CBO PAPERS

THE POTENTIAL EFFECTS OF TAX RESTRUCTURING ON NONPROFIT INSTITUTIONS

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CONGRESSIONAL BUDGET OFFICE

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CONGRESSIONAL BUDGET OFFICE
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NOTE

Numbers in the text and tables of this paper may not add up to totals because of rounding.

PREFACE

This paper assesses the potential effects of tax restructuring on nonprofit institutions. Written at the request of the Chairman of the Senate Budget Committee, it looks at the makeup and tax treatment of nonprofit institutions under current law and analyzes how provisions in recent proposals for tax restructuring could affect their operations.

Most of the proposals would lower tax rates and, in some cases, impose a single uniform, or "flat," rate. Most would also involve switching from an income-based to a consumption-based tax system—an objective that could entail enactment of a national retail sales tax, a value-added tax, or a variety of direct taxes on individual consumption. Proposals introduced in the 104th Congress exemplify each of those approaches, with varying implications for nonprofit institutions.

The paper was written by Pearl Richardson of the Tax Analysis Division, under the direction of Rosemary Marcuss and Frank Sammartino. Jeffrey Groen, Richard Kasten, William Randolph, and Dennis Zimmerman provided valuable comments. Chris Spoor edited the paper. Marlies Dunson provided editorial assistance, and Simone Thomas prepared the final version of the manuscript.

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Director

February 1997

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SUMMARY AND INTRODUCTION

In recent years, several Members of the 103rd and 104th Congresses have introduced proposals to restructure the tax system. Most of the proposals would replace the current system, which is based primarily on income, with one that is based either wholly or partially on consumption. Most of the restructuring plans would also lower tax rates and cut back sharply on current tax preferences, including those that favor nonprofit institutions. The preferences that benefit nonprofit institutions the most are exemption from paying taxes, deductibility of charitable contributions from individual and corporate income, and eligibility to use proceeds from tax-exempt bond issues to raise capital, which makes it possible for the institutions to borrow funds at below-market interest rates.

Like income taxes, consumption-based taxes can be levied on businesses or individuals. Many of the current proposals would replace the corporate income tax with a value-added tax or some variant of it. Although most of those proposals would provide tax-exemption either for some or all nonprofit corporations, as defined in current law, the benefits of tax exemption would be more limited than now. Moreover, the nature of the proposals is such that current provisions permitting corporations to deduct charitable contributions from their income would no longer apply.

Among the proposals for taxes levied on individuals, some would retain the deduction for charitable contributions; others would not. Similarly, some would maintain the tax-exemption for interest on bonds issued by state or local government agencies on behalf of charitable institutions. Other proposals would eliminate that tax exemption—either directly or by excluding all interest income from the tax base, thus obliterating the distinction between taxable and tax-exempt notes and bonds.

Limiting the benefits of tax-exemption, reducing the incentive for individuals and corporations to make charitable contributions, and removing the tax advantage for bonds issued on behalf of charitable institutions could decrease the income that nonprofit organizations have available to meet their operating and capital expenses. The magnitude of that effect is uncertain, however, and it would not be uniform among the various proposals. A few would retain most of the tax preferences in current law and thus would have minimal consequences, particularly for those nonprofit institutions that current law designates as charitable, religious, educational, scientific, or literary.

The effects of some of the other proposals are likely to vary by type of institution. For example, churches and synagogues depend heavily on donations and receive them from a broad spectrum of income classes, including people who do not itemize their deductions and thus do not benefit from the preferential treatment of charitable contributions under current law. Other institutions, such as museums, are more dependent on large gifts from wealthy donors, who generally itemize their deductions and therefore might be more sensitive to changes in tax law that affect charitable contributions. By contrast, institutions such as hospitals that derive most of their income from service charges and fees and that have access to credit markets might be more sensitive to changes in law that affect their tax-exempt status and ability to benefit from tax-exempt financing.

Whatever their extent, the effects that the proposals might have on nonprofit institutions would essentially be a byproduct of tax restructuring. The primary objectives of restructuring are to simplify the tax system, encourage saving, and lower tax rates without also reducing revenues. Those objectives require broadening the tax base. A consumption-based tax system could be designed to provide preferential treatment for nonprofit institutions, although the mechanisms for doing so might differ from those under current law and, in some cases, might pose conceptual or technical problems. But regardless of whether the tax base was income or consumption, the trade-off for providing preferences would be higher tax rates and a more complex, less efficient tax system. The fundamental issue for policymakers is how to balance social- and tax-policy objectives. And that issue centers not on the tax base, but on the rationale for exempting institutions from taxation and the costs and benefits of subsidizing charitable activity.

CHAPTER II

THE NONPROFIT SECTOR AND ITS TAX TREATMENT

As of 1995, nearly 1.2 million institutions in the United States were registered as tax-exempt entities under section 501(c) of the Internal Revenue Code. A much smaller number of organizations were exempt under other sections of the code (notably sections 401(a), 501(a), 501(d), 501(e), 501(f), 521, and 527). Institutions that are exempt from paying federal income taxes frequently are also exempt from state and local income taxes, sales taxes, and property taxes.

Tax-exempt institutions are a diverse group. They include foundations, colleges and universities, art museums, hospitals, churches, social welfare institutions, fraternal beneficiary societies, war veterans' organizations, employee-funded pension trusts, religious and apostolic organizations, farmers' cooperatives, and many others.

Overall, the nonprofit sector represents a significant slice of the national economy. In 1995, tax-exempt organizations held $1.4 trillion in assets and generated $784 billion in revenue. They accounted for nearly 11 percent of gross domestic product (GDP), up from about 6 percent two decades ago.[1]

CURRENT TAX BENEFITS FOR NONPROFIT ORGANIZATIONS

Nonprofits benefit from special treatment under federal tax law—a practice that dates to the mid-19th century (see Box 1). All organizations that meet the requirements of sections 501(c) or other relevant sections of the Internal Revenue Code are exempt from paying income taxes. Organizations that satisfy the more stringent requirements of section 501(c)(3) receive two additional benefits: access to tax-deductible contributions and eligibility to raise capital in the tax-exempt bond market. (Federal law imposes strict limits on the use of tax-exempt financing by other tax-exempt and taxable entities.)

1. Unpublished data from the Internal Revenue Service's Statistics of Income Division.

BOX 1.
A BRIEF HISTORY OF THE TAX TREATMENT OF NONPROFIT ORGANIZATIONS

In the United States, the practice of exempting institutions from federal taxes evolved during most of this century, but its beginning goes back to the Civil War and stems from British common law. At the state level, institutions dedicated to religion, education, poverty relief, or social welfare have received special treatment under tax law since Colonial times.

In 1863, when the federal government imposed a corporate income tax for the first time, it exempted charitable organizations.[1] The Revenue Act of 1894 and the Revenue Act of 1913 also provided that organizations operated for charitable purposes would be exempt from tax.[2] Donations by individuals to charitable organizations were made tax-deductible in 1917. Corporate donations have been tax-deductible since 1935. In the Revenue Act of 1968, the federal government for the first time placed limits on the use of tax-exempt bonds for private purposes. Section 501(c)(3) institutions were exempted from those limits; but today, only acute care hospitals are exempt from limits on the amount of tax-exempt financing available to them. Before 1968, the use of tax-exempt bonds to finance the projects of health care or educational institutions depended entirely on state law.

The Congress has never provided a statutory definition of the term "charitable." In 1923, an Internal Revenue Service ruling narrowly defined "charitable" as the relief of poverty. That definition remained in force until 1959, when the Treasury's final regulations putting into effect the Internal Revenue Code of 1954 changed it to conform to a much broader "generally accepted legal definition."[3] The broader definition had its roots in common law, which recognizes as charitable activities several that go beyond providing relief for the poor, such as advancing education, religion, or community benefit. In writing the regulations for the Internal Revenue Code of 1954, the Treasury relied on judicial decisions, which echo the British Statute of Charitable Uses of 1601. A British legal decision of 1891 defined "charity" as consisting of "four principal divisions: trusts for the relief of poverty; trusts for the advancement of education; trusts for the advancement of religion; and trusts for other purposes beneficial to the community."[4] That broad standard of charitable activity remains in effect and underlies current U.S. policy.

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1. David A. Hyman, "The Conundrum of Charitability: Reassessing Tax Exemption for Hospitals," *American Journal of Law and Medicine*, vol. 16, no. 3 (1990), p. 334.

2. The Revenue Act of 1894 was declared unconstitutional in *Pollack v. Farmers' Loan and Trust Company*, 158 U.S. 601 (1895).

3. Treasury Regulations, section 1.501(c)(3)-1(d)(2).

4. *Commissioners for Special Purpose of Income Tax v. Pemsel* (1891), as cited in Boris I. Bittker and George K. Rahdert, "The Exemption of Nonprofit Organizations from Federal Income Taxation," *Yale Law Journal*, vol. 85, no. 3 (January 1976), p. 131.

Exemption from Federal Income Taxes

Tax exemption makes it possible for those institutions with net income to retain their earnings and use them to advance their programs. Most tax-exempt institutions fall under either section 501(c)(3) or 501(c)(4) of the tax code. Section 501(c)(3) states that entities are eligible for exemption from federal income taxes if they are organized as nonprofit corporations for charitable, religious, educational, scientific, or literary purposes, or to foster national or international amateur sports, or for the prevention of cruelty to children or animals; if no part of their net earnings benefits members of the board, officers, managers, staff, employees, or other individuals associated with the enterprise; and if "no substantial part" of their activities consists of participating in political campaigns or attempting to influence legislation. Under section 501(c)(3), public charities include organizations that receive substantial support in the form of contributions from the public as well as churches, schools, hospitals or other health care institutions, or nursing homes. (Section 501(c)(3) does not specifically mention hospitals or other health care institutions, but it has always applied to them.) Although private foundations are also charitable organizations, they are subject to a 2 percent tax on investment income and to restrictions that do not apply to public charities.

