

SUBSTITUTING A CHARITABLE CREDIT FOR THE CHARITABLE TAX DEDUCTION*

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THE PROPOSAL IN PRESIDENT OBAMA'S FIRST budget to cap the tax rate at which charitable contributions can be deducted focused renewed attention on the current form of the charitable tax incentive. Recent research on giving behavior also provides new evidence on the magnitude of the price elasticity of giving, and variation in the price elasticity, both by income and by type of giving.

Among other issues, the debate engendered by the proposal to cap charitable deductions at a maximum of 28 percent has called attention to a long-standing criticism that the current charitable deduction provides larger subsidies to higher income taxpayers who both are more likely to itemize deductions and to deduct charitable contributions at a higher tax rate. One proposal that has been put forward for reforming the charitable deduction is to replace the current deduction with a tax credit that would be available to all taxpayers at the same rate without regard to whether they itemize or not.

Replacing the current tax deduction with a tax credit would affect the amount of giving by increasing the subsidy for some taxpayers and lowering it for others. It would also affect the pattern of giving by reducing the tax subsidy for higher income taxpayers and raising it for middle and lower income taxpayers.

This paper presents preliminary estimates of the effect of replacing the federal charitable deduction with a flat rate tax credit of equal revenue cost. In developing these estimates, I draw on recent estimates of patterns of giving by income level, as well as of the varying price sensitivity of giving by income level.

CRITICISMS OF THE CURRENT CHARITABLE DEDUCTION

As noted by Brody and Cordes (2006), in principle, the charitable deduction is a neutral tax subsidy that is not targeted on particular donors or charitable activities. In practice, the deduction provides a greater financial incentive to giving

among higher income taxpayers who have higher marginal tax rates.

This feature of the charitable deduction has often been criticized as unfair. Richard Thaler expresses a fairly typical criticism in a column in the *New York Times*.¹

It is...hard to justify subsidizing the gifts of rich people more than those of poor people. We do so because our tax system treats donations and mortgage interest as "deductions" from income. That is, we subtract these from income and pay taxes on the rest. This is logical when it comes to business expenses. Someone who owns a business should pay taxes only on profits, not on revenue. But that logic does not follow for charitable deductions, which are not a cost of doing business.

A typical recommendation for reform in response to such criticisms would be to replace the current charitable deduction with flat-rate charitable tax credit and to make the tax credit available to all taxpayers without regard to whether they itemize deductions or not. The effect of such changes on giving would be relatively predictable in the simple, but also unrealistic, case in which the flat rate credit was set equal to the top marginal income tax rate. Namely, at an additional cost in tax revenue, charitable giving would increase, with the size of the increase dependent on the price-elasticity of giving.

A more fiscally realistic policy change would involve replacing the current charitable deduction with a flat-rate tax credit of equal yield. The credit could be limited to those who itemize charitable deductions (in effect, itemizers would still be allowed to deduct charitable contributions but at a fixed rate). Alternatively, the credit could be made available to all taxpayers, without regard to itemization status.

A change of this sort would increase the tax-subsidy to giving by some taxpayers and lower it for others. Suppose for example that there are two types of taxpayers: lower income taxpayers whose marginal tax rate is T_L and higher income taxpayers whose marginal tax rate is T_H . Under a charitable deduction, the revenue cost of the subsidy would be: $R = T_L \cdot G_L + T_H \cdot G_H$ where G_L and G_H are the

*I am grateful to Molly Sherlock for helpful comments provided on the Conference draft of this paper.

amounts contributed by the lower income and the higher income taxpayers, respectively. Replacing the deduction by a flat rate tax credit (or fixed tax rate reduction) of equal revenue cost would amount to providing both low and high income taxpayers with a tax subsidy at the rate of T_C where $T_L < T_C < T_H$. If we define the after tax price of giving as $(1 - T_i)$, the effect of replacing the deduction with a tax credit of equal yield would therefore be to raise the after-tax cost of giving to higher income taxpayers, while lowering it for lower income taxpayers because $(1 - T_C) < (1 - T_L)$, and $(1 - T_C) > (1 - T_H)$.

