

## RE-THINKING THE DEDUCTION FOR CHARITABLE CONTRIBUTIONS: EVALUATING THE EFFECTS OF DEFICIT-REDUCTION PROPOSALS

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*The need for deficit reduction has prompted several proposals for modifying the income tax deduction for charitable contributions. This paper combines aggregate tax return data with data on finances of individual nonprofit organizations and data on patterns of household giving to simulate the potential effects on nonprofit organizations of scaling back the charitable deduction. The paper also reviews the various rationales for providing a tax subsidy to charitable contributions.*

*Keywords: charitable deduction, tax expenditures, nonprofit organizations*

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### I. INTRODUCTION

According to estimates made by the Tax Policy Center, the fiscal year 2011 budget for the U.S. federal government includes about \$31,000 of annual spending per household and \$19,000 of tax collections (Steuerle, 2011). The tax law also includes \$10,000 per household of special tax breaks or tax expenditures. Although eliminating all tax expenditures would not necessarily add \$10,000 in revenue per household back to the tax base, there is general agreement among tax policy experts that scaling back tax expenditures offers one avenue for deficit reduction.

Among the many tax expenditures that are in the federal tax code, the tax deduction for charitable contributions is among the largest in terms of its estimated revenue impact. The Joint Committee on Taxation (2011) has estimated the five-year revenue cost (from 2010–2014) at just under \$246.1 billion, and the charitable deduction has routinely been among the top 10 to 15 federal tax expenditures in terms of its revenue cost. Although no changes have yet been made in the charitable deduction, it is widely

expected that the deduction will be affected by the outcome of ongoing discussions regarding how to address the federal budget deficit.

The objective of this paper is to provide a first look at the unfolding debate about the size and scope of the charitable deduction. I first summarize the main features of the current law tax treatment of charitable contributions, and follow with a brief discussion of changes in the deduction that have been proposed as parts of broader efforts at tax reform or, most recently, as parts of proposals to reduce the federal deficit. I then present empirical estimates of the possible effects of several of these changes, both on charitable contributions and on the financial resources of nonprofit organizations. Finally, I conclude with a discussion of some broad policy issues and implications raised by proposals to scale back and/or modify the charitable deduction.

## II. INCOME TAX DEDUCTION FOR CHARITABLE GIVING

As noted by Brody and Cordes (2006), the most visible way in which the federal government acts as a benefactor of the nonprofit sector is by allowing individuals and corporations an income tax deduction for the value of their charitable contributions. These deductions are widely seen as providing an important economic incentive for private donors to provide financial support to a wide range of philanthropic enterprises.

Allowing such deductions effectively reduces the out-of-pocket cost of supporting nonprofit organizations by an amount that depends on the donor's tax rate. For example, if the tax rate is 28 percent, allowing a tax deduction for charitable contributions reduces the net cost of contributing from \$1 to 72 cents, because the taxpayer "gets back" a tax deduction that saves 28 cents in tax for every dollar contributed. Two well-known and controversial features of the deduction are that it provides a subsidy only to taxpayers who itemize deductions and, among those who claim the deduction, the tax subsidy increases with the marginal tax bracket and hence income of the taxpayer. Taxpayers who donate an asset or property that has appreciated in value receive an added tax benefit from not having to pay capital gains taxes due on the increased value of the asset or property.

## III. PROPOSALS FOR CHANGE

Unlike some other tax expenditures (e.g., the home mortgage interest deduction), there has until recently been broad if not unanimous agreement that the charitable tax deduction provides a reasonably efficient, if imperfect, means of subsidizing activities that generally serve an important public purpose. This rough consensus, however, has recently come under scrutiny as the charitable deduction, like other tax expenditures, has been eyed as a candidate for change, either as a part of broader proposals to make

the income tax simpler and more transparent or as a possible source of additional federal tax revenue.

For many years the tax deduction for charitable giving was seen to be a reasonably efficient tax subsidy because estimates of the price elasticity of giving generally equaled or exceeded unity (in absolute value); Andreoni (2008) characterizes this magnitude as a “golden rule” because in this case the amount of revenue foregone by allowing tax deductions for contributions is matched by a roughly equal or greater amount of private spending on charitable goods and services. A number of more recent studies, however, that use arguably better data than earlier research have resulted in estimates of the charitable contributions price elasticity that are both statistically and quantitatively less than unity — perhaps more on the order of 0.50 (in absolute value) (Gravelle and Sherlock, 2009). These lower estimates of the price sensitivity of giving have caused some to question the efficiency of the charitable deduction, since an elasticity of giving less than unity (in absolute value) implies that a portion of the revenue foregone as a result of the deduction does not stimulate more charitable giving.

Questions about the efficiency of the charitable deduction have been reinforced by questions about whether the charitable deduction in its current form is an equitable subsidy, and indeed, whether many charitable activities actually serve a public rather than a private purpose. Several scholars have criticized the credit for providing a larger benefit for higher income taxpayers, and for providing larger subsidies to charities that high-income people favor (Reich, 2005; Fleisher, 2008). Indeed, Thaler (2010) has questioned what many would regard as the main underlying policy rationale for the deduction, arguing that subsidizing private contributions to nonprofits may be as much about subsidizing the private tastes of donors as about supporting entities that serve a true social purpose.

