

Taxing Charitable Giving

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Executive summary

The government is nearing the end of a consultation process on charity taxation. This Commentary considers one possible area for reform — the taxation of individual donations to charity. We point out the following:

- Currently, tax-free giving is restricted to those who make a commitment to the same charity for four years (covenants), those who give one-off donations of £250 or more (Gift Aid) or at least £100 to ‘anti-poverty and education programmes’ overseas (Millennium Gift Aid) and those who work for an employer operating a payroll-giving scheme. These schemes have not been taken up very widely. Total tax-free giving is estimated to account for less than 20 per cent of total donations.¹
- Before considering arguments for or against particular reforms, it is worth considering the general case for having tax-free giving. Tax relief for donations is often seen, unequivocally, as ‘a good thing’. Yet it is not a free lunch for charities. The opportunity cost may be most clearly seen as the government giving up tax revenue that it could pass on to charities as grants.
- The case for tax-free giving is typically that charities provide goods and services that are deserving of government support. In economic terms, if charities provide public goods (such as environmental clean-up) or merit goods (such as education, where other individuals benefit apart from the consumer), then there is an argument for government intervention. Whether this argument applies to each charity is clearly an issue that is pertinent to the debate (although not one that is considered in this Commentary). In any case, the argument is one for some government intervention, not specifically tax relief.
- One aim of tax relief might be to increase charities’ incomes. But if seen in terms of potential grants forgone, this relies on a knock-on effect of tax relief on individual donations. There is a possible danger that tax relief may cause givers to reduce the size of their donations, knowing that the government is providing a top-up. Evidence from the US suggests that the financial incentive provided by tax relief has only a small positive effect on individual donations.²
- A second aim may be to encourage more individuals to give to charity. The government may not care simply about charities’ total income, but also about having a society in which individuals interact with charities. Granting tax relief, rather than handing out grants, allows individuals rather than government to decide which charities should get government money (and relieves the government of an administrative burden).

¹Source: *NCVO Research Quarterly*, September 1998.

²The decision to introduce tax relief is unlikely to involve such an explicit trade-off between grants and tax relief. In this case, the introduction of tax relief will benefit the charitable sector, but as a result of a deliberate policy decision by the government to direct more revenue towards the charitable sector.

- Encouraging individuals to give more and encouraging more individuals to give are both ways to increase charities' incomes. But the relative importance that the government attaches to these two objectives will affect the form that tax relief should take. If the government is concerned only with trying to increase the total income of the charitable sector (and is unconcerned about who gives — and to whom they give), it may choose to target tax relief at wealthy givers. If the government cares about letting a wider range of individuals express their preferences for different charities, it should choose a system of tax relief that opens up tax-free giving to a wider range of individuals.
- Since the announcement of the consultation process, much attention has been paid to 'US-style tax deductions'. It is important to distinguish between the administrative features of US-style tax deductions and their end result. This is particularly important since the administration of the tax system in the UK is very different from that in the US. Given these differences, there are a number of alternative reforms to the current system that could achieve the same ends (i.e. making almost all donations tax-free) for a greater number of givers.
- Simply taking the administrative features of US-style tax deductions and implementing them in the UK would have no effect for taxpayers who do not file tax returns. For those who do file (mainly higher-rate taxpayers and the self-employed), the effect would be to allow almost all gifts to be tax-free.³ For these people, US-style tax deductions would be more attractive than the current system because they would extend tax relief to one-off, or irregular, gifts of less than £250.
- However, the same end result could be achieved either by abolishing the time-limits on covenants (presumably substituting a minimum and/or maximum threshold to keep the costs down) or by reducing the minimum threshold on Gift Aid.⁴ One obvious option would be to extend Millennium Gift Aid to donations to all good causes. These alternatives would be available to all taxpayers.
- It might be argued that US-style tax deductions have an additional psychological effect, but we are not aware of any evidence for this one way or the other. There may also be an information effect associated with government backing for a new scheme, but this is not unique to the nature of US-style tax deductions: the argument applies equally to increasing the level of information about the current ways of giving to charity.

³Presumably there would be a minimum and/or maximum threshold to make the scheme administratively feasible and to keep the costs down.

