Tax Reform Lessons Learned From State Experiments

By: Lisa Maruyama and Tim Delaney

As Congress begins to dive deeper into comprehensive tax reform, much depends on unproven projections and economic theories. Americans would be served better if Congress instead considered the real world lessons that states have learned by experimenting with limits on charitable tax deductions: local communities lose far more than governments gain.

States have learned the hard way about the vital nature of charitable giving incentives. Research in Michigan, for example, reveals that contributions have declined considerably since 2011, when the state repealed tax credits for donations to the work of food banks, homeless shelters, and community foundations. Missouri, which had allowed a series of tax credits to lapse, recently saw the need to restore them for giving to various charities, including food pantries.

Lawmakers in several other states have considered limiting charitable giving incentives -- but then reversed course when they saw the damage that would result to their constituents. Last week North Carolina's legislature put the finishing touches on tax reforms that cap all itemized deductions, but intentionally exempted charitable donations from those limits. Similarly, last month, Kansas legislators implemented significant tax reform in an effort to reduce tax rates, but they expressly rejected calls to limit charitable deductions. Likewise, lawmakers in Minnesota voted to retain their state's reliable charitable deduction laws after rejecting a proposal to switch to a tax credit system. And Montana's legislature recently extended the state's charitable endowment tax credit for another six years.

Hawaii also offers insights. In 2011, confronting a severe state budget deficit, Governor Abercrombie supported imposing a cap on how much taxpayers could claim for all itemized deductions, including mortgage interest and charitable donations. But after two years of seeing the adverse effects on charitable giving, the Governor urged the legislature to remove charitable deductions from the caps and restore the full incentive for giving to support the work of charities in Hawaii's communities. Earlier this month, he signed legislation that lifts the experimental cap on charitable giving.

Why did this policy change happen? Because wise lawmakers considered the new data, saw the unintended damage and took corrective action to help their constituents.

The cap on charitable deductions was expected to bring in $12 million per year to the state treasury. As a result, however, charitable donations were estimated to fall by at least $60 million per year, according to the Hawaii Community Foundation. Those numbers -- a one to five ratio of loss of good works in the community -- led to an undeniable bottom line: the tax experiment cost the community more than it generated.

Congress and policymakers elsewhere would be wise to heed this informed insight from the Office of Hawaii's Governor: "After having taken a close look at the impact this particular section of the law is having on charitable donations made to Hawaii's nonprofit organizations, we support carving out this portion of the law" to protect full deduction of charitable contributions.

Lessons for the Federal Tax Debate

For the past four years, Congress and President Obama have talked about tax reforms that would eliminate loopholes, deductions and exemptions. According to the Center for Effective Government, President Obama and House Budget Committee Chairman Paul Ryan (R-WI) continue to push proposals to cap or limit deductions that would reduce giving to the work of charitable nonprofits by more than $100 billion over ten years. That's money taken away from communities at a time when needs continue to rise. Fortunately, several in Congress recognize that charitable giving is not a loophole, but a lifeline for our communities.

Let's examine some of the lessons learned from states' experiments with capping deductions for charitable giving:

First, government relies on charitable nonprofits to do some of its work and solve the problems that are too big for government alone; it doesn't make sense to remove incentives that help pay for this important work.

Second, Americans are concerned that their community needs are met and are much less concerned about what tax breaks the donors got for giving their own money away. Donating to the work of charitable nonprofits isn't a political question; it's a nonpartisan answer to meet community needs.

Finally, people across America celebrate when policymakers look at the facts and then fix policies that aren't working as expected. We applaud Governor Abercrombie and the Hawaii legislature for their political courage in recognizing the experiment's unintended consequences and removing the cap on charitable giving. Americans want their leaders to get things right, whether from the start, or when evidence shows that a course correction is needed.

State legislators are learning from real world experiences and operating more intelligently with respect to incentives to support the important work of nonprofits in local communities. As the debate over our federal tax code continues, Congress and the President must do the same.

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