Several tax policy proposals have been put forward that would modify the deduction for charitable contributions. The main proposals are summarized in Table 1. Some of the proposed changes are fairly incremental, such as the change proposed in the Obama budget, which retains the structure of the current deduction while capping the tax rate at which charitable contributions, along with other itemized deductions, can be deducted at 28 percent. Others are more fundamental, such as the proposals in the Simpson-Bowles plan which would replace the current deduction with a flat-rate tax credit; and the Bipartisan Policy Center (2010) plan, which would replace the current deduction with a matching grant that would be paid to individual charities by the Treasury on the taxpayer’s behalf. Several proposals, primarily those designed to be revenue raisers such as the Obama proposal, the Simpson-Bowles plan, and the Bipartisan Policy Center proposals, lower the overall amount of the fiscal subsidy, while others, such as the Demos and Economic Policy Institute proposals, are conceived as elements of revenue neutral tax reforms. A feature of each of the proposed changes, however, is the presumption that a federal subsidy for charitable giving is to be retained, even if in scaled-back form.

**Table 1**  
Alternative Tax Treatment of Charitable Contributions

Policy Proposal	Eligibility	Deduction Floor (Percentage of Adjusted Gross Income (AGI))	Deduction Ceiling	Tax Deduction	Tax Credit (Percent)
Obama Budget <sup>1</sup>	Status quo	No	Status quo	28 Percent cap	No
Wyden-Gregg <sup>2</sup>	Status quo	No	Status quo	15–25–35 Percent	No
CBO Deficit Reduction <sup>3</sup>	Status quo	No	Status quo	15 Percent cap	No
Demos, EPI, Century Foundation <sup>4</sup>	All taxpayers	No	Status quo	No	25
Feldstein-Feenberg-MacGuineas <sup>5</sup>	Itemizers	No	All deductions ≤ 2% of AGI	Status quo	No
Bipartisan Policy Center <sup>6</sup>	All taxpayers	No	Not Applicable	No	15
CBO Deficit Reduction <sup>7</sup>	Status quo	2	Status quo	Status quo	No
Simpson-Bowles <sup>8</sup>	All taxpayers	2	Status quo	No	12

Sources:

- (1) Office of Management and Budget (2011)
- (2) Wyden (2011)
- (3) Congressional Budget Office (CBO) (2011b, pp. 151–152)
- (4) Century Foundation (2010)
- (5) Feldstein, Feenberg, and MacGuineas (2011)
- (6) Bipartisan Policy Center (2010)
- (7) CBO (2011b, p. 150)
- (8) National Commission on Fiscal Responsibility and Reform (2010)

#### IV. EFFECTS OF PROVISIONS

Understandably, many of these proposed changes in the status of the charitable deduction have been the cause of concern among nonprofit organizations. This section provides some rough estimates of how scaling back the charitable deduction might affect the nonprofit sector. More complete estimates of the effects of the proposals summarized in Table 1 would require an analysis based on a micro-simulation tax model, which is beyond the scope of this paper.<sup>1</sup> Instead, I use aggregate data on giving to simulate the effects of two representative changes in the deduction for charitable contributions: (1) the effect of capping the deduction at 28 percent; and (2) the effect of replacing the current deduction with a flat rate 12 percent tax credit. The latter simulation is meant to capture the essential features of the more fundamental proposals for change in the charitable deduction; although simply substituting a flat rate credit for the current itemized deduction is not exactly the same as the changes proposed in either the Simpson-Bowles or the Bipartisan Committee proposals, this hypothetical policy illustrates the orders of magnitude of some of the changes proposed in these plans.

The data used to simulate these effects are taken from three sources. First, 2008 data from the Internal Revenue Service Statistics of Income on itemized deductions grouped by AGI, along with estimates of the price and income elasticities of giving, are used to simulate the effects of the two representative policies on the amount of charitable giving.<sup>2</sup> Second, these simulated changes in total giving are then disaggregated into giving by different types of charitable causes, using data from Google (2007) on patterns of giving to different types of charities by income class. Finally, in Section VI, I estimate how a reduction in individual contributions of 10 percent — a magnitude comparable to that simulated for the case of substituting a flat rate 12 percent credit for the deduction — is likely to affect the financial capacity of different types of nonprofit organizations.<sup>3</sup> This latter analysis is based on data on the financial attributes of nonprofit organizations taken from the Core File of Nonprofit Organizations maintained by the National Center on Charitable Statistics.<sup>4</sup>

In order to reflect the range of uncertainty that exists about the price sensitivity of giving, I simulate the effects of these two policy changes using two different values of the elasticity of charitable contributions with respect to changes in the after-tax price of giving (Gravelle and Sherlock, 2009). Following Ackerman and Auten (2006), I assume that the price elasticity of giving is  $-0.5$  at the lower end of the range of estimates, and  $-1.0$  at the higher end.

<sup>1</sup> The Urban Institute and Brookings Institution Joint Tax Policy Center is currently preparing such estimates.

<sup>2</sup> See Internal Revenue Service, 2008, Statistics of Income Division, Table 2.1 Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2008, Internal Revenue Service, Washington, DC, <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96981,00.html>.

<sup>3</sup> Due to the limitations imposed by using aggregate tax return data, the analysis implicitly assumes either that all taxpayers would be able to fully utilize the tax credit, or alternatively that the credit would be refundable.

<sup>4</sup> A detailed description of these data may be found at <http://nccs.urban.org/>.

