



# Improving Social Welfare through Tax Incentives for Philanthropy

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## Abstract

To be justified, charity tax incentives should improve social welfare. This paper illustrates the importance of allocating public funds to worthier causes in evaluating the effectiveness of charity tax incentives and proposes a tax-incentive scheme (new scheme) that can substantially improve the allocation of funds. The new scheme consists of a refundable equal-percentage tax credit for all donors, a tax on the receipts of nonprofit organizations (NPOs), and a tax exemption for NPOs based on the number of donors. Tying the tax exemption to the number of donors should improve the allocation of public funds, provided that worthier causes attract more donors. In addition, the new scheme can increase philanthropic contributions, improve the operational efficiency of NPOs, and produce more intangible benefits, such as social cohesion and giving culture. The new scheme is also fairer in that it treats low-income and high-income donors equally.

## Keywords

philanthropy, charitable giving, tax expenditures, tax incentives

## 1 Introduction

Many countries provide tax incentives for philanthropic activities (charity tax incentives). Since philanthropy is socially desirable, it is hard to argue against promoting it. That does not automatically justify charity tax incentives, however. To be justified, charity tax incentives should improve social welfare by promoting worthy causes (public goods) effectively. The literature on charity tax incentives loosely refers to activities producing social benefits as public goods.

To evaluate the social benefits of charity tax incentives, one needs to consider several factors: the total amount of spending on public goods (social spending), the composition of social spending, the operational efficiency of nonprofit organizations (NPOs) receiving charitable contributions relative to that of governments, and intangible benefits (e.g., strengthening social cohesion and promoting sharing culture).

The amount of social spending depends on the responsiveness of private contributions to charity tax incentives. Charity tax incentives increase private contributions but reduce tax receipts (incur tax expenditures). To increase the amount of social spending, the increase in

private contributions must be larger than the decrease in tax receipts (treasury efficient). The public goods chosen by NPOs are not the same as those chosen by governments. Holding the amount of spending and other factors constant, NPOs must choose worthier public goods to improve social welfare. The operational efficiency of NPOs affects the net amount of social spending. Widespread philanthropic activities might produce intangible benefits.

It is hard to determine either conceptually or empirically whether charity tax incentives improve social welfare. The responsiveness of private contributions to the tax incentives is an empirical issue, but the empirical estimates vary widely across studies (Han et al., 2024). The worthiness of each public good is subjective and can hardly be quantified. The complexity of government operations and a large number of NPOs make it difficult to compare the operational efficiencies of governments and NPOs. By definition, intangibles are not measurable.

The contributions of this paper are highlighting the importance of allocating social spending to worthier public goods (allocational efficiency) and proposing ways to improve the effectiveness of charity tax incentives (new scheme). Despite its importance, previous studies have not paid much attention to the allocational efficiency of charity tax incentives. This paper illustrates that the effect of charity tax incentives on allocational efficiency can be much more important than treasury efficiency when the social benefit differs across public goods and the marginal benefit from each public good decreases with the amount of spending on it.

Although it is hard to tell whether or not charity tax incentives improve social welfare, it is more manageable and practical to explore how to improve the effectiveness of charity tax incentives. With a careful design, the government can substantially increase the effect of charity tax incentives on social welfare and make the tax breaks fair. The key design principle adopted in this paper is to utilize the private sector's strength in allocating resources, that is, to rely on market mechanisms. The new scheme has the following features: a refundable equal-percentage tax credit for all donors (uniform tax credit), a tax on the receipts of NPOs, and a tax exemption for NPOs based on the number of donors. The uniform tax credit would be fair in that it treats low-income and high-income donors equally. The tax on NPOs would enable the government to control the tax expenditure. Tying the tax exemption to the number of donors should improve the allocation of social spending, provided that worthier public goods attract more donors, and more strongly urge NPOs to improve operational efficiency. The new scheme might also produce more intangible benefits by increasing the number of donors.

The rest of this paper is organized as follows. The next section reviews the arguments for and against charity tax incentives. Section 3 shows that allocating funds to worthier public goods can be more important than raising a larger amount of funds. Section 4 presents a new tax-incentive scheme that can more effectively improve social welfare, and Section 5 concludes the inquiry.

