

The Charitable Deduction: Policy and Analysis*

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¹ This paper is taken from “Rationales for the Charitable Deduction,” developed for the Urban Institute’s Tax Policy and Charities project. For further information and related publications, see <http://www.urban.org/taxandcharities>. The Tax Policy and Charities project is funded by, among others, the Bill and Melinda Gates Foundation, the Charles Stewart Mott Foundation, and the Rasmuson Foundation. The findings and conclusions are those of the authors and do not necessarily reflect positions or policies of the Urban Institute, its trustees, or its funders.

Rationales for the Charitable Deduction

Many recent proposals for budget and tax reform would change the value of the charitable contribution deduction. In addition, many other tax policy reforms, such as changes in tax rates, boundaries defining what types of organizations are eligible as donees, and general rules or overall limits on itemized deductions, can affect its value. This report provides context for policymakers who may be considering one or more of these reforms, as well as for other interested observers. We first offer a basic overview of charitable giving and the legal rules for claiming the deduction. Next we discuss the various rationales that have been offered in its support and highlight critiques of the deduction. We then examine various proposed reforms, including caps, floors, credits, and grants, in light of those critiques.

Rules for the Deduction and Who Benefits from It

The charitable contribution deduction is a long-standing feature of the federal income tax.² Enacted in 1917, four years after the income tax, it is linked to tax exemption³ and has become an important source of support for the charitable sector,⁴ and one of the principal subsidies or tax expenditures in the tax code. The Joint Committee on Taxation estimates the deduction's five-year cost as \$246.1 billion.⁵ Of that number, \$25.3 billion is

² There is also a charitable contribution deduction for estate and gift tax purposes (I.R.C. § sections 2001 through 2801). This report focuses on the income tax deduction.

³ Organizations that qualify for tax exemption under section 501(c)(3) are eligible to receive deductible contributions. See Internal Revenue Service (IRS), "Exemption Requirements-Section 501(c)(3) Organizations," <http://www.irs.gov/charities/charitable/article/0,,id=96099,00.html>, accessed February 20, 2012.

⁴ Several other notable tax provisions also affect the nonprofit sector. In addition to tax exemption, section 501(c)(3) charitable organizations may benefit from tax-exempt financing, and section 501(c)(3) status often triggers state-level benefits, such as property-tax and sales-tax exemption, and eligibility to receive deductible contributions in states that provide for a deduction.

⁵ A tax expenditure estimate is not the same as a revenue estimate, but the tax expenditure estimates provide a good sense of the magnitude of the federal government's support for the charitable sector through the deduction.

for health, \$33.3 billion for education, and the remaining \$187.5 covers other charitable purposes.⁶

Rules for Claiming the Deduction

Donors

Individual donors are given an option of claiming a set of itemized deductions, including the charitable deduction, or the standard deduction (\$5,950 for singles; \$11,900 for joint returns in 2012). Thus, non-itemizers technically do not have a tax incentive to contribute but generally receive an overall deduction of greater value than if they did itemize.⁷ Most taxpayers (about 70 percent)⁸ take the standard deduction. At income levels above about \$75,000, however, the majority itemize.⁹

Various other limits, such as a maximum charitable deduction of 50 percent of the individual's annual adjusted gross income, apply to the deduction. Tighter percentage limits apply for gifts of capital gain property and for gifts to private foundations.¹⁰ Unlike

⁶ Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2010–2014," December 15, 2010.

⁷ Is the itemizer favored over the non-itemizer? While the itemizer gets to take deductions not available to the non-itemizer, the non-itemizer gets bonus deductions not available to the itemizer. Also, non-itemizers do face the incentive but do not give away enough that it applies at the margins at which they operate. The standard deduction is conceived as way to simplify administration of the tax system, allowing individual taxpayers a generic deduction as a substitute for itemized deductions. No recordkeeping or similar requirements apply.

⁸ IRS Statistics of Income Division, "SOI Tax Stats," 2009, tables 2.1 and 2.3, <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96981,00.html>.

⁹ IRS Statistics of Income Division, "SOI Tax Stats," 2009, tables 2.1 and 2.3 (showing that itemized deductions make up 66.1% of returns for incomes of \$75,000–\$100,000; 84.7% for incomes of \$100,000–\$200,000, and more than 95% of returns for incomes of \$200,000 or more. By contrast, at income levels of \$50,000–\$75,000, itemizers constituted 49.6% of returns, decreasing to 37% for incomes of \$40,000–\$50,000, 25.2% for incomes of \$30,000–\$40,000, and continuing to decrease with income.) According to Gerald Auten from the Treasury Department, the share who itemize in 2007 not counting dependent filers is 38 percent. If we exclude those who do not claim a taxpayer exemption in 2009 as an approximation of dependent filers, then some 34.5 percent would itemize, as opposed to 32.5 percent.

¹⁰ Contributions to private foundations are subject to a 30 percent limit, and contributions of capital gain property are subject to a 30 percent limit when given to most charities, but only 20 percent when given to private foundations. Also, there is a 50 percent limit to the total of all charitable contributions made during the year. Any amount in excess of a percentage limit generally may be carried forward and deducted over the subsequent five years. The alternative minimum tax (AMT) indirectly affects the charitable deduction. Although charitable contributions reduce AMT liability, the AMT's disallowance of other itemized deductions

some other itemized deductions, the charitable deduction is not subject to a particularized floor.¹¹

The value of a charitable contribution deduction depends upon the taxpayer's marginal rate of tax. For example, assume a taxpayer in a 25 percent bracket. If the taxpayer makes a qualifying \$100 charitable contribution, her taxable income will decline by \$100. That, in turn, will reduce her tax by 25 percent times \$100, or \$25. A similar contribution by a taxpayer with a 15 percent marginal rate would save only \$15 in tax.