In 1995, about half of the tax-exempt organizations in the United States, roughly 626,000, were registered as public charities under Section 501(c)(3).[2] About 67 percent of those institutions were religious in nature, 13 percent provided social services, 7 percent were devoted to health, and 5 percent were educational.[3] In 1995, public charities held about $948 billion in assets and generated $589 billion in revenue. They accounted for 8 percent of GDP, up from 4 percent in 1975.[4]

Many nonprofit organizations that do not meet the criteria of section 501(c)(3) are eligible for exemption from federal income taxes under the less stringent requirements of section 501(c)(4), which apply to organizations that "promote social welfare." One of the differences between the two sections is that 501(c)(3) organizations are subject to restrictions on lobbying activities, whereas 501(c)(4) organizations are not, so long as such activities are germane to their exempt

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2. Internal Revenue Service, *1995 Data Book*, Publication 55B (7-96), p. 25. The total does not include all religious organizations because some, such as churches, integrated auxiliaries, and associations of churches, need not apply for recognition of exemption unless they desire a ruling from the Internal Revenue Service.

3. American Association of Fund-Raising Counsel, *Giving USA 1995: The Annual Report on Philanthropy for the Year 1994* (New York: AAFRC Trust for Philanthropy, 1995), p. 31. Data on section 501(c)(3) institutions by type are for 1990.

4. Unpublished data from the Statistics of Income Division of the Internal Revenue Service. The data do not include private foundations.

purpose. Until recently, 501(c)(4) organizations were also not subject to prohibitions on private inurement that apply to 501(c)(3) organizations. The Taxpayer Bill of Rights (Public Law 104-168), enacted in July 1996, extended the prohibitions to 501(c)(4) organizations. About 139,000 institutions are registered as social welfare organizations under section 501(c)(4).[5]

Tax-exempt organizations that earn income from business activities unrelated to their tax-exempt purposes must pay taxes at the regular corporate rates on that income. In addition, some tax-exempt organizations that fall under sections of the code other than 501(c)(3) or 501(c)(4)—specifically, social clubs, voluntary employee beneficiary associations, and political organizations—are required to pay taxes on their investment income. But for most section 501(c)(3) institutions, investment income—dividends, interest, royalties, or rents (excluding those derived from debt-financed property or certain types of subsidiaries)—is exempt from the corporate income tax.

Tax-Deductible Contributions

Under section 501(c)(3), charitable organizations have access to tax-deductible contributions; that is, donors to those institutions may deduct their contributions, up to specified limits, when computing their income for tax purposes. That benefit generally does not apply to institutions that are tax-exempt under any other provision of the tax code. Thus, in appealing for charitable donations, institutions with tax-exempt status under section 501(c)(3) have an advantage over other nonprofit organizations.

Section 501(c)(3) institutions vary widely in their reliance on charitable contributions. Such donations account for about 85 percent of the total revenue of religious organizations.[6] By contrast, they account for only 10 percent of the total revenue of all other types of 501(c)(3) organizations, excluding foundations (see Table 1). Even that figure masks differences. In 1993, charitable contributions made up 21 percent of the revenue of publicly supported organizations (such as the American Red Cross, United Way and its affiliated agencies, voluntary health and community service agencies, museums, and other cultural institutions); 12 percent of the revenue of educational institutions; and only 1 percent of hospital revenue. The primary source of income for hospitals and educational institutions is program revenue, such as hospital service charges and tuition payments. Overall, program

5. Internal Revenue Service, *1995 Data Book*, p. 25.

6. American Association of Fund-Raising Counsel, *Giving USA, 1995*, p. 86.

TABLE 1. REVENUES AND EXPENSES OF SELECTED TYPES OF CHARITABLE ORGANIZATIONS, 1993
(In millions of dollars, unless otherwise indicated)

Type of Organization	Total Revenue	Percentage of Revenue in the Form of: Contributions and Gifts	Government Grants	Program Service Revenue	Total Expenses	Excess of Revenue Over Expenses
Educational Institution	89,495	12.0	11.1	63.1	80,482	9,013
Hospital	256,661	1.3	1.0	94.0	246,294	10,367
Hospital Research Organization	2,990	16.4	11.3	47.8	2,673	317
Publicly Supported Organization[a]	158,778	20.6	19.2	49.9	149,962	8,816
Organization Supporting a Public College	6,411	37.3	18.4	27.9	5,244	1,167
Organization Supporting Other Charitable Institutions[b]	44,816	12.0	1.0	43.7	39,095	5,721
Other[c]	5,305	15.3	26.0	51.5	4,944	360
Total	564,457	9.9	8.2	71.3	528,695	35,762

SOURCE: Congressional Budget Office based on unpublished tabulations from the Statistics of Income Division of the Internal Revenue Service.

NOTE: Data are from form 990 filed by nonprofit charitable organizations that are tax-exempt under section 501(c)(3) of the Internal Revenue Code. The data exclude private foundations and most religious organizations (religious organizations are not required to file income tax returns). The data also exclude organizations that file form 990-EZ. Those organizations accounted for less than 1 percent of both revenues and contributions.

a. Publicly supported organizations are ones that normally receive a large part of their funds from a governmental unit or from the general public in the form of contributions or revenue from services or products related to their tax-exempt functions. Such organizations include United Way, the American Red Cross and its affiliated agencies, voluntary health and community service agencies, and cultural institutions.

b. Organizations that support other charitable institutions include the College Retirement Equities Fund, the Teachers Insurance and Annuity Association of America, and the Common Fund for Nonprofit Organizations.

c. Other organizations include those that did not report or incorrectly identified their type, those with religious affiliations that filed voluntarily, those involved with testing for public safety, and governmental units.

revenue accounts for roughly 70 percent of income for section 501(c)(3) institutions, excluding foundations and religious organizations.[7]

Donations by individuals make up the bulk (about 80 percent) of charitable contributions, which in 1994 amounted to nearly $130 billion. Foundation grants, bequests, and corporate donations account for the rest.[8] Religious institutions are the largest single recipient of charitable donations. In 1994, they received 45 percent of donations, compared with 13 percent for educational institutions, 9 percent for human service agencies, 9 percent for health-related organizations, and 7 percent for arts and cultural institutions (see Table 2).[9]

The tax deduction for charitable contributions, which is available only to taxpayers who itemize deductions, provides an incentive for charitable giving by lowering the after-tax cost of contributions. For a taxpayer in the 28 percent bracket, the cost after taxes of giving an additional $1 to a charitable organization is 72 cents. The federal government, in effect, contributes the other 28 cents in the form of forgone revenue. The amount of forgone revenue—or the tax subsidy—depends on the person's tax bracket. The higher the tax bracket, the lower the cost and the greater the tax subsidy for additional charitable contributions. For a taxpayer in the 36 percent bracket, for example, the cost of an additional contribution of $1 is only 64 cents. If the deduction was eliminated, the price would rise to $1 for all taxpayers.

Gifts of appreciated property receive particularly favorable treatment under current law. Subject to specified limits and exclusions, donors may deduct the full market value of gifts of property, including works of art, even though they have paid no taxes on the amount of appreciation. The effect on the price of giving depends on when the taxpayer would have otherwise disposed of the asset and the amount of appreciation as a share of the total value of the asset. For example, if a taxpayer was in the 28 percent tax bracket, the value of the asset had doubled, and the taxpayer would have sold the asset immediately, the price of giving $1 in appreciated property would be 58 cents (72 cents minus 14 cents in unpaid taxes on capital gains). If, at the other extreme, the taxpayer would have made a bequest of the asset, the price of giving it to a charitable institution would be the same as giving cash, since current law provides for a step-up in basis at death (in other words, the original cost of a

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7. Data are based on unpublished tabulations from the Statistics of Income Division of the Internal Revenue Service. In addition to foundations and religious organizations, the data exclude organizations with annual revenues of less than $25,000, which are not required to file annual returns with the Internal Revenue Service.

8. American Association of Fund-Raising Counsel, *Giving USA, 1995*, p 12.

9. Ibid., p. 13.

bequeathed asset is revalued at its market price, so no appreciation is recognized or taxed).

The tax deduction for charitable contributions is effective only if people are responsive to the after-tax cost of charitable giving. If people choose to give the same amount regardless of the tax subsidy, then the deduction does not stimulate additional giving and is only a windfall to the taxpayers who claim it. If taxpayers are responsive to the after-tax cost of contributions, then the deduction stimulates added giving, and charitable organizations gain part or all of the benefits of the tax subsidy. Although several studies suggest that taxpayers do respond to the after-tax cost of giving, recent work has raised questions about the size of that response (see Chapter IV for details).

Tax-Exempt Financing

Apart from being able to solicit tax-deductible gifts, section 501(c)(3) institutions also have access to funds raised in the tax-exempt bond market. In most cases, an

TABLE 2. RECIPIENTS OF CHARITABLE CONTRIBUTIONS IN 1993 AND 1994, BY TYPE OF ORGANIZATION (In billions of dollars)

Type of Organization	1993	1994
Religious	56.29	58.87
Educational	15.40	16.71
Human Services	12.47	11.71
Health	10.83	11.53
Arts, Culture, and Humanities	9.57	9.68
Public and Social Benefit	5.44	6.05
Environment and Wildlife	3.19	3.53
International Affairs	1.86	2.21
Other	10.24	9.59
Total	125.27	129.88

SOURCE: Congressional Budget Office based on American Association of Fund-Raising Counsel, *Giving USA, 1995: The Annual Report for the Year 1994* (New York: AAFRC Trust for Philanthropy, 1995), p.13.

NOTE: These figures include only organizations that are tax-exempt under section 501(c)(3) of the Internal Revenue Code.

agency of a state or local government will issue the bonds on an institution's behalf. Because the interest income on such bonds is exempt from federal taxation, investors are willing to accept lower rates on them than on comparable taxable bonds. That allows 501(c)(3) institutions to borrow at more favorable rates than generally prevail in the market.