## **2 Debates on Charity Tax Incentives**

Many studies (e.g., OECD, 2020; Colinviaux, 2013; Colinviaux et al., 2012) evaluate the rationales for charity tax incentives. The rationales include increasing the provision of public goods, producing intangible benefits, decentralizing decision-making, and adjusting income bases. The theoretical justifications for these rationales are controversial, and the empirical results are mixed at best. As such, OECD (2020, 8) asserts, “[t]here is no single generally accepted rationale for the preferential tax treatment of philanthropy.”

The private sector underproduces public goods because the producer of a public good captures just a fraction of its social value. To increase the production of public goods, the government may provide public goods directly or subsidize the private producers of public goods. Provided that all public goods are equally worthy, the subsidy for a public good is justified if the government is unable to provide it directly or the subsidy is more cost-effective than the direct provision.

Some legal restrictions prevent governments from being involved in certain activities. The U.S. government, for example, cannot directly aid religious institutions. One can argue that religion is a socially desirable activity promoting good citizenship and generosity. Such social benefits could justify indirect subsidies through charity tax incentives. Legal restrictions exist for a reason, however. The separation of church and state may help maintain political stability and religious freedom. The government may also be restricted from allocating funds to help illegal aliens. While it is humane to help needy people regardless of their citizenship status, aiding illegal aliens can encourage illegal immigration. Thus, it is debatable whether bypassing legal restrictions produces a positive net benefit.

Charity tax incentives increase social spending if they are treasury efficient. The treasury efficiency of charity tax incentives is largely an empirical question, and the empirical results are mixed at best. According to OECD (2020), taxpayers in many cases are relatively unresponsive to charity tax incentives, suggesting charity tax incentives may not be treasury efficient. The literature routinely produces highly divergent estimates of the responsiveness (Han et al., 2024). Researchers face many difficulties. To obtain a convincing estimate, they need a large number of observations, but governments do not change charity tax incentives often. And responses to charity tax incentives can depend greatly on economic and social circumstances (Karlan & List, 2007). Marginal tax rates vary across donors, and the complexity of tax codes makes the calculation of marginal tax rates difficult. Marginal tax rates can even be endogenous because households can increase contributions enough to move into a lower tax bracket (Meer & Priday, 2020).

The importance of treasury efficiency is debatable also at the conceptual level. According to Kaplow (2024), treasury efficiency can even be irrelevant in a general optimal income taxation framework that incorporates the adjustment of the tax schedule. For welfare analyses, a tax-and-transfer regime offering a special provision for philanthropic giving can be equivalent to a regime offering no special provision when the tax schedule is adjusted to produce the same revenue in the two regimes.

Charity tax incentives can produce intangible benefits by making philanthropic contributions more common. People may feel and behave better when they see more philanthropic activities. The literature describes this intangible benefit using various terms: promoting a giving culture, strengthening civil society, promoting a more altruistic and cooperative society, and developing better citizenship. These are just possibilities which cannot be verified. It would be imprudent to justify charity tax incentives largely based on these abstract notions. It is not even clear whether people view larger amounts/numbers of contributions driven by tax incentives more favorably than smaller amounts/numbers of contributions purely driven by benevolence. Some people might even resent big contributions that wealthy individuals make for the purpose of tax planning.

It is practically impossible for governments to evaluate the worthiness of each public good accurately and allocate funds based on the evaluation. Governments cannot observe the preferences of all individuals. Even if they could, political outcomes would hardly be the same as analytical solutions. Given the limitations of governments, decentralized decisions can improve the outcome. The hurdle is high, however. Worthier public goods would probably receive more

funds if donors care only about social benefits, as opposed to personal benefits. In this case, giving decisions could function as voting for the worthiness of each public good. The outcome of fair voting is likely to be better than that of a bureaucratic or a political process. Giving decisions are not fair voting, however. Many types of contributions, such as giving to alma mater or ideology-driven organizations, reflect personal interests. More importantly, larger donors exercise larger numbers of votes (more influence on the allocation of tax expenditures). In effect, charity tax incentives allow wealthy individuals to purchase votes. Unless large donors care more about social benefits than small donors do, disproportionate influence of large donors might produce a socially undesirable outcome.

