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CGAP Briefing Note

# Commentary on recent research and debate about reforming Gift Aid

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The purpose of this note is to provide a commentary on recent debate and new research<sup>1</sup> on reforming the Gift Aid scheme through alternative options for donors. The note is intended to stimulate thinking, through focussing mainly on the research and its findings, and help charities and others come to a view on the way forward for Gift Aid.

It does not provide a detailed description of the research, which is available as a report. The note sets out the background to the research, outlines its approach and conclusions, and makes some comments both on specific and general aspects of the study, which represents an extremely important and substantive contribution to research on tax incentives for charitable giving in the UK.

## Background

Charitable gifts made by individual donors through Gift Aid are worth around £3.4 billion<sup>2</sup> net of tax, just under one-third of all giving. They attract a further £947 million of donor income tax relief on giving which is paid back to charities by government. Though Gift Aid is a growing, popular and highly important mechanism for individual giving, there are a number of significant current challenges to the effectiveness and impact of the scheme. These informed the consultation on Gift Aid launched by the government in 2007. Main challenges are:

- **Accessibility/take-up:** Gift Aid is not fully efficient, as it is used by just one-third of donors for one-third of donations, though potentially the majority of donors and gifts would be eligible.

- **Transaction costs:** processing Gift Aid requires resources which come at a cost to both charities and donors: the costs of reclaiming tax reliefs are often felt to outweigh the benefits.
- **Incentive power:** low take-up of Gift Aid and donor tax rebates raises questions about the extent to which they are effective options for incentivising more donors to give more, and to maximise value to charities.
- **Impact of tax changes:** the reduction to personal income tax rates effective from 2008 reduced the value of Gift Aid to charities, and the transitional tax relief made available to compensate for this by government comes to an end in 2011, potentially leaving a gap in charity funding.

An extensive consultation process has been carried out, which has led to some modifications aimed at simplifying the scheme and a package of donor awareness-raising and charity training measures.

Ideas for more 'root-and-branch' reform of the way in which Gift Aid worked were also put forward in the consultation process, and a number of options for donors were explored in recent research published by HMRC and HM Treasury.

#### **Scope of the research (in brief)**

The full report of the research is available online. In summary, the research compared the possible impacts on the value of individual donations of two basic options:

- **'Re-direction'**, an option under which income tax relief on charitable giving currently reclaimed by higher-rate-taxpaying donors, a 'rebate', is paid back to charities; or
- **'Composite rate'**, an option under which higher-rate tax relief would be abolished and in its place charities could simply reclaim a larger 'composite' rate of tax relief, set at a value between standard and higher-rate tax relief.

Using these two options, the research constructed seven different scenarios for giving and tested their likely effect on levels of giving and cost of tax relief to the Exchequer.

#### **Findings of the research (in brief)**

Main findings from the research are that:

- across all the scenarios offered for changing Gift Aid, the majority of donors reported that they would not change donations out of their net income;
- a small but sizeable minority of donors preferred a Gift Aid system in which a 'rebate' on donations can be claimed by themselves;
- the different scenarios produced very different results from donors in relation to changes to the value of cash donations, gross donations, and the costs of tax relief to the Exchequer;
- any changes would be likely to have winners and losers, and different charitable causes would experience negative or positive effects.

## Commentary

### (a) Estimating the impacts of reforms

#### ***Redirection makes donating more expensive for the higher-rate taxpayer with potentially damaging consequences.***

At present, higher-rate taxpayers can reclaim 25p in tax credit for every pound that they donate to charity. Not all of them do, so it has been proposed that this 25p be redirected to the charity instead, in addition to the 25p Gift Aid the charity already receives. In other words, the total value to the charity of a one pound donation from a higher-rate taxpayer would increase to £1.50 (one pound donation plus 50p Gift Aid).<sup>3</sup> On the face of it, this may seem like a good deal for charities but the downside is that this system actually makes it more expensive for a higher-rate taxpayer to donate. At present, the higher-rate taxpayer only need donate 60p net (80p donation minus 20p rebate) in order for the charity to receive one pound (80p donation plus 20p Gift Aid). Under the proposed redirection policy, the higher-rate taxpayer would have to donate 67p net (67p donation and no rebate) in order for the charity to receive one pound (67p donation plus 33p Gift Aid).

