable contribution deduction, as most of it was

37 *See* James Andreoni, *Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving*, 100 Econ. J. 464 (1990) [hereinafter Anderoni, *Warm-Glow Giving*]; James Andreoni, *Giving with Impure Altruism: Applications to Charity and Ricardian Equivalence*, 97 J. Pol. Econ. 1447 (1989); Russell D. Roberts, *Financing Public Goods*, 95 J. Pol. Econ. 420 (1987).

38 $130 X (1- 0.35) = $84.5

39 $130 X 0.35 = $45.5

devoted to explaining and discussing the issue of elasticity. This Part focuses 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) how progressive the distribution of the outputs of nonprofit organizations is.

A. The Distributive Implications of Using the Mechanism of Donations to Finance Public Goods

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 a 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 to 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*.[40] 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.[41] However, some of the good feeling experienced by donors comes from the increase in their social status. Such an increase may create a negative externality on others and be regarded as rent-seeking, as social status is a zero-sum game.[42] 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 tradeoff between the increase in wellbeing of the donors due to the warm

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40 The term was coined by Andreoni. *See* Anderoni, *Warm-Glow Giving*, *supra* note 37.

41 There are arguments against including warm glow in social welfare, as discussed below.

42 *See* Robert H. Frank, Choosing the Right Pond: Human Behavior and the Quest for Status (1985); Tomer Blumkin & Efraim Sadka, *A Case for Taxing Charitable Donations*, 91 J. Pub. Econ. 1555 (2007); Robert H. Frank, *Frames of Reference and the Quality of Life*, 79 Am. Econ. Rev. 80 (1989); Robert H. Frank, *Positional Externalities*, *in* Strategy and Choice 25 (Richard J. Zeckhauser ed., 1991); Richard H. McAdams, *Relative Preferences*, 102 Yale L.J. 1 (1992).

glow on the one side, and the decreased wellbeing 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 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.[43] Moreover, the analysis of warm glow may be too incomplete to allow policy recommendations to be based 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.[44] 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.[45]

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 responsibility.[46] This is so even if everyone wants the public good to be financed by donations rather than taxes. This is because when the public

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43 *See* Diamond, *supra* note 35, at 909, 917; James Andreoni, *Philanthropy*, *in* Handbook of the Economic of Giving, Altruism and Reciprocity 1201, 1225 (Serge-Christophe Kolm & Jean Mercier Ythier eds., 2006). *But see* David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals*, 62 Tax L. Rev. 221, 226 (2009) (arguing that it is a matter of context and that 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.").

44 *See* Diamond, *supra* note 35, at 916.

45 *See, e.g.*, Catherine Eckel & Phillip Grossman, *Rebate Versus Matching: Does How We Subsidize Charitable Contributions Matter?*, 87 J. Pub. Econ. 681 (2003) (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).

46 Avihay Dorfman & Alon Harel, Against Privatization as Such (Jan. 2015) (unpublished manuscript) (on file with author).

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.[47]

B. 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 while 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 maximizes 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.[48]

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.[49] Moreover, if the price elasticity for contributions by high-income individuals is greater than that of low-income individuals, offering the former a greater subsidy — as a deduction does — it would increase overall contributions.[50] This, however, requires empirical support. Unless such support is provided, a tax credit seems to be better from a policy perspective than a deduction.

C. The Distribution of the Outputs of Nonprofit Organizations

Much has been written about the distributive allocation of charitable contributions.[51] As a percentage of annual income, deductible contributions

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47 The argument is presented de-ontologically. It could be "translated" to welfarism to better fit the rest of this Article, 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 35, at 909 ("Perhaps there is resentment at the need to provide privately what is seen as a government obligation.").

48 *See* Schizer, *supra* note 43, at 238.

49 *See* Gerard M. Brannon, *Tax Expenditures and Income Distribution: A Theoretical Analysis of the Upside-Down Subsidy Argument*, *in* THE ECONOMICS OF TAXATION 87, 92-95 (Henry J. Aaron & Michael J. Boskin eds., 1980).

50 *See* Strand, *supra* note 22, at 276.

