

Tax Incentives for Charitable Donations

Briefing Note for the House of Commons Standing Committee on Finance

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January 18, 2012

The Canadian government, like most governments of developed nations, provides tax incentives to encourage charitable giving. From an economic perspective, the underlying rationale for charitable donation tax policy is to encourage support for those goods and services often not provided by the private sector due to market failures. The tax incentive can be viewed as an indirect form of charitable support by governments who forego tax revenue in exchange for charitable donations.

Since 1988, tax incentives for charitable giving in Canada have been provided to tax payers through a tax credit system, different from the more common tax deduction system. The Canadian tax credit system is a two-tier system such that there are two levels of tax credits at both the federal and provincial levels, such that the amount of tax benefit depends on the size of the donation rather than on the donor's marginal income tax rate in the deduction system.

Dr. Belayet Hossain and I have completed two empirical studies on the effectiveness of tax incentives on charitable giving by individuals in Canada. The first focuses on an individual's decision to give to charity and the second, on the decision of how much to give to charity. Our studies use data from the public use microdata files (PUMF) of the 2007 Canada Survey of Giving, Volunteering and Participating (CSGVP) published by Statistics Canada. The target population of the survey is all persons 15 years of age and over residing in the ten provinces.

Our first study, which has been accepted for publication in *Applied Economic Letters*, explores two aspects of the Canadian tax credit system. First, it assesses the effectiveness of tax incentives on the decision to give and second, it evaluates and compares the effectiveness of tax credits across different donation sectors. The analysis includes the following four largest donation sectors, according to the value of total donations: religious, health, social services, and international.

The methodology involves empirically estimating two models, one to evaluate the effectiveness of the tax credit on the decision to give and the second to evaluate the effectiveness across the four donation sectors. The first model is estimated with a probit model and the second with a probit two-stage selection model, to deal with the potential econometric problem of selection bias which results in inconsistent and biased parameter estimates. Selection bias occurs if the behaviour of those who do not

participate in charitable giving is not observed. The maximum likelihood approach is used for all estimations such that observations are weighted to correct for different sampling probabilities.

The empirical results indicate that the current tax incentive has a significant effect on the decision to give, such that a 10 percent increase in the tax credit is expected to increase the likelihood of making a donation by 5 percent, on average.

The results of the second part of the analysis on the specific donation sectors indicate that the tax incentive does not have a significant effect on giving to the religious sector. The tax credit does have a significant effect on the other three sectors, and the extent of the effectiveness of the tax credit is found to vary across the sectors. For instance, a 10 percent increase in the tax credit would increase the probability of donating to the social services sector by 3.6 percent, the health sector by 2.8 percent, and the international sector by 1.6 percent.

Our second study focuses on the effectiveness of the tax credit on donation expenditures and extends the analysis to compare the effectiveness across the four aforementioned donation sectors. Two models are required, one to test the effectiveness of the tax credit on an individual's total charitable expenditure and another to test the effectiveness across the four donation sectors. The first model is estimated with a standard tobit model. The second is estimated with the Heckman selection model to deal with selection bias. The maximum likelihood approach is used in which observations are weighted to correct for different sampling probabilities.

The statistical significance of the tax incentive variable implies the tax credit is effective at influencing the amount of the total donation expenditure of an individual, as well as for each of the four donation sectors. The results suggest that a 10 percent increase in the tax incentive would result in a 17 percent increase in total donation expenditures. The price elasticity of donating, a measure of responsiveness of the donation expenditure to changes in the tax incentive, varies among the four donation sectors. For instance, a 10 percent increase in the tax incentive is expected to lead to an increase in individual donation expenditures of 17 percent to social services, 15 percent increase to health, 22 percent increase to international, and 8 percent to religious organizations.

The results imply that a marginal increase in the tax credit will result in a proportionately larger increase in the level of total individual donation expenditures and donation expenditures to the health, social services, and international sectors. And the amount of the tax revenue forgone will be less than the rise in donation expenditures for all sectors except religion.

Other significant socio-economic characteristics affecting both the decision to give and the size of the donation expenditure in Canada include household income, employment,

age, female gender, marital status, education, volunteer status, and attendance of religious meetings.

Policy Implications

The results of the two research studies suggest that tax incentives have a significant effect on both the likelihood of individual Canadians making a donation and the amount of the donation expenditure, suggesting the ability of government policy to influence the number of donors and the level of donation expenditures in Canada. The tax credit appears to be fiscally efficientⁱ, as indicated by elastic demand for charitable donations. In other words, an increase in the tax credit is expected to lead to a loss of tax revenue to the public sector which would be more than fully compensated by the rise in donation expenditures. Donations to religious organizations are not price elastic suggesting the tax credit may not be fiscally efficient for that particular sector. Given that Canadians tend to donate to more than one charitable sector, on average the tax credit system for charitable donations may be considered to be fiscally efficient.

The results imply government has the ability to influence the probability of donating by adjusting the tax credit rates. In addition, the results suggest that some donation sectors are either not responsive or less responsive to tax credits thereby calling for the need for other types of subsidization in order to provide some desired public goods.

Given the distinguishable price elasticities for each of the four charitable sectors, there are concerns about policy decisions made under the assumption that all donation sectors are equally affected by the tax credit. For instance, an increase in the tax credit is expected to lead to a relatively larger increase in donation expenditures to the international sector relative to the social services, health, and religious sectors. These results inevitably lead to normative discussions about which types of organizations provide the goods and services most valued by society, thus there is a need for policy makers to be cognizant of the varying levels of responsiveness of each donation sector to potential changes in tax incentives.

ⁱ Fiscal efficiency as it relates to tax incentives is defined as the case where an increase in donation expenditures is greater than the loss of tax revenue due to the tax incentive (Brooks, 2007).