⁴It should be noted that reforming either of these schemes along these lines would make the other effectively obsolete.

1. Introduction

The Prime Minister wants this to be a 'giving age'. Evidence from household surveys,⁵ however, points to a fall in the number of people, particularly young people, who are giving to charity. The government is currently nearing the end of a consultation process on charity taxation and one possible area for reform is the tax treatment of individual donations to charity. The current system comprises a wide range of different tax incentives for particular types of giving, yet none has been taken up to any great extent. Total tax-free giving is estimated to account for less than 20 per cent of total donations.⁶

The consultation process was announced in July 1997 and it should yield results by the end of 1998. In the mean time, a scheme known as Millennium Gift Aid was introduced in December 1997. Targeted at education, health and anti-poverty projects in the world's poorest countries, the scheme provides tax relief on donations of more than £100. The scheme also allows smaller donations to be bundled up and still qualify for tax relief. Introducing the scheme, the Chancellor announced that the government has 'a major role [to play] in encouraging individuals to give more to charity'.⁷

But is tax relief the way to achieve this? Unfortunately, tax relief for charitable donations is not a free lunch. By granting tax relief, the government loses potential tax revenue that could otherwise be given as grants to charities (or, indeed, be used by the government to provide public, or charitable, goods and services directly). In this Commentary, we argue that there is a need for clarity of thought in this area. First, what reasons are there for government to grant tax relief on charitable donations? Many arguments focus on the types of goods and services that charities provide — public goods, such as environmental protection, and merit goods, such as education, which are essentially private but could have large positive spillover effects on others in society via increased productivity, for example. We do not consider in this Commentary whether public or merit good arguments do, in fact, apply to each individual charity, although it is clearly an issue that is pertinent to the debate. In any case, these arguments are for some form of government support, not necessarily for tax relief. Rather, we consider whether tax relief is likely to be more effective at increasing charities' incomes, rather than just being more politically palatable, than direct grants.

We also assess particular reforms to tax relief that the government might be considering. What the government should do depends very much on what it is trying to achieve. Clearly, one aim in granting, or extending, tax relief is to increase individual donations and to increase charities' incomes. But the government may care not only about getting individuals to give more but also about getting more individuals to give. There are certainly indications that the government's vision of a 'giving age' encompasses a greater involvement in society by all, including voluntary work as well as donations. The relative importance that the government attaches to these two objectives will affect the form that

⁵See Section 2 of this Commentary, or Banks and Tanner (1997) for a more detailed analysis.

⁶Source: *NCVO Research Quarterly*, September 1998.

⁷Inland Revenue, 1998a.

tax relief should take. This is clear in the current debate over ‘US-style tax deductions’, which, in the UK, would restrict tax relief to a minority of individuals who file tax returns. If the government cares about encouraging a wider range of individuals to give, it should choose a system of tax relief that opens up tax-free giving to a wider range of individuals than would have easy access to US-style tax deductions.

The following sections address these issues. Section 2 provides some summary background evidence on recent trends in individual giving in the UK. Section 3 considers the taxation of charitable giving from an economic perspective. Section 4 describes the current systems of tax relief on charitable donations in the UK, and Section 5 looks at aggregate trends in tax-relieved forms of giving. In Section 6, we draw out the implications of our analysis for reform. Section 7 concludes.

2. Recent trends in charitable giving

The number of people giving to charity has been falling in recent years. Data from the Family Expenditure Survey (FES)⁸ show that there was a statistically significant fall in the number of givers over the period 1978–96. Table 2.1 shows that the proportion of all households giving to charity (in the two weeks in which they were interviewed) fell by almost 4 percentage points — around 11 per cent — between 1978 and 1996. There has been much speculation about the effect of the National Lottery on individual giving. In fact, the table shows that a decline in the number of givers began long before the Lottery's introduction.