The Appendix presents more detail on how the effects of the two policies are simulated. The results of these simulations are shown below in Tables 2 and 3, and can be summarized as follows:<sup>5</sup>

- The incremental policy change of retaining the current deduction but capping the maximum rate at which contributions are deductible at 28 percent is simulated to reduce total deductible charitable contributions by a predictably modest amount of between 1.7 percent (when the price elasticity of giving is  $-0.50$ ) and 3.2 percent (when the price elasticity is assumed to be  $-1.0$ ). Because tax deductible contributions comprise about 61 percent of all contributions to charity (with the remaining 39 percent not directly affected by changes in the individual tax treatment of charitable contributions), the net effect on total charitable contributions of this policy change would be a reduction of between 1 and 2 percent. This amount is comparable to that estimated by Van de Water (2009) in an analysis of the same policy change.
- Replacing the current deduction with a flat rate tax credit of 12 percent is simulated to reduce individual contributions by between 5.3 and 14.2 percent, and to reduce total contributions by between 3.2 and 8.7 percent.
- All types of charities would experience reductions in contributions under either policy change. Both proposals also result in larger proportionate reductions in giving to charities, such as higher education and the arts, which tend to be favored by higher-income taxpayers. In the case of the 28 percent rate cap, this reflects the fact that the cap raises the after-tax cost of giving only for higher income taxpayers.
- In the case of replacing current deductions with the flat rate tax credit of 12 percent, most taxpayers would experience an increase in the after-tax cost of giving (and some taxpayers with marginal tax rates of 10 percent would actually experience a decrease in the after-tax cost). But replacing deductibility with a flat rate tax credit of 12 percent would have the greatest proportional effect on the after-tax giving of higher income taxpayers (e.g., receiving a tax credit of 12 percent instead of deducting contributions at a 35 percent rate would raise the after tax of giving from \$0.65 to \$0.88 — an increase of more than one-third).

Table 4 compares the revenue increases and the reductions in charitable contributions under the two proposals. The effect of scaling back the charitable deduction depends on

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<sup>5</sup> The CBO (2011a) has published an analysis of various proposals for modifying the income tax deduction for charitable contributions. This analysis, which uses a microsimulation model, is based on charitable contributions expressed in 2006 dollars, and simulates the effects of different changes than those analyzed in this paper. Nonetheless, in the case of proposals simulated by CBO that are similar (though not identical) to replacing the charitable deduction with a flat rate credit of 12 percent, the magnitudes reported in the CBO analysis are comparable to those reported in this paper.

**Table 2**  
 Simulated Effects on Giving of a 28 Percent Cap on the Rate at which Charitable Contributions are Deducted

Type of Giving	Price Elasticity of Giving = -0.50			Price Elasticity of Giving = -1.0		
	Change in Deductible Contributions (\$Billion)	Percentage Change in Deductible Contributions	Percentage Change in Total Contributions	Change in Deductible Contributions (\$Billion)	Percentage Change in Deductible Contributions	Percentage Change in Total Contributions
Religious	-0.975	-1.1	-0.7	-1.851	-2.0	-1.2
Combined purpose	-0.322	-1.8	-1.1	-0.616	-3.5	-2.1
Basic needs	-0.227	-1.3	-0.8	-0.432	-2.5	-1.5
Health	-0.157	-1.9	-1.2	-0.299	-3.6	-2.2
Education	-0.697	-3.8	-2.3	-1.339	-7.2	-4.4
Arts	-0.320	-3.9	-2.4	-0.616	-7.6	-4.6
Other causes	-0.217	-1.9	-1.1	-0.416	-3.6	-2.2
Total	-2.915	-1.7	-1.0	-5.568	-3.2	-2.0

**Table 3**  
**Simulated Effects on Giving of Replacing Deductions with a 12 Percent Tax Credit**

Type of Giving	Price Elasticity of Giving = -0.50			Price Elasticity of Giving = -1.0		
	Change in Deductible Contributions (\$Billion)	Percentage Change in Deductible Contributions	Percentage Change in Total Contributions	Change in Deductible Contributions (\$Billion)	Percentage Change in Deductible Contributions	Percentage Change in Total Contributions
Religious	-4.546	-5.0	-3.0	-10.46	-11.5	-7.0
Combined purpose	-1.005	-5.7	-3.5	-2.696	-15.4	-9.4
Basic needs	-1.004	-5.7	-3.5	-2.339	-13.3	-8.1
Health	-0.512	-6.2	-3.8	-1.341	-16.2	-9.9
Education	-1.059	-5.7	-3.5	-4.185	-22.6	-13.8
Arts	-0.460	-5.7	-3.5	-1.885	-23.2	-14.2
Other causes	-0.584	-5.0	-3.1	-1.690	-14.5	-8.9
Total	-9.170	-5.3	-3.2	-24.59	-14.2	-8.7

**Table 4**  
Simulated Changes in Contributions and Revenue

	Change in Contributions (\$Billion)	Change in Revenue (\$Billion)
<i>28 Percent Deduction Cap</i>		
Elasticity = -0.50	-2.915	4.465
Elasticity = -1.0	-5.568	5.593
<i>12 Percent Credit</i>		
Elasticity = -0.50	-9.702	16.86
Elasticity = -1.0	-24.59	25.26

the price elasticity of giving to charities. In Table 4, at the lower value for the elasticity (-0.50), the increase in tax revenue from the proposed change exceeds the corresponding reduction in private charitable giving. Conversely, at the higher elasticity, the tax revenue gained is offset by a comparable reduction in charitable giving. These results are not surprising but bear emphasizing because of their potential policy relevance. To paraphrase Buckley (2011), when the revenue gained from scaling back the charitable tax expenditure exceeds the reduction in charitable contributions, more of the incidence of limiting the tax expenditure falls on individual givers and less on charitable organizations. By comparison, when the revenue gain is roughly offset by the reduction in contributions received by charities, the incidence of the tax change is borne in large part by the recipient organizations.

