

# An Analysis of Potential Tax Incentives to Increase Charitable Giving in Puerto Rico

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Improved incentives for private charitable giving would strengthen nonprofit organizations in Puerto Rico. Because of the public benefits provided by a strong and vibrant nonprofit sector, policymakers are interested in identifying ways to increase the private financial support received by these organizations. This study investigates options for reforming current tax incentives in Puerto Rico to stimulate additional charitable giving. We summarize current laws and charitable giving in Puerto Rico, review studies by economists on how tax incentives affect giving, and present and estimate the effects of alternative ways to structure the deduction.

We estimate that lifting the current 15 percent ceiling on contributions would increase contributions by more than the revenue loss to the Puerto Rican Treasury

and would, therefore, be a more cost-effective way to pay for additional services of charitable organizations than increasing direct government grants. Reforms that instead modify or eliminate current floors on contributions would add less to contributions than the revenue loss. Such changes would, however, make it easier for taxpayers to understand and claim the deduction. By increasing the number of taxpayers who would take advantage of the incentive, simplification could increase charitable giving by more than our estimates, which consider only the effect of the improved financial incentive.

## Current Law and Charitable Deductions in Puerto Rico

Puerto Rico allows a full charitable deduction only for donations by itemizers in ex-

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cess of 3 percent of adjusted gross income (AGI), up to a limit of 15 percent of AGI. As an alternative, itemizers may elect to deduct 33 percent of contributions. Itemizers in Puerto Rico are much less likely than those in the United States to claim charitable deductions, but among those who give, average giving is higher as a share of AGI in Puerto Rico than in the United States.

#### ***Rationale for a Charitable Deduction***

Supporters of tax incentives to encourage private giving point to several benefits from a large and vibrant nonprofit sector. Many nonprofits provide goods and services that would otherwise be provided by the public sector, or complement publicly provided goods and services in areas such

as health care, education, family support, and support for culture and the arts. Nongovernment organizations that must compete directly for donations from individuals may be more efficient and responsive than organizations that rely wholly on public funds and provide a different mix of services than publicly funded organizations, reflecting the preferences of donors.

The government can encourage nonprofit organizations with tax incentives or by providing subsidies directly to selected recipients. The concept of *treasury efficiency* measures the relative cost-effectiveness of funding nonprofits indirectly through tax incentives instead of by direct grants. Treasury efficiency is measured as the ratio of *additional* donations in response to a tax

incentive to the revenue loss to the government. If this ratio is greater than 1, it costs the government less per dollar transferred to nonprofits to provide a tax incentive than to give the nonprofit organizations direct grants.

### *How Charitable Tax Incentives Work*

Tax incentives work by reducing the cost to taxpayers of making donations to eligible charitable organizations. To illustrate, suppose that a taxpayer is considering donating \$100 to a charity, but there is no financial incentive to do so. In that case, the cost of the \$100 charitable gift is \$100. Now suppose that this taxpayer is in the 33 percent bracket and is allowed to take a full income tax deduction for the \$100 gift. If she gives \$100 to charity, she is able to reduce her taxable income by the amount of the gift (\$100), resulting in a tax saving to her of \$33. The net effect is that the actual cost of giving \$100 is \$67. If one assumes that the taxpayer gets satisfaction from transferring money to a charity just as she gets satisfaction from buying consumption goods for her own use, the drop in the price of transferring a dollar to a charity to 67 cents should increase the amount she chooses to give to charities.

The fiscal effects of a financial incentive for charitable giving depend on how responsive people are to a price discount for giving. Consider the example above, in which the person is willing to give \$100 to charity without any financial incentive but is now allowed a deduction for the \$100 gift at a 33 percent tax rate. If the deduction leaves the person's giving unchanged

at \$100, the government would effectively pick up \$33 of the \$100 gift (through the tax deduction), and the person's cost of giving (or "spending" on gifts) would be \$67. But the deductions leave the amount charity would receive unchanged at \$100. In this example, the tax deduction raises the giver's after-tax income available for other uses (consumption of other goods or saving) but leaves charitable contributions unchanged. Suppose, instead, that the 33 percent drop in the cost of giving causes the taxpayer to increase her gift to \$120. The cost to the treasury in terms of forgone tax revenue would be just under \$40 (e.g.,  $0.33 \times \$120$ , or \$39.60), while the gift would increase by \$20. The taxpayer would spend \$20 of her almost \$40 tax benefit on increasing giving and would have the remainder left over for other uses. Finally, suppose the taxpayer increased her giving to \$160. The cost to the treasury would be \$52.80 ( $0.33 \times \$160$ ), which is less than the increase in giving. The taxpayer would be increasing her giving by more than her tax benefit, causing her to "spend" more on giving to charities and less on other uses.

