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.

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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.

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.