## V. POLICY DISCUSSION

As indicated by the above results, the likely consequences of the proposed changes in the charitable deduction would range from the modest, if painful, to more consequential. It is reasonable to ask whether, aside from revenue considerations, there are affirmative policy rationales for modifying or limiting the charitable deduction. Two broad policy rationales have been offered in support of changes to the deduction. The first argues that the charitable deduction is inequitable, while the second suggests that the public purpose argument for subsidizing charitable activities may be overstated.

### A. Fairness of the Charitable Tax Deduction

It is well known that tax deductions provide subsidies that increase with taxpayer income. This distributional incidence follows both from the fact that deductions are available only to those who itemize and then, conditional on itemization status, increase

with the taxpayer's marginal tax rate. Table 5, which is based on data from 2008 tax returns<sup>6</sup> shows that the distribution of tax savings from the current deduction among itemizers clearly favors higher income taxpayers.

Table 5 also shows that the distribution of tax savings from a charitable tax incentive would become more evenly distributed under a flat rate tax credit (or a flat rate deduction match). Such reforms are favored by those who believe that the benefits of the charitable deduction are inequitably distributed.

At the same time, the progressivity of the charitable deduction may be misunderstood.<sup>7</sup> The progressive impact of any particular provision by itself differs from the progressivity of the system as a whole. Thus, any degree of overall progressivity can be determined independently of the deductions allowed in each income bracket. As a simple example, if the desired degree of progressivity can be achieved by taxing two people making \$100,000 a total of \$40,000, then the tax code can either require each to pay \$20,000, with no charitable deduction, or grant charitable deductions and then adjust rates so that the individual making substantial charitable deductions pays \$19,000 and the individual making no contributions pays \$21,000. Either system has the same degree of overall progressivity. Thus, eliminating the charitable deduction or converting it to a credit need not make the overall tax system any more (or less) progressive, depending on how rates are adjusted.

Moreover, a distribution of tax savings from the charitable deduction that favors high-income taxpayers is of greatest concern if one believes that charitable giving constitutes spending on essentially private goods. Such a view is consistent with the "warm glow" motive for giving, under which people give because doing so yields personal (private) satisfaction. This is distinct from the altruistic motive, under which people derive satisfaction from the goods and services that are provided to others by charitable organizations (Andreoni, 1989, 1990). In the latter case, it is still unclear what broader social purpose is served by providing a subsidy that increases with the income of the recipient. (This concern would be lessened if charitable giving financed goods with positive externalities, and higher income taxpayers were also more sensitive than other taxpayers to the price of giving (Cordes, forthcoming).)

A similar concern arises if charitable giving is relatively insensitive to the after-tax cost of giving. In the extreme case in which charitable giving is completely inelastic to its after-tax cost, providing a charitable deduction lowers the tax bill of the giver, but provides no added benefit to the charitable sector. In this case, the incidence of the benefits of the charitable deduction falls entirely on the donor, and providing the deduction is tantamount to providing a tax cut to individuals who happen to have a taste for giving to charities. There may be a public purpose in "rewarding" individuals who give to charity, but it is, once again, less clear why such rewards should be distributed disproportionately with respect to the income of the giver.

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<sup>6</sup> See footnote 2.

<sup>7</sup> I owe this point and the accompanying argument to Gene Steuerle.

**Table 5**  
Distribution of Tax Benefits from the Charitable Deduction

AGI	Percent of Total AGI	Percentage Share of Contributions (2008)	Percentage Share of Tax Benefits (2008)	Percentage Share of Contributions 12 Percent Credit	Percentage Share of Tax Savings 12 Percent Credit
1-10,000	0.1	0.4	0.0	0.8	0.8
10-20,000	0.6	1.4	0.0	2.0	2.0
20-30,000	1.3	2.4	0.0	3.2	3.3
30-40,000	2.4	3.4	2.1	3.8	4.0
40-50,000	3.3	4.1	2.5	4.7	4.9
50-75,000	10.8	11.5	7.1	13.0	13.6
75-100,000	12.2	11.5	7.1	12.9	13.6
100-200,000	28.0	23.5	24.1	23.3	23.7
200-500,000	16.5	13.7	16.8	12.6	12.4
500-1,000,000	6.5	5.5	7.9	4.6	4.2
≥ 1,000,000	18.3	22.6	32.4	19.2	17.6

## B. Efficiency of the Charitable Deduction

A somewhat different perspective emerges if one believes that giving to charitable organizations is motivated by an altruistic desire to support the provision of (presumed) social goods, and such goods are provided by nonprofit organizations. In that case, the justification for retaining the deduction in more or less its current form rests more on whether the current charitable deduction is an efficient subsidy.

Two dimensions of efficiency are relevant. One is the budgetary criterion of “treasury efficiency” — is the amount of additional giving that is prompted by the subsidy commensurate with its revenue cost? The other is whether the range of goods and services provided by nonprofits are in fact social goods.