To truly decentralize allocation decisions, the government should restructure the tax incentives. Reich (2018) argues that philanthropy can be a threat to democracy because big philanthropy is often an exercise of power. In the U.S., philanthropy policies make the threat more serious by facilitating the conversion of private assets into public influence for wealthy individuals. In restructuring philanthropy policies, he suggests, the government should aim to decentralize power in the production of public goods.

Another rationale for charity tax incentives is an adjustment to the income tax base; the income tax base should be the amount available for taxpayers' consumption, but the amount contributed is unavailable for donors' own consumption. This argument has a historical background. According to Colinvaux et al. (2012), when the U.S. Congress enacted the tax deduction for philanthropic contributions in 1917, only four years after the income tax, its concern was that taxpayers giving away their income might have less money to pay tax. Many economists may dispute this rationale.

When individuals spend on something voluntarily, they must derive utility from the spending. For example, Saez (2004) treats the philanthropic contribution as a variable generating utility in his model. The main criterion for the tax deductibility should be the essentiality of a spending category. Based on this criterion, the child tax credit is reasonable, but not the deduction of philanthropic contributions. Parents must raise their children. Spending on childcare is unavoidable ethically and legally. Perhaps, one can refine the rationale somewhat. When the government provides few essential goods (e.g., social safety nets and education), philanthropic contributions are essential from the society's perspective, although not from the donors' perspective. This may have been the case in the early 1900's when governments provided few social safety nets, but not anymore.

Charity tax incentives, especially those of the U.S., are subject to several criticisms (see OECD, 2020 for the review of charity tax incentives around the world). The tax breaks are regressive and undemocratic (OECD, 2020). Most low-income people do not itemize deductions, and those people do not get a tax break for philanthropic contributions. Even among those who itemize deductions, the tax benefit disproportionately increases with the marginal tax rate and hence with income. As a result, wealthy people have a disproportionate influence over public funds. But the priorities of big donors may not be consistent with those of society in general.

Typically, high-income donors favor higher education, arts, and culture, while low-income donors favor religion and welfare (Atkinson, 1997; Rabin, 1966). Husock (2024) reports that large foundations have their own agendas which are ideology-driven in many cases. In addition, the U.S. tax code gives donors ample room for tax planning and abuse (Colinvaux, 2013).

In sum, it is unclear whether charity tax incentives produce a net social benefit. The tax incentives have several rationales, but all of them are disputable. Moreover, charity tax incentives have side effects.

### 3 Treasury Efficiency versus Allocational Efficiency

In evaluating the effect of charity tax incentives on social welfare, previous studies focus largely on treasury efficiency. The total amount of social spending determines social welfare if all public goods have the same and constant effect on social welfare. It is more reasonable, however, to assume that public goods are not the same and that the marginal benefit of each public good decreases with the amount of spending on it. Under these assumptions, the allocation of funds across public goods can be much more important than the amount of funds. According to Saez (2004), government and private contributions are rarely perfect substitutes; for example, private and public schools do not provide exactly the same services and are not attended by the same public. Allocational efficiency is especially important when the NPOs’ selections of public goods are dramatically different from the governments’ selections. This section presents simple examples to illustrate these points.

Let us assume that there are 3 public goods: *PG1*, *PG2*, and *PG3*. *PG1* and *PG2* are equally good, and *PG3* is inferior. For every public good, the marginal social benefit decreases with the amount of spending on it.