If the gift is not cash but property, the amount deducted is generally equal to the fair-market value of the property. For example, a taxpayer who donates publicly traded stock with a fair-market value of \$10,000 and a basis (a tax term generally defined as the cost to the taxpayer of the property) of \$1,000 receives a deduction of \$10,000; neither the taxpayer nor the charity is taxed on the stock's \$9,000 of appreciation. Thus, donations of capital gain property provide an extra benefit over cash contributions. Deductions may be reduced, however, depending on the type of property.¹²

somewhat diminishes the usefulness of the charitable deduction. Corporations also may claim the charitable deduction. The corporate deduction may not exceed roughly 10 percent of the corporation's taxable income (with certain adjustments). Like individuals, corporations may carry forward excess contributions for five subsequent years. (IRS, Publication 526, <http://www.irs.gov/publications/p526/ar02.html>.)

¹¹ As discussed below, a floor excludes amounts beneath it from deductibility. A handful of deductions, "miscellaneous itemized deductions," are subject to a 2 percent floor. Other examples include a 7.5 percent floor for medical expenses and a 10 percent floor for casualty losses. In addition, the charitable deduction has been subject to the overall phaseout of itemized deductions, although that provision has been temporarily repealed. For technical reasons, the phaseout generally does not affect donors' overall incentives. (26 USC § 67–2–percent floor on miscellaneous itemized deductions; 26 USC § 213–Medical, dental, etc., expenses; 26 USC § 165–Losses; <http://www.law.cornell.edu/uscode/text/26/67>.)

¹² The deduction is reduced to the taxpayer's basis of \$1,000 if the stock was held for less than a year. The deduction also would be \$1,000 if the property was not stock but instead was inventory of the taxpayer, or was tangible personal property not used by the donee for an exempt purpose. In addition, charitable contributions of property to most private foundations generally are disfavored relative to other contributions. For such contributions, the general rule is a deduction equal to the donor's basis (cost) in the property (with an exception for publicly traded stock). Further, certain types of property are disfavored or have special rules regardless of whether the donee is a private foundation or other charity—for example, contributions of intellectual property, vehicles, and clothing.

Property valued at less than basis is deductible at fair-market value. As a result, taxpayers do not typically donate loss properties unless the item would not generate a tax loss if sold. Losses on personal property such as clothes and personal-use automobiles, however, are not deductible, so these items are common donation items (IRS, Publication 526).

Donee Organizations

Organizations eligible to receive deductible charitable contributions, described in section 501(c)(3),¹³ serve “religious, charitable, scientific, literary or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals.”¹⁴ For our purposes, we use “charitable” to mean organizations that qualify under section 501(c)(3). These organizations may not distribute profits to organization insiders, although they may pay reasonable amounts to their workers, to profit-making firms for services rendered, and for interest on any borrowed money. Thus, an organization can be nonprofit, in the sense of not generating formal returns to shareholders, yet it can provide rents and other returns to both labor and capital. Except for lower percentage limits for gifts to private foundations, the charitable deduction does not distinguish among donee organizations in purpose, function, efficiency, financial health, or sources of revenue.

Ultimate Beneficiaries

Those who benefit from the work of section 501(c)(3) organizations generally are not taxed on the goods or services they receive.

Who Gives and Who Benefits from the Deduction?

Charitable giving, of course, is not the exclusive province of individuals or of itemizers. Total charitable giving in 2010 is estimated and reported as \$291 billion, less certain contributions made to foundations (Giving USA 2011). Table 1 shows the sources of gifts.¹⁵

¹³ Over 1.8 million section 501(c)(3) organizations were registered with the IRS in 2009 (IRS 2009, table 25).

¹⁴ Section 170(c) uses the same language as section 501(c)(3) in describing qualifying organizations based on purpose: religious, charitable, scientific, literary or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals.

¹⁵ This amount includes giving by individuals who are itemizers (\$163.56 billion) and by non-itemizers (\$42.60 billion; see Giving USA 2011). Because individuals give to private foundations, and foundations lat-

Table 1. Sources of Contributions to Section 501(c)(3) Organizations, 2010

Individuals	\$212 billion (73%)
Private foundations	\$41 billion (14%)
Bequests	\$23 billion (8%)
Corporations	\$15 billion (5%)

Source: Giving USA Foundation (2011).

Although a wide variety of organizations are eligible to receive charitable deductions, some organizations are more dependent on contributions than others. Broadly speaking, certain organizations, such as hospitals and colleges and universities, rely primarily on private payments from program service revenue (i.e., fees for health care or tuition), or tax-exempt financing, to continue operations or fund capital expenditures. They rely less on contribution income. By contrast, as shown in Table 2 (Wing, Pollak, and Blackwood 2008, 134, and CRS calculations), cultural organizations and charitable organizations that serve basic needs rely to a greater extent on contribution income—whether in the form of charitable contributions or direct government support (grants) (Sherlock and Gravelle 2009).

Table 2. Revenue Sources for Section 501(c)(3) Organizations, by Sector (percent), 2009

	Private contributions	Private payments	Government grants/payments	Investment income	Other revenue
Arts, culture, humanities	44	34	16	< 1	6
Education	20	65	15	-3	2
Environment/animals	51	28	15	< 1	5
Health care	4	59	35	< 1	2
Human services	17	28	51	1	3

Source: National Center for Charitable Statistics calculations based on the Urban Institute, National Center for Charitable Statistics, Core Files (2009); Internal Revenue Service, Statistics of Income Division, Exempt Organizations Sample Files (2007); American Hospital Association Survey, 2009; and the Centers for Medicare & Medicaid Services, National Health Accounts.

Notes: This sample is derived from public charities filing Form 990 and thus does not include small organizations or religious charities. Percentages may not sum to 100 percent because of rounding.

er make grants to other charities, the \$290 billion figure overstates the total new wealth transferred to the charitable sector.

With respect to the entire charitable sector, the revenue sources for 2005 are shown in Table 3, with support from private contributions constituting about 13 percent of total support (Wing et al. 2008, 134, and CRS calculations).