### *Charitable Giving in Puerto Rico*

*Incentives.* Taxpayers will choose to claim a charitable deduction equal to either 33 percent of all giving or 100 percent of giving in excess of 3 percent of AGI, depending on how much they are giving. Taxpayers who give less than 4.5 percent of AGI are better off deducting 33 percent of all contributions. For example, if a taxpayer with AGI of \$70,000 gives 4 percent of AGI (\$2,800), she may take a deduction of \$924 (33 percent of \$2,800). If instead she chose to

deduct 100 percent of contributions above 3 percent of AGI (\$2,100), she could deduct only \$700. In contrast, taxpayers who give more than 4.5 percent of AGI gain more by deducting 100 percent of contributions above 3 percent (table 1).

The price of giving an additional dollar varies according to the taxpayer’s marginal tax bracket and how much he or she gives. For taxpayers who give less than 4.5 per-

cent of AGI, the deduction is worth only 33 percent of their marginal tax rate. For example, a taxpayer in the 33 percent bracket gets a tax saving of 11 cents, which means that it costs her 89 cents to give a dollar to charity. For a taxpayer in the lowest bracket (7 percent), the net price of giving a dollar is 98 cents, almost no incentive at all. In contrast, for those in the top tax bracket who give more than 4.5 percent of AGI, the net price of giving a dollar is 67 cents.

**Table 1. Structure of the Puerto Rican Charitable Tax Incentive**

Contributions as percentage of AGI	Amount of contribution (AGI = \$70,000)	3% of AGI	Tax deduction = 33% of contributions	Tax deduction = 100% of contributions > 3% of AGI	Most favorable option	Value of tax deduction (next \$1 of giving)				
						Tax Bracket				
						7%	10%	15%	28%	33%
1.0%	\$700	\$2,100	\$231	\$0	33% of contributions	\$0.02	\$0.03	\$0.05	\$0.09	\$0.11
1.5%	\$1,050	\$2,100	\$347	\$0	33% of contributions	\$0.02	\$0.03	\$0.05	\$0.09	\$0.11
2.5%	\$1,750	\$2,100	\$578	\$0	33% of contributions	\$0.02	\$0.03	\$0.05	\$0.09	\$0.11
3.0%	\$2,100	\$2,100	\$693	\$0	33% of contributions	\$0.02	\$0.03	\$0.05	\$0.09	\$0.11
3.5%	\$2,450	\$2,100	\$809	\$350	33% of contributions	\$0.02	\$0.03	\$0.05	\$0.09	\$0.11
4.0%	\$2,800	\$2,100	\$924	\$700	33% of contributions	\$0.02	\$0.03	\$0.05	\$0.09	\$0.11
4.5%	\$3,150	\$2,100	\$1,050	\$1,050	33% of all contributions or 100% of contributions > 3% of AGI	\$0.07	\$0.10	\$0.15	\$0.28	\$0.33
4.6%	\$3,220	\$2,100	\$1,063	\$1,120	100% of contributions > 3% of AGI	\$0.07	\$0.10	\$0.15	\$0.28	\$0.33

The charitable deduction is capped at 15 percent of AGI. This means that Puerto Rican taxpayers who donate more than 15 percent of AGI receive no incentive (price subsidy) for giving more. They do receive a deduction for charitable contributions equal to the difference between the capped amount of 15 percent of AGI and the floor amount of 3 percent of AGI (an amount equal to 15 percent minus 3 percent or 12 percent of AGI). In our example, this is worth 3.96 percent of AGI to a taxpayer in the 33 percent bracket. This “lump sum” tax cut raises the person’s after-tax income and may enable him or her to give more, but it does not reduce the price of giving.<sup>1</sup>