Let  $x$  be the spending on the social good. The marginal benefit from *PG1*,

$$f(x) = 10 - 0.01x \quad \text{for } 0 < x \leq 1,000$$

$$= 0 \quad \text{otherwise} \tag{1}$$

Integrating  $f(x)$ , the total benefit from *PG1*,

$$F(x) = \int f(x)dx = 10x - 0.005x^2 \quad \text{for } 0 < x \leq 1,000$$

$$= 0 \quad \text{for } x \leq 0$$

$$= F(1000) \quad \text{for } x > 1,000 \tag{2}$$

The marginal benefit from *PG2*,

$$g(x) = 10 - 0.01x \quad \text{for } 0 < x \leq 1,000$$

$$= 0 \quad \text{otherwise} \tag{3}$$

The total benefit from *PG2*,

$$G(x) = \int g(x)dx = 10x - 0.005x^2 \quad \text{for } 0 < x \leq 1,000$$

$$= 0 \quad \text{for } x \leq 0$$

$$= G(1000) \quad \text{for } x > 1,000 \tag{4}$$

The marginal benefit from *PG3*,

$$h(x) = 3 - 0.01x \quad \text{for } 0 < x \leq 300$$

$$= 0 \quad \text{otherwise} \tag{5}$$

The total benefit from *PG3*,

$$H(x) = \int h(x)dx = 3x - 0.005x^2 \quad \text{for } 0 < x \leq 300$$

$$= 0 \quad \text{for } x \leq 0$$

$$= H(300) \quad \text{for } x > 300 \tag{6}$$

Without charity tax incentives, the government spends \$1,000 on public goods, and NPOs spend \$200 on public goods. With charity tax incentives, the tax revenue decreases by \$100, so the government spends \$900 on public goods. The government makes the allocation first, and NPOs follow.

### 3.1 Case One

In *Case 1*, both the government’s allocation of funds and the NPOs’ allocation of funds are socially optimal.

For the allocation to be optimal, the benefit from the last dollar must be the same across the public goods that deserve to be funded (high-benefit public goods). Since  $f(x)$  and  $g(x)$  are identical,  $PG1$  and  $PG2$  must receive the same amount of funds.  $PG3$  becomes a high-benefit public good only after large allocations to  $PG1$  and  $PG2$  make their marginal benefits equal to the benefit from the first dollar spent on  $PG3$ .

Without charity tax incentives, the government allocates \$500 to  $PG1$ , \$500 to  $PG2$ , and \$0 to  $PG3$  because  $PG3$  is a low-benefit public good ( $f(500) = g(500) = 5 > h(1) = 2.99$ ). NPOs allocate \$100 to  $PG1$ , \$100 to  $PG2$ , and \$0 to  $PG3$  because  $PG3$  remains to be a low-benefit public good ( $f(600) = g(600) = 4 > h(1) = 2.99$ ). The social benefit without charity tax incentives (baseline) totals \$8,400 ( $F(600) + G(600) = \$4,200 + \$4,200$ ).

With charity tax incentives, the government allocates \$450 to  $PG1$ , \$450 to  $PG2$ . The social benefit from the government’s spending is \$6,975 ( $F(450) + G(450) = \$3487.5 + \$3487.5$ ). The \$8,400 baseline is matched if NPOs add \$150 to  $PG1$  and \$150 to  $PG2$ , that is, if the \$100 tax expenditure is matched by a \$100 increase in private contributions (treasury neutral).

In this case, treasury efficiency solely determines the effectiveness of charity tax incentives. Social welfare stays the same if charity tax incentives are treasury neutral, improves if they are treasury efficient, and worsen it if they are treasury inefficient.

### 3.2 Case Two

In *Case 2*, the government’s allocation is socially optimal, and the NPOs’ allocation is socially suboptimal.

As in *Case 1*, the government spends \$500 each on  $PG1$  and  $PG2$ . Suppose that NPOs spend only on  $PG1$ . In this case, the social benefit without charity tax incentives is \$8,300 ( $F(700) + G(500) = \$4,550 + \$3,750$ ). With charity tax incentives, the social benefit from the government’s spending is \$6,975 ( $F(450) + G(450) = \$3487.5 + \$3487.5$ ). To match the \$8,300 baseline, the benefit from NPOs’ spending must be \$1,325 ( $\$8,300 - \$6,975$ ), and hence the total benefit from  $PG1$  must be \$4,812.5. The amount of spending needed to generate \$4812.5 from  $PG1$  rounds up to \$807 ( $F(806) = \$4811.82$  and  $F(807) = \$4813.755$ ). Thus, to breakeven, the tax subsidy of \$100 must increase private contributions by \$357. To improve social welfare, charity tax incentives must be extremely treasury efficient.