In order to borrow funds in the bond market, institutions must have a steady and reliable source of revenues to make principal and interest payments. Consequently, the 501(c)(3) institutions most likely to avail themselves of tax-exempt financing are hospitals and other health care facilities, universities, colleges, and scholarship funding corporations. Tax-exempt financing for health care facilities amounted to nearly $13.3 billion in 1995, down from an annual average of $22.5 billion from 1991 to 1994.[10] (The drop reflects a steady decline in new construction, particularly of acute care hospitals, since 1991 and an even sharper decrease in refinancing, which reached a record high in 1993.) About three-fourths of tax-exempt financing for health care facilities is for nonprofit acute care hospitals. Tax-exempt financing for higher education totaled $7.2 billion in 1995, compared with an annual average of $9.5 billion between 1991 and 1994. Of the tax-exempt bonds issued for higher education in 1995, about $2.1 billion was for public colleges; the remainder was for private institutions.[11]

Section 501(c)(3) institutions may use tax-exempt bonds to finance capital facilities and working-capital needs. Most 501(c)(3) institutions, such as colleges, universities, health maintenance organizations, and clinics, are not allowed to have more than $150 million in tax-exempt bonds outstanding at any time. Hospitals are the exception. Hospital facilities that are integrally related to acute care—for example, same-day surgery centers—are not subject to any limit. But other facilities that a hospital may construct, such as physicians' offices, are subject to the $150 million limit. Non-acute care facilities that are under common ownership are subject to an overall limit of $150 million per institution.

Tax-exempt bonds appeal to investors—especially those in high tax brackets—because purchasing and holding the bonds gives them an opportunity to shelter some of their income from taxation. That situation occurs because of the relationship of marginal tax rates to the spread in yields on tax-exempt and taxable bonds. The marketplace offers investors a wide variety of choices, which include tax-exempt bonds, taxable bonds, and equities. The traditional model maintains that

10. That amount includes refundings. New financing issues in 1995 amounted to nearly $8.3 billion; issues that combined new financing and refunding totaled nearly $2.3 billion, and refunding issues amounted to $2.8 billion. American Banker, *The Bond Buyer: 1996 Yearbook* (New York: American Banker, 1996), p. 148.

11. Ibid., p. 116.

yields on tax-exempt and taxable bonds must adjust so that, in equilibrium, a taxable investor is indifferent between holding the two kinds of securities. Thus, the marginal tax rate of the investor who purchases the last bond of a tax-exempt issue (the so-called marginal investor) would determine the ratio of the tax-exempt to taxable yield. An alternative—but not inconsistent—model suggests that the ratio may fluctuate with the yield on equities as well as marginal tax rates because different types of investors hold tax-exempt and taxable securities, and in each case they would compare the return on those securities to the return on equity. That model predicts a narrower spread between tax-exempt and taxable yields than the more traditional one.[12]

At present, interest rates on long-term tax-exempt bonds are roughly 80 percent of the rates on comparable taxable bonds. Thus, for example, if the long-term interest rate on a high-grade taxable bond is 6.5 percent and the rate on a similar tax-exempt bond is 5.2 percent, the investor in a marginal tax bracket of 20 percent would realize an after-tax return of 5.2 percent from either bond. For an investor in a marginal tax bracket of 36 percent, however, the after-tax return on the taxable bond would be 4.2 percent—a full percentage point less than the after-tax return on the tax-exempt bond. The higher return on the tax-exempt bond, which is a windfall for high-income investors, reduces the efficiency of the tax subsidy. In other words, the borrowers of funds do not reap the full benefits of tax-exempt financing; rather, they share them with investors in the bonds.

In sum, tax-exemption under section 501(c)(3) probably stimulates donations, reduces the cost of assets that are purchased with borrowed funds, and, in some cases, increases the retained earnings of nonprofit institutions compared with for-profit ones.

REVENUE LOSSES FROM THE CURRENT SYSTEM

By exempting some institutions from taxation, the federal government incurs costs in the form of forgone revenue, known as tax expenditures. Tax expenditures are measured by comparing existing law with a "normal," or basic, income tax structure that does not include special provisions, such as preferential rates, exclusions, exemptions, deductions, special credits that are subtracted from tax liability, or deferrals of tax liability. The government's official lists of tax expenditures include two related to nonprofit institutions: the revenues forgone by exempting from taxation the interest that investors earn on bonds for financing construction or acquisition of health care or educational facilities and equipment, and the revenues

12. N. Gregory Mankiw and James M. Poterba, *Stock Market Yields and the Pricing of Municipal Bonds*, Working Paper No. 5607 (Cambridge, Mass.: National Bureau of Economic Research, June 1996).

forgone by permitting individuals and corporations to deduct their contributions to 501(c)(3) institutions from taxable income.

The Congress's Joint Committee on Taxation estimates that revenue losses from outstanding issues of tax-exempt bonds for health care and educational facilities and equipment will amount to $2.5 billion in 1997 and about $14.3 billion over the 1997-2001 period. The estimated revenue losses from deductions for charitable contributions will amount to $21.3 billion in 1997 and about $118.1 billion through 2001.[13]

At present, official estimates of tax expenditures do not include the revenues forgone by exempting nonprofit institutions from federal income taxes. For many organizations, that exemption is minor because their revenues do not exceed expenses. The exemption from state and local sales and property taxes represents a greater savings. But some organizations—particularly those that derive most of their income by charging for services, such as schools and hospitals—frequently generate surplus revenue (see Table 1 on page 7).

THE ECONOMIC RATIONALE FOR THE NONPROFIT SECTOR AND ITS TAX TREATMENT

Quite apart from its historical roots, the nonprofit sector has an economic rationale: it may compensate for the failure of the private sector and government to produce collective goods (products or services that benefit all members of society regardless of whether they pay for them) or it may correct for "contract failure," which occurs when consumers are inadequately informed about the products or services they are buying. The rationale for the special tax treatment of nonprofit institutions is a separate—and much debated—issue.

The Economic Rationale for a Nonprofit Sector

In the simple competitive model of a classic market economy, an industry is composed of many private firms acting to maximize their profits and many consumers acting to maximize their welfare. If firms can enter and leave an industry readily, and if consumers have enough information to make informed decisions, prices will serve as signals for how much firms should produce. In a state of equilibrium, firms will produce the quantity and mix of goods and services that

13. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1997-2001*, JCS-11-96 (November 26, 1996).

consumers will want to buy. When competitive markets work well, the price system naturally leads to an efficient allocation of resources.

In some cases, though, the private sector may fail to produce the goods or services that society desires, or it may produce them in insufficient quantities. The reason may be that certain conditions, such as adequate information for consumers to make informed decisions, are lacking, or that production and consumption of some goods or services have benefits or costs that extend to other parties beyond those involved in the transaction. Even if all conditions for an efficient private market exist, some goods or services may be too expensive for the poor to afford. Society may decide that all people, regardless of income, should have access to such goods as education, housing, and health care because their benefits spill over to the public in general. When the outcome of the private market is inadequate, the government may intervene by producing a service itself or subsidizing some or all of its private production. If government intervention does not adequately compensate for the shortfall, the nonprofit sector may help fill the gap. In practice, some nonprofit institutions receive federal funds and help deliver public services.

Nonprofit organizations may also correct for the contract failure that can occur when consumers are insufficiently informed about the products they are buying and high transaction costs inhibit their ability to switch from one supplier to another. Many analysts cite contract failure as a rationale for nonprofit medical institutions, for example. When buyers are at an informational disadvantage and cannot easily switch suppliers, for-profit producers might take advantage of them by selling inferior goods or services at excessive prices or in excessive quantities. A nonprofit organization, which has goals other than maximizing profits, may be more likely to act in the interests of consumers and earn their trust.[14] Nonprofit institutions generally operate under a "nondistribution constraint"—a prohibition against distribution of their net earnings or assets. Although nonprofit institutions must be sensitive to costs, they are free from concern about providing returns to shareholders and thus might strive harder than for-profit institutions to hold down prices or improve quality.[15]

14. See Henry B. Hansmann, "The Role of Nonprofit Enterprise," *Yale Law Journal*, vol. 89, no. 5 (April 1980); Dennis Zimmerman, "Nonprofit Organizations, Social Benefits, and Tax Policy," *National Tax Journal*, vol. 44, no. 3 (Fall 1991); and Burton A. Weisbrod, *The Nonprofit Economy* (Cambridge, Mass.: Harvard University Press, 1988).

15. See, for example, Robert A. Boisture, "Maintaining a Strong Nonprofit Health Care System Will Be More—Not Less—Important After Health Care Reform," *Exempt Organization Tax Review*, vol. 9, no. 4 (April 1994), pp. 785-787.

The Rationale for Tax Benefits

Tax preferences for nonprofit institutions raise two basic questions: do they provide a public benefit that is commensurate with their associated loss of revenue, and are they efficient (that is, to what extent do they benefit the donor rather than the charity, and to what extent do they lead to poor allocation of resources)? Public benefit is difficult to measure and has been the subject of much debate. Under current law, a wide variety of institutions and activities receive tax benefits. Some serve a broad stratum of society, others a relatively narrow one. Some provide aid to the poor; others appeal to the interests of many socioeconomic groups, including the relatively well educated and well-off. Some institutions depend on small donations from a large number of contributors; others rely on large donations from relatively few wealthy givers. In practice, the implicit definition of public benefit for the purposes of tax law seems to reflect longstanding precedent and prevailing social values.

If education, health care, aid to the poor—to name a few—have positive effects that extend beyond their recipients, and private markets fall short of meeting the needs of all members of society, the case for public assistance may become compelling. The question then becomes how best to deliver that assistance. Should it be given directly to consumers, directly to providers, or indirectly to providers through the tax system? For example, the federal government directly subsidizes health care through the Medicaid and Medicare programs and by supporting public hospitals. It could increase its direct funding subsidies and reduce its indirect tax subsidies, thereby relieving health care providers of some of the burden of caring for lower-income patients. Similarly the federal government provides direct payments to educational institutions; it could increase them and decrease the levels of subsidy it provides through the tax system.

Tax-exemption, tax-deductible contributions, and, in most cases, tax-exempt financing provide subsidies indirectly to the providers, not the consumers, of goods and services. Assuming a public benefit, the rationale for those preferences may vary by the type of organization. In general, nonprofit organizations lack access to equity capital and therefore are limited to three sources in raising funds: donations, debt, and retained earnings. Those sources may or may not be adequate. Nonprofits that depend heavily on donations may not have sufficient contributions to meet the needs of their programs or services. At the same time, they generally cannot issue debt because they lack a steady stream of income to secure it.

