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CGAP Briefing Note 1

# Thinking through the effects of changes in income-tax relief on giving

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**Economists believe that the amount people give is related to the ‘price of giving’ and that people will adjust their donations in line with the impact of tax changes both on their *income* and on the *price* of giving. Current (proposed and actual) changes in the environment for giving in the UK will affect both income and price:**

- **Gift Aid** A proposal has been put forward by charity representatives that the government let charities assume a certain proportion of donors to be taxpayers and have non-taxpayers, or those unwilling to give tax-efficiently, ‘opt out’ of the Gift Aid scheme. This is under consideration, along with other possible streamlining of the scheme.
- **Gift Aid and higher-rate tax** Another proposal is that charities rather than donors should receive the tax relief on Gift-Aided donations currently paid back to the higher-rate taxpaying donor. At present, higher-rate taxpayers can claim for themselves the difference between the standard rate and the higher rate.
- **Top rate tax** The future increase in the top rate of income tax to 50 per cent for those on incomes of over £150,000 announced in the Budget will have implications for both donor income and the price of giving. Some have seen the move as positive as it will reduce the price of giving and they expect this to stimulate more giving. Others are wary of the effect of the higher tax on donor incomes and how this might affect giving decisions.

## How tax rebates on charitable donations work

Tax rebates reduce the cost to the donor of making a donation and work either by allowing the donor to reclaim income tax paid on money donated, or by letting the recipient (charity) collect it. The former method is practicable only insofar as people file a tax return, which is why it is more common in the US, where most people do, than in the UK, where only those on high incomes are required to file returns. Many higher-rate taxpayers do not reclaim the tax relief on their donations to which they are entitled. This is likely to be due to a range of factors including ignorance of the tax break, not considering it important<sup>1</sup> and failure to keep records.

## Examples of tax breaks

Under the Gift Aid scheme, UK charities may claim 25p from the government for every pound donated. That is equivalent to the tax paid on the gross income from which the donation was made (£1.25), assuming the donor pays the basic rate of income tax (20 per cent). So, if the donor wanted the charity to receive £1 altogether, she would in fact only have to donate 80p. The price of giving for a basic-rate taxpayer is thus 80p per pound, or 0.8.<sup>2</sup>

Donors paying the higher rate of income tax of 40 per cent are eligible to reclaim the difference between this and the basic rate back from government themselves (ie 20 per cent of the total amount the charity receives, or 25p per £1 donated). Note in this case that the government does not offer full tax relief on the income and still retains some of the tax.

In deciding how much the charity should receive, the donor can choose to give less in the knowledge that their gift will be topped up to the desired amount.

## Changes in the price of giving

If the government raises the income-tax rate and continues to allow taxpayers to reclaim tax on donations made to charity, it effectively lowers the price of giving, as donors can reclaim more per pound donated than before the tax change. Numerous attempts have been made to gauge the sensitivity of donors to changes in the price of giving, ie its 'price elasticity'.<sup>3</sup> John Peloza and Piers Steel compared the price-elasticity estimations from 69 (mainly US) studies of the effects of tax on charitable giving.<sup>4</sup> Based on these studies, they calculate that on average, decreasing the price of giving by 1 per cent may be expected to lead to an increase in donations of 1.11 per cent. If this elasticity held for top-income UK donors, the increase in the top income tax rate would result in an increase in their giving. However, other factors may affect the outcome such as whether the tax change is taken to be permanent or temporary, and of course donors' perceptions of their own likely future income, particularly in an economic downturn where incomes are falling.

## Increasing the top rate of income tax and donor behaviour among the rich

It might be reasonable to expect donations to increase as a result of the rise in income tax to 50 per cent amongst wealthy donors. However, when income tax is increased, donors will also have smaller budgets than before for all of their other spending. Through this income effect, they may decide to donate less to charity in order to maintain the same living standard as before.

## Overall effect

Income and price effects work against each other. For both government and charities, it is therefore important to understand whether the income or price effect is stronger in order to predict the overall effect of tax changes on donations.