MODELING THE EFFECTS OF REPLACING THE CHARITABLE DEDUCTION WITH A CHARITABLE TAX CREDIT

The net effect of replacing the charitable deduction with a tax credit of equal revenue cost depends on two key parameters: (1) the price elasticity of giving, and (2) the distribution of total giving to different charities.

Case A: Identical Price Elasticities and Patterns of Giving

Table 1 shows the impact of substituting a charitable tax credit for the charitable deduction for the simplest case in which higher income and lower income givers have the same price sensitivity of giving and the same patterns of giving to different charities.²

Although one might think that in the situation described in Table 1, substituting a charitable tax credit for a charitable deduction would have a neutral effect on total charitable giving, in practice, one would expect overall charitable giving to change because $\% \Delta P_L \neq \% \Delta P_H$ and $C_L \neq C_H$. Indeed, since $C_H > C_L$ as long as charitable giving is a normal good, and in the cases considered below, $\% \Delta P_H > \% \Delta P_L$ (in absolute value); then $\Delta C < 0$. That is, total charitable giving would fall (although by a relatively small amount) in response to a revenue neutral substitution of a tax credit (fixed rate deduction) for the current charitable deduction.

Case B: Differing Price Elasticities, Identical Patterns of Giving

Table 2 illustrates the effects of substituting a charitable tax credit for a charitable deduction when patterns of charitable giving are assumed to be the same for all givers, but when higher income and lower income givers have different price elasticities of charitable giving: ϵ_H and ϵ_L .

In this scenario, if $C_H > C_L$ and $|\% \Delta P_H| > |\% \Delta P_L|$, then $\Delta C < 0$ if $|\epsilon_H| > |\epsilon_L|$, with the size of the change depending on the difference between the price elasticity of giving of higher income taxpayer/givers — $|\epsilon_H|$ — and the price elasticity of giving of lower income taxpayer/givers. Recent research suggests that higher income givers have a measurable higher price elasticity of giving than lower

Table 1
Substituting an Equal Revenue Cost Charitable Tax Credit for a Charitable Deduction
Case A: Identical Price Elasticity and Patterns of Giving

<i>Change in Giving</i>	<i>Behavioral Relationship</i>
Change in Giving by Higher Income Taxpayer	$\Delta C_H = (\% \Delta P_H \cdot \epsilon \cdot C_H) < 0$
Change in Giving by Lower Income Taxpayer	$\Delta C_L = (\% \Delta P_L \cdot \epsilon \cdot C_L) > 0$
Change in Total Giving	$\Delta C = (\% \Delta P_H \cdot C_H - \% \Delta P_L \cdot C_L) \cdot \epsilon$

Note, in the third row, $\% \Delta P_H$ and $\% \Delta P_L$ are absolute values of the relative price changes.

Table 2
Substituting an Equal Revenue Cost Charitable Tax Credit for a Charitable Deduction
Case B: Identical Patterns of Giving, Unequal Price Elasticity of Giving

<i>Change in Giving</i>	<i>Behavioral Relationship</i>
Change in Giving by Higher Income Taxpayer	$-\Delta C_H = (\% \Delta P_H \cdot \epsilon_H \cdot C_H)$
Change in Giving by Lower Income Taxpayer	$+\Delta C_L = (\% \Delta P_L \cdot \epsilon_L \cdot C_L)$
Change in Total Giving	$\Delta C = (\% \Delta P_H \cdot C_H \cdot \epsilon_H - \% \Delta P_L \cdot C_L \cdot \epsilon_L)$

income taxpayers (Bakija and Heims, 2008).³ In this case, for a wide range of plausible values of the parameters, substituting a charitable tax credit for a charitable deduction of equal revenue cost will lower total charitable contributions.