This 13 percent number includes giving by corporations, private foundations, bequest, and non-itemizers, so private giving attributable to individual itemized contributions is considerably less than 13 percent. Itemizers provide the bulk of contributions, mainly because this minority of the population has the majority of the country’s wealth and income.

Table 3. Total Revenues for Charitable Organizations by Source, 2009

Private contributions	\$184.99 billion (13.2%)
Private payments (program service revenue)	\$733.55 billion (52.4%)
Government grants and payments	\$455.62 billion (32.5%)
Investment income	-\$3.00 billion (-0.2%)
Other revenue (e.g., member dues, special events)	\$29.72 billion (2.1%)

Source: National Center for Charitable Statistics calculations based on the Urban Institute, National Center for Charitable Statistics, Core Files (2009); Internal Revenue Service, Statistics of Income Division, Exempt Organizations Sample Files (2007); American Hospital Association (AHA) Survey, 2009; and the Centers for Medicare & Medicaid Services, National Health Accounts.

Note: This sample is derived from public charities filing Form 990 and thus does not include small organizations or religious charities.

As to the allocation of giving by donors, as noted by CRS, “higher-income donors contribute larger shares of their donations . . . to health, education, art, environmental, and similar organizations, and less to religious organizations, those meeting basic needs, and combined purpose organizations” such as the United Way (Gravelle and Marples 2010, 12). Table 4 reports the donation preferences of the population by income class, as reported by Indiana University’s Center on Philanthropy.

Table 4. Income Class of Contributors to Section 501(c)(3) Organizations by Sector (percent), 2005

	Less than \$100,000	\$100,000–\$200,000	\$200,000–\$1 million	More than \$1 million
Religious	59.4	11.3	20.8	8.6
Combination	34.8	9.8	46.1	9.3
Basic needs	49.1	12.9	27.9	10.2
Health	13.9	5.1	21.9	59.1

	Less than \$100,000	\$100,000– \$200,000	\$200,000– \$1 million	More than \$1 million
Education	5.9	2.5	63.5	28.2
Arts	4.4	1.9	59.3	34.4
Other	31.4	6	37.9	24.7

Source: Sherlock and Gravelle (2009), table 15. Data from *Patterns of Household Charitable Giving by Income Group, 2005*, prepared for Google by the Center on Philanthropy at Indiana University, summer 2007.

Why the Deduction?

When enacting the charitable contribution deduction in 1917, Congress emphasized that it wanted to ensure that the income tax, particularly at the high World War I levels, would not discourage private giving. Congress was concerned that someone giving away their income might have less money to pay tax—particularly in a system that originally collected tax at the end of the year, rather than through regular withholding. Regardless of the original intention, the deduction tends to be justified today mainly as a subsidy or as an appropriate adjustment to income according to ability to pay.

Subsidy Theories

Subsidy theories take many forms but generally posit that the deduction is warranted as a way of achieving some widely agreed-upon social good for beneficiaries, either as individuals or part of some collective. In most theories, the deduction helps support the provision of goods and services that would not be supplied sufficiently by the free market.

One type of such market failure derives from so-called “public goods.” Public goods are goods that once purchased by one person can be enjoyed at little or no additional cost by many, such as pollution control, basic scientific research, or parkland. These goods may be undersupplied if people fail to contribute and instead free-ride on the contributions of others. The government, of course, can provide such goods, but at times it might also want to encourage individuals to do so. For instance, goods whose benefits cross local governmental borders, such as support for delinquent boys or girls, might not be adequately provided by any one government, but some local group might (with federal fiscal support) be willing to tackle the problem. Other gaps might arise because of consti-

tutional or practical restrictions on what government may do. Governments generally must offer their services equally to all, whereas private individuals may target their assistance more easily. And government, of course, cannot directly support religious worship. Charitable organizations can also create an environment or public sphere in which changes to government behavior are discussed and advocated; government is less likely to criticize itself. Also, there are practical limits on tax collection, partly because of its own set of costs such as for enforcement.

Promotion of the charitable sector may additionally supplement government efforts by developing social welfare organizations to which government can efficiently contract out. For example, charitable organizations may have subject-specific expertise that would be useful to a one-time project. An open debate exists, however, on whether nonprofits perform more cost-effectively than government or other private contractors; it often depends upon the activity or area of the country. Nonprofits may benefit from volunteer or below-market cost labor, but these workers may also have poorer training or fewer skills, or require greater supervision to be useful. Some church-related schools seem to recruit quality teachers at lower cost than government; some nonprofit hospitals seem no less expensive or provide no more free care than profit-making or government-operated ones.

Viewed broadly, fostering acts of charity through a charitable deduction may promote a more altruistic, cooperative society and help develop better citizenship. Such gains to society derive not just from the benefits transferred to ultimate donees, but from a contagious effect on the behavior of the donors. Some further assert that a subsidy, whether in general or for particular sectors, such as the arts and humanities, signals government approval for endeavors that deserve recognition and support.¹⁶ Indeed, the United States is often considered a leader throughout the world in the size and scope of its charitable sector, with many countries seeking to imitate it—sometimes by adding a deduction to their own tax codes.

¹⁶ Psychological research finds that financial incentives may sometimes “crowd out” or reduce altruistic or other internal motivations for doing good, but researchers acknowledge that much additional work remains to be done. (See, for example, Seabright 2002.)

Note here also that a deduction may be considered a way to encourage an activity through citizen rather than government decision-making. For instance, the United States may provide less direct support than many other governments for cultural activities partly because of a greater reluctance to have government officials decide what is culturally more valuable.

Finally, promotion of giving is also viewed as a way that a capitalistic society reduces the tensions that arise from the unequal distribution of power and wealth. The power of the wealthy may be less threatening if they adhere to a social norm of eventually sharing a significant part of their gains.