Nonprofits that depend primarily on the sale of services for their revenue —so-called commercial nonprofits, such as hospitals—usually receive only a small portion of their funds from donations. Thus, expanding their programs or facilities must depend largely on using retained earnings and whatever capital they can raise by issuing debt. Exemption from taxation increases the amount of earnings that

nonprofits can accumulate, retain, and use either to finance expansion directly or to help secure debt. And those nonprofits that have access to the tax-exempt bond markets can borrow funds at below-market interest rates.

At present, tax-exempt financing for health care and educational facilities is broadly available to 501(c)(3) institutions and is not targeted toward any particular purpose or area. Thus, the subsidy may stimulate investment where facilities are in short supply, but it may also lead to overinvestment in other areas. If capital subsidies are necessary, a more direct approach would be to provide federal loans at below-market interest rates or federal grants to subsidize interest costs. An institution would then benefit from the full amount of the subsidy instead of sharing it with the buyers of tax-exempt bonds.

Whether direct subsidies would compensate for contract failure is more debatable. Even if tax benefits were unavailable, a nonprofit sector might exist to fill a need for information that would otherwise be unmet. A nonprofit sector that operates independently might be better at meeting such needs than are profit-seeking firms or the federal government. If such needs for information exist, a rationale for tax exemption and other tax preferences is that they help to compensate for the constraints on capital formation that nonprofits commonly face.[16]

Policymakers and social scientists have justified the deduction for charitable contributions on the grounds that such contributions reallocate income from private to public purposes; they do not enrich the giver and therefore should not be included in the tax base. The tax-favored treatment of charitable institutions may promote social-policy objectives by providing goods or services that the government might otherwise have to supply or by serving educational, religious, cultural, medical, or scientific purposes that benefit the public. Further justifications for the deduction are that it stimulates private initiatives, avoids governmental intrusiveness, encourages pluralism, and in the case of contributions to support the social assistance programs of religious organizations, avoids compromising the principle of separation of church and state.

A counterargument is that the electorate as a whole, not individual donors, should determine which activities deserve taxpayer support. A further argument against the deduction is that, regardless of benefits to third parties, donations to charitable causes also benefit the giver. In some cases, the benefit may simply be the gratification associated with giving. In other cases, the benefit may be tangible. For example, many individuals contribute to institutions that provide them or their families with such benefits as education, cultural enrichment, or places of worship.

16. See Henry B. Hansmann, "The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation," *Yale Law Journal*, vol. 91 (November 1981), pp. 54-100.

And businesses and corporations frequently donate as a means of projecting a positive image without directly advertising particular products or services.

Some critics of the current tax deduction would distinguish among different types of charities and argue, for example, that providing assistance to the poor serves a broad social purpose and therefore merits tax subsidies, whereas contributing to a performing arts center, an opera company, or a ballet troop does not because it serves the interests of the donors and, in any event, primarily benefits the wealthier and better educated. Others would argue that contributions to the arts promote broader access by making it possible to provide training scholarships, support programs on public television, and subsidize the cost to students and other groups of attending museums and cultural events.

In part, the rationale for the deduction for charitable contributions rests on the notion that it stimulates increased giving. But empirical studies on how much it does that show varying results. If giving is less responsive to the deduction, the rationale for the subsidy is weakened. Likewise, if the availability of tax-exempt financing stimulates overexpansion of capital facilities and results in an inefficient allocation of resources, the rationale for that subsidy is weakened as well.

CHAPTER III

PROPOSALS TO RESTRUCTURE THE TAX SYSTEM

Many of the recent Congressional proposals for restructuring the tax system involve, to a greater or lesser degree, replacing the current system, which taxes income, with one that primarily taxes consumption. The main purposes are to encourage saving and investment and to simplify the tax code. The emphasis on taxing consumption is new. A decade ago, tax reform efforts focused on restructuring the income tax to make it fairer, simpler, and more efficient but did not attempt to replace it with a consumption-based tax.

Taxes based on consumption can take several forms and can be collected from businesses, individuals, or both. Like income tax systems, consumption tax systems can have either a single statutory rate or rates that vary among individuals and different types of consumption. Similarly, the base may be narrow or broad, and the system can include many tax preferences or none. The main types of consumption taxes are a retail sales tax, a value-added tax (VAT), and consumption-based taxes levied directly on households.

Retail sales and value-added taxes are collected by businesses. Both types of taxes can be broad-based or can exempt certain goods and services or certain types of businesses. The main difference between the two is that retail sales taxes are levied on final consumer purchases, whereas value-added taxes are levied at each stage of the production and marketing of goods and services. The value added by labor and capital at each stage determines the amount of tax owed at that stage. The methods for calculating value-added taxes vary (as outlined in Box 2) and can affect the treatment of nonprofit institutions.

The proposals for consumption-based taxes levied on individuals or households have taken two forms. Some proposals exclude interest, dividends, and capital gains from the tax base, whereas others tax all income but provide a deduction for net savings. The latter scheme is known as a consumed (or savings-exempt) income tax. By definition, income equals consumption plus saving. Thus, exempting savings from taxation is equivalent to taxing consumption.

The tax-restructuring measures discussed in this paper are not inclusive, but they illustrate the general nature of recent proposals. Most are based on consumption rather than income, and several call for flat rates. The proposals vary widely in their level of detail and in their treatment of charitable and other nonprofit institutions (see

BOX 2.
METHODS OF CALCULATING VALUE-ADDED TAXES

Three methods exist for calculating value-added taxes: the credit method, the subtraction method, and the addition method.

Under the credit method, the firm calculates the value-added tax (VAT) it owes by applying the tax rate to its sales. It then receives as a credit against its tax liabilities the VAT it has paid on purchases from other businesses, and it remits the difference to the government. The credit-invoice method, which most European countries use, requires the firm to show the VAT separately on all of its sales invoices and to calculate the VAT credit by adding all VAT shown on its purchase invoices. The credit method thus ensures against final purchase prices that include multiple layers of tax (that is, "cascading" of the VAT).

Under the subtraction method, also known as a business transfer tax, a firm pays tax on the difference between its sales and its purchases from other businesses, including buildings and equipment. The subtraction method does not require invoices.

Under the addition method, a firm calculates its VAT by adding up all payments for untaxed inputs and multiplying the added value by the tax rate.

Table 3). However, most of them are intended to raise the same amount of revenue as current tax laws. Thus, the tax rates in the proposals could change, if necessary, to avoid revenue losses. The bill numbers below refer to legislation introduced in the 104th Congress.[1]

A NATIONAL RETAIL SALES TAX

The National Retail Sales Tax Act of 1996 (H.R. 3039), introduced by Congressman Dan Schaefer and others, would replace the individual and corporate income taxes with a national retail sales tax of 15 percent on property and services. The tax base would include rents and leaseholds but would exclude exports and goods that were purchased for resale or to produce taxable property or services. Tuition payments for education or job training would fall into that last category and thus would not be subject to tax.

In general, H.R. 3039 would exclude from taxation dues, contributions, and payments to charitable and other nonprofit institutions. Payments for the goods and services of nonprofits would also be exempt, provided they were related to the organization's exempt purpose and were not commercially available.

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1. See also Joint Committee on Taxation, *Impact on State and Local Governments and Tax-Exempt Organizations of Replacing the Federal Income Tax*, JCS-4-96 (April 30, 1996).

TABLE 3. MAJOR PROVISIONS THAT AFFECT NONPROFIT ORGANIZATIONS IN SELECTED TAX-RESTRUCTURING PROPOSALS OF THE 104TH CONGRESS

Proposal	Tax-Exemption for Public Charities	Tax-Exemption for Other Nonprofits	Deductibility of Charitable Contributions: Individual	Deductibility of Charitable Contributions: Corporate	Preferential Treatment of Tax-Exempt Bond Interest
Current Law	Yes	Yes	Within limits[a]	Within limits[a]	Yes
H.R. 3039 (National Retail Sales Tax Act of 1996)	Yes	Yes	No	No	No
H.R. 4050 (VAT)	No[b]	No[b]	No	No	No
H.R. 2060 and S. 1050 (Freedom and Fairness Restoration Act of 1995)	Yes	Yes	No	No	No
S. 488	Yes	Yes	Limited to $2,500	No	No
Ten Percent Plan	Yes	Yes	No	No	Yes
S. 722 (USA Tax Act of 1995)	Yes[c]	No[c]	Within limits similar to current law	No	Yes
Bingaman-Daschle Proposal	Yes	No	Yes	No	Yes

SOURCE: Congressional Budget Office.

NOTE: VAT = value-added tax; USA = Unlimited Savings Allowance; AGI = adjusted gross income.

a. The limits in any year are 50 percent of AGI for gifts of cash to public charities and private operating foundations and 30 percent of AGI for gifts of appreciated capital gain property for individual contributions and 10 percent of taxable income for corporate contributions.

b. The goods and services of charitable and other nonprofit institutions would be exempt from tax only if the entity did not charge for them.

c. Most section 501(c)(3) organizations would be tax-exempt. The exceptions would be organizations that promote amateur sports or that sponsor seminars or conduct research to educate the Congress or the general public about policy issues. Qualified pension and employee benefit plans, certain real estate and title holding companies, cemetery companies, and cooperative hospital service and educational organizations would also be exempt. Other nonprofit entities, including social welfare organizations registered under section 501(c)(4), would be subject to the business tax on any transfer of goods or furnishing of services.

A VALUE-ADDED TAX

Legislation introduced by Congressman Sam Gibbons (H.R. 4050) would replace the individual income tax (for all but high-income taxpayers), the corporate income tax, and the Social Security and Medicare payroll taxes with a single-rate, subtraction-method value-added tax. The VAT rate would be 20 percent of the difference between a firm's gross receipts and its purchases of goods and services from other enterprises, whether for-profit or nonprofit. (Twenty percent is an estimate of the rate that, in combination with other provisions, would produce the same revenue and distributional effects as current law.) For purposes of the bill, a firm's purchases would not include employee compensation. If, during any taxable period, a business's purchases exceeded its gross receipts, the business would be entitled to a refund equal to the VAT rate times that excess.