Case C: Different Price Elasticities and Patterns of Giving

Table 3 shows the effect of replacing the deduction with a tax credit when not only the price elasticity of giving, but also the pattern of giving varies with income. For purposes of exposition, it is assumed that higher and lower income givers divide total charitable giving, C_H and C_L , between contributions to two types of charity: C_1 and C_2 . Giving patterns are represented by the shares of total contributions going to each type of charity: α_{H1} , α_{H2} for high income givers, and α_{L1} , α_{L2} for lower income givers. Thus total giving by higher and lower income taxpayers is allocated between the two types of charity according to:

$$C_H = C_{H1} + C_{H2} = \alpha_{H1} \cdot C_H + \alpha_{H2} \cdot C_H;$$

$$C_L = C_{L1} + C_{L2} = \alpha_{L1} \cdot C_L + \alpha_{L2} \cdot C_L$$

In this case, substituting a tax credit of equal revenue cost for tax deductions would affect both the aggregate amount of giving and also the pattern of giving to different charities.

- Lower income taxpayers would experience a drop in the out-of-pocket cost of giving and would increase their giving to both charities;
- Higher income taxpayers would face higher out-of-pocket costs of giving and would reduce giving to both charities;
- If $|\epsilon_H| > |\epsilon_L|$ the total amount of charitable giving would fall

In addition to these effects, the mix of charitable giving would change as well. One might think that

a policy change, which lowered the after-tax cost of giving for lower income taxpayers while raising it for higher income taxpayers, would unambiguously benefit charities favored by lower income givers. However, the ultimate impact on contributions to different charities is theoretically ambiguous. For example, in a world in which higher income taxpayers had a significantly higher price elasticity of giving, and contributed larger *absolute* amounts to charities (including those charities *relatively* less favored by high income givers), it is empirically possible that the drop in giving by higher income taxpayers to charities relatively favored by lower income givers would offset or more than offset increased giving to those charities by lower income givers.

SOME ILLUSTRATIVE SIMULATIONS

In the setting characterized by Case C, the ultimate effect of replacing the charitable deduction with a tax credit of equal revenue cost would depend on the empirical magnitude of the following factors: (1) the differential between the price elasticity of giving of high income and low income giver: $[|\epsilon_H| - |\epsilon_L|]$; (2) the differential between the shares of giving allocated to different charities: $[\alpha_{H1} - \alpha_{L1}]$; and $[\alpha_{H2} - \alpha_{L2}]$; and (3) the absolute amounts of giving to charities of different type by taxpayers of given income levels: C_{1HP} , C_{2HP} , C_{1L} , and C_{2L} . In this section, we present the results of a simple simulation that provides some insight about possible effects.

The main inputs into the simulation model are as follows:

- We use data on charitable giving broken down by Adjusted Gross income (AGI) from the Statistics of Income for the year 2006 to benchmark giving in the presence of the current charitable deduction for taxpayers.

Table 3
Substituting an Equal Revenue Cost Charitable Tax Credit for a Charitable Deduction
Case C: Different Price Elasticities and Patterns of Giving

<i>Giving</i>	<i>Low Income</i>	<i>High Income</i>	<i>Δ Giving</i>
ΔC_1	$\Delta C_{L1} = (\% \Delta p_L \cdot \epsilon_L \cdot \alpha_{L1} \cdot C_L) > 0$	$\Delta C_{H1} = (\% \Delta p_H \cdot \epsilon_H \cdot \alpha_{H1} \cdot C_H) < 0$?
ΔC_2	$\Delta C_{L2} = (\% \Delta p_L \cdot \epsilon_L \cdot \alpha_{L2} \cdot C_L) > 0$	$\Delta C_{H2} = (\% \Delta p_H \cdot \epsilon_H \cdot \alpha_{H2} \cdot C_H) < 0$?
$\Delta C = \Delta C_1 + \Delta C_2$	$\Delta C_{L1} + \Delta C_{L2} > 0$	$\Delta C_{H1} + \Delta C_{H2} < 0$	

- We combine these data with observed patterns of giving to different types of giving from Indiana University to estimates shares of giving to different types of charities by different income groups.