*Performance.* Partly as a result of these constrained incentives, the proportion of taxpayers who claim charitable deductions in Puerto Rico is small compared with the United States, although the average deduction for those who contribute is larger. In a recent year, fewer than 1 in 10 Puerto Rican taxpayers who itemized claimed deductions for charitable contributions, compared with almost 9 of 10 itemizing U.S. federal taxpayers. The average amount claimed by Puerto Rican contributors to charity (\$4,500) is, however, slightly higher than the average amount claimed by U.S. contributors (\$4,200), and is a much higher share of overall AGI.<sup>2</sup>

These figures may reflect the incentives in Puerto Rico, which are very limited for small contributors but more generous for large (though not very large) donors. It is also possible that contributors may time or bunch their contributions from year to

year in response to the contribution floor to maximize their deductions. Representatives of stakeholder groups in Puerto Rico also cite social and cultural factors, including a tendency for people to be very generous in response to emergency appeals but less likely to give on an ongoing basis to established nonprofit organizations. (However, a number of stakeholders who were interviewed for this project noted that Puerto Ricans give regularly to churches.)

### **Estimates of the Effects of Charitable Deductions**

Numerous studies, mostly in the United States, have attempted to estimate the responsiveness of charitable contributions to tax incentives. The key variable used is the price elasticity of contributions; that is, the percentage change in giving in response to a given percentage change in the price. If, for example, a 10 percent reduction in the price of giving increases giving by 15 percent, the price elasticity is equal to  $-1.5$ ; if it only increases giving by 5 percent, the price elasticity is  $-0.5$ . The value of the price elasticity determines whether the subsidy is said to be treasury efficient in the sense that additional giving induced by the incentive exceeds the revenue loss to the treasury. While virtually all research finds a significant response to the price of giving, the results vary regarding whether the subsidy is treasury efficient.

Studies have used a variety of data sources (including administrative and survey data) and methods (including multiple regression analysis and experiments on subjects).

Peloza and Steel (2005) summarized the results of studies applying regression analysis to administrative and survey data. The studies examine the statistical relationship between amounts contributed and a set of explanatory variables, including a taxpayer's income and the cost of giving (which is 1 minus the marginal tax rate if an additional dollar contributed is deductible). The studies examine variations in giving among individual taxpayers and over time. The more sophisticated studies make use of panel datasets—data that examine the behavior of the same group of taxpayers over time. This approach enables researchers to separate out permanent effects of incentives from transitory effects of temporarily lower tax rates on the timing of contributions.

The studies that Peloza and Steel summarize reach three main conclusions:

1. Contributions are affected by the price of giving; people contribute more (less) when the price of contributing is lower (higher).
2. On average, price elasticity estimates from survey data are larger than estimates from administrative data.
3. On average, the price elasticity estimates are greater than 1, suggesting that charitable incentives can be treasury efficient (i.e., can increase charitable contributions by as much as or more than they cost the treasury). However, 40 percent of the studies reviewed found an absolute value less than 1.<sup>3</sup>

In recent years, researchers have also estimated the responsiveness of giving to incentives using laboratory experiments in which subjects are divided into treatment and control groups with different incentives to give to charities. Compared with earlier studies, these experiments usually find lower price responses. Preliminary findings also suggest that the structure of the incentive matters—people are much more responsive to government or private grants that explicitly match a fraction of the amount given than to tax rebates with the same net effect on the price of giving.<sup>4</sup>

Recent research also has found that sensitivity to changes in the cost of giving increases with income. Thus, in our analyses of reform options below, we assume that Puerto Rican taxpayers whose AGI places them in the top 10th of those who itemize have a price elasticity of giving of  $-1.2$ , while the remaining 9/10ths of itemizers have a price elasticity of  $-0.80$ . In other words, our simulations assume that a 10 percent cut in the cost of giving would increase contributions by 12 percent among high-income itemizers and by 8 percent among other itemizers. We also assume that the income sensitivity of giving (its income elasticity) is positive and that a 10 percent increase in the taxpayer's after-tax income (through, for example, a deduction that for inframarginal contributions does not reduce taxes for contributions beyond what the taxpayer would have given anyway) would increase contributions by 7 percent. We use these estimates as representative findings from previous research, although a wide range of uncertainty exists regarding the size of these responses.