Because the proposed VAT would most likely result in a tax increase for lower-income households and a decrease for upper-income households, the bill includes adjustments to make the tax burden, on average, similar to that under current law:

- o Taxpayers with income between $30,000 and $75,000 would pay no income tax and file no tax returns.

- o Taxpayers with adjusted net income of less than $30,000 would get a credit to offset their VAT payments. The credit would be 20 percent of adjusted net income, reduced by two-thirds of one percent for each whole $1,000 of the taxpayer's net income. (For purposes of the credit, the bill defines adjusted net income as the sum of adjusted gross income and the value of some nonindexed federal transfer payments.)

- o Taxpayers with net income of more than $75,000 would pay a 17 percent flat rate on the amount of adjusted net income over $75,000. (For purposes of the assessment, the bill defines adjusted net income as adjusted gross income plus tax-exempt interest, some foreign-earned income that is excludable under current law, and items of elective deferred compensation.) The bill does not provide for any deductions from income—such as for state and local taxes, home mortgage interest, or charitable contributions.

The VAT base would include sales of goods and services by nonprofit entities, agricultural cooperatives, and state and local governments. The goods and services of tax-exempt organizations and government agencies would be exempt only if the provider did not charge for them. (However, public utility, mass transit, and

postal services that a government agency might furnish would be taxed, even if it did not impose a separate charge for them.) Corporate gifts would generally come out of net receipts, which would be subject to the VAT.[2]

FLAT-RATE CONSUMPTION TAXES

Proposals for consumption-based taxes include several that would impose a single statutory rate on businesses and individuals. Flat rates can apply to any tax base. With one exception, however, all of the proposals in the 104th Congress involve changing the base to consumption and eliminating many tax preferences.

H.R. 2060 and S. 1050

The flat-tax proposal introduced by House Majority Leader Richard Armey (H.R. 2060) and Senator Richard Shelby (S. 1050)—the Freedom and Fairness Restoration Act of 1995—would replace individual and corporate income taxes and estate and gift taxes with a wage tax on individuals and a cash flow tax on businesses. The tax on individuals would be levied on wages, salaries, pension benefits, and unemployment compensation, but not on Social Security benefits. In addition, Social Security contributions would be made from after-tax income, as under current law. The individual tax would include no deductions, but it would have exemptions of $21,400 for a married couple filing jointly, $14,000 for a single head of household, $10,700 for a single person, and $5,000 for each dependent. The individual tax rate, which would apply to the excess of income over exemptions, would start at 20 percent and drop to 17 percent when the system was fully phased in.

Businesses—corporations, partnerships, and sole proprietorships—would pay a tax on the difference between gross receipts and the sum of purchases from other firms, wage payments, and pension contributions. The rate structure would be the same as for the individual tax. Payments for fringe benefits, state and local taxes, and payroll taxes would not be deductible. The main difference between the proposed cash flow tax on businesses and a subtraction-method VAT is that the latter normally would not allow firms to deduct wages and pension contributions.

Nonprofit entities that are now tax-exempt would remain so and, as under current law, would be subject to tax only on income from unrelated business activities. They would, however, have to pay a tax equal to the cash flow tax on the value of employees' compensation other than wages, contributions to retirement

2. *Congressional Record*, September 11, 1996, pp. E1572-E1580.

plans, and payments for services performed outside the United States. Thus, employee fringe benefits, such as health and life insurance, would be subject to tax.

S. 488

The proposal introduced by Senator Arlen Specter (S. 488) is similar to H.R. 2060 and S. 1050. It would replace the individual and corporate income taxes with a 20 percent flat-rate consumption tax, consisting of a wage tax on individuals and a cash flow tax on businesses.

The individual tax would be levied on earned income (excluding income from foreign sources). In addition, employees of nonprofits and government agencies would have to add the imputed value of their fringe benefits to their wage base. Besides a "basic standard deduction," based on filing status, and an "additional standard deduction" for each dependent, S. 488 would allow individuals to deduct home mortgage interest on the first $100,000 of acquisition indebtedness and up to $2,500 for charitable contributions of cash or its equivalent.[3] The deduction for charitable contributions would be available for itemizers and nonitemizers alike.

The business tax would be levied on gross income minus the sum of purchases from other firms, the costs of tangible and real property, reasonable travel and entertainment expenses, wage payments, and pension contributions. (Deductions that exceeded revenues could be carried forward to the following year.) Charitable contributions by corporations would not be deductible.

H.R. 214 and H.R. 1780

Other proposals in the 104th Congress for flat-rate taxes include H.R. 214 and H.R. 1780. H.R. 214, the Crane Tithe Tax Act of 1995, would replace corporate and individual income taxes and estate and gift taxes with a 10 percent tax on the excess of an individual's earned income over a specified exemption amount. The bill would permit no exclusions from gross income, no credits against individual income taxes, and no deductions.

H.R. 1780 would replace corporate and individual income taxes with a 20 percent flat-rate tax on the earned income of individuals and on business taxable income. For individuals, it would provide a basic standard deduction, based on filing status; an additional standard deduction for each dependent; and a home mortgage

3. Acquisition indebtedness, as defined in section 163(h)(3) of the Internal Revenue Code, is incurred in acquiring, constructing, or substantially improving a residence.

interest deduction, limited to the first $100,000 of acquisition indebtedness; and a deduction for charitable contributions.

A FLATTER INCOME TAX

A proposal introduced by House Minority Leader Richard Gephardt—the Ten Percent Plan—would result in a flatter tax but would not change the base to consumption. Under the plan, three-fourths of all individuals and households would pay income tax at a 10 percent rate. For the remainder, the rates would be graduated in four steps, from 20 percent to 34 percent. The proposal would raise current personal exemption levels to $5,000 for single taxpayers and $8,350 for married couples. An additional personal exemption of $2,750 would be available for each family member. Social Security benefits would be treated as under current law.

The Ten Percent Plan would include tax-exempt interest, fringe benefits, and employers' pension contributions in gross income and would allow deductions only for interest paid on home mortgages. It would broaden the base of the corporate income tax by eliminating some $50 billion in preferences but would otherwise leave it intact. Taxes for smaller businesses would be lower than under current law.

TWO-TIER INCOME AND CASH FLOW TAXES

Some Members of Congress have proposed two-part tax systems that would modify the individual income tax and replace the corporate income tax with a cash flow tax similar to a subtraction-method VAT. Depending on the proposal, the revisions to the individual tax would either shift the base to consumption or leave it unchanged.

The Unlimited Savings Allowance Tax

The proposal introduced by Senators Pete Domenici and Sam Nunn (S. 722)—the Unlimited Savings Allowance (USA) Tax Act of 1995—would replace the individual and corporate income taxes with two consumption-based taxes.

For individuals, the tax base would consist of gross income minus net additions to savings and specified exemptions and deductions. Gross income would include wages, salaries, pensions, most fringe benefits, alimony, child support, interest, dividends, rents, royalties, proceeds from the sale of financial assets, and gains from the sale of nonfinancial assets. Gross income would not include proceeds from borrowing, interest on tax-exempt bonds, income from gifts and bequests,

health care payments and reimbursements, certain government transfer payments, veterans' benefits, military pay, and a portion of Social Security payments.

The net additions to savings that individuals could deduct from gross income would include acquisition of such assets as stocks, bonds, securities, and shares of mutual funds; certificates of deposit; investments in proprietorships and partnerships; life insurance policies; annuities; net new deposits in savings, money market, checking, credit union, and brokerage accounts; and contributions to retirement accounts. Additions to savings would not include investments in land, cash on hand, or collectibles. Borrowing would reduce (but not below zero) the deduction for net savings, as would interest earned on tax-exempt bonds.

Individuals would be entitled to personal exemptions of $2,550 for each member of the household, a family living allowance, and deductions for alimony, home mortgage interest, postsecondary education, and charitable contributions. Deductions for education would be limited to a maximum of $2,000 per person or $8,000 per household. Charitable contributions would generally be subject to the same limits specified in current law but would include the full market value of some donated property—specifically, real estate and tangible property that is related to an institution's exempt purpose, such as works of art donated to museums (which would not qualify for the savings deduction). Donors of marketable stock would be able to deduct the untaxed appreciation at the time of contribution. (The original cost would be deductible from income in the year of purchase.) Charitable contributions that exceed the deductible limit could be carried forward for up to five years. All other deductions, including those for state and local taxes, would be eliminated.

A progressive rate schedule—8 percent, 19 percent, and 40 percent after 1999—would apply to the individual tax base, with a credit for the 7.65 percent Social Security and Medicare payroll taxes that workers pay. Lower-income households would be eligible for an earned income tax credit similar to the existing one.

For businesses, a cash flow tax—essentially a subtraction-method VAT—would replace the corporate income tax. The tax base would be gross receipts minus business purchases and would be subject to an 11 percent rate. Gross receipts would not include interest, dividends, proceeds from the sale of stocks and bonds, or taxes. Business purchases would include employee compensation, interest and dividend payments, life insurance premiums, financial assets, and property purchased outside the United States other than imports. A credit would be allowed for the 7.65 percent payroll taxes that employers pay.

S. 722 would exempt most section 501(c)(3) charitable, religious, and educational organizations from the business tax (with the exception of income they

earned from unrelated business activities). Qualified pension and employee benefit plans, certain real estate and title holding companies, cemetery companies, and cooperative hospital service and educational organizations would also be exempt. Other nonprofit entities, including social welfare organizations registered under section 501(c)(4), would be subject to the business tax on any transfer of goods or furnishing of services. Section 501(c)(3) organizations that promote amateur sports or that sponsor seminars or conduct research to educate the Congress or the general public about policy issues would also lose their tax-exempt status.

The Bingaman-Daschle Proposal

The proposal introduced by Senators Jeff Bingaman and Tom Daschle—which is part of a larger plan designed to foster "family-friendly" policies—would modify the existing individual income tax and would replace the corporate income tax with a business activity tax. With a few exceptions, their tax proposal is similar to the one introduced in the 103rd Congress by (then) Senators John Danforth and David Boren.