At the same time, the average size of donation (among those who continued to give) increased in real terms — from £2.24 a week per donating household in 1978 to £3.65 a week in 1996. This increase more than outpaced the decline in the number of givers, with the result that the average donation across the whole population (i.e. averaging across givers and non-givers) also increased in real terms. However, the increase was by no means uniform across the period and growth has stagnated since the mid-1980s. These trends are confirmed by recent evidence from the Barclays/NGO Finance Index of the incomes of the top 100 charities, which shows a year-on-year fall in voluntary donations as a proportion of total charity income — from 19 per cent in 1992 to 17 per cent in 1996.

Table 2.1. Household donations to charity

	Percentage of households giving to charity	Average donation (mean, givers only) £ per week, 1997 prices	Average donation (mean, all households) £ per week, 1997 prices
1978	33.2	2.24	0.74
1979	32.4	2.47	0.79
1980	33.5	2.15	0.71
1981	33.6	2.49	0.83
1982	32.7	2.38	0.77
1983	30.7	3.20	0.97
1984	31.8	2.74	0.86
1985	30.8	3.60	1.11
1986	31.9	3.10	0.97
1987	31.5	3.60	1.09
1988	30.0	3.97	1.16
1989	29.9	3.70	1.08
1990	28.9	3.92	1.11
1991	29.5	3.80	1.09
1992	29.1	3.83	1.09
1993	29.8	4.27	1.23
1994	31.6	4.02	1.25
1995	31.9	3.64	1.19
1996	29.7	3.65	0.99

Source: Authors' calculations from Family Expenditure Survey, 1978–96.

⁸See Appendix for a description of the information on charitable giving in the FES.

The increasing 'inequality' of giving (i.e. more donations coming from fewer donors) is driven by differing trends in participation amongst separate, identifiable, demographic groups. The biggest fall in the number of givers has occurred among younger households. Among those aged 20–34, for example, the proportion giving to charity fell from 28 per cent in 1978 to 21 per cent in 1993, while among those aged 50 plus, the proportion giving to charity remained fairly constant.⁹ The evidence suggests that the likelihood of giving to charity increases with both age and income, but younger households today are less likely to give to charity than today's middle-aged households were when they were young. A large part of the decline in the aggregate proportion giving over time therefore appears to be driven by younger generations, who are less likely to give, replacing older ones, who were more likely to give.

Unless this trend can be reversed, it does not bode well for charities' incomes in the future.¹⁰ One might argue that households born later are different in many respects from their predecessors, having fewer children on average and having different employment patterns, particularly much higher female paid labour-force participation. The change in behaviour of their predecessors as they aged may well be no predictor of what the young will do in the future. In other words, giving could well increase markedly as the younger generation becomes middle-aged, and the downward trend in the number of givers may be reversed. However, it has also been argued, by Pharoah and Tanner (1997), that young households form attachments to the charitable sector which are then developed and extended in middle age. If this is the case, it may be difficult for fund-raisers to generate the same increases in donations from today's young households who will not have, by the time they reach middle age, such a history of attachment.

⁹Banks and Tanner, 1999.

¹⁰For further details, see Banks and Tanner (1997) and Pharoah and Tanner (1997).

3. The economics of tax-free giving

'Charities contribute a great deal to society and this is reflected in their favourable tax treatment.'

Dawn Primarolo, Financial Secretary to the Treasury, July 1997
(HM Treasury, 1997)

Why should the government give tax relief on the income that individuals choose to donate to charity? Most commonly, as the opening quote suggests, the case for tax relief is made on the grounds of the types of goods and services that charities provide. These may be pure public goods or services, such as cleaning up the environment, or goods that are essentially private but have big positive spillover effects (externalities), such as medical research or education. With these types of goods and services, there is not a direct link between what people pay and the benefits they receive. There is a danger that individuals will 'free-ride' on the contributions of others, resulting in underprovision. One issue, not dealt with in this Commentary, is the extent to which we believe charities actually provide public or merit goods. Clearly, it is relevant to the debate and, indeed, it may be argued that, without a clear idea of this, it is impossible to design a coherent policy towards taxing charities.