## Options for Reform

We assess the effect of the current Puerto Rican charitable deduction and analyze four options for reform:

1. Raise the 15 percent ceiling on charitable contributions to 50 percent.
2. Allow a full deduction for all contributions in excess of 1 percent of AGI, while eliminating the 33 percent partial deduction for contributions less than the 1 percent floor.
3. Combine options (1) and (2); that is, reduce the floor, eliminate the partial deduction, and increase the ceiling.
4. Allow a full deduction for all contributions up to a ceiling of 50 percent of AGI (U.S. law).

### *Incentive Effects*

Changes in the tax treatment of charitable contributions can affect individual taxpayers in two distinct ways: (1) through changes in the price of giving, and (2) through changes in the income of the giver (Feldstein and Lindsey, 1983). Changes in the price of giving occur when policy changes lower or raise the out-of-pocket cost of giving an additional dollar. For example, changing Puerto Rican tax law to allow a taxpayer in the 33 percent tax bracket who previously had deducted one-third of contributions to deduct 100 percent of contributions would lower the price of giving an additional dollar from 89 cents to 67 cents. To simulate the effect on giving of such a change, we first compute the per-

centage change in the cost of giving ( $-24.7$  percent), then multiply this amount by the price elasticity of giving ( $-1.2$ ), which yields an estimate that the lower cost of giving would increase contributions by 29.6 percent ( $24.7 \times 1.2$ ). This percentage is then applied to the total amount of giving to estimate the increased giving we would expect to result from a drop in its cost.

Other changes in current law would either eliminate or modify floors and ceilings. Such changes affect not only the price of giving, but also the taxpayer's after-tax income. For example, the effect of allowing taxpayers to deduct 100 percent of contributions in excess of 3 percent of AGI is financially equivalent to an incentive that (a) reduces the cost of giving a dollar for all contributions but then (b) claws back deductions up to (tax increase to the treasury) the first 3 percent of AGI. We treat the lump-sum claw-back as a reduction in after-tax income and estimate the impact this would have on giving in two steps. First, we estimate the percentage change (reduction) in the taxpayer's after-tax income owing to the claw-back, then we multiply this percentage by the income elasticity of giving.

The options we consider would have the following incentive effects:

- *Current Puerto Rican law* relative to the absence of a deduction reduces the price of giving by only  $(1 - (1/3 \times \text{MTR}))$  for taxpayers who contribute less than 4.5 percent of AGI (where MTR is the taxpayer's marginal tax rate, or tax bracket). For taxpayers who give more

### Simulating the Effect on Giving of a Contribution Floor

Consider a taxpayer with \$100,000 of pretax income and \$80,000 of after-tax income who is in the 33 percent bracket and who would give \$5,000 with no tax deduction. Under current Puerto Rican law, her contribution of \$5,000 is more than 4.5 percent of AGI, so she gets a tax deduction equal to \$2,000 (\$5,000 minus the \$3,000 floor), which is worth \$660 at a 33 percent tax rate.

The charitable deduction affects her giving in two ways. First, the deduction reduces the cost of giving from a dollar to 67 cents, which reduces the cost of giving an additional dollar by 33 percent. Applying the price elasticity of  $-1.2$  to the decline in price of 33 percent increases her contributions by \$1,980 ( $0.33 \times 1.2 \times \$5,000$ ). But because of the 3 percent contribution floor, she also faces a lump sum tax from the loss of deductions on the first \$3,000 of contributions. This tax equals \$990 ( $0.33 \times 0.03 \times \$100,000$ ) and reduces her after-tax income by 1.24 percent ( $\$990 / \$80,000$ ). These changes are economically equivalent to changing the income of the taxpayer. Thus, applying the income elasticity of  $0.7$ , the drop in after-tax income reduces her contributions by \$43 ( $0.0124 \times 0.7 \times \$5,000$ ). On balance, the charitable deduction raises her contribution by \$1,937 to \$6,937 (\$1,980 minus \$43). The giver's total deduction in this example would be \$3,937, and the revenue cost to the treasury would be \$1,299.

than 4.5 percent of AGI, it reduces the price of giving to  $(1 - \text{MTR})$ , but the 3 percent floor imposes a lump sum tax equal to  $(\text{MTR} \times 0.03 \times \text{AGI})$ . For taxpayers who give more than 15 percent of AGI, the price of giving remains at \$1 (no price subsidy), but these taxpayers receive a lump sum subsidy equal to  $(0.12 \times \text{MTR} \times \text{AGI})$ , where  $(0.12 \times \text{AGI})$  is the difference between the floor ( $0.03 \times \text{AGI}$ ) and the ceiling ( $0.15 \times \text{AGI}$ ).