Ability-to-Pay or Income Measurement Theories

Ability-to-pay theories offer that the deduction is necessary to measure appropriately and fairly the bases for taxation against which taxes are assessed. Equal justice under the law requires equal treatment of those equally situated. In taxation, therefore, a base of taxation should be established so that those with equal ability to pay actually pay equal taxes.

Under an income tax, income is the primary consideration in determining the tax base. For both financial and tax purposes, income is a net concept that excludes money spent in order to earn that income. Exceptions apply when those expenses also convey some personal benefit, such as entertainment. On a similar logic, some costs that reduce the taxpayers' ability to consume are sometimes excluded from the tax base. For example, extraordinary medical expenses are usually deductible (subject to a floor); an individual with \$100,000 in income and extraordinary medical expenses of \$20,000 can be thought of as having a standard of living more comparable to healthy taxpayers who earn \$80,000 than to those earning \$100,000.

Under the ability-to-pay rationale, this logic is extended to the charitable contribution deduction, on the theory that such contributions reduce the taxpayers' funds available for personal consumption or payment to the government as tax. A person who gives away

earnings arguably has less available to pay taxes, or at least should be treated equally to someone with the same income net of the contributions.¹⁷

This takes us to a related issue often given less attention when relating charitable giving to the tax base: the tax code's ambivalent treatment of transfers and whether a transfer is income of the transferor or transferee, or both. Most transfers are taxed only to one of the two parties. Earnings transferred as payments of alimony are considered the income only of the transferee; child support payments and some gifts are taxable to the transferor but not the transferee. The tax code's allowance of personal exemptions and joint returns is designed explicitly to treat earnings among members of the family as shared (i.e., taxed to the transferee, such as children), rather than taxing each earner distinctly.¹⁸

If one accepts that it is appropriate to grant a charitable deduction to the transferor, who as a result has a lower ability to consume, then one should also recognize that the ability to consume of the donee or transferee has gone up. If that income remains nontaxable, then there is still a tax break or subsidy, but the loss of tax revenues would be better measured by looking at the tax savings of the donees.

Sovereignty Explanation

The deduction has also been explained, mainly in the context of religious organizations, as a ceding of "sovereignty." Just as the federal government sometimes cedes sovereignty to state and local governments and Indian tribes, the same ceding of authority may apply to churches, due to separation of church and state (Brody 1998). Although more an argument for exemption than for a deduction, a sovereignty explanation for the deduction could also be seen as a way of setting aside a portion of taxpayer's ability to pay for the support of the other sovereign.¹⁹

¹⁷ Not all the authors agree on this point. See Galle (2012, 786–87).

¹⁸ On the other hand, addition of an estate tax sometimes causes income to be taxed both when earned and then when transferred by gift or bequest.

¹⁹ Sovereignty explanations do not theorize whether or why this is a normatively attractive approach.

One does not have to choose among a subsidy or ability to pay theory, or sovereignty. A deduction might be justified on all these grounds simultaneously.

Critiques of the Deduction

Subsidy: Is It Worth the Cost?

Subsidy theories of the deduction have been criticized on cost-effectiveness grounds. How much does it change behavior? Some taxpayers would give the same amount irrespective of the deduction. Some might only respond mildly to the deduction.²⁰ Thus, the amount of *additional* donations purchased with each dollar of lost government revenue, sometimes known as the “price-elasticity of giving,” is an important data point in assessing the efficacy of the deduction.²¹

If each dollar of forgone revenue purchases less than one dollar of giving, arguably the subsidy should be scrapped and replaced with direct spending.²² That assumes, though, that a dollar of government spending is a direct substitute for charitable activity and the goal of the deduction is simply to encourage the production of the public goods that government would provide. If the goal instead is to encourage some public-good production by the private sector (including some valuable but otherwise undersupplied goods or services the government would not provide), or to encourage individual generosity, then a dollar-by-dollar comparison with government spending may not be the best measure of efficacy. The two sectors can be complementary or adversarial, not just substitutes. For

²⁰ Although fully inframarginal donors do not respond to changes in the relative cost of giving, the deduction may still somewhat increase their donations by making them a bit wealthier, enabling them to donate more.

²¹ Ignoring administrative considerations, ability to pay adjustments would apply to inframarginal gifts, as well, since the cost of giving is not part of household wealth available to pay federal tax. Administrative considerations, however, generally support the types of floors that apply to other tax base adjustments, such as the miscellaneous itemized deduction.

²² Another comparison might take into account the possibility that direct government spending can crowd out some purely voluntary production that society could have obtained without imposing any tax. Thus, the comparison might be between the amount of charity produced by each dollar of subsidy and the amount of *new* public goods produced by each direct government dollar. Studies find average crowd-out from government spending ranging from zero to \$.50 on the dollar. (For example, see Payne 1998.)

instance, the charitable sector may serve as a catalyst for government action or provide a forum for debate that the government could not easily provide or properly regulate.

In addition, the economic literature measuring responsiveness to charitable deduction incentives is complex, and there is a large dispute as to effectiveness. The research also has gaps. For instance, most studies to date have not accounted for the costs of fundraising. Fundraising costs, of course, diminish the relative efficacy of donations.²³ By the same token, the cost of grants and direct government expenditures often fail to account for the additional direct and indirect costs of taxation.

There are also important subsets of issues that revolve around the design of any incentive. Government incentives would be more powerful if concentrated where responsiveness is expected to be higher. For instance, most taxpayers are likely to give at least some amount to charity. A person may give some fixed amount to a church or pay what she considers her fair “dues” to a charity in which she actively participates; she may be more likely to vary the amount she gives to a special collection that is less related to her involvement with the institution. Suppose a person who gives \$1,000 without a charitable deduction would give \$1,200 with a charitable deduction for all giving. The incentive has affected the additional \$200 of giving but had no effect on the \$1,000 that would have been given anyway. This suggests that government incentives would have more effect on giving above some base amount, or for larger or unusual gifts, than for everyday contributions that would be made regardless of encouragement.