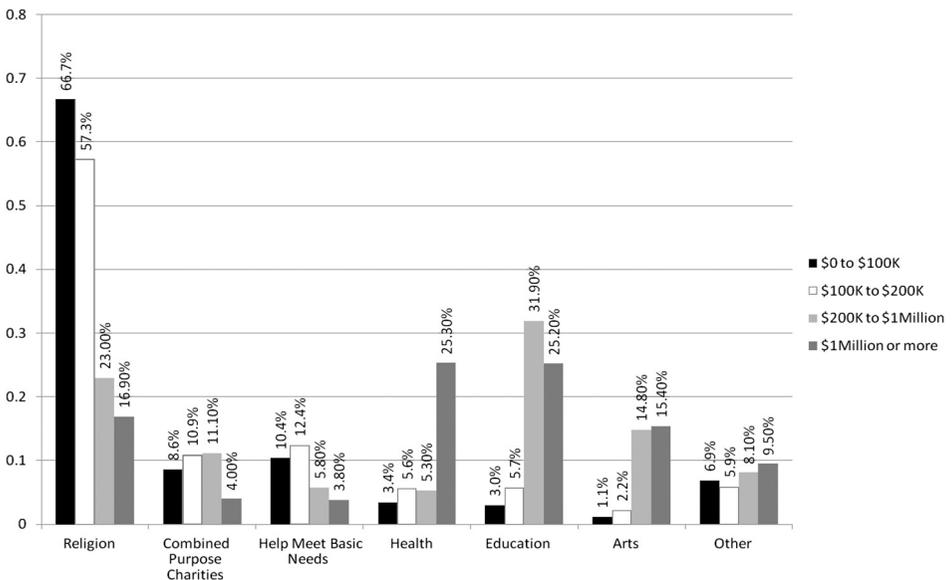
The results of these steps are shown in Table 4 and Figure 1. The last column of Table 4 also presents an estimated revenue cost which is estimated by applying a range of marginal tax rates to the various contribution amounts.⁴

Table 4
Charitable Contributions Reported on 2006 Income Tax Returns

<i>AGI</i>	<i>All Itemizers</i>	<i>Total AGI (Thousands)</i>	<i>Contributions</i>	<i>Tax Benefits (Estimated)</i>
1-10000	922978	\$5,381	\$633,064	\$0
10-20000	2306005	\$35,524	\$2,607,858	\$0
20-30000	3358387	\$84,292	\$4,680,312	\$0
30-40000	4363179	\$153,351	\$6,825,961	\$1,023,894
40-50000	4546362	\$204,620	\$7,946,927	\$1,192,039
50-75000	10918922	\$673,118	\$22,900,682	\$3,435,102
75-100000	8297996	\$719,122	\$21,320,365	\$3,198,055
100-200000	10655930	\$1,426,278	\$38,470,089	\$9,617,522
200-500000	2962237	\$849,219	\$22,027,498	\$6,608,249
500-1000000	875823	\$1,104,684	\$33,052,891	\$11,568,512
1000000 or more	15735	\$447,193	\$26,180,998	\$9,163,349
	49223554	\$5,702,782	\$186,646,645	\$45,806,723

Tax benefits are estimated by applying assumed values of the marginal tax rate at which deductions are taken at each income level. These tax rates range from 15 percent at AGI levels of 30,000 to 40,000 to 35 percent at the top income level.

Figure 1: Giving Patterns by Income Group



Source: Indiana University Center for Philanthropy, 2007.