- *Lifting the 15 percent cap* converts the lump sum subsidy to a price subsidy, combined with a lump sum tax equal to  $(\text{MTR} \times 0.03 \times \text{AGI})$  for taxpayers who

give more than 15 percent of AGI. This substantially increases their contributions, while the government loses additional revenue only on the additional contributions above 15 percent of AGI.

- *Reducing the floor to 1 percent and eliminating the one-third deduction* reduces the price of giving to  $(1 - \text{MTR})$  from  $(1 - 1/3 \times \text{MTR})$  for taxpayers who currently give between 1 and 4.5 percent of AGI, providing these relatively small givers with bigger incentives to contribute more. However, these taxpayers will face a small lump sum tax from the new floor they are subject to  $(\text{MTR} \times 0.01 \times \text{AGI})$ . For taxpayers who cur-

rently give between 4.5 and 15 percent of AGI, lowering the floor from 3 to 1 percent reduces the lump sum tax by  $(MTR \times 0.02 \times AGI)$  but leaves their price of giving unchanged. For taxpayers who give less than 1 percent of AGI, this option raises the price of giving slightly by eliminating the small price subsidy they currently receive  $(1/3 \times MTR)$ . Finally, reducing the floor to 1 percent provides a small lump sum benefit  $(MTR \times 0.02 \times AGI)$  to taxpayers who now contribute more than 15 percent of AGI.

- *Allowing a full deduction up to a ceiling of 50 percent of AGI (U.S. law)* converts the deduction into a pure price subsidy with no lump sum taxes or subsidies for anyone giving less than 50 percent of AGI. Compared with current Puerto Rican law, it reduces the price of giving for those who contribute less than 4.5 percent of AGI or between 15 and 50 percent of AGI, eliminates the lump sum tax on those who give between 4.5 and 15 percent of AGI, and eliminates the lump sum subsidy for those who give between 15 and 50 percent of AGI. Compared with current law, this increases the incentive to give for all taxpayers, with the largest increased incentive for those who currently contribute less than 4.5 percent or more than 15 percent of AGI.

### ***Estimated Effects on Charitable Giving and Tax Revenue***

We simulated the effects of these options on charitable giving and revenue to the

Puerto Rican Treasury using a spreadsheet model of taxpayers grouped by AGI. Ideally, we would use taxpayer data at the micro or individual level, which would reflect the diversity of taxpayer behavior within income groups; however, because the available data are aggregated by income group, we treat each AGI group as a single representative taxpayer and examine how that representative taxpayer would respond to the different charitable giving provisions. Where we need additional data on within-group distributions of taxpayer behavior (such as the distribution within each AGI group of taxpayers with different contributions as a percentage of AGI), we impute data to the Puerto Rican spreadsheet model from the Urban-Brookings Tax Policy Center microsimulation model for U.S. individual income tax returns (Rohaly, Carasso, and Saleem 2005).

The simulations are based on contribution data aggregated by income class for 2007 and provided to us by Hacienda. Thus, the results are best interpreted as an attempt to gauge the effect of different policies had they been in effect in 2007. Because of the subsequent economic recession, baseline contributions under current law could be lower in both the present and the future.

We estimate that the current Puerto Rican deduction increases contributions by approximately \$15 million (relative to the 2007 baseline) at a roughly equal cost to Hacienda of \$15.2 million. Raising the ceiling on deductions would cost an additional \$5.3 million but would raise contributions by \$7.0 million—an increase of over \$1.30 in giving for each dollar of revenue

sacrificed. Raising the ceiling is relatively efficient, because it provides an incentive for very large donors to give more, while current law gives large donors a significant rebate for gifts up to 15 percent of AGI but no incentive to give more. In contrast, lowering the floor to 1 percent and retaining the 15 percent ceiling costs more (\$6.4 million) than the increase in giving (\$5.3 million), because it provides rebates for contributions between 1 and 3 percent of AGI by people who are already giving more than the 3 percent floor.