Some studies find that higher-income donors are more sensitive to the size of their deduction than others. Other evidence finds that donations to churches and educational organizations appear less sensitive to the amount of the deduction than other gifts. If the goal of the deduction is to increase giving, then one might be most concerned about proposals that would pare it back more among the most responsive givers.

²³ The Tax Policy Center is currently investigating the relationship between the generosity of the deduction and fundraising costs.

Ability to Pay and Horizontal Equity: Should the Measure of Taxable Income Be Adjusted for Charitable Contributions?

There also is no consensus on the ability-to-pay justification for the deduction. Some believe as a matter of horizontal equity or “equal treatment of equals” that it is reasonable to adjust taxable income or ability to pay by accounting for donations made, and others do not.

As noted, the Code itself is inconsistent in its treatment of transfers more generally. If one holds strongly to a pure income notion, with few or no exceptions, then a household’s ability to pay might be thought to include all the resources it controls, whatever the ultimate use of those resources. Some critics also argue that charitable gifts result in “consumption” benefits or “warm glow” for the giver, such as social recognition and personal satisfaction. Studies of giving tend to confirm that donors are motivated at least in part by “warm glow.”

That, in turn, raises the issue of whether such benefits—often referred to as positive externalities—should be added to the tax base. As a general rule, they are not. For instance, the tax code adjusts ability to pay downward for children in the family, even though some suggest that this adjustment should not be allowed because children provide “consumption” benefits to the parent. In some cases, we know that income could be imputed to a person, such as the consumption provided by owning a car, but the tax code still does not attempt to tax it.

Even if one thinks that charitable contributions ought to be treated as income of the ultimate beneficiary, rather than the donor, that beneficiary would not necessarily be poor and subject to no tax (i.e., those who benefit from soup kitchens). Many charitable subsidies go to middle-class or wealthy users of hospitals, universities, or museums. If a tax cannot be assessed on the beneficiaries of such organizations for income received, some

may be willing to accept a tax on the donor instead by denying a deduction for charitable contributions.²⁴

Ability to Pay and Vertical Equity: Is the Deduction Unfair or Regressive?

Another ability-to-pay issue refers not to the horizontal (equal treatment of equals) aspect of the deduction, but to its effect on vertical equity or progressivity. One objection sometimes voiced is that the deduction is unfairly regressive because a higher subsidy rate applies to higher-income donors.²⁵ But regressivity is not inevitable. Marginal tax rates can be adjusted to offset any unwanted distributive effects of the deduction.²⁶

For example, suppose in a progressive tax system that there are two high-income taxpayers earning \$200,000 each, only one of whom gives to charity, and that the desired degree of progressivity is achieved by collecting \$100,000 in total from both of them (25 percent of their combined \$400,000 income) whether or not either gives to charity. Let's also assume that no tax is collected from any other person, perhaps because in this world all the others are poorer. Suppose that a charitable deduction is allowed, but the same amount of tax is collected from them. In this case, it is true that the charitable deduction will provide more of an incentive for the high-income taxpayers than for others (who owe no tax and get no deduction). But the tax system is not necessarily any less progressive.

For instance, the tax system might collect \$50,000 each from the two high-income taxpayers if it doesn't allow a charitable deduction, or it might allow a charitable deduction and collect \$55,000 from the nongiver and \$45,000 from the giver. Exactly the same amount is still collected from the higher-income taxpayers. In fact, if the incentive induces

²⁴ Carrying this logic further might suggest that charitable organizations might be taxed on the value of program-related expenditures, as an estimate of the value received by untaxed beneficiaries. Obviously, that is not current law and implies once again that subsidizing charitable actions cannot be removed as a basis for a charitable deduction even if ability-to-pay adjustments are also accepted as reasonable.

²⁵ This disparity may also result in a lower average tax rate for high-earning taxpayers overall.

²⁶ Indeed, these forms of adjustment were part of the policy debate preceding the Treasury's 1984 proposal leading to the Tax Reform Act of 1986. Because the rate schedule was adjusted to achieve the desired degree of overall progressivity, decisions as to whether to provide deductions, credits, or no tax break at all had no effect on overall progressivity. See Steuerle (2004).

more giving, then the lower-income taxpayers come out ahead in this example if they benefit at all from any additional giving the deduction may have inspired. They get the same amount of public services from the government and more from charities.

Ultimately, the ability-to-pay question comes down to whether an adjustment for charitable giving is appropriate for defining equals, not progressivity. Under an ability-to-pay rationale, the deduction does not necessarily reduce progressivity any more than would deductible payments of alimony: both are simply part of the proper measure of income tax base.

In the end, what is stated as a fairness issue often relates to how the subsidy itself is allocated across charities. A deduction does provide a greater incentive to give for higher- than for lower-income taxpayers. So, also, does a higher standard deduction that by itself increases progressivity but removes charitable incentives for some taxpayers. Thus, both a charitable deduction and a higher standard deduction will bias dollars of subsidy more in the direction of the types of charities higher-income taxpayers favor.²⁷

This turns the issue primarily into one of efficiency. Would we get better outcomes if we changed the basic incentive structure? To answer that question, we must delve into many other issues. For instance, the econometric literature tends to find that higher-income individuals, partly because they give more, are more responsive to charitable incentives. Thus, providing them with higher incentives might be more efficient from the perspective of inducing more giving overall.

Alternative Reforms of the Charitable Deduction

Numerous recent reform proposals would change the tax treatment of charitable contributions. Some proposals are driven by various criticisms of the deduction. For others, budget considerations tend to dominate. In addition, many other tax policy changes indirectly affect charities even more than direct changes. For instance, changes in tax rates

²⁷ At the same time, it may create an even more progressive tax system.

may have bigger impacts on charitable organizations than a restructuring of the deduction. Similarly, proposals with comparable revenue scores may have considerably different impacts on charitable giving. It is also possible to increase revenues and simultaneously increase charitable giving. This section analyzes several recent proposals to reform the charitable contribution deduction or itemized deductions as a whole.