Having calibrated the amounts of giving under current tax law, I then estimate what the rate of an “equal yield” tax credit would be using the revenue cost of the charitable deduction estimated by applying marginal tax rates to the amounts contributed. This rate is estimated to equal 24.5 percent.

I then calculate the percentage increase or decrease in the after-tax cost of giving for different income groups that would result from replacing the current deduction with a flat-rate tax credit of 24.5 percent. These changes are shown in the fifth and

sixth columns of Table 5. Given the average percentage change in the out-of-pocket cost of giving, I then estimate the change in total charitable giving that would result from the change in these out-of-pocket costs. For illustrative purposes I assume in the baseline simulation that the price elasticity of giving for taxpayers with AGI of \$75,000 and higher equals -1.0, and that the price elasticity of giving for those with AGI below \$75,000 equals -0.7.⁵

The results in Table 6 show that *for the assumed values of parameters* replacing the current chari-

Table 5
Substituting a Flat Rate Tax Credit of 24.5% for the Charitable Deduction

<i>AGI</i>	<i>Tax Rate</i>	<i>After Tax Price</i>	<i>Credit Rate</i>	<i>After Tax Price</i>	<i>Chng. In Price</i>	<i>Pct. Chng. In After-Tax Price</i>	<i>Change in Contributions</i>
1-10000	0	1	0.245	0.755	-0.245	-24.5%	\$551,715
10-20000	0	1	0.245	0.755	-0.245	-24.5%	\$777,077
20-30000	0	1	0.245	0.755	-0.245	-24.5%	\$975,668
30-40000	0.15	0.85	0.245	0.755	-0.095	-11.2%	\$587,452
40-50000	0.15	0.85	0.245	0.755	-0.095	-11.2%	\$666,986
50-75000	0.15	0.85	0.245	0.755	-0.095	-11.2%	\$1,892,829
75-100000	0.15	0.85	0.245	0.755	-0.095	-11.2%	\$2,457,011
100-200000	0.25	0.75	0.245	0.755	0.005	0.7%	-\$262,597
200-500000	0.3	0.7	0.245	0.755	0.055	7.9%	-\$1,766,632
500-1000000	0.35	0.65	0.245	0.755	0.105	16.2%	-\$5,452,499
1000000 or more	0.35	0.65	0.245	0.755	0.105	16.2%	-\$4,395,032
Total							-\$3,968,022

Table 6
Change in Contributions by Type of Charitable Activity

<i>Religious</i>	<i>Combined Purpose</i>	<i>Basic Needs</i>	<i>Health</i>	<i>Education</i>	<i>Arts</i>	<i>Other Causes</i>	<i>Total</i>
\$790,029	\$101,455	\$123,063	\$40,318	\$35,443	\$13,308	\$81,164	\$1,184,779
\$2,257,125	\$289,858	\$351,594	\$115,190	\$101,262	\$38,020	\$231,886	\$3,384,935
\$3,771,492	\$484,331	\$587,487	\$192,474	\$169,201	\$63,529	\$387,465	\$5,655,980
\$4,943,374	\$634,823	\$770,032	\$252,280	\$221,776	\$83,269	\$507,858	\$7,413,413
\$5,743,886	\$737,624	\$894,728	\$293,134	\$257,689	\$96,753	\$590,099	\$8,613,913
\$16,532,684	\$2,123,110	\$2,575,305	\$843,729	\$741,710	\$278,486	\$1,698,488	\$24,793,511
\$15,855,110	\$2,036,097	\$2,469,759	\$809,150	\$711,312	\$267,072	\$1,628,877	\$23,777,376
\$21,890,510	\$4,151,317	\$4,727,889	\$2,152,535	\$2,190,973	\$845,639	\$2,248,630	\$38,207,492
\$11,608,212	\$2,201,382	\$2,507,129	\$1,141,457	\$1,161,840	\$448,430	\$1,192,415	\$20,260,866
\$15,813,303	\$2,998,835	\$3,415,340	\$1,554,952	\$1,582,719	\$610,874	\$1,624,369	\$27,600,392
\$5,003,532	\$2,426,749	\$1,262,195	\$1,145,502	\$6,942,074	\$3,231,696	\$1,774,218	\$21,785,966
\$104,209,257	\$18,185,580	\$19,684,521	\$8,540,722	\$14,115,999	\$5,977,076	\$11,965,469	\$182,678,623
-\$22,295.49	-\$625,230.21	-\$358,957.18	-\$383,459.36	-\$1,592,910.93	-\$728,711.10	-\$256,457.33	-\$3,968,022
0.0%	-3.3%	-1.8%	-4.3%	-10.1%	-10.9%	-2.1%	-2.1%