But, even if the government does believe that the types of goods that charities provide are public or merit goods, it is an argument for some government intervention in the area of public or merit good provision. It is not, directly, an argument for tax relief on charitable gifts. The government could use tax revenue to provide the goods and services itself. Given trends in the size and scope of government service provision, this is less likely than it was. Alternatively, the government could give tax revenue to charities in the form of direct grants for provision of charitable services. In considering the arguments for tax relief, it is important to bear these alternatives in mind since they serve as appropriate bench-marks against which to assess the relative merits of tax relief.¹¹

Briefly, the arguments for tax relief that we consider are: (i) that tax relief reduces the 'price' of giving to charity and may therefore increase the overall level of donations; (ii) that tax relief may be less distortionary than the taxes needed to fund government grants; and (iii) that tax relief allows individuals to express their preferences about which charities should benefit from government money.

3.1 Tax relief and the 'price' of giving

Unfortunately, tax relief on donations is not a free lunch for charities. There is a cost to granting tax relief that can be measured by the government revenue — and hence

¹¹Another possible argument for granting tax relief on donations may be that charitable giving is a purely intermediate activity. One example of this might be a transfer of income to pay the salaries of administrative workers at the charity who will then pay tax on their income. As such, giving could be thought to be an activity that should not be subject to tax. However, not all charitable activities fit this model. Even if they did, the principle of not taxing intermediate activities is not strictly adhered to in the tax system as a whole. The issue would be better addressed by considering reform of the taxation of intermediate activities as opposed to reform of the taxation of charitable activities.

potential grants to charities — forgone. Assume that the government decides to switch from giving £1 million worth of direct grants to charities to granting £1 million worth of tax relief on individual donations. If the level of donations by individuals is unaffected by the introduction of tax relief, the effect on the total income of the voluntary sector of the two policies would be the same.¹² Of course, this assumes that the government's choice between tax relief and direct grants is made explicitly in this way — and is seen by donors in this way. In fact, both of these are unlikely. It is unlikely, for example, that granting tax relief to charitable donations will be matched one-for-one with cuts in grants.

Given the size of total government spending, donors may not equate the introduction of tax relief with an effect on the level of government grants going to charity. In this case, the effect of tax relief is to lower the perceived 'price' of giving to charity. Not counting government grants out of tax revenue, the 'price' of giving £1 to charity (without tax relief) is £1. With tax relief, the 'price' of giving £1 to charity to a basic-rate taxpayer is 77p (and 60p for higher-rate taxpayers).¹³

If the price of something falls, economics predicts that, other things being equal, its consumption will rise. This is both because it is cheaper relative to other goods (the 'substitution effect') and because consumers' real disposable incomes will increase, allowing them to afford more of all goods (the 'income effect').

Assuming that donations are like other goods, when the price of giving goes down, it makes sense to donate more (and substitute away from other goods and services), since giving is now a relatively cheaper way of getting utility. So the effect of introducing (or broadening) tax relief on donations will be to increase the level of donations. By this argument, tax relief would be more effective than grants at increasing charities' incomes — if the government switches from grants to tax relief, charities' total income rises because individuals' donations increase by more than enough to offset any fall in grants.

Note that changes in the marginal tax rate will also have an effect on the level of giving, once a system of tax relief has been introduced. Increases in the tax rate will cause donations to charity to be cheaper relative to other goods by reducing the cost, in terms of net income, of donating a pound. Similarly, a reduction in the tax rate will tend to reduce the level of charitable giving by making donations relatively more expensive. This fact has been used to identify price effects in the US (see Box 3.1).

But it is not clear that donations are substitutes for other goods and services. Donors may decide on the level of donation on the grounds of a perceived level of need or of a belief in an appropriate level of provision of charitable goods and services. In this case, it is very unclear how donations will react to the introduction of tax relief. Donors may

¹²Grants to charities may be seen as an endorsement of a good cause and hence encourage donations or divert existing donations from other good causes. We are unaware of any evidence relating to this hypothesis.

¹³Note that this price effect depends on there being no switch of government spending from grants to tax relief (or if there is a switch, then it not being perceived). If all tax revenue on income that was donated was passed on to charities through grants, then the price of giving £1 to charities was 77p to a basic-rate taxpayer before the introduction of tax relief. Introducing tax relief and cutting the level of grants equivalently will have no effect on the actual price of giving (although it may affect the allocation of resources between different charities — see below).

reduce their *net* donation exactly to offset the tax relief granted by the government. If the government has made a decision to switch from giving charities direct grants to granting tax relief, the total amount of money going to charities will actually fall.