### 1. Treasury Efficiency

There is general agreement that charitable giving is responsive to price incentives. As discussed above, there is considerably less agreement about the magnitude of the response (Gravelle and Marples, 2009; Gravelle and Sherlock, 2009; Boris, Cordes, Soto, and Toder, 2010). The two values of the price elasticity of giving used in the simulations represent the relatively wide range of reasonable estimates.

If the price elasticity of giving is assumed to be  $-0.50$ , the simulated consequence of capping the rate at which charitable contributions can be deducted at 28 percent is a small drop in individual contributions, and a smaller drop in total contributions. In the case of the more fundamental change of replacing the deduction with a 12 percent credit, the result would be more substantial reductions in contributions. In either case, at the lower elasticity the reduction in contributions is more than offset by an increase in tax revenue. When the price elasticity of giving is assumed to be  $-1.0$ , one observes similar differences in the magnitudes of the effects on contributions under the incremental change as compared to the more fundamental change in the deduction. In this case, however, the simulated increase in tax revenue is accompanied by a drop in contributions of equal magnitude.

In the former case, when the simulated changes in the deduction increase tax revenue by more than the drop in deductible contributions, the charitable tax subsidy would be characterized as “treasury inefficient.” It would, in principle, be possible to provide more resources to the nonprofit sector by scaling back the deduction, and then using the added revenue to support the subsidized activity — either through explicit grants or subsidies, or in the current fiscal environment, by foregoing other cuts in federal spending.

In the latter case, when the price elasticity of giving is assumed to equal  $-1.0$ , the increased revenue from the proposed changes is offset by the corresponding drop in private giving. In this case, the charitable deduction would be treasury efficient because it encourages an amount of added giving that is commensurate with the cost in foregone tax revenue. In this instance, the amount of financial resources that could, in principle, be provided to the nonprofit sector would equal the increase in revenues.

## 2. Social Efficiency

Although treasury efficiency is a useful metric for gauging the financial effects of tax incentives, it does not imply that providing a particular tax incentive is “socially efficient,” as the concept of social efficiency is commonly defined in public finance. In order for a treasury-efficient tax expenditure to also be socially efficient, it must be the case that the extra resources that are induced to flow to the subsidized activity have net social benefits.

The charitable deduction is commonly regarded as a “good” tax loophole, presumably because, as Brody and Cordes (2006, p. 152) note, it is tempting to view favorable tax treatment of the nonprofit sector as a “quid-pro-quo in recognition of the...goods and services (that nonprofits) provide.” As Brody and Cordes (2006, p. 152) go on to note, however, “the underlying policy rationale for tax policy toward the nonprofit sector may be better characterized as involving some mix of (1) a historic desire to respect the ‘sovereign’ boundaries between the nonprofit and public sectors ... and (2) an explicit intent to subsidize nonprofit organizations

### C. Base-Defining and the Sovereignty of the “Third” Sector

An historical argument can be made that the impetus for exempting nonprofit organizations from income and other taxes appears to have emanated from a mix of “tax-base-defining” objectives combined with a historical desire on the part of government (at least in the Anglo-Saxon tradition) to avoid intruding into a sphere of activities believed to “properly” belong to the church and its secular philanthropic successors (Brody and Cordes, 2006). This is one reason why, unlike the charitable tax deduction, the exemption of nonprofit organizations from federal income taxation is not treated as a tax expenditure (Joint Commission on Taxation, 2005, p. 7 [emphasis added]):

“With respect to . . . charities, tax-exempt status is not treated as a tax expenditure because the nonbusiness activities of such organizations generally must predominate and their unrelated business activities are subject to tax. In general, the imputed income derived from nonbusiness activities conducted by individuals or collectively by certain nonprofit organizations is *outside the normal income tax base*.”

Whatever the merits of this argument, it is quite clear that almost from the inception of the federal income tax, the intent of Congress in providing favorable income tax treatment of charitable deductions was to provide a subsidy to charitable activities. As noted by Brody and Cordes (2006, p. 152),

“While Congress did not grant the deduction for charitable contributions in the 1913 enactment of the income tax, from its 1917 inception the deduction has been designed to provide a government subsidy to charitable activities

through the tax code. Concerned that the high marginal tax rates enacted to finance World War I would deter donations, Congress permitted individuals to reduce up to 15 percent of their net taxable income by charitable contributions. From that point on, the scope of the deduction steadily expanded — to broaden the range of charitable activities eligible for the deduction; to extend the deduction to corporate contributions; and to increase the percentage of taxable income (later, adjusted gross income) that could be deducted annually. The legislative history of these changes reflects a clear subsidy motivation. In the 1969 Act, for example, Congress declared that raising the contribution limit from 30 percent of adjusted gross income to 50 percent (for cash contributions to public charities) would “strengthen the incentive effect of the charitable contribution deduction.”

Congress did not, however, state an explicit rationale for why charitable activities should be subsidized. There has, however, been an extensive scholarly literature that has attempted to fill this gap.

#### **D. Nonprofit Organizations, Public Goods, and Private Market Failures**

To economists, the most persuasive efficiency argument for providing a subsidy for charitable giving is that nonprofit organizations are potentially useful institutions for correcting private market failures. This argument takes several forms.

##### *1. Indirect Subsidies and Crowding Out*

Roberts (1987) has shown that if individuals respond to direct government finance of public goods by reducing their own spending on such goods, net spending on public goods will increase by less than the amount of direct government provision. Indeed, under certain assumptions, one can show that direct provision of the public good can lead to no net increase in spending as individuals simply reduce their own spending on the public good dollar for dollar as government spending increases. Roberts shows further, however, that this outcome will not obtain if instead, individuals are provided with a government matching subsidy for spending on the public good.