Unlike other comprehensive tax-restructuring proposals, the Bingaman-Daschle plan would not replace the individual income tax with a consumption-based tax. Rather, it would alter the current tax by adding an extra standard deduction, reducing payroll taxes, expanding the earned income credit, providing a $500 credit for each child, and allowing a deduction of up to $10,000 for educational expenses. Charitable contributions would be affected only by the increase in the standard deduction. The exclusion for interest on tax-exempt bonds would remain.

The proposed business activity tax is essentially a subtraction-method VAT. All businesses with gross annual receipts of more than $100,000 would pay a flat-rate tax on the amount by which their sales exceeded their purchases from other businesses. Employer-provided benefits, such as health care and pension contributions, would not be deductible. The tax rate would be 11 percent for businesses that adopted "family-friendly" labor and environmental practices (such as offering acceptable profit sharing, health care, work training, and pension plans and maintaining an acceptable environmental record) and 18 percent for all other businesses. State and local governments would be subject to the tax on activities that were related to public utility services, mass transit services, postal services, and services not involving an "essential governmental function."

Nonprofits other than section 501(c)(3) institutions would be subject to the business activities tax, even if their activities were related to their exempt purpose. Charitable organizations would pay the tax only on unrelated business activities.[4]

TAX TREATMENT OF NONPROFITS IN COUNTRIES WITH VATs

The general form that most of the proposals to replace the corporate (and, in some cases, the individual) income tax have taken so far—the subtraction-method VAT—differs from the VATs in nearly all developed countries, where the credit method is more common (see Box 2 on page 18). The method of calculating the VAT has important implications for nonprofit institutions. The credit method allows for zero rating and thereby makes full tax-exemption feasible. An organization with a zero rating pays no taxes on the value of its sales and receives credit for taxes paid on its purchases. Under the subtraction-method VAT, by contrast, nonprofit organizations can be exempted from paying tax on the value of their sales minus purchases, but they will probably pay higher prices for their purchases to compensate for the VAT paid by their suppliers. In other words, under a subtraction-method VAT tax-exemption is partial, whereas under a credit-method VAT it can be partial or full.

Tax-exemption under a VAT or a cash flow tax can be based either on the nature of the institution or on the activities it performs. Although countries that impose broad-based consumption taxes have used both approaches, the more common practice is to exempt nonprofit institutions but to tax certain activities. In European countries, a nonprofit organization's noncommercial activities are exempt from tax, but its commercial goods and services that compete with those of private-market providers generally are not. Canada at times departs from that practice by taxing some nonprofit organizations but exempting certain activities. Canada also applies an exemption test based on taxable revenues that is the same for nonprofits and small businesses.[5]

Typically, certain goods and services are either exempted (that is, partially taxed) or zero-rated (that is, not taxed at all). The goods that European countries most commonly exempt or zero-rate are medical services, educational services, rental housing, and financial services. Some countries also exempt or zero-rate food, medicine, books, newspapers, museum admission charges, entertainment, and sports.

4. Senator Jeff Bingaman, *Scrambling to Pay the Bills: Building Allies for America's Working Families* (February 28, 1996); also see Bureau of National Affairs, "Technical Overview, Legislative Language, and Memoranda on the Comprehensive Tax Restructuring and Simplification Act of 1994," *BNA Special Supplement*, Report No. 101 (May 27, 1994).

5. Robert Carroll, Thomas S. Neubig, and Kathleen M. Nilles, "Impact of Structural Tax Reform on Nonprofit Organizations," *Exempt Organization Tax Review*, vol. 12, no. 1 (July 1995), p. 106.

In most countries, exemption is more common than zero-rating. The United Kingdom and Ireland zero-rate about one-third of household consumption, which is significantly more than most other countries. Specifically, the United Kingdom zero-rates food, drugs, purchased housing, books, and newspapers and exempts medical, educational, and financial services and rental housing.[6]

The European Community has taken the position that activities in the "public interest"—such as postal services, medical and dental care, education, cultural activities, and noncommercial radio and television—should be exempt from VAT, regardless of the nature of the institution that provides them, which may be publicly or privately owned, charitable, nonprofit, or for-profit.[7]

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6. Alan A. Tait, *Value Added Tax: International Practice and Problems* (Washington, D.C.: International Monetary Fund, 1988), pp. 49-79.

7. Sixth Council Directive, European Community, as described in Tait, *Value Added Tax*, pp. 69-79.

CHAPTER IV

EFFECTS OF THE PROPOSALS ON THE NONPROFIT SECTOR

Restructuring the tax code could reduce or even remove some of the benefits that charitable—section 501(c)(3)—and other nonprofit institutions now enjoy. Although much would depend on the measures involved, a major overhaul could affect the tax-exempt status of nonprofit institutions and the ability of charitable organizations to solicit tax-deductible contributions and benefit from tax-exempt financing. Most of the proposals would limit the benefits of tax-exemption or, in some cases, eliminate tax-exemption entirely. Moreover, several of the proposals would reduce or abolish the deduction for charitable contributions. Finally, many of the proposals exclude interest income from the tax base, thereby obliterating the distinction between taxable bonds and the tax-exempt bonds issued by state and local governments for their own purposes or on behalf of 501(c)(3) institutions.

The extent of the effects of tax restructuring would vary not only with a plan's provisions but probably also with the type of institution. For example, most nonprofit institutions benefit from their tax-exempt status, but many would have little, if any, taxable income regardless of their status, whereas others consistently show a surplus of revenue over expenses. Similarly, charitable donations constitute the major source of revenue for some 501(c)(3) institutions, such as churches, but only a small share for others, such as hospitals. The ability to benefit from tax-exempt financing is confined largely to nonprofits, such as hospitals and educational institutions, that have a steady stream of revenue from sales of services and is of little significance to other nonprofits, such as medical research foundations or beneficial societies.

A restructured tax system could be designed to minimize the effects on nonprofit and charitable institutions. For example, all of the proposals discussed in Chapter III could exempt such institutions, and some in fact do. Similarly, deductions for charitable contributions are possible under a consumed-income tax and under a two-part consumption tax, and some of the proposals would permit them. In general, however, narrowing the tax base by introducing preferences would require higher tax rates, leading to some loss of the efficiency, equity, and simplicity that would otherwise result from taxing all forms of consumption equally.

The same issue applies under an income tax system. Exempting nonprofits from paying taxes, providing deductions for charitable contributions, and excluding interest on the bonds of charitable institutions from income also result in losses of efficiency, equity, and simplicity. Under a pure income tax, deductions would be

permissible only for expenses associated with producing income. Exemptions, exclusions, special rates, credits, and deductions designed to promote social or economic objectives, such as those available under current law, would not exist.

Deciding to exempt the activities of charitable and nonprofit institutions may raise some issues that are specific to a particular tax system, but the basic issue of whether to extend preferential tax treatment to such institutions is to a large extent independent of the tax base and involves a trade-off between tax policy and social-policy objectives. Many nonprofit institutions provide goods and services that are similar to those offered by the private market. Questions then arise about whether those goods and services should be subject to a national sales tax or a value-added tax. Should the test be whether the goods create competitive inequities? If so, what should be the basis for determining inequities? Or, more broadly, should the test be whether the products or services that nonprofits offer in some way benefit society in general or prevent contract failure? Should exemption be based on the nature of the institution or on the nature of the goods and services that nonprofits—and perhaps some for-profit institutions—provide? Those issues are also central to the rationale for providing tax benefits to charitable and other nonprofit institutions under an income tax system. In short, preferential tax treatment for nonprofit entities, or the goods and services they provide, may raise some special definitional and technical problems under a consumption tax system, but the fundamental policy issues have little to do with the tax base.

TAX-EXEMPT STATUS

The proposals that would most affect tax exemption are ones that would replace the current corporate income tax with a national retail sales tax, a value-added tax, or a cash flow tax (essentially a modified subtraction-method VAT).

H.R. 3039, which proposes a national retail sales tax, would exempt most nonprofit institutions other than those that sell goods or services that are commercially available. The definition of "commercially available" is open to interpretation and could affect a wide variety of goods and services. For example, the services of nonprofit hospitals and other health care facilities might be subject to the tax if for-profit entities were operating in the same market. Or the services of all nonprofit health care facilities might be subject to the tax on the grounds that for-profit institutions provide the same services. On a more mundane level, Girl Scout cookies might be considered part of a broader class of commercially available products and thus subject to tax, or they might be exempt on the grounds that they are not sold in stores.

The VAT, as proposed in H.R. 4050, would apply to the sales of goods and services of all nonprofit institutions. And if a nonprofit's charges for goods or services did not fully cover its costs, it would not be able to deduct the portion of its business purchases funded from other sources in computing its tax. The Unlimited Savings Allowance Tax (S. 722) would exempt most 501(c)(3) and a few other types of institutions. Other nonprofit entities, including social welfare organizations registered under section 501(c)(4), would be subject to tax. The other business transaction taxes discussed in Chapter III vary in the degree of exemption they would provide to nonprofit organizations.

In general, repealing the corporate income tax would benefit taxable corporations, such as hospitals and other health care institutions, that compete with nonprofit organizations. Some proposals would apply the same taxes to nonprofit and for-profit institutions; others would exempt charitable institutions but not other nonprofits. But even if nonprofits were exempt from tax, they would receive less preferential treatment compared with for-profit institutions than is now the case for several reasons:

- The exemption would be worth less because the rates of the proposed business taxes are generally lower than corporate rates under current law.

- Under current law, most nonprofit corporations are exempt from paying taxes on income from financial investments. That relative advantage would no longer exist because the proposals that repeal the corporate income tax generally exclude financial income, such as dividends and interest, from the base of the business tax. That is true for S. 722, H.R. 2060/S. 1050, and the VAT (although special rules may apply in the case of financial intermediaries).

- Finally, none of the recent consumption tax proposals would give nonprofits credit for the VAT that their suppliers paid, which in turn would cause their costs of goods and services to rise. In addition, H.R. 2060/S. 1050 would tax some of the compensation (such as fringe benefits) of workers in nonprofits even if the organizations were exempt from the cash flow tax. Under a subtraction-method VAT, zero-rating (and thus full tax-exemption) is generally infeasible. A subtraction-method VAT with exclusions that approximate zero-rating is theoretically possible but would probably be quite complicated. No such system now exists.