One point worth making here is that any decision by the government to introduce tax relief may receive a lot of media attention. This may have an additional effect on the level of donations by increasing the level of awareness about giving to charity, independent of any effect on the price.

Ultimately, investigation of the effect of tax relief on individual donations is an empirical matter. The key is the responsiveness of donors to a change in the perceived 'price' of donations. This is a concept referred to as the 'price elasticity of giving' — the percentage change in the level of donations resulting from a 1 per cent change in the price. Typically, price elasticities are less than zero since the effect of a price increase is to reduce the demand for a good. If the elasticity is less than -1 , a small reduction in price results in a larger proportionate change in donations, and charities' total income will increase as a result of tax reliefs being introduced. Several empirical studies have been carried out in the US to estimate the price elasticity of giving. The results of some of these are summarised in Box 3.1. The most recent (and most convincing) studies estimate price elasticities of giving that are greater than -1 , at least in the short run.

Box 3.1. The responsiveness of giving to tax and price changes

Early US studies of the effects of the tax price of giving (Taussig (1967) and Schwartz (1970), for example) found price elasticities close to zero and certainly significantly greater than -1 . Over the 1970s, the studies that followed used more sophisticated data and appeared to reach a consensus value of somewhere between -1 and -1.5 , which would imply greater responses of individual donations to tax reliefs. But probably the two most convincing studies subsequently produced estimates lower in absolute value again. Clotfelter (1980) used repeated observations of data on the same households over time to separate the short-run effects from the long-run effects of a tax change. He found short-run elasticities of less than half the long-run values (-0.5 compared with -1.1), with a fairly slow adjustment to the new long-run position over a period of five years. Reece and Zieschang (1985), on the other hand, corrected for the fact that individuals' preferences, disposable incomes and marginal tax rates (and hence the tax price) may be determined jointly. Correcting for this possible endogeneity led to an estimate of -0.2 — a much lower response than estimated in previous studies. Quantitatively similar findings (-0.43) were obtained by Kingma (1989) in a cross-section study of grants and individual donations to public radio stations.

There have been fewer studies for other countries. Jones and Posnett (1991) found that UK tax reliefs had only small effects on giving and total charity income, with results showing a price elasticity of close to zero and an income elasticity of around one-half. Studies using Canadian data (for example, Scharf, Cherniavsky and Hogg (1996)) have found responses similar to (if slightly lower than) those found in the US. In one interesting extension (Kitchen, 1992), however, non-religious giving was found to be highly responsive to the tax price whereas religious giving was found not to respond to changes in price.

Clotfelter (1980), for example, finds a value of -0.5 . This would mean that donations would not rise by enough to completely offset the fall in government grants, were the government to make a revenue-neutral switch from grants to tax reliefs. The Clotfelter (1980) finding of a price elasticity of -1.1 after five years suggests that the level of giving may be more responsive to tax reliefs in the longer term.

3.2 Efficiency and tax-neutrality issues

Even assuming that tax relief has no effect on individuals' net donations to charities and that the effects on charities' incomes of introducing a tax relief or paying the same tax revenue in direct grants are the same, there may still be an argument for the use of tax relief on the grounds of economic efficiency. Put simply, proportional taxes on labour distort individuals' choices between consumption and leisure, as does the interaction of these taxes and the benefit system.¹⁴

The size of this distortion will depend upon individual preferences. If preferences were homogeneous and all elasticities were -1 , then there would be no distortion. On the other hand, given that preferences for giving, consumption and leisure are almost certainly heterogeneous, there could be effects for individuals or groups of individuals even if aggregate elasticities were -1 . Those who want to work a lot but give little will be penalised relative to those who wish to work less and give more by a system that imposes labour supply taxes to finance government grants to charities.

The principle of economic efficiency should also be applied in the operation of tax relief on donations. Tax relief should be neutral between different types of charitable giving and apply equally to all charitable causes. Government policy should not distort individual choices over which charities to give to, unless there is an identifiable additional market failure for some charities and not for others that the government is seeking to correct.