The basic argument made by Roberts is extended in an optimal tax framework by Saez (2004). Saez derives formal expressions for the optimal charitable subsidy that depend on several key parameters: (1) the price elasticity of giving; (2) the degree to which charitable contributions finance goods and services with positive externalities; (3) the extent to which charitable goods and publicly financed goods are substitutes; and (4) the extent to which charitable giving has desirable distributional effects. Saez obtains the strong result that charitable subsidies should be fairly low when the price elasticity of giving is less than unity (in absolute value). In contrast, when charitable giving is price elastic, and when charitable contributions finance goods with positive externalities that are substitutes for public spending, the optimal charitable subsidy

should be fairly substantial. In the special case in which charitable contributions are perfect substitutes for government spending, Saez shows that the optimal charitable subsidy should be set equal to (or greater than) the rate at which income is taxed — a theoretical result that is comparable to the current charitable deduction.

## 2. *Meeting Unsatisfied Demands for Public Goods*

A distinct but complementary argument due to Weisbrod (1988) is that nonprofit organizations offer a mechanism whereby individuals are able to satisfy demands for public goods that are unmet by the public sector. His basic argument is aptly summarized by Ferris (1998, p. 140):

The market fails and there is a need for collective action ... There are two options: public or nonprofit. In terms of service provision, government is appropriate when there is sufficient demand to generate the majority for action and the demands are homogeneous. However, when a majority cannot be sustained or there is heterogeneous preference, the nonprofit option is likely to be preferred ... as collective action becomes manifested in government action, nonprofit organizations are a vehicle for reacting to government choices. For example, nonprofits may provide an alternative to government action (e.g. private schools vs. public schools) or serve to augment government action (e.g. religious instruction to complement public schools). Nonprofit organizations make possible greater community satisfaction than would likely be attained if government were the only option.

## 3. *Nonprofits as Alternative Providers of Public Goods and Services*

A rationale for providing public subsidies to nonprofit organizations that is quite close to the two public goods arguments just presented falls under the heading of the so-called “quid-pro-quo” case for public support of certain charities. The argument is straightforward. To the extent that nonprofits provide goods and services (mainly social services) that the government would otherwise be called upon to provide, nonprofit organizations merit public support as a quid-pro-quo for providing such services.<sup>8</sup>

## 4. *Trust Goods and Informational Market Failures*

Hansmann (1980) has also argued that nonprofit organizations have the potential to help overcome market failures that arise from informational asymmetries between suppliers and consumers in the case of goods with complex and hard to verify quality

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<sup>8</sup> Carroll (2008) finds a correlation between nonprofit spending and lower government spending at the state level.

attributes. In Hansmann's framework, the key is the imposition by nonprofits of the "non-distribution constraint" which, if credible, limits the incentive of a nonprofit organization to exploit potential informational asymmetries for its financial gain. Ferris (1998, p. 142) again provides a useful summary:

The contract failure theory of nonprofit organizations is based on the principal agent problems that exist for some goods and services in the marketplace. In effect, consumers are at an information disadvantage in their dealings with producers. The profit motive might encourage business to take advantage of the consumer. As a result there might be a need for government to regulate suppliers, or society may choose to rely on supply by nonprofit organizations. The promise of nonprofit organizations as a remedy for contract failure stems from the fact that such organizations, under tax law are constrained from distributing their profits (residuals) either directly or implicitly through unreasonable compensation. As a consequence, nonprofit organizations are presumed to be more trustworthy than for-profit organizations.

#### *5. Nonprofit Organizations as Providers of Club Goods*

Nonprofit organizations also serve the important function of providing club goods. Like non-excludable public goods, the consumption of club goods is non-rival over some sharing unit, which implies that there are potential welfare gains from collective finance of the provision of such goods. Unlike non-excludable public goods that often are provided by government, however, it is feasible to exclude non-contributors from consuming club goods, which makes private finance of such goods more feasible. In this case, the nonprofit organizational form provides a convenient mechanism for providing for the private finance of such goods.

#### *6. Nonprofit Organizations and Advocacy*

As Ferris (1998) and others note, however, nonprofit organizations exist not only to provide goods and services, but also to provide a forum in which individuals can advocate for particular public policies. The potential efficiency benefits of creating advocates have been recognized by Dewatripont and Tirole (1999), who develop a model in which it is in the interest of public decision makers to create advocates who are capable of providing information on both sides of policy issues.

### **VI. RANGE AND SCOPE OF ACTIVITIES SUPPORTED BY CONTRIBUTIONS**

From the standpoint of tax policy, the question is not so much what nonprofits can do in theory, but rather, what nonprofits actually do in practice. Table 6 provides some data on the range of activities undertaken in the not-for-profit sector, and also on how