Now, suppose that NPOs spend only on  $PG3$ . Then the baseline is \$7,900 ( $F(500) + G(500) + H(200) = \$3,750 + \$3,750 + \$400$ ). To match the baseline, the benefit from the NPOs’ spending on  $PG3$  must increase to \$925 ( $F(500) + G(500) + H(200) - F(450) - G(450) = \$7,300 - \$6,975$ ). The maximum benefit from  $PG3$  ( $H(300)$ ), however, is only \$450. Thus, in this case, charity tax incentives decrease social welfare, regardless of treasury efficiency.

### 3.3 Case Three

In *Case 3*, the government's allocation is socially suboptimal, and the NPOs' allocation is socially optimal.

The government spends only on *PG1*, and NPOs spend on *PG2* to mitigate the suboptimal allocation by the government. In this case, the baseline is \$6,800 ( $F(1000) + G(200) = \$5,000 + \$1,800$ ). With charity tax incentives, the social benefit from the government spending is \$4,950 ( $F(900)$ ). To match the baseline, the social benefit from the NPOs' spending on *PG2* must increase to \$1,850 ( $6800 - 4950$ ). The amount of spending needed to generate \$1,850 from *PG2* rounds up to \$207 ( $G(296) = \$1,847.82$  and  $G(207) = \$1,855.76$ ). In this case, social welfare improves if private contributions increase by only \$7 in response to \$100 in tax breaks. Charity tax incentives can be extremely treasury inefficient and still improve social welfare.

These examples highlight the importance of allocational efficiency. The effect of charity tax incentives on social welfare depends both on treasury efficiency and allocational efficiency. In the circumstances where the marginal benefit varies widely across public goods, allocational efficiency can easily dominate treasury efficiency. Charity tax incentives that are highly treasury efficient can fail to improve or even worsen social welfare if the NPOs' selections of public goods are inferior to the government's selections. The converse is also true.

## 4 Improving the Effectiveness of Charity Tax Incentives

The effectiveness of charity tax incentives depends on allocational efficiency, treasury efficiency, and the size of intangible benefits. Allocational efficiency, despite its importance, has been understudied. This section discusses ways to improve the effectiveness of charity tax incentives, with an emphasis on allocational efficiency.

Governments around the world regulate NPOs to ensure that they duly serve social purposes. An obvious way to improve the effectiveness of charity tax incentives, therefore, is to improve rules and regulations. The difficulty of quantifying the outcomes of philanthropic activities, however, limits governments' ability to improve the effectiveness of charity tax incentives through rules and regulations. In the U.S., few rules are particularly designed to improve allocational efficiency, which is very difficult to measure. At the federal level, the Internal Revenue Service grants tax-exempt status to NPOs and regulates them based on broad rules: NPOs must operate for exempt purposes, including charity, religion, education, and science; the rules prohibit NPOs from distributing their earnings to their shareholders or individuals; and the rules restrict NPOs from many political or lobbying activities. States oversee NPOs for their operational integrity. Neither the federal government nor the states scrutinize the relative worthiness of NPOs' activities.

There are some rules that can indirectly contribute to improving allocational efficiency. The U.S. government, for example, gives a more generous tax break to public charities than that to private foundations. The tax deduction limit is higher for donors giving to public charities than for those giving to private foundations, and public charities avoid the investment income tax imposed on private foundations. Provided that activities of private foundations are more likely to be steered by personal interests of a few large donors, the tax rules favoring public charities may improve allocational efficiency.

The tax rules also treat cash contributions and in-kind contributions differently. The tax deductibility limit is higher for cash contributions than for in-kind contributions. Possibly,

donors contributing cash are more serious about social benefits than those who contribute an unwanted vehicle. Those who are more serious about social benefits may choose a better NPO that spends money more wisely. These tax rules might help improve allocational efficiency somewhat, but probably not significantly. Furthermore, most rules have loopholes. For example, donating appreciated assets, such as stocks and real estate, is often more tax-efficient than selling and donating cash, as it enables donors to avoid the capital gains tax.

To significantly improve the effectiveness of philanthropic tax incentives, the government would have to link the tax incentives to social benefits more explicitly and strongly. Considering the difficulty of quantifying social benefits, the task is impractical. To quantify the social benefits of philanthropic activities, the government would need to learn the socio-economic conditions of beneficiaries and externalities from NPOs' activities, and develop innovative analytical tools.