DEDUCTIBILITY OF CHARITABLE CONTRIBUTIONS

Most of the recent proposals—including the Unlimited Savings Allowance tax, the various flat taxes, the VAT, and the national retail sales tax—would eliminate the deduction for corporate gifts. Such gifts totaled $6.1 billion in 1994.[1] Some of the proposals—H.R. 2060 and S. 1050, the Ten Percent Plan, and the VAT, for example—would also do away with the deduction for charitable contributions by individuals. Giving by individuals amounted to $105.1 billion in 1994.[2] Nearly two-thirds of that amount, roughly $69 billion, was included in itemized deductions and thus resulted in tax savings to the donors.[3]

Other proposals, such as S. 488, would retain the deduction for gifts by individuals but place new limits on it. In S. 488, which proposes a single statutory rate of 20 percent, the deduction would be available for all individual taxpayers —itemizers and nonitemizers—up to a maximum of $2,500. That amount is significantly less than the average annual contributions of taxpayers with income of more than $100,000 (see Table 4). Thus, relative to current law, the proposal would raise the cost of giving for those taxpayers who now itemize and face marginal tax rates higher than 20 percent and would lower it for other taxpayers. The contribution limit suggests that the proposal would dampen the incentive of higher-income taxpayers to contribute and, in particular, to make large gifts.

The USA tax would maintain a charitable deduction subject to the same percentage-of-income and other limits that apply under current law. The rate structure would also be similar to the present one, but the tax base would be significantly different, making direct comparisons difficult. The USA tax seems less likely than other proposals to lead to a decrease in giving relative to current law, and it conceivably could stimulate an increase. However, the current tax system treats spending and saving in the same way and offers preferential treatment to charity, whereas the USA tax would offer preferential treatment to savings as well as charitable contributions. Thus, the amount of savings could increase relative to current consumption and charitable contributions.

Any proposal that eliminates or cuts back the deduction for charitable contributions, or that lowers tax rates, effectively raises the price of giving for taxpayers who itemize their deductions—and vice versa. How much that would

1. American Association of Fund-Raising Counsel, *Giving USA 1995: The Annual Report on Philanthropy for the Year 1994* (New York: AAFRC Trust for Philanthropy, 1995), p. 76.

2. Ibid., p. 46.

3. Therese M. Cruciano, "Individual Income Tax Returns, Preliminary Data, 1994," *Statistics of Income Bulletin*, vol. 15, no. 4 (Spring 1996), p. 11.

affect contributions is uncertain. Even if (all else being equal) eliminating or cutting back the deduction would result in less giving, lower tax rates could have a compensatory effect, so giving might remain unchanged.

Some studies have found that taxpayers are highly responsive to changes in the after-tax cost of giving. Those studies concluded that the tax subsidy affects giving by lowering its cost compared with the cost of other goods or services, thereby making more income available for all purposes. If the price of giving is lower relative to other goods and services, people have an incentive to give more; and if income rises, they have an additional incentive to give more.

TABLE 4. ITEMIZED DEDUCTIONS FOR CHARITABLE CONTRIBUTIONS, BY TAXPAYERS' INCOME, 1994

Adjusted Gross Income	Number of Returns	Total Contributions to Charity (In thousands of dollars)	Average Contribution (In dollars)
Less Than $25,000	3,403,283	4,198,211	1,234
$25,000 to $49,999	9,501,054	13,574,631	1,429
$50,000 to $74,999	8,864,078	15,210,156	1,716
$75,000 to $99,999	3,989,612	9,237,724	2,315
$100,000 to $199,999	3,057,196	10,455,991	3,420
$200,000 to $499,999	801,402	6,709,365	8,372
$500,000 to $999,999	129,647	2,798,029	21,582
$1 Million or More	61,269	6,704,331	109,425

SOURCE: Congressional Budget Office based on Therese M. Cruciano, "Individual Income Tax Returns, Preliminary Data, 1994," *Statistics of Income Bulletin*, vol. 15, no. 4 (Spring 1996), p. 23.

NOTE: Figures are estimates based on samples.

More recent evidence, however, raises some questions about those results. It suggests that taxpayers are less responsive to the deduction for charitable donations than was previously thought and that earlier work may have confounded the transitory and long-term responses of taxpayers to changes in the tax price of giving.[4]

Effects of Earlier Changes in Tax Law

Several changes in tax law in the 1980s affected charitable contributions. The most significant were contained in the Economic Recovery Tax Act of 1981 (ERTA) and the Tax Reform Act of 1986 (TRA-86). ERTA reduced individual tax rates, thereby lowering the tax subsidy for charitable giving. It also permitted nonitemizers to deduct charitable contributions for 1982 through 1986.

TRA-86 decreased the tax subsidy for charitable contributions even more. It lowered marginal tax rates and increased the standard deduction, thereby reducing the number of itemizers. In addition, TRA-86 raised the tax rate on capital gains by eliminating the exclusion for long-term gains. That measure would have reduced the price of giving appreciated property, except that the act also included capital gains on gifts of appreciated property as a preference under the alternative minimum tax. The interaction of those two measures decreased the incentive to make large gifts of appreciated property and increased the incentive to make modest gifts.

Empirical studies of the effect of ERTA and TRA-86 on charitable contributions have yielded varying results. Several studies indicated that taxpayers time their gifts to take advantage of changes in tax law that affect the relative price of giving. A study by Charles Clotfelter found that contributions, particularly from the highest-income donors, surged in 1986 in anticipation of the enactment of tax reform. It also found that after both ERTA and TRA-86, contributions tended to fall in income classes that experienced the largest increases in the price of giving, and that the most affluent taxpayers gave a smaller share of total contributions—relative to their income—following the two tax acts.[5]

4. See Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* (Chicago: University of Chicago Press, 1985). More recent evidence is presented in Gerald A. Auten, James Cilke, and William C. Randolph, "The Effects of Tax Reform on Charitable Contributions," *National Tax Journal*, vol. 45, no. 3 (September 1992), pp. 267-290; and William C. Randolph, "Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions," *Journal of Political Economy*, vol. 103, no. 41 (August 1995), pp. 709-738.

5. Charles T. Clotfelter, "Impact of Tax Reform on Charitable Giving: A 1989 Perspective," in Joel Slemrod, ed., *Do Taxes Matter?* (Cambridge, Mass.: MIT Press, 1990), pp. 203-235. Also see Amy Broman, "Statutory Tax Rate Reform and Charitable Contributions: Evidence from a Recent Period of Reform," *Journal of the American Taxation Association*, vol. 10 (Fall 1989), pp. 7-20.

Other analysts have suggested that those findings do not take sufficient account of year-to-year shifts in giving that are based not only on anticipated changes in tax law, but also on fluctuations in income, changes in taxpayers' preferences, and responses to funding-raising efforts. A study by Gerald Auten, James Cilke, and William Randolph, which looked at charitable contributions over the 1979-1990 period by taxpayers who would have been eligible to itemize deductions in 1990, found that the effects of ERTA and TRA-86 were indeed greatest for the highest-income taxpayers. But although their findings suggested that high-income taxpayers responded to the higher price of giving by contributing less than they would have without the tax changes, the decrease was smaller than cross-section regression estimates predicted. The study also found that in response to changes in the relative tax prices of cash and noncash contributions, taxpayers in the highest income groups increased their cash giving relative to noncash giving after 1986. The authors noted that because the regression model does not account for short-term timing effects or distinguish between single-year income and permanent income, its value in measuring and predicting behavioral responses to changes in tax law is limited.[6]

More recent work by William Randolph suggests that variations in income over time combine with progressive marginal tax rates to influence the way people plan their charitable contributions. People appear to smooth their annual giving relative to transitory changes in income, but also time their giving to take advantage of transitory changes in tax prices by substituting between current and future giving. Randolph's analysis distinguishes between the effects of transitory and permanent changes in income and raises questions about the extent to which tax incentives permanently influence the level, rather than simply the timing, of charitable contributions.[7] A significant feature of his work is that it analyzes the effects of changes in tax law by looking at the behavior of the same people over a 10-year period. Earlier, more traditional studies used observations of the behavior of different people at one point in time to predict future responses to policy changes. Thus, they could not distinguish between the effects of temporary and permanent changes in tax prices. In general, the more recent work suggests that the stimulative effect of the deduction for charitable contributions, although not negligible, is smaller—and the windfall to contributors larger—than some economists had previously assumed.

6. Auten, Cilke, and Randolph, "The Effects of Tax Reform on Charitable Contributions," pp. 267-290. Also see Don Fullerton, "Comments," in Slemrod, ed., *Do Taxes Matter?* pp. 237-238.

7. Randolph, "Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions," pp. 709-738.

Estimates of Proposed Tax Changes

A recent article by Charles Clotfelter and Richard Schmalbeck estimates the effect of some of the proposals of the 104th Congress on levels of corporate and individual contributions. The authors estimate that eliminating the deduction for corporate donations could cause contributions to decline between 15 percent and 21 percent (relative to a baseline of $4.6 billion in 1991).[8]

The authors also estimate the possible effects on individual contributions of H.R. 2060/S. 1050, the Ten Percent Plan, and the USA tax. Based on William Randolph's econometric model, their simulations indicate that H.R. 2060/S. 1050 and the Ten Percent Plan could lower individual contributions by 10 percent relative to a projected level of giving of $116 billion in 1996. The USA tax, by contrast, could increase contributions by 11 percent.

Clotfelter and Schmalbeck also present simulations based on earlier models, which suggest much stronger responses to the changes—specifically, that H.R. 2060/S. 1050 and the Ten Percent Plan would lower individual contributions by 22 percent, and the USA tax would raise them by 31 percent.[9] Those results most likely overstate the responsiveness of giving to the deductibility of contributions because, as noted above, they are based on models that do not make it possible to distinguish between the effects of transitory and permanent changes in tax prices. The estimates for the USA tax may also be overstated because the simulations do not take into account changes in the current trade-off between savings and consumption that the proposal would bring about.