3.3 Letting individuals decide

Tax relief, rather than direct grants, allows individuals, not government, to make choices about which charities should receive government revenues. This is an important argument since it seems to lie at the heart of why a government chooses to support the work of charities rather than providing all public and merit goods directly. Speaking earlier this year, the then Home Office Minister, Alun Michael, said that government, whether local or national, could not meet all of a community's needs and should not seek to do so. 'This is not a question of money', he said. 'The issue is one of morality and common sense. Seeking to do everything for communities can only harm the activity and intelligence which characterise healthy communities.'¹⁵ Tax relief allows individuals to express their preferences about the level and type of provision of charitable goods and services and encourages a diversity of charities.

¹⁴This will always be true unless taxes are raised in lump sums (hence not changing the ranking of individual choices) and then redistributed via the benefit system.

¹⁵Quoted in the *Financial Times*.

Of course, tax relief is not the only way of letting individuals decide where the money should go: making direct grants contingent on matching funds from individual donations is another. But tax relief also relieves the government of the administrative burden of allocating grants among different charities, allowing the money to be diffused to a potentially wider group of charities and avoiding any controversy that may surround the grant-giving process. Such controversy is typified by the recent experiences of the National Lottery Boards. Charities may also prefer the certainty of the introduction of a system of tax relief, which may be much harder to reverse than decisions about individual grants.

But it should be made clear that, although a system of tax relief gives individuals a voice in deciding which charities should get government money, it does not give all individuals an equal voice. The first, albeit obvious, point is that no tax relief is given on the donations of non-taxpayers. With tax reliefs, the preferences of non-taxpayers are not given any weight in deciding which charities should gain from the associated government tax expenditure. The second point is that if tax relief is given at the individual's marginal tax rate, the preferences of higher-rate taxpayers are given more weight than those of basic-rate taxpayers. For every 77p of net income donated by a basic-rate taxpayer, the government donates 23p. A higher-rate taxpayer still has to give 77p for the charity to get £1, but this gift only 'costs' the higher-rate taxpayer 60p of consumption forgone, as a result of the extra refund from the Inland Revenue. This effect will be greater according to the extent to which higher-rate taxpayers give more to charity than basic-rate taxpayers or non-taxpayers.

If all individuals had the same preferences for giving, none of this would matter — as long as the government represented the preferences of its voters, allocating revenue through government grants or through tax relief would result in the same distribution of money across the charity sector. But evidence on giving patterns suggests that preferences for giving to different kinds of charities do vary across individuals in a systematic way, particularly with their income. Table 3.1 shows the proportion of givers

Table 3.1. To which types of charity do people give?

Type of charity	Percentage of givers giving to different types of charity, by annual income band					
	All givers	£2,600 or less	£2,600– £4,159	£4,160– £9,099	£9,100– £19,499	£19,500 or more
Economic, social and community development	7.4	5.9	4.0	10.0	6.7	13.8
Culture and arts	2.2	1.5	2.6	1.0	3.4	3.4
Animals	12.9	16.3	11.9	11.0	14.0	6.9
Education	14.3	15.3	11.3	16.5	11.2	20.7
General social services	18.5	17.3	17.2	21.0	17.4	20.7
International aid	14.9	17.8	13.2	14.0	14.6	13.8
Health and medicine	39.9	40.0	38.4	38.0	45.5	32.8
Environment	1.5	1.9	0.6	0.5	2.2	3.4
Recreation and leisure	7.4	7.4	3.3	6.5	10.7	10.3
Religion	19.0	18.8	15.2	24.0	16.3	20.7

Source: Authors' calculations from Individual Giving Survey, 1993.

in different income groups who give to charities of different types, using data from the 1993 Individual Giving Survey (IGS). It shows that richer givers are more likely than poorer givers to give to charities in the following areas: culture and arts, education, recreation and leisure, environment and economic, social and community development. Poorer individuals are more likely than richer ones to give to international aid charities and animal charities. The differences between income groups are small. However, the overall impact on the distribution of government revenue between different charities will be affected by the fact that richer individuals are more likely than poorer ones to give to charity overall and tend to give larger donations.