Caps, Floors, Credits, and Grants

Recent proposals can be grouped loosely into four categories: caps, floors, credits, and grants. Roughly speaking, caps would limit the size of the tax benefit for individual donors, while floors would permit deductions only for total annual giving above a set amount. Credits would delink the value of the tax benefit from the donor’s marginal tax rate and instead reduce taxes by a set percentage of total donations for each donor. Credits are also sometimes available to non-itemizers. Grants delink the government subsidy from the donor entirely by paying amounts directly to the donee organizations based on the amount contributed by the donor. Table 5 summarizes a few of these proposals.

Table 5. Summary of Revenue-Raising Proposals Affecting the Nonprofit Sector

Caps	Floors	Credits	Grants
1. American Jobs Act (2011): Limit value of each itemized deduction to 28% of the expense for families making over \$250,000 a year ^a	1. CBO, <i>Reducing the Deficit: Spending and Revenue Options</i> (2011): Create a 2% AGI floor for the charitable deduction and a cap of 15%	1. Bowles-Simpson Commission (2010): In lieu of a deduction, allow all taxpayers a tax credit equal to 12% of their donations, subject to a 2% AGI floor ^b	1. Rivlin-Domenici (2010): In lieu of a deduction, provide charities an amount equal to 15% of a donor’s contribution
2. Feldstein, Feenberg, and MacGuineas (2011): Cap the total benefit taxpayers receive from combined effect of various tax expenditures, including itemized deductions, at 2% of AGI ^c	2. Ackerman and Auten (2006): Create a 1% AGI floor or a \$210/\$420 floor ^d	2. Demos, the Economic Policy Institute, and the Century Foundation (2010): In lieu of a deduction, allow a 25% tax credit	

a. This same 28 percent cap on itemized deductions is also included in President Obama’s formal deficit reduction recommendations submitted to the Joint Select Committee on Deficit Reduction, and in President Obama’s FY 2012 budget outline.

b. This credit is also proposed by the National Commission on Fiscal Responsibility and Reform.

c. See Feldstein, Martin, Daniel Feenberg, and Maya MacGuineas, “Capping Individual Tax Expenditure Benefits,” Working Paper 16921 (Cambridge, MA: NBER, 2011), <http://www.nber.org/papers/w16921>.

d. See Ackerman, D., and G. Auten, “Floors, Ceilings and Opening the Door for a Non-Itemizer Deduction,” *National Tax Journal* 59, No. 3 (2006): 509–29.

Cost-Effectiveness and Fairness of Alternatives

Proposals with similar revenue impacts can be “cheaper” or “costlier” to the charitable sector than others because each may have varying effects on donors’ propensity to give. For instance, even if all changes save Treasury \$10 billion, some might cause charitable giving to drop by very different amounts. Table 6 provides some examples of different hypothetical proposals, all of which raise about \$10 billion relative to current law. The extent that charitable giving responds to tax incentives does not have a clear consensus among economists, so we have measured changes in revenue and giving using two levels of responsiveness. “Low” indicates a price elasticity of charitable giving of -0.5 and “high” indicates an elasticity of -1.0.

Table 6. Impact of Various Options to Change the Charitable Deduction on Charitable Giving, 2011

Cash Income Percentile	Baseline Contributions (\$ millions)	Percent Change in Contributions							
		Replace with 15.25% Refundable Credit		22% Cap on Deduction		Current Law with 1% AGI Floor		"Above-the-Line" Deduction with 1.7% AGI Floor	
		Low	High	Low	High	Low	High	Low	High
Lowest quintile	3,048	8.6	18.5	0.0	0.0	0.1	0.7	0.6	1.5
Second quintile	9,480	7.3	15.2	0.0	0.0	0.0	-0.1	3.6	4.2
Middle quintile	21,118	4.7	9.8	-0.1	-0.1	-0.2	-0.4	2.9	3.9
Fourth quintile	40,221	1.1	2.4	-0.4	-0.7	-0.5	-0.9	1.2	3.0
Top quintile	126,428	-6.6	-12.6	-3.8	-7.5	-0.9	-1.6	-1.1	-2.0
All	200,323	-3.0	-5.4	-2.5	-4.9	-0.7	-1.2	0.0	0.0
Addendum									
80–90	31,135	-3.0	-5.7	-1.4	-2.7	-0.7	-1.3	0.3	0.4
90–95	21,420	-5.7	-10.9	-2.5	-4.8	-1.0	-1.8	-0.7	-1.0
95–99	27,560	-9.5	-17.9	-6.2	-12.1	-1.2	-2.2	-2.5	-4.4
Top 1 percent	46,314	-7.8	-14.8	-4.7	-9.3	-0.8	-1.4	-1.5	-2.7
<i>Memo: Revenue effect (\$ billions)</i>		9.7	10.4	9.4	10.4	10.5	10.4	11.0	10.4
<i>Memo: Total change in contributions (\$ billions)</i>		-6.0	-10.8	-5.0	-9.8	-1.4	-2.4	0.0	0.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).

Overall, although floors, caps, and credits can all have similar revenue effects under plausible policy parameters, each has distinctive impact on charitable giving. To the extent that one places emphasis on the subsidy theory for the deduction, then, all else equal, policymakers should favor options that are more “cost effective”—that is, have smaller impacts on charitable giving for any given revenue target. For example, as the simulation suggests, floors are likely to be among the more cost-effective of the proposals (see third option in Table 6). They tend not to affect incentives at the margin, but instead simply provide less of a subsidy for the first dollars of contributions that more likely would be given anyway.²⁸ As noted earlier, there are various ways to adjust the tax system for some desired level of progressivity.