table tax deduction with a flat rate tax credit (for itemizers) lowers all contributions by approximately 2%, although the proportional reductions differ widely among charitable activities. Not surprisingly, the charities experiencing the greatest declines in giving are those that are favored by higher income donors, who's after tax of giving is increased by the policy change.

Somewhat less expected is the fact that *in these particular simulations*, charities that are favored by lower income givers experience declines. Such a result, however, is both theoretically and empirically possible: although lower income taxpayers experience a reduction in their after-tax cost of giving, and hence give more to their preferred charities, this is countered by the (potentially) greater reduction in giving to these charities by higher income donors, who in absolute terms give more to these charities than lower income taxpayers, and who also are more sensitive to changes in the after-tax of giving. It should be emphasized, however, that the specific outcome reported in Table 6 reflects the specific parameters chosen for the illustration. For example, if high income and low income givers were assumed to have identical price elasticities of giving of -0.7, the results of replacing the deduction with a credit would be as shown in Table 7. In this case, the overall reduction in charitable falls from 2% to 0.7%, and contributions to religious charities, which are favored by lower income donors, increase by approximately 1% (\$1 billion).⁶

EFFECT OF EXTENDING THE TAX CREDIT TO NONITEMIZERS

As noted above, the simulations that produce the results in Tables 6 and 7 assume that a flat-rate tax credit replaces the charitable deduction only for taxpayers who itemize charitable deductions. We do not present simulations for the case in which the charitable tax credit that replaces the deduction would be extended to taxpayers who do not itemize. The reason for doing so is that, aside from a brief interlude in the 1980s in which the charitable deduction was extended to non-itemizers and responses to surveys, there is very limited data on giving by non-itemizers.

Nonetheless it is possible to speculate about how including non-itemizers in the above simulations might affect the results. In terms of the equal-revenue-cost constraint, adding nonitemizers to the group of taxpayers eligible to claim a charitable tax credit would lower the "equal-yield" credit rate below 24.5 percent. This would have the effect of (a) reducing the incentive for added giving by lower income taxpayers whose tax price of giving would fall, but by not as much, as if the credit were equal to 24.5 percent; (b) further reducing the incentive to give among higher income taxpayers whose after-tax price of giving would rise by more than it would if the credit were equal to 24.5 percent. These changes would be offset by increased giving by non-itemizers, whose attributes are likely to be similar to those of lower income taxpayers. It is