A natural alternative to analytical approaches is to employ market mechanisms. In essence, charity tax incentives are a public-private partnership. The government provides some funds to NPOs in the form of tax expenditures, and NPOs provide public goods using the funds. As I have argued earlier (Park, 2019), the key to a successful public-private partnership is to identify the tasks that the private sector can do better and delegate those tasks to the private sector with proper incentives.

Currently, the U.S. government delegates the task of allocating tax expenditures to the private sector in an incorrect way that fails to utilize the strength of the private sector sufficiently. The private sector efficiently allocates resources through market mechanisms, which aggregate the decisions of a large number of participants. The current arrangement, however, lets a small number of large donors manage a huge amount of tax expenditures. The allocation decisions of those large donors may not be better than those of the government. If they base their decisions on analyses, their decisions may be comparable to those of a well-functioning government. If they base their decisions on ideology and personal interests, their decisions may be comparable to those of a dysfunctional government.

To take advantage of market mechanisms, the government should delegate the task of allocating tax expenditures to the general public. An ordinary person may choose an NPO based on a guess about the NPO's worthiness. In most cases, the size of the error may be larger for a guess than for a sophisticated analysis. Some people may greatly overestimate the worthiness, and some others may greatly underestimate it. When a large number of those estimates are aggregated, however, overestimates should largely offset underestimates. Thus, the average of a large number of guesses may be much more accurate than an analytical estimate. Furthermore, personal interests of donors will have an insignificant influence on the allocation of tax expenditures when allocation decisions are decentralized among a large number of people. Since personal interests vary widely across individuals, any particular NPO is unlikely to benefit significantly from personal interests.

This section presents a charity tax incentive scheme (new scheme) that delegates the task of allocating tax expenditures mostly to the general public and hence takes advantage of market mechanisms more fully. Although the main goal of the new scheme is to improve allocational efficiency through market mechanisms, it could also improve treasury efficiency, incentivize NPOs to improve their operational efficiency, and increase intangible benefits. In addition, the tax break would become fairer.

The new scheme features a uniform tax credit for all donors, a tax on NPOs' receipts, and a tax exemption tied to the number of donors. Obviously, the uniform tax credit would make the tax break fairer. In percentage terms, low-income people and high-income people would get the same tax break. More importantly, the uniform tax credit plays a critical role in improving

allocational efficiency. In a sense, the new scheme is a voting system; NPOs getting more votes get a larger tax break. To obtain a fair voting outcome, the voting system should give all eligible voters the same incentive to vote. The uniform tax credit would substantially equalize the voting incentive.

Tying the tax exemption for NPOs to the number of donors is a way to delegate the task of allocating tax expenditures to the general public, as opposed to a few large donors. It would be a transition from the vote-per-dollar system to the vote-per-person system. A simple way to tie the tax exemption to the number of donors is to grant a fixed amount of exemption per donor up to the total amount of receipts. Suppose that a NPO has 1,000 donors and that the per-donor exemption amount is \$100. Then the allowable exemption amount is \$100,000 ( $100 \times 1,000$ ). For the calculation of the exemption amount, it does not matter whether a donor contributed \$10 or \$10,000. Thus, if a NPO receives \$10,000 from only one donor, the exemption is only one percent of the receipt. If a NPO receives \$10,000 from 200 donors, on the other hand, the allowable exemption ( $100 \times 200 = \$20,000$ ) exceeds the total receipt, and the exemption is 100 percent of the receipts.

Tying the tax break to the number of donors should improve allocational efficiency if the market mechanisms described above operate properly. Measuring the worthiness of a public good is subject to large errors because many relevant variables, such as the utility of beneficiaries and the value of externalities, are unobservable. Thus, analytical estimates may not be much better than simple guesses. Market mechanisms can be much more reliable in this circumstance. Donors may rank public goods based on their guesses about the worthiness of each public good and choose highly ranked public goods. A single guess is likely to be less accurate than an analytical estimate, but the average of guesses is likely to be more accurate than an analytical estimate when the number of observations is large. This market mechanism makes the number of donors a fairly reliable measure of the worthiness of a public good. The new scheme employing the market mechanism should steer tax expenditures towards worthier causes.