4. The current system of tax relief on giving

There are currently three different schemes under which taxpayers can get income tax relief for charitable donations — covenanted giving, Gift Aid and payroll giving.¹⁶ In the last year for which information is available (1997–98), tax-free gifts (from individuals and companies) amounted to £1,735 million and the total cost¹⁷ of these reliefs was estimated to be £495 million.¹⁸ This compares with estimates of overall individual giving (i.e. excluding companies) between £5 billion and £6 billion.¹⁹ There are no single figures for the total amount of government grants given to charities. As an indication, however, government grants (excluding fees) to the Charities Aid Foundation's (CAF's) top 500 fund-raising charities in 1996–97 totalled £623 million, while total grants to charities given by the National Lottery Boards had reached £2.4 billion by the end of 1997.²⁰

4.1 Covenants

Under the longest-running scheme for tax relief on contributions, individuals and companies can set up a covenant committing them to donate a fixed amount to a particular charity each year. As long as the covenant runs for a minimum of four years, covenanters can get relief from income or corporation tax on their donations. There is no upper limit on the size of covenanted gifts. The charity claims back basic-rate tax on the gift; higher-rate taxpayers can claim the difference between the basic rate and the higher rate from their Inland Revenue tax office. Covenants are the single biggest form of tax-free giving. In the last year for which information is available (1997–98), a total of £1,125 million was donated by companies and individuals, with an associated tax expenditure of some £310 million.²¹

Charity accounts provide a more flexible way for individuals to give by covenant to a number of different charities by channelling their donations through an organisation such as CAF. Individuals deposit money into an authorised charity account (the biggest scheme being run by CAF) and are issued with a cheque book and a charity card. Donations are made out of the account by telephone, post or in person, or by setting up a standing order. Scheme operators claim back the basic-rate tax after subtracting an administration fee from the gross amount. Higher-rate taxpayers can claim the difference between the basic rate and the higher rate from their Inland Revenue tax office. A total of £47.6 million was donated through CAF in 1996–97.²²

¹⁶Individuals can also get inheritance tax relief on bequests to charities.

¹⁷As with any tax expenditure, the estimate of the 'cost' of the tax relief is a counterfactual estimate which would only be valid if individuals did not change their behaviour on the abolition of the tax relief.

¹⁸Inland Revenue, 1998b.

¹⁹See Pharoah and Smerdon (1998, p. 9).

²⁰Pharoah and Smerdon, 1998.

²¹These figures, and the totals and tax expenditures that follow in this section, are taken from Inland Revenue (1998b).

²²Pharoah and Smerdon, 1998.

4.2 Gift Aid

Established in 1990, the Gift Aid scheme provides a way for individuals and companies to get tax relief on one-off donations of money — so long as the donations exceed a minimum threshold. Originally, the threshold was set at £600 (after deduction of basic-rate tax), but this was reduced to £400 from May 1992 and to £250 from March 1993. An original upper limit of £5 million was abolished in March 1991. Donors cannot meet the threshold through a series of smaller gifts or pass on money raised through fund-raising by others.

An extension — the Millennium Gift Aid scheme — was announced in December 1997 and introduced in July 1998 to run until 31 December 2000. The scheme reduces the lower limit to £100 on donations to charities supporting education, health and anti-poverty projects in 80 nominated ‘poor countries’. The scheme also allows smaller donations to be bundled up and still qualify for tax relief.

The operation of Gift Aid is very similar to that of a covenant. Donations are made net of basic-rate tax; the charity recovers the basic-rate tax, and higher-rate taxpayers may claim additional tax relief on the grossed-up amount from their Inland Revenue tax office. A total of £583 million was donated in 1997–98, of which £260 million was donated by individuals. Tax repayments to charities on these gifts amounted to £177 million.