**Table 6**  
Effect of a 10 Percent Drop in Contributions on Nonprofit Finances

NTEE Major Group	Share of Total Contributions (Percent)	Contributions as a Percentage of Total Revenue			Percentage Reduction in Revenue from a 10 Percent Reduction in Contributions		
		Mean	Lower Quartile	Upper Quartile	Mean	Lower Quartile	Upper Quartile
Religion	33.3						
Education (non-higher)	22.7	25.4	12.0	37.2	2.5	1.2	3.7
Hospitals	7.4	2.0	1.4	1.4	0.2	0.1	0.1
Philanthropy	5.6	32.0	0.0	73.5	3.2	0.0	7.3
Health	4.2	35.5	0.0	78.4	3.6	0.0	7.8
Higher education	3.7	14.0	3.4	16.5	1.4	0.3	1.7
International, foreign affairs	3.5	50.4	28.9	79.4	5.0	2.9	7.9
Arts	3.4	14.8	4.1	16.8	1.5	0.4	1.7
Human services	3.4	21.1	0.1	44.8	2.1	0.0	4.5
Disease specific	2.3	72.1	75.9	78.6	7.2	7.6	7.9
Animal related	2.0	51.3	26.9	78.5	5.1	2.7	7.8
Environment	1.4	29.6	16.8	40.4	3.0	1.7	4.0
Housing shelter	1.1	30.8	0.9	59.0	3.1	0.1	5.9
Religion related	1.1	42.3	9.6	80.0	4.2	1.0	8.0
Community improvement	0.8	33.5	36.6	36.6	3.4	3.7	3.7
Science and technology	0.7	22.6	2.0	36.9	2.3	0.2	3.7
Food and agriculture	0.5	36.1	10.0	64.5	3.6	1.0	6.5
Recreation sports	0.5	15.8	0.7	36.1	1.6	0.1	3.6
Mental health	0.4	8.1	4.6	4.6	0.8	0.5	0.5
Youth development	0.4	7.3	0.6	0.6	0.7	0.1	0.1
Disease research	0.4	2.5	0.0	0.0	0.2	0.0	0.0
Employment	0.3	2.3	0.1	0.1	0.2	0.0	0.0
Crime	0.3	19.6	0.0	37.1	2.0	0.0	3.7
Public safety	0.2	55.1	61.2	61.2	5.5	6.1	6.1
Public social benefit	0.2	34.3	7.7	60.7	3.4	0.8	6.1
Civil rights advocacy	0.1	9.9	7.0	7.0	1.0	0.7	0.7
Social science	0.1	34.6	3.2	66.8	3.5	0.3	6.7
Mutual membership	0.0	29.3	6.6	44.9	2.9	0.7	4.5

**Table 7**  
**Effect of a 10 Percent Drop in Contributions on Nonprofit Finances by Organization Size**

Size (Total Revenue)	Number	Share of Total Contributions (Percent)	Contributions as a Percentage of Total Revenue			Percentage Change in Revenue from a 10 Percent Drop in Contributions		
			Mean	Lower Quartile	Upper Quartile	Mean	Lower Quartile	Upper Quartile
< \$25K	14,746	0.1	17.3	7.0	25.7	1.7	0.7	2.6
\$25K to \$100K	72,069	2.0	28.9	9.1	41.2	2.9	0.9	4.1
\$100K to \$500K	67,784	8.0	28.7	0.6	43.8	2.9	0.1	4.4
\$500K to \$1M	22,839	7.4	23.3	4.6	25.8	2.3	0.5	2.6
\$1M to \$10M	22,741	33.3	22.1	0.1	43.4	2.2	0.0	4.3
> \$10M	7,466	49.1	4.5	0.7	1.4	0.4	0.1	0.1

private contributions (as distinct from other sources of nonprofit revenue) are distributed among these activities. The estimates of contributions reported by nonprofits other than those with a religious designation are based both on information reported on IRS 990 returns that comprise the Digitized Data Base of Nonprofit Organizations maintained by the National Center on Charitable Statistics.<sup>9</sup> Because these data do not include giving to religious bodies, the amount of giving reported on the IRS 990 returns is multiplied by 0.5 to estimate the amount of religious giving. The factor of 0.5 is based on data presented in Center on Philanthropy at Indiana University (2011). The estimates in the second column of Table 6 indicate that the vast majority of contributions (just under 90 percent) are claimed by 10 broad groups of nonprofits (religious nonprofits through disease-specific nonprofits). Among these, religious nonprofits claim the largest contribution share of 33 percent. Table 6 also shows that private contributions vary in importance as a resource for supporting nonprofit activities. On the one hand, some nonprofits, such as those in health care (most notably hospitals), depend relatively little on charitable gifts. For education and research, as well as social and legal service organizations, charitable gifts are a major, but clearly not the only (or even the main) source of revenue. On the other hand, notwithstanding growth in alternative sources of funding, private contributions remain a significant financial resource for many nonprofit organizations.

From a policy perspective, it is interesting to gauge how the financial capacity of nonprofit organizations would be affected by a significant scaling back of the charitable contribution. The final three columns of Table 6 provide estimates of the effect of a 10 percent reduction in private contributions as a share of total nonprofit revenue.<sup>10</sup> The estimated effects vary widely. Table 7 shows the same information as Table 6 by the size of the nonprofit, and shows that the relative impact of a 10 percent reduction in private contributions as a share of total revenue is likely to decline as organization size increases.

## VII. SUMMARY AND CONCLUSIONS

As the debate regarding the deduction for charitable contributions moves forward, several points made in this analysis are worth highlighting. First and foremost, it is of some significance that all of the proposals for scaling back the deduction acknowledge that many nonprofit organizations serve a broad public policy purpose. A broad policy implication is that in contrast to other tax expenditures which subsidize activities whose public purpose is less certain, proposals to scale back the charitable tax deduction should perhaps be treated with greater caution.

That said, recognizing the special character of the charitable deduction is not a sufficient argument for retaining the status quo. In principle, the policy case for scaling

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<sup>9</sup> See <http://nccs.urban.org/database/overview.cfm>.