Note, however, that the standard deduction already establishes a floor against itemized deductions more generally; it effectively excludes most taxpayers from the incentive effects of a charitable deduction, but not from getting another tax break in lieu of the deduction. A floor under charitable deductions would move it in the direction of medical expense deductions, which are also subject to their own floor, as well as the standard deduction.

Caps have somewhat the opposite effect of floors in cost-efficacy terms. There is some evidence that wealthier donors are more sensitive to the after-tax cost of donations, implying that a cap would have among the largest negative effects on donations relative to the amount of revenues raised. For example, in Table 6 the “high response” column may represent the better assumption about how taxpayers will react to introduction of a cap (but less so other proposals that also affect low- and middle-income taxpayers). Caps are often proposed to deliver a system overall that is more progressive by reducing the benefits of a higher income group, but as discussed earlier, there are other ways to achieve progressivity goals.

²⁸ If stated as a fixed dollar amount, a floor may have a greater impact (relative to income) on relatively small donors. Designed as a percentage of income, however, a floor tends to reduce taxes less for the wealthy.

In many respects, caps do not adhere to any theory of how to treat charitable contributions. They accord neither with a theory that all income should be taxed nor that ability to pay should be adjusted for charitable contributions made. At best they can be thought of as a step toward a credit or an indirect way to increase taxes on richer individuals.²⁹

A credit adheres most closely to the notion that equal charitable incentives should be applied to all charitable contributions regardless of the taxpayer's tax rate. As such, it departs significantly from what an ability-to-pay rationale would prescribe. We have already noted that a tax system with a credit is not necessarily more progressive than one with a deduction. Only when converting to a credit with other parts of the tax system (in particular, tax rates) fixed does conversion to a credit necessarily establish greater progressivity.

However, credits are not neutral on all fronts. They create unequal incentives to work for charitable purposes—that is, to make money and donate it to charity. A high-income earner (including a secondary earner in a family) who wants to donate all earnings to charity, for instance, will be less likely to take a job for this purpose than a low-income earner because of these tax effects. Suppose a credit rate is established above the marginal tax rate of the lower-income donor and below the marginal tax rate of the higher-income donor. The former would get a net subsidy when donating income to charity, the latter would get a net penalty.³⁰

Direct grants to charities that would be triggered by private donations represent the largest departure from current law of existing proposals, but they do have some precedent here and abroad. Grants are similar in spirit to Build America Bonds, or BABs, which paid subsidies directly to state borrowers but imposed taxes on the interest earned by bond

²⁹ For additional discussion, see Colivaux (2011b).

³⁰ Additionally, since volunteer labor is untaxed, and hence is effectively equivalent to a full deduction on the value of labor contributed, shifts to a credit may increase the incentives for high-income households to substitute volunteerism for some paid labor and for low-income households to substitute paid labor for volunteerism.

holders. BABs thereby allowed the amount of the subsidy to be set independently of the marginal rate of the bond holders. This flexibility could be an advantage, but, like credits, aligns poorly with ability-to-pay rationales for the deduction.

It is unclear whether grants would be as effective as tax subsidies in encouraging donations. If donors are pure altruists who are concerned only with the money they can transfer to charity, and calculate efficiently the exact value of any type of subsidy, then grants or tax subsidies should operate identically. But if donors are “impure” altruists and care also about their own rewards for giving, grants could be less effective, because with grants the donor does not receive a direct tax benefit. Grants paid directly to charities by the government may also simply be harder for donors to notice than the deductions they see when filing their tax returns, and so be less effective even for purely altruistic donors. On the other hand, if taxpayers do not understand the nature of the subsidy, then a grant may get more money to a charity simply because the taxpayer thinks in terms of gross, not net, cost.³¹ At least one study implies that grants are more readily seen by taxpayers, who then are more responsive, although the jury is still out on a set of U.K. grants called Gift Aid.³²

The importance of the salience and “marketing” of the charitable incentive is also a reason one of us has proposed that taxpayers be allowed a deduction not just for the current calendar year but, like an individual retirement account, up until April 15 or the time of filing for the last calendar year (Steuerle 2011).³³ The simple notion is that people will give more when they directly see the value of the incentive.

³¹ Thus, if one would give \$100 to a charity regardless of an incentive, then a taxpayer getting a 25 percent deduction would, on net, be giving \$75 (\$100 less \$25 in tax subsidies) to the charity, and the government would be giving \$25. If the government were to provide a 33 percent grant, then the individual giving \$75 to charity would still generate \$100 for the charity, but the individual giving \$100 would end up granting the charity \$133.

³² Under a program called Gift Aid, the British government matched 20 percent of a donation (the basic income tax rate). Taxpayers with higher rates still were allowed to claim a reduction in their taxes for whatever amount goes over 20 percent. See Scharf and Smith (2010).

³³ See also Galle and Klick (2010), making similar suggestion for deduction for state and local taxes.

Note that grants tend to raise more constitutional or sovereignty issues when dealing with religion. Other types of government grants get around this issue by being only for explicit secular services—for example, the social services provided by Catholic or Lutheran Charities, but not any of their religious activities. It is questionable whether the courts would allow matching grants that went solely for support of religious worship.

Combined Reforms

Combinations of proposals offer many opportunities to pursue more than one reform objective. Table 6 showed how the combination of a floor and a non-itemizer deduction can increase revenues without significantly reducing giving. With a slightly lower floor, the combination would increase both. This type of approach also has administrative benefits: the floor relieves the Internal Revenue Service (IRS) of the necessity to try to audit many of those who give away only a small percentage of their income, while the non-itemizer extension adds larger givers who might not now get an incentive because of the standard deduction. Similarly, there is no reason that the government cannot pursue some objectives with a deduction, other objectives with direct spending, and yet others with matching grants.

Other Issues Related to Reform of the Charitable Deduction

In assessing the merit of the charitable deduction and various alternatives, a number of other concerns must be taken into account. This final section looks briefly at some of them.