As usual, there would be some implementation issues. Counting a very small contribution like \$1 (micro-donation) as one vote could be problematic. Many micro-donors might not be serious about the worthiness of public goods. In addition, micro-donations might make it easy for NPOs to manipulate the donor count. To assure the reliability of the donor count as a measure of worthiness, the government might need to set a floor on the contribution amount as a seriousness check. As a compromise, the government might aggregate micro-donations. If the floor would be \$50, for example, the government might count 50 one-dollar contributions as one donor.

Another issue is how to link the donors' tax break to the tax exemption for NPOs. Foreigners would not be eligible for the tax credit. People who had dropped a few dollars into the Salvation Army's Red Kettle might not claim the tax credit. To be fair, the government should neither tax nor count as votes those contributions that did not incur tax expenditures. Those contributions would be revenue-neutral transactions between private parties. Implementation issues could be challenging, but in this era of big data, they should be resolvable.

The new scheme would prevent large donors from commanding a large amount of tax expenditures. This restraint is important if large donors are more likely to have a strong personal interest. Many alumni of Ivy League schools contribute a large amount to their alma mater, probably to enhance the prestige of their alma mater and secure the legacy preference for their children. Some rich people generously support a specific genre of art or music. Under the new scheme, the tax exemption for those contributions would be small, unless the general public joined the rich donors. Overall, the influence of personal interests would be very limited

because personal interests vary widely across individuals. The new scheme is a desirable form of democracy that rules out the tyranny of the majority and the tyranny of the wealthy. Each group would take its fair share; NPOs receiving 60 percent of votes would manage 60 percent of tax expenditures, and NPOs receiving 40 percent of votes would manage 40 percent of tax expenditures. Neither the majority nor the wealthy would be allowed to control a disproportionate share of tax expenditures.

The new scheme can also improve the treasury efficiency. Suppose that the government structures the new scheme such that the tax expenditure is the same as that of the current tax structure of the U.S. The government can recoup the cost of the tax credit through the tax on NPOs to any desired extent. The government can even predetermine the tax expenditure in the budget and allocate the tax exemption to each NPO based on its share of donors (the number of its donors / total number of donors). Thus, it is not a problem to set the tax credit at a generous level. If the government sets the tax credit at the highest marginal income tax rate, the tax break will be the same as before for the donors in the highest tax bracket and larger for all other donors.

Imagine that a donor is contemplating about “purchasing” a public good. There are two relevant prices for the donor: the after-tax price for the donor disregarding the tax on NPOs (list price) and the price that fully reflects both the tax credit for the donor and the tax on NPOs (impact price). Assuming that the fair market price of the public good is 1, the list price is  $1-t_1$ , where  $t_1$  is the tax credit as a share of the contribution. The impact price is  $\frac{1-t_1}{1-t_2}$ , where  $t_2$  is the effective tax rate on the NPO's receipts; the donor pays  $1-t_1$  for  $1-t_2$  unit of the public good.

Unambiguously, donors making contribution decisions based on the list price would contribute more. For donors making contribution decisions based on the impact price, the new scheme would have an ambiguous effect on the treasury efficiency; low-income donors would contribute more, and high-income donors would contribute less. The relative importance of the list price and the impact price is not really testable. However, there are several reasons why the new scheme might not reduce high-income donors' contributions significantly.

Many high-income donors are motivated by tax planning and publicity. For example, corporations make philanthropic contributions to increase their profit (Navarro, 1988). What matters for those donors is the list price. Some large donors may be motivated by personal interests, such as gaining influence over certain matters. Provided that their interests are strong, those donors may not reduce their contributions significantly when the impact price rises. It is even possible that they increase their contributions. A charitable contribution motivated by personal interests is like the purchase of a consumption good. The contribution will increase if the demand for influence is inelastic. If the price of beef rises, consumers may buy less beef, but they may spend more money on beef. Among those donors who are purely altruistic, the effect of uneven changes in the impact price across tax brackets should be neutral. In addition, high-income donors could lower the impact price by switching to more popular public goods. Such switching would mitigate the effect of a high impact price on the treasury efficiency, while further improving the allocational efficiency. All in all, the new scheme is likely to improve the treasury efficiency.