In brief, the estimates may indicate the direction of the effects of some of the proposed changes, assuming all else remains the same. But the Congressional Budget Office would caution against attaching significance to the magnitude of the estimates because comprehensive tax restructuring would change the entire economic environment in which corporations and individuals make decisions about charitable giving.

Possible Differential Effects of Eliminating Charitable Deductions

Whatever their extent, the effects of eliminating the deduction for charitable contributions could vary by type of institution. For example, the price of giving

8. Charles T. Clotfelter and Richard L. Schmalbeck, "The Impact of Fundamental Tax Reform on Nonprofit Organizations," in Henry J. Aaron and William G. Gale, eds., *Economic Effects of Fundamental Tax Reform* (Washington, D.C.: Brookings Institution Press, 1996), pp. 232-233.

9. Ibid., pp. 228-231.

would rise most for higher-income taxpayers—and donations to museums, the performing arts, colleges, and universities tend to come from higher-income individuals and corporations (see Table 5). In 1994, nearly 40 percent of corporate contributions were for education; another 26 percent were for health and human services, and 11 percent were for the arts.[10] Similarly, the largest share of foundation grants was for education (24 percent), followed by health and human services (15 percent) and the arts (15 percent).[11]

A significant portion of donations to educational and cultural institutions and the performing arts is in the form of large gifts. People who support the arts also give more to charity in general (see Table 6). And they devote a significantly higher proportion of their income to donations than do all givers (3.7 percent versus 2.1 percent of income in 1993, according to a recent survey).[12] Thus, although the magnitude of the effect of eliminating charitable deductions is uncertain, educational and cultural institutions and health and human services organizations might bear the brunt of the change because, even though they depend on contributions for a smaller share of their revenue than do religious institutions, the price of giving is likely to increase more for their contributors than for contributors to religious institutions.

Educational, cultural, and research institutions might also be hurt by the elimination of estate and gift taxes—a feature of H.R. 2060/S. 1050 and H.R. 214—which could affect both charitable bequests and lifetime giving. In 1993-1994, bequests accounted for 23 percent of total giving by individuals to higher education; deferred gifts accounted for another 17 percent.[13] Bequests totaled nearly $8.8 billion in 1994.[14] In general, the largest bequests tend to go to colleges, universities, foundations, and medical, scientific, and cultural institutions rather than to churches and religious institutions. Estimates by Clotfelter and Schmalback suggest that eliminating the estate tax could cause giving by bequest to decline by between 24 percent and 44 percent (relative to a baseline of $7.3 billion in 1993).[15]

The estate tax also provides an incentive for charitable giving by living donors because charitable contributions are a means of reducing the size of an estate.

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10. American Association of Fund-Raising Counsel, *Giving USA, 1995*, p. 79.

11. Ibid., p. 64.

12. Virginia A. Hodgkinson and others, *Giving and Volunteering in the United States*, vol. 2, *Trends in Giving and Volunteering by Type of Charity* (Washington, D.C.: Independent Sector, 1995), pp. 18-19.

13. American Association of Fund-Raising Counsel, *Giving USA, 1995*, p. 95.

14. Ibid., p. 12.

15. Clotfelter and Schmalbeck, "The Impact of Fundamental Tax Reform on Nonprofit Organizations," p. 234.

TABLE 5. AVERAGE HOUSEHOLD INCOME OF CONTRIBUTORS TO CHARITY, BY TYPE OF ORGANIZATION, 1987-1993

Type of Organization	1987	1989	1991	1993
Arts, Culture, Humanities	52,389	52,929	59,119	56,535
Educational	48,896	46,600	51,737	50,527
Environmental	45,482	48,699	50,368	50,922
Health	40,208	44,229	47,053	48,896
Human Services	42,165	45,109	47,326	47,099
Public and Social Benefit	46,203	44,892	52,306	53,799
Religious	36,527	39,121	40,723	40,923
Youth Development	42,305	43,789	47,864	47,481
All Organizations	37,113	39,360	41,222	41,350

SOURCE: Congressional Budget Office based on data in Virginia A. Hodgkinson and others, *Giving and Volunteering in the United States*, vol. 2, *Trends in Giving and Volunteering by Type of Charity* (Washington, D.C.: Independent Sector, 1995).

NOTE: Data were obtained from in-home personal interviews conducted by the Gallup Organization with representative national samples of 1,509 adults in 1993 and 2,700 adults in previous years. The samples included both households that itemized deductions on their federal income tax return and those that did not.

A recent study estimates that repealing estate and gift taxes under current law could reduce lifetime charitable giving by about 12 percent.[16]

ACCESS TO TAX-EXEMPT FINANCING

The proposals for restructuring the tax system differ in their treatment of bonds issued by state and local governments. H.R. 2060/S. 1050, the VAT, and the retail sales tax would eliminate taxation of all interest and other capital income at the individual level. They would thereby wipe out the distinction between taxable

16. Gerald Auten and David Joulfaian, "Charitable Contributions and Intergenerational Transfers," *Journal of Public Economics*, vol. 59, no. 1 (January 1996), p. 64.

TABLE 6. AVERAGE CHARITABLE GIVING FOR ALL PURPOSES BY HOUSEHOLDS CONTRIBUTING TO SPECIFIC TYPES OF ORGANIZATIONS, 1987-1993

Type of Organization	1987	1989	1991	1993
Arts, Culture, Humanities	1,376	2,115	1,930	2,101
Educational	1,452	1,447	1,408	1,546
Environmental	845	1,091	1,169	1,458
Health	1,031	1,131	1,064	1,244
Human Services	1,077	1,455	1,257	1,275
Public and Social Benefit	1,273	1,141	1,256	1,506
Religious	955	1,242	1,140	1,190
Youth Development	1,146	1,128	1,252	1,269

SOURCE: Congressional Budget Office based on data in Virginia A. Hodgkinson and others, *Giving and Volunteering in the United States*, vol. 2, *Trends in Giving and Volunteering by Type of Charity* (Washington, D.C.: Independent Sector, 1995).

NOTE: Data were obtained from in-house personal interviews conducted by the Gallup Organization with representative national samples of 1,509 adults in 1993 and 2,700 adults in previous years. The samples included both households that itemized deductions on their federal income tax return and those that did not. The sampling procedure did not target households with income of more than $200,000. Therefore, the data are unlikely to reflect gifts from the very wealthy and are likely to understate contributions to educational and cultural institutions and the arts, which receive significant sums in the form of large gifts.

notes and bonds, on the one hand, and tax-exempt notes and bonds issued by state and local governments and by or on behalf of nonprofit institutions, on the other hand. In addition, the VAT proposal in H.R. 4050 would include interest earnings from tax-exempt bonds in net income for purposes of determining assessments on taxpayers with income above $75,000. Conversely, the USA tax would retain a preference for state and local bonds by excluding the interest on them from the cash income of individuals. However, such interest would offset the deduction for new savings, so the preference would apply only when individuals had no savings or had net spending.

Tax-exemption provides a federal subsidy of the borrowing costs of state and local governments and those nonprofit institutions that have access to the bond market. Losing that interest rate subsidy would cause the borrowing costs of

nonprofits and state and local governments to rise relative to those of for-profit entities. The reason is that outstanding tax-exempt debt represents a fairly small share of total debt in the domestic credit market, so of itself, the loss of tax-exemption on the interest income from state and local bonds would most likely cause interest rates on the debt of nonprofit organizations to reach a level close to that now prevailing for taxable institutions. (At the end of 1995, the volume of outstanding municipal securities was $1,307 billion, or 7 percent of the total outstanding debt in the domestic credit market of $18,570 billion.)[17]

The enactment of a pure income tax, which would eliminate tax-exemption for state and local bonds, would have similar effects. The USA tax, by contrast, would retain a preference for tax-exempt bonds; however, because the interest on tax-exempt bonds would offset new savings, such bonds might become a less attractive investment compared with other instruments. If so, the differential in interest rates between tax-exempt and taxable bonds of similar risk could narrow somewhat, and nonprofits' cost of borrowing could rise relative to that of for-profit entities.

Although a loss of tax-exemption would raise the relative cost of financing for nonprofits, a drop in the overall level of interest rates could to some degree mitigate that effect. The impact of tax restructuring on interest rates is difficult to predict, however. The effect is uncertain because saving would most likely increase at the same time as demand for capital rose. If the increase in demand for capital significantly exceeded the increase in saving, intermediate-term interest rates could rise.[18] But predicting movements in investment and saving—and the response of the Federal Reserve to those movements—is difficult.

DIFFERENCES FROM PREVIOUS TAX REFORM EFFORTS

The proposals in the 104th Congress are part of a continuing effort to restructure the tax system, with the goals of simplifying it and promoting efficiency, neutrality, and growth—without increasing the deficit. What distinguishes most of the recent proposals is the change in the tax base from income to consumption. Earlier efforts for the most part focused on modifying the income tax system. What further distinguishes many of the proposals is their elimination of virtually all tax preferences. The proposals that depart most significantly from current law and long-established practice are the ones that would abolish the tax-exempt status of

17. *Federal Reserve Bulletin*, vol. 82, no. 12 (December 1996), p. A40.

18. Based on analysis conducted for a future Congressional Budget Office publication on the economic effects of replacing the U.S. income tax with a consumption-based tax.

charitable and other nonprofit institutions. The VAT proposal would eliminate or substantially reduce the benefits of tax-exemption for all nonprofits. Some of the other proposals would eliminate tax-exemption for all but charitable institutions. None of the proposals that call for value-added or business transaction taxes would continue to provide full tax-exemption.

The proposals that would abolish the deduction for charitable contributions and the exclusion of interest on state and local bonds from income have come up many times in past discussions of reforming the income tax system. The arguments for and against those tax preferences are much the same whether the tax base is income or consumption. And, all else being equal, the effects of eliminating them would be similar under either system. A consumption tax, like an income tax, could include preferences for charitable contributions and state and local bonds. Whether or not those subsidies provide social benefits that justify the accompanying losses of efficiency and revenue is a policy issue that the recent proposals address in different ways.