Table 7
Change in Charitable Contributions Equal Price Elasticity Case

Religious	Combined Purpose	Basic Needs	Health	Education	Arts	Other Causes	Total
\$790,029	\$101,455	\$123,063	\$40,318	\$35,443	\$13,308	\$81,164	\$1,184,779
\$2,257,125	\$289,858	\$351,594	\$115,190	\$101,262	\$38,020	\$231,886	\$3,384,935
\$3,771,492	\$484,331	\$587,487	\$192,474	\$169,201	\$63,529	\$387,465	\$5,655,980
\$4,943,374	\$634,823	\$770,032	\$252,280	\$221,776	\$83,269	\$507,858	\$7,413,413
\$5,743,886	\$737,624	\$894,728	\$293,134	\$257,689	\$96,753	\$590,099	\$8,613,913
\$16,532,684	\$2,123,110	\$2,575,305	\$843,729	\$741,710	\$278,486	\$1,698,488	\$24,793,511
\$15,378,431	\$1,974,882	\$2,395,506	\$784,823	\$689,926	\$259,043	\$1,579,906	\$23,062,517
\$21,934,592	\$4,159,677	\$4,737,410	\$2,156,869	\$2,195,385	\$847,342	\$2,253,158	\$38,284,432
\$11,905,693	\$2,257,796	\$2,571,379	\$1,170,709	\$1,191,615	\$459,921	\$1,222,973	\$20,780,086
\$16,731,031	\$3,172,873	\$3,613,550	\$1,645,194	\$1,674,572	\$646,326	\$1,718,640	\$29,202,186
\$5,294,928	\$2,568,078	\$1,335,703	\$1,212,213	\$7,346,366	\$3,419,904	\$1,877,545	\$23,054,738
\$105,283,265	\$18,504,506	\$19,955,756	\$8,706,935	\$14,624,946	\$6,205,901	\$12,149,181	\$185,430,489
\$1,051,711.84	-\$306,303.89	-\$87,721.76	-\$217,246.07	-\$1,083,964.08	-\$499,886.12	-\$72,745.65	-\$1,216,156
1.0%	-1.6%	-0.4%	-2.4%	-6.9%	-7.5%	-0.6%	-0.7%

plausible to conjecture that the net effect of these changes would be to produce an outcome qualitatively similar to that shown in Tables 6 and 7.⁷

CONCLUSIONS

As noted above, the simulations that have been presented are meant more to provide insight about the possible effects of substituting a charitable tax credit for the current tax deduction. Perhaps the main insight that emerges is that for plausible values of the price elasticity of giving, relative to a tax credit of equal revenue cost, the current charitable tax deduction may actually be a “Pareto-superior” tax incentive if one assumes that giving is “altruistic”, and that the objective of the tax incentive is to maximize the amount of additional giving to charity per dollar of revenue loss. It should, however, be acknowledged that drawing comparisons between deductions and credits is more ambiguous if giving is motivated by “warm glow” motives.

Notes

- ¹ http://www.nytimes.com/2010/12/19/business/economy/19view.html?_r=1 For an analysis of the effects of the Obama proposal to cap charitable deductions at a 28% tax rate, see Gravelle and Marples (2009).
- ² Substituting a charitable credit for a charitable deduction would also change the taxpayer’s after-tax income. For simplicity, we ignore the role of any income effect from such a change in discussing the qualitative effects of replacing the deduction with a tax credit. We do, however, include an income effect in the policy simulations. The quantitative impact of accounting for this effect is small relative to the changes resulting from changing the after-tax-cost of giving.
- ³ Based on the estimates presented in Bakija and Heims, the difference could be on the order of a price elasticity of giving among high income donors of approximately -1.2, and price elasticity of giving among low income donors of -0.5 to -0.7. In the simulations in this paper, we use a price-elasticity of giving for higher income donors of -1.0 and a price elasticity of giving for lower income donors of -0.7.
- ⁴ The estimated total of just under \$46 billion for 2006 is quite close to the projected revenue cost in 2008 of the

charitable deduction as reported on the Pew Subsidy Scope website. <http://subsidyscope.org/nonprofits/tax-expenditures/>

- ⁵ I assume a common income elasticity of demand for both high and low income givers of 0.7.
- ⁶ As the discussant of this paper correctly notes, any results can be quite sensitive to the empirical parameters, and more extensive analysis would involve sensitivity analysis for a wide range of parameter estimates.
- ⁷ Preliminary simulations undertaken with rough data on giving by nonitemizers confirm this intuition. These results are available on request from the author. For an empirical analysis of giving by non-itemizers, see Duquette, (1999).

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