Administrative Concerns and Private Compliance

Administrative costs influence the cost-effectiveness of any proposal. Good policy should account for not only the government's own administrative burdens but also the costs of private tax compliance.

The IRS audits less than 1 percent of returns in recent years and a much smaller percentage of low- and middle-income households (excluding at times EITC recipients).

With limited enforcement resources, it has often been difficult to enforce the law with respect to charities. This can create particular problems when allowing deductions, credits, or any other type of incentive for those who give only small amounts. As noted above, floors can be used to reduce the number of such taxpayers for whom enforcement is required.

A related issue is the extent to which either a deduction or a credit should be made available to non-itemizers without the simultaneous introduction of a floor. Reforms that on net add to the number of taxpayers claiming a deduction will add to the amount of giving that is not effectively monitored by the IRS.

In practice, the current law toward deductions is quite complex, with special provisions, rules, or compliance issues applying to donations for foundations; gifts out of individual retirement accounts and trusts; and donations of easements, artwork, stocks, certain inventories, clothing and household goods, and other property. Such difficulties could apply as well to credits, grants, and alternative forms of subsidy.

Reforms that set caps or floors, as well as the current standard deduction, provide some encouragement to bunch giving in particular years so more is deductible over time. Whether the effect is large depends upon the scope of the provision. One recent study found that a fairly low floor of 1 percent was unlikely to promote bunching (Ackerman and Auten 2006).

Grants would replace one set of bureaucratic interactions for another and cannot easily be assessed on the net gains or losses in administrative costs without examining specific proposals. Grants also raise the question of whether government ought to go beyond matching donor's choices and simply make direct appropriations to charities, which relates to the broader discussion of whether one wants any separate incentive conditioned on taxpayers rather than government choices. Whether entrusting these decisions to Congress or

to bureaucrats could be done in a way that would remain true to the goals of the subsidy is a more difficult question beyond the scope of this report.³⁴

The Charitable Exemption and Volunteer Labor: Already in a “Deduction” World

Changes to the deduction may also have indirect and significant effects on how people time their charitable contributions and on their volunteer labor. Donors may choose to restructure their support for charity depending on the relative price of each choice.

The charitable deduction itself is really an add-on to a world where many charitable gifts are already exempted from tax or “deducted” from income. The charitable exemption effectively allows charities to earn a return, then exempt that return from any tax. Similarly, to the extent that volunteer labor produces a return or income that is donated to the charity, that income, too, is exempted from tax.

As a consequence, if the regular deduction is restricted (e.g., capped or converted to a credit) below a taxpayer’s marginal tax rate, but the exemption for passive and related operating income earned by a charity is retained, different types of donations would receive different incentives. The earnings on assets within the charity would effectively be deducted (exempted) from tax, while the donor giving those earnings to charity would get a less advantageous treatment. This may encourage a donor (with higher marginal tax rates than subsidy rates) to contribute to an organization sooner than she otherwise would and may encourage the build-up of reserves. In general, endowments and non-operating foundations would be especially favored.

We demonstrated above that the incentive to work and contribute those earnings to a charity would affect high- and low-tax rate taxpayers very differently with caps and credits. A parallel issue arises with respect to volunteer labor, which would be favored for the taxpayer whose subsidy rate on cash contributions is below his or her marginal rate and

³⁴ For additional discussion, see Colinvaux (2011a) and Galle (2012, 847–50).

vice versa. Of course, one can make similar comparisons for other restrictions on charitable deductions, such as the 50 percent cap on contributions that can be deducted from income. These, too, can influence behavior—for example, retiring early to do volunteer labor. The general point is that conversion of a charitable deduction into some other form of subsidy still leaves aside substantial amount of resources—endowments, reserves, and volunteer labor—likely to be left in a “deduction” world.

In-Kind Donations

As noted, donors can claim deductions for gifts of noncash property, and in many cases can deduct the full fair-market value of the items donated. In-kind donations account for roughly a quarter of the amount of all gifts. There is good reason, however, to think that deductions for some gifts of tangible personal property are problematic, for example where valuation is difficult or the gift likely would be made anyway (depreciated property in clothes or household goods). In-kind donations of appreciated property also raise issues of equity at all income levels, since cash gifts are disfavored relative to gifts of appreciated property, which get additional capital gains tax exclusion for the unrealized capital gains.³⁵ Neither subsidy nor ability-to-pay theories offer significant support for full-fair-market-value deductions; for example, there is no reason to believe that the social benefit to charity varies with the amount of the donor’s built-in gains.

The strongest argument in favor of the fair-market value deduction is that (for the most part) it leaves donors indifferent between gifts during life and bequests.³⁶ Gains are excluded from tax at death, so removal of the charitable deduction of appreciated property

³⁵ At best, an ability-to-pay rationale might permit donors to exclude from income any appreciation in value above basis, as that would be income that (by hypothesis) was never consumed by the taxpayer. But granting a deduction in addition to exempting built-in gains would shelter income above and beyond the appreciation.

³⁶ Because inherited property has basis equal to fair-market value (FMV) at the time of the bequest, a rule that limited donors to a basis deduction might encourage would-be benefactors nearing the end of their lives to instead pass their property to their heirs, and then allow the heirs to take a deduction that is effectively FMV.

would tend to lock in existing gains until death, at which point donees could still avoid capital gains taxation on that income.

Conclusion

Various reform proposals could have relatively similar impacts on the federal budget but quite different effects on nonprofits and the tax rules affecting them. Some of these reforms, we've suggested, are more consistent with the spirit and the purposes of underlying existing supports for the sector than others. Designed well, some can even increase giving while reducing revenue costs associated with any incentive. Any reform effort should account for the administrative costs and limitations on what tax authorities can enforce. In the end, the charitable deduction and any reform of it should be judged on the traditional grounds of fairness, effectiveness or efficiency, and simplicity.

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