<sup>10</sup> I select this percentage reduction as broadly illustrative of the maximum possible effect on contributions resulting from the more fundamental proposals for change discussed above.

back versus retaining the current deduction depends on the price elasticity of giving and on the nature of the goods and activities that are subsidized by the charitable deduction. Some possible cases, along with their implications for policy, are summarized in Table 8.

Table 8 highlights the importance of the price sensitivity of giving. As noted above, the case for retaining the subsidy is relatively weak if charitable giving is insensitive to changes in the after-tax price, and empirical evidence on this score is mixed. For example, charitable giving did not drop as sharply in the 1980s after marginal tax rates were cut as one might have expected based on many estimates of the price elasticity. Some recent empirical studies present estimates that are significantly and substantially less than unity (in absolute value) (Gravelle and Marples, 2009; Gravelle and Sherlock, 2009; CBO, 2011a). On the other hand, there is evidence that giving among higher income taxpayers declined, as predicted by economic theory, in the 1980s (Clotfelter, 1990), and other studies, most notably recent estimates by Bakija and Heims (2011), using state-of-the-art econometric methods, imply that contributions are elastic with respect to the after-tax cost.

Similarly, while data on the operating characteristics of nonprofits indicate that many provide goods and services that have positive externalities and substitute for government goods, others provide what are more properly regarded as either private or club goods. In principle, this might lead one to consider a targeted approach to reforming the charitable subsidy by perhaps limiting deductibility to certain types of charitable contributions. Practically speaking, however, drawing distinctions among nonprofits in terms of their public benefit may be difficult to achieve.

Empirically, the practical effects of the proposals for scaling back the charitable contribution on the financial resources of nonprofits depend not only on how responsive charitable deductions are to out-of-pocket cost of giving, but also on the relative importance of private contributions as a source of revenue. It is sometimes asserted that limiting the charitable deduction would have minimal effect on nonprofits because individual contributions are only a small share of nonprofit revenues. While it is true

**Table 8**  
Policy Case for Scaling Back the Charitable Tax Deduction

Price Elasticity of Giving	Type of Nonprofit Activity		
	Private Good	Club Good	Social Good
Low	Yes	Yes	Mixed
High	Yes	Mixed	No

Note: "Yes" indicates there is a case for scaling back the charitable deduction, "Mixed" indicates that the case is mixed, and "No" indicates there is no case for such a reform.

that individual contributions are not the only or even the major source of revenue for many nonprofits, the estimates presented above indicate that they comprise a significant share of revenue for many nonprofits.

Lastly, from a benefit-cost perspective, given the severity of the fiscal problems in the United States, even if there is a strong case in principle for maintaining the deduction at its current level of generosity, one can reasonably question whether the nonprofit sector should be asked, along with other stakeholders (including a number of public stakeholders), to share in the sacrifices that need to be made. That said, even if one thinks that there is a case for scaling back the charitable deduction, one should also be mindful of a possible cascading effect on individual nonprofits resulting from: (1) scaling back the deduction; (2) scaling back the nonprofit income tax exemption (as has been proposed by Senator Grassley); (3) scaling back government grants to nonprofits; and (4) scaling back state and local tax exemptions of nonprofits. Although each of these measures individually might have modest effects, when combined they could have more significant effects that warrant consideration.

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## APPENDIX: SIMULATING THE EFFECTS OF CHANGING THE AFTER-TAX COST OF CHARITABLE CONTRIBUTIONS

This appendix provides details on the methodology used to generate the simulation results presented in the text. The simulations take into account the fact that the deduction for charitable contributions affects giving through both a price effect and a tax/transfer effect.

### A1. Price Effect

The price effect refers to changes in giving prompted by changes in the after-tax cost of giving. In a world with no tax deduction, the cost of giving one dollar to charity is simply one dollar. However, if charitable contributions are deductible under an income tax, the after-tax cost of giving is reduced to  $(1 - T)$ , where  $T$  is the taxpayer's marginal tax rate.

The predicted percentage change in the amount given due to the change in the after-tax price of giving — the price effect — equals

$$(1) \quad \% \Delta C = \% \Delta P \cdot E_p,$$

where  $\% \Delta C$  is the percentage change in contributions due to the change in the after-tax price of giving,  $\% \Delta P$  is the percentage change in the after-tax price of giving, and  $E_p$  is the price elasticity of charitable giving.

The predicted absolute change in giving then equals

$$(2) \quad \Delta C = \% \Delta C \cdot C,$$

where  $C$  is the amount contributed before the price change.

### A2. Tax/Transfer Effect

Changes in the rate at which charitable deductions can be deducted also affect the taxpayer's after-tax income. The predicted percentage change in the amount given due to changes in the taxpayer's after-tax income as a result of change in the treatment of charitable deduction is given by

$$(3) \quad \% \Delta C_y = \% \Delta Y_D \cdot E_y,$$

where  $\% \Delta C_y$  is the percentage change in contributions,  $\% \Delta Y_D$  is the percentage change in the taxpayer's after-tax income due to the policy change, and  $E_y$  is the income elasticity of charitable giving. The absolute change in giving due to the income effect equals

$$(4) \quad \Delta C = \% \Delta C_y \cdot C,$$

where  $C$  is the amount of contributions before the change in after-tax income.

Ackerman and Auten (2006) show that the changes in charitable contributions due to the income effect are relatively small, relative to the changes due to the price effect.