The new scheme might strengthen the incentives of NPOs to improve their operational efficiency. The government might provide standardized performance measures, such as operating expenses and the composition of beneficiaries, so that donors could evaluate NPOs more easily and choose more efficient ones. Under the new scheme, efficient NPOs could keep a larger portion of receipts by attracting a larger number of donors, in addition to raising more funds.

The new scheme might produce larger intangible benefits. The tax credit should increase the number of donors by incentivizing small donors more strongly. Widespread giving should strengthen social cohesion and promote a giving culture more effectively.

One may argue that prominent contributions by superrich people have stronger effects on social cohesion and giving culture. Contributions by superrich people are more conspicuous and may positively influence the public perception about social justice. The new scheme is unlikely to make superrich people stop contributing. Several tycoons, such as George Peabody (1795–1869) and Andrew Carnegie (1835–1919), established a philanthropic foundation in the era of no income tax. Perhaps, superrich people might contribute a smaller amount. A reduced amount might not necessarily reduce the positive influence on the public perception. A smaller amount of donation perceived to be motivated by pure goodwill could be more inspiring to the general public than a larger amount suspected of tax management.

In sum, by tying the tax exemption for NPOs to the number of donors, the new scheme would effectively delegate the task of selecting worthier public goods to the general public. Given that it is very difficult to estimate the worthiness of public goods analytically, market mechanisms averaging the estimates of a large number of participants may be more reliable than analyses by the government or a few large donors. The new scheme employing market mechanisms should improve the allocational efficiency of charity tax incentives and might also improve their treasury efficiency. In addition, the new scheme would more strongly urge NPOs to improve their operational efficiency, it would be fairer, and it might produce larger intangible benefits.

## 5 Conclusion

To be justified, charity tax incentives should improve social welfare. It is hard to tell whether charity tax incentives improve social welfare, however. Charity tax incentives can improve social welfare in several ways: increasing the amount of social spending, allocating public funds to worthier public goods, reducing the cost of delivering public goods, and generating more intangible benefits. None of these possibilities is convincingly supported. Empirical findings about the treasury efficiency are mixed at best. Estimating the allocational efficiency is nearly impossible because the worthiness of each public good is subjective and can hardly be quantified. The complexity of government operations and a large number of NPOs make it difficult to compare the operational efficiencies of governments and NPOs. By definition, intangibles are not measurable.

This paper has looked at a more manageable and practical issue, namely, how to improve the effectiveness of charity tax incentives, rather than whether or not charity tax incentives improve social welfare. The main contributions are illustrating the importance of allocational efficiency and proposing a new scheme that might significantly improve the allocational efficiency of charity tax incentives. In evaluating the effect of charity tax incentives on social welfare, the allocational efficiency can matter much more than the treasury efficiency under the following conditions: the government and NPOs select different public goods; the social benefit differs across public goods; and the marginal benefit from each public good decreases with the amount of spending on it. If the NPOs' selection of public goods is more socially optimal than the government's selection, charity tax incentives that are treasury inefficient can still improve social welfare. The converse is also true.

The new scheme has the following features: a uniform tax credit for all donors, a tax on the receipts of NPOs, and a tax exemption for NPOs based on the number of donors. In effect, the

government delegates the task of choosing worthy public goods to the general public by tying the tax exemption for NPOs to the number of donors. Provided that worthier public goods attract more donors, the new scheme would substantially improve the allocation of tax expenditures. The new scheme could also positively affect the treasury efficiency of charity tax incentives, the operational efficiency of NPOs, and the generation of intangible benefits. In addition, the new scheme would be fairer in that it offered the same tax break to low-income and high-income donors.

Since philanthropic activities involve highly complex elements, such as externalities and intangible benefits, it is exceptionally difficult to estimate their effects analytically. The new scheme relies on market mechanisms coordinating a large number of participants, as an alternative to analytical approaches. Given the complexity of philanthropic activities, any reform proposal would be debatable. At the minimum, however, the new scheme offers a new perspective for policy debates and future research.

### Acknowledgement

The author thanks three anonymous reviewers for their helpful comments and suggestions.

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