Among the options, shifting to a U.S.-style unlimited deduction has the largest impact on contributions (\$13.4 million of additional giving) but also the largest revenue cost (\$12.1 million). It would improve the

efficiency of the subsidy, but efficiency differences among the options are not large and the revenue loss would increase. Still, Puerto Rico might want to fund a moderate expansion of its charitable sector. Moreover, simplifying the calculation of deductions, removing the floors and partial deduction, and raising the ceiling might induce more participation and thereby provide even larger net benefits than these calculations suggest.

In addition to changing the incentive structure of the deduction, the government might make other changes in the charitable provisions. Many stakeholders in Puerto Rico expressed the view that it would be desirable to link any expansion of the deduction to measures to improve the

**Table 2. Effects of Options—Summary**

Options	Charitable Giving \$(Millions)	Revenue Cost \$(Millions)
<b>No Deduction</b>	88.3	--
<b>Current Puerto Rican law</b>	103.4	-15.2
Change in Giving and Revenue Compared with No Deduction	+ 5.1	15.2
<b>Lift the Deduction Ceiling</b>	110.4	-20.5
Change in Giving and Revenue Compared with Current Law	+7.0	5.3
<b>Deduction for 100 percent of contributions &gt; 1 percent of AGI up to 15 percent of AGI</b>	108.7	-21.6
Change in Giving and Revenue Compared with Current Law	+5.3	-6.4
<b>Deduction of 100 percent of contributions in excess of 1 percent of AGI</b>	115.8	-25.8
Change in Giving and Revenue Compared with Current Law	+12.3	-10.6
<b>Adopt a U.S.-Style Charitable Contribution</b>	116.8	-27.3
Change in Giving and Revenue Compared with Current Law	+\$13.4	-12.1

accountability of nonprofit organizations in Puerto Rico. One option is to require organizations to register with the IRS as 501(c)(3) organizations as a condition of receiving either any deductible contributions or the enhanced deductions advanced in these options. This could be an important first step toward greater transparency and accountability, and could help ensure that the revenue lost as a result of enacting these options would go to pay for the activities the subsidy intends to promote.

## Conclusions

Nonprofit organizations provide public benefits to society and have some advantages over government agencies when it comes to supplying these services. Puerto Rico is seeking to strengthen the nonprofit sector while at the same time restraining budgetary costs. Tax incentives for private giving may be an efficient way to stimulate nonprofit activity, which can help relieve some of the public sector burden of providing social services.<sup>5</sup>

On the basis of our assessment of the economic literature on how people respond to incentives for giving, we estimate that lifting the ceiling on contributions could increase contributions by more than the revenue loss to the Puerto Rican Treasury and, therefore, would be a cost-effective way to pay for additional services from these organizations, compared with direct grants. Reforms that modify or eliminate floors on contributions would add less to giving than the revenue loss, but they would simplify tax filing and could increase the very low current participation

in charitable giving in Puerto Rico by more than our estimates suggest. Any expansion of the charitable deduction, however, should be accompanied by measures to improve the accountability of nonprofit organizations in Puerto Rico.

## Notes

1. Given the current high rate of unemployment in Puerto Rico (15.6 percent in October 2009), a secondary effect of providing enhanced charitable deductions would be to provide a tax cut. If such a tax cut were not offset by other tax increases or public spending cuts, it would raise total spending in the economy. This higher spending could produce multiplier effects when sellers re-spend their increased incomes on goods and services in the Puerto Rican economy, further raising Puerto Rican employment and incomes by amounts comparable to those of income tax cuts of a similar magnitude.
2. In both the United States and Puerto Rico, only itemizers may claim charitable deductions on their individual income tax returns.
3. These studies are described in more detail in Boris et al. (2009).
4. A 25 percent matching grant is equivalent to a 20 percent deduction; in each case, every \$80 spent by the taxpayer transfers \$100 to the charity. But research shows that people are more responsive if they are told that their \$80 contribution will be supplemented with

a 25 percent (\$20) matching contribution than if they are given a \$20 rebate for every \$100 they contribute.

5. Some recent research, for example, finds evidence that nonprofit organizations may relieve individual states of some of the fiscal costs of providing services. See Carroll (2008).

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