There is evidence within the report that wealthier donors are more sensitive to price and we do not know the exact impact of this because of the difficulties of estimating their true significance within overall giving.

#### ***Composite rates would make donating more expensive for higher-rate taxpayers but cheaper for basic-rate taxpayers.***

Under the composite rate, the rate of Gift Aid would rise for both basic-rate and higher-rate taxpayers to a standard amount of between 25p and 50p per pound donated, with the higher-rate taxpayers losing their rebate. The current price of donating for basic-rate taxpayers is 80p (80p donation and no rebate) per charity pound (80p donation plus 20p Gift Aid). The current price of donating for higher-rate taxpayers is 60p per charity pound as outlined above. The new price of donating would be between 67p and 80p, representing a fall in price for basic-rate<sup>4</sup> taxpayers but a rise in price for higher-rate taxpayers.<sup>5</sup> As argued above, we do not know what the precise impact of this might be.

#### ***Higher-rate taxpayers might switch systems from donating with Gift Aid to payroll giving.***

Under both the redirection policy and the composite rate, it would be cheaper for higher-rate taxpayers to donate via payroll giving, where they only need forgo 60p in net pay for every pound that the charity receives. In removing the higher-rate tax rebate to donors, government would have to offer a total of 67p Gift Aid per pound donated for the 'price' of donating to remain at 60p per charity pound for the higher-rate taxpayer. Only then could the higher-rate taxpayer donate 60p net (60p donation and no rebate) for the charity to receive one pound (60p donation plus 40p Gift Aid). There is evidence in the report that more than half of current higher-rate tax reclaimers who already use payroll giving would switch.

#### ***People appear to be more sensitive to changes in Gift Aid than to donor rebates.***

The report highlights important differences in the responsiveness of donors to different forms of tax relief. In economic terms it should not matter whether the tax relief on

donations is administered as a payment to the charity or a payment to the donor as long as the price of donating is held constant. However, it was calculated that higher-rate taxpayers would in practice reduce their donations to a lesser extent in response to withdrawing the donor rebate than they would increase them in response to an equivalent rise in the rate of Gift Aid.<sup>6</sup> This was true both among those who claim their due rebate and those who do not. Basic-rate taxpayers also responded positively to the proposed higher rate of Gift Aid.

These findings would suggest that the Gift Aid system offers a stronger incentive to donate than the corresponding system of donor rebates.<sup>7</sup> It is not clear, however, that any increases arising from the proposed composite rate approach to Gift Aid would prove a stronger attraction to the wealthier major donors than a rebate, and produce more money for charities overall. Figures in Table 13 of the research paper show that the gross value to charities of donations from donors currently reclaiming tax would only increase by 5 per cent where a 50p match was offered, and would actually fall by 8 per cent at the 30p composite rate.

***The estimated benefits of tax changes may not be sufficient to justify the risks involved.***

Table 19 in the report estimates the changes in charity income from donations and relief, as well as the change in cost to the Exchequer, for proposed composite rates of 30p and 37p, and the 50p match for higher-rate taxpayers. The estimates allow for expected switching of donors to payroll giving. Results show the value of donations and relief to charities would rise by between 3 per cent (for the 30p composite rate) and 10 per cent (for the 37p composite rate). While this would suggest that the 37p composite rate is preferable for charities, Exchequer costs would go up by 24 per cent. These predicted benefits are rather small and, even if they were to materialise, it is not clear that they would outweigh the long-term risks to the charity sector associated with changing the relief system. Caution is also necessary since these estimates are based on survey responses to hypothetical scenarios and some strong assumptions about the structure of the donating population.<sup>8</sup>

## **(b) General aspects**

### **Single-issue focus**

The research was aimed primarily at exploring the **incentive power** of Gift Aid and not at accessibility, transaction costs or the impact of changes to personal income tax rates on charities. It was a study of donors, exploring donors' psychological and economic reactions to changes in tax relief, and whether total amounts given to charities would be affected.

The various Gift Aid options put forward have implications for accessibility, transaction costs and the impact of future tax changes, but alternative solutions for these issues *per se* were not studied, and would benefit from being assessed on their own merits.