51 *See, e.g.*, Gerald E. Auten, Charles T. Clotfelter & Richard L. Schmalbeck, *Taxes*

make a U-shaped 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 an annual income of around $500,000 (in 2009) donations as a percentage of income start to increase.[52] 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.[53] Only about 7.5% of all donations go towards the satisfaction of basic needs, that is, towards relieving poverty.[54] Empirical studies find diversity within the nonprofit sector, with no overarching distributional impact.[55] In no subsector of the nonprofit 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[56] and healthcare,[57] it appears that government-funded schools and hospitals are much more favorable to the poor and the uninsured than the nonprofits. When it comes to hospitals, even for-profit hospitals are often more generous to the poor than the nonprofit

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and Philanthropy Among the Wealthy, *in* Does Atlanta Shrug? The Economics Consequences of Taxing the Rich 392 (Joel B. Slemrod ed., 2000); Gerald E. Auten, Holger Sieg & Charles T. Clotfelter, *Charitable Giving, Income and Taxes: An Analysis of Panel Data*, 92 Am. Econ. Rev. 371 (2002); Charles T. Clotfelter, *The Economics of Giving*, *in* Giving Better, Giving Smarter: Working Papers of the National Commission on Philanthropy and Civic Renewal 31 (John W. Barry & Bruno V. Manno eds., 1997).

52 Charles T. Clotfelter, *Charitable Giving and Tax Policy in the U.S.*, *in* Charitable Giving and Tax Policy: A Historical and Comparative Perspective 38 (Gabrielle Fack & Camille Landais eds., 2014).

53 *Id.*

54 *Id.*

55 Charles T. Clotfelter, *The Distributional Consequences of Nonprofit Activities*, *in* Who Benefits from the Nonprofit Sector? 1 (Charles T. Clotfelter ed., 1992).

56 *See, e.g.*, Saul Schwartz & Sandy Baum, *Education*, *in* Who Benefits from the Nonprofit Sector?, *supra* note 55, at 55.

57 *See, e.g.*, David S. Salkever & Richard G. Frank, *Health Services*, *in* Who Benefits from the Nonprofit Sector?, *supra* note 55, at 24.

hospitals.[58] 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.[59]

To sum up, empirical studies support William Vickrey's hypothesis that "the role of philanthropy in redistribution is relatively slight."[60] Does it matter? Perhaps not. As detailed in the first parts of this Article, the charitable contribution deduction, or any other subsidy provided to the nonprofit sector, can be justified on efficiency grounds. The nonprofit sector provides pluralism; it brings individuals' preferences over public goods to the government's attention; and the tax subsidy manipulates donors to contribute even more than they would otherwise contribute.[61]

One could focus on the efficiency role of the tax preference alone. To the extent that 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 an 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 otherwise have been 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 tradeoff between efficiency and equity to take place at a higher level, striking a balance between efficient legal rules and the tax-and-transfer system.[62] Adopting this view does not relieve us of the need to assess the distributional effects of donations. However, this is done not necessarily to change the structure of incentives to make the nonprofits more redistributive,

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58 Ken Stern, With Charity for All: Why Charities Are Failing and a Better Way to Give (2013).

59 Lester M. Salamon, *Social Services*, *in* Who Benefits from the Nonprofit Sector?, *supra* note 55, at 134.

60 William Vickrey, *One Economist's View of Philanthropy*, *in* Philanthropy and Public Policy 31 (Frank G. Dickenson ed., 1962).

61 I use the word "manipulate" because at least some of the subsidy's effect on donors has to do with cognitive biases.

62 *See* Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient Than the Income Tax in Redistributing Income*, 23 J. Legal Stud. 667 (1994).

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 otherwise not have 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 nonprofit sector does not have a significant redistributional 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 nonprofit sector in terms of pluralism, information and decreased excess burden,[63] it is possible that redistribution should be left to the tax-and-transfer system.

Conclusion

In this Article, 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 otherwise have been required to finance some public goods, it increases social wellbeing 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

63 Providing the tax subsidy involves forgiving tax revenue, namely, it 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.

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.