A further point is that donors might reduce their gifts if charities were to receive the 50 per cent-taxpaying donor's share of Gift Aid relief. As it stands, government will gain from a higher top tax rate under the present tax-relief regime because overall relief entitlement is still calculated at basic-rate tax, as the next example shows.

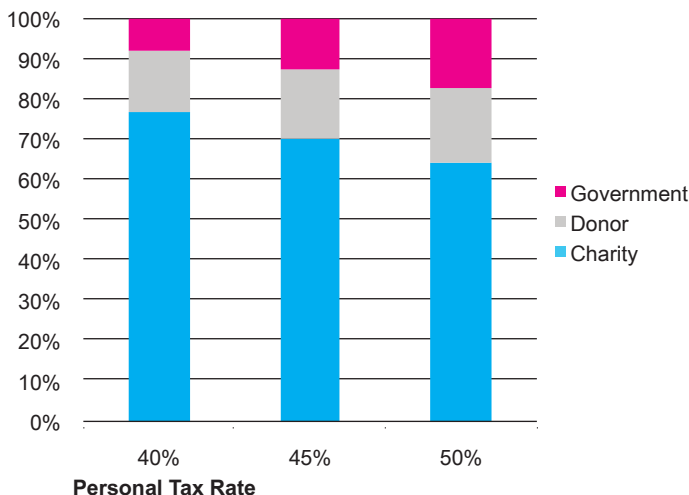
## Government's growing slice of the pie

According to figures published by HMRC, £270 million was paid back to higher rate taxpayers as relief on their donations to charity last fiscal year. Assuming all of the income from which these taxpayers donated was taxed at 40%, they will have had to have received gross income of £1.8 billion and their original donations will have totalled £1.08 billion. The charities will have been able to claim £270 million in Gift Aid plus a further £32.4 million under the extra 3p-in-the-pound rule. The remainder of the original gross income, £147.6 million, will have been retained by government.

If the top rate of tax increases and HMRC rules for reclaiming tax on donations remain unchanged, both government and donors stand to gain at the charities' expense, see adjacent graph based on unchanged pre-tax income for donations.

The debate about the impact of changes to the price of giving for donations is not restricted to the UK. In the US, President Obama has proposed changes that will reduce the amount of tax rich donors can reclaim, from 35 cents to 28 cents per dollar donated, starting from 2010. This will make it more expensive for the rich to give to charity; the price of giving a dollar will rise from 65 to 72 cents. The Association of Fundraising Professionals is already encouraging its members to lobby Congress against the new measures. It makes the point that charities' services are in greater demand during an economic downturn and that now is not the right time to place extra strain on their sources of funding.

## Division of a Gross Donation



<sup>1</sup> See HMRC/IPSOS MORI (2007) 'Charitable Giving by Wealthy People', Jayne Taylor, Caroline Webb and Daniel Cameron (eds.), Ipsos MORI Social Research Institute for HM Revenue & Customs. Available online on 6 July 2009 at: <http://www.hmrc.gov.uk/research/report29-giving-by-wealthy.pdf>

<sup>2</sup> The basic rate of tax was reduced from 22 per cent to 20 per cent in April 2008. Under the previous 22 per cent tax rate, charities were able to claim 28p per pound donated through the Gift Aid scheme (28p represents 22 per cent of £1.28). Under the current 20 per cent rate, they can

only claim 25p per pound. In order to compensate for a potential loss in their revenue caused by the reduction in the tax rate, charities have been allowed to claim an extra 3p per pound donated during a transition period until April 2011. During this transition period, the price of giving effectively remains at the lower rate of 78p per pound.

<sup>3</sup> The percentage change in donations that results from a 1 per cent change in the price of giving, all else being equal.

<sup>4</sup> See Pelozo, John and Piers Steel (2005) 'The Price Elasticities of Charitable Contributions: A Meta-Analysis', *Journal of Public Policy and Marketing* 24 (2), pp260–72.

## 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.

**For further information on CGAP, visit [www.cgap.org.uk](http://www.cgap.org.uk)**