### **Distortion to current tax system**

A 'composite rate' approach would distort the current tax system. The current UK tax system may be described as progressive as those on high incomes are taxed at a higher rate than those on low incomes. Under a composite rate of Gift Aid, higher-rate

taxpayers who donate would effectively be subsidising the donations of basic-rate taxpayers, making the tax system more progressive. In effect the rich would be taxed to give to the charities favoured by the less well-off. While such an outcome may be attractive in some ways, it would carry political-economic consequences.

### **From tax relief to government spending**

A 'composite rate' approach runs the risk of converting donor tax relief into government spending. Gift Aid would no longer be equivalent to a tax rebate to the donor, and could be seen as a simple extension of government spending funded by all taxpayers. (The status of the tax payment under the composite-rate approach is currently under discussion between Treasury, HMRC and the Office for National Statistics). The risk to charities would be that it would then be easier for the government of the day to decrease the rate of Gift Aid or even dispose of it altogether in line with other spending caps.

### **Short and long-term effects**

The introduction of a 'composite-rate' rate approach would separate the amount of tax relief reclaimable from real tax rates, meaning that donors and charities might not be able to maximise benefits when tax rates change in the future. For example, the increase in the top rate of tax to 50% for those on incomes of over £150,000 would offer these taxpayers a higher incentive to donate to charity under the current donor rebate system. Charities would not benefit from this with composite-rate approach.

Another point is that the way in which donors react in the short term to income tax changes is not always a predictor of how they will react in the longer term. US research indicates that long-term adjustments to changes in the tax rate differ from short-term effects.

## **Overview**

The research provides very important new insights into donors' potential reactions to some suggested changes in Gift Aid which would affect the price of giving and the balance of tax relief between donor and charity. Donor responses might also be incorporating the apparent greater simplicity of some options.

Care needs to be taken in drawing conclusions from the research. It is not based on a general population sample and cannot fully estimate the significance of major donors for giving. Its results predict rather small benefits for charities from many of the scenarios for change; there is therefore a fairly strong argument to opt for no change and continue to promote the current system.

A straightforward 'one-size-fits-all' solution to the challenges currently facing the Gift Aid scheme may not be feasible. It could also be argued that the only alternative to the current system that is presented in the research and likely to benefit charities is the 67p match for higher-rate taxpayers. There may also be a case for further research focussing specifically on options for the simplification, transaction costs and accessibility of Gift Aid.

Government has invited a robust debate on the research and the options for transforming Gift Aid, and this paper is intended as a contribution to such a debate on Gift Aid. We would welcome your responses.

<sup>1</sup> *Gift Aid donor research: Exploring options for reforming higher-rate relief*. A report for HMRC and HMT. Kimberley Scharf, Warwick University, and Sarah Smith, University of Bristol. HMRC 2009.

<sup>2</sup> HMRC, June 2009. Table 10.3: *Gift aid and covenants*.

<sup>3</sup> The total value to the charity of a Gift Aided donation from basic-rate taxpayers would remain the same as at present, ie £1.25 (not including transitional relief of 3p).

<sup>4</sup> Assuming the composite rate of Gift Aid is more than 25p per pound donated.

<sup>5</sup> If the new rate of Gift Aid is  $Xp$  per pound donated, the price of donating for both basic-rate and higher-rate taxpayers would be  $100/(100+X)$ , which lies between 67p and 80p for values of  $X$  between 50 and 25.

<sup>6</sup> Basic-rate taxpayers were not questioned on rebates and so no such comparison is possible for them.

<sup>7</sup> See Tables 21 and 22 in the report for the elasticity estimates.

<sup>8</sup> The extent to which the sample represents the population is discussed at length on pp35–36 and in Appendix 2 (pp81–83). A table providing estimates for alternative population assumptions is presented on p12.

## About the authors

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## About CGAP

The ESRC Centre for Charitable Giving and Philanthropy (CGAP) is the first academic centre in the UK dedicated to research on charitable giving and philanthropy. Three main research strands focus on individual and business giving, social redistribution and charitable activity, and the institutions of giving. CGAP is a consortium comprising Cass Business School, University of Edinburgh Business School, University of Kent, University of Southampton, University of Strathclyde Business School and NCVO. CGAP's coordinating 'hub' is based at Cass Business School. CGAP is funded by the ESRC, the Office for Civil Society, the Scottish Government and Carnegie UK Trust.

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