4.3 Give As You Earn

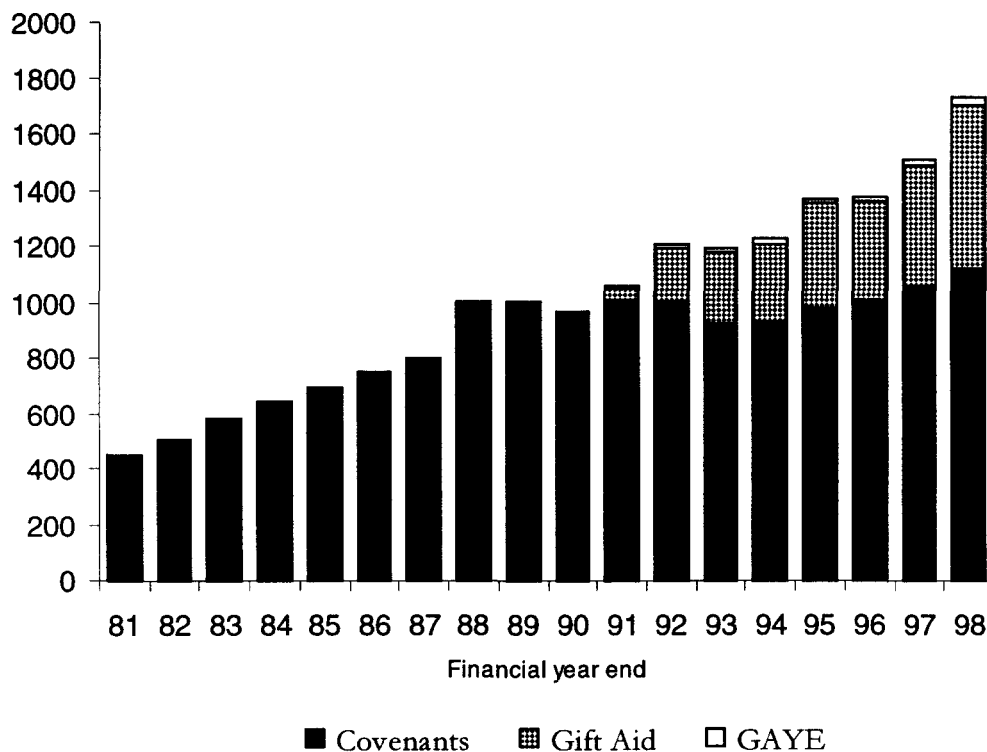
Payroll-giving schemes, or Give As You Earn (GAYE), were established in 1987. Under such schemes, employees can authorise their employer to deduct amounts from their pay and nominate the charities to which their gifts should go. This requires the employer to contract with a collection agency approved by the Inland Revenue. The donation is deducted from pay *before* calculating tax due under Pay As You Earn (PAYE). The key difference between tax deductions and conventional tax credits is the possibility (as with pension deductions, for example) that giving to charity can move taxpayers to a lower marginal tax rate. Since an individual’s taxable income is calculated net of all donations, the deduction itself could move an individual from the higher to the basic rate. This is also true for covenanted payments.

On GAYE’s introduction, gifts made under payroll-giving schemes could not exceed £120 a year. Since then, the upper limit has been raised from time to time and it currently stands at £1,200. By 1996–97, 370,000 employees were participating (reflecting 5,200 contracted employers), although the total amount donated through payroll-giving schemes is considerably less than that given by covenant or Gift Aid — £27 million in 1997–98. The cost of the income tax relief was £6 million.

5. Trends and patterns in tax-free giving

Figure 5.1 plots the total amount donated by covenant, Gift Aid and payroll-giving schemes since 1981 (in real terms). It shows clearly the differences in scale between the schemes. Around two-thirds of all tax-free giving is done through covenant and less than 2 per cent is done through payroll-giving schemes. A further thing that is striking about Figure 5.1 is the relationship between covenanted giving and Gift Aid since the introduction of the latter in 1990–91. Although gifts made through Gift Aid are now large in total, the years since its introduction have not coincided with a significant increase in total tax-free giving relative to the previous trend. This is, perhaps, not very surprising since Gift Aid and covenanted giving are fairly close substitutes.²³ What this means is that, in real terms, growth in total tax-free giving has followed close to a linear trend since the early 1980s, as shown in the figure. This is despite an increase in the number of schemes and a broadening of their scope over the second half of the period.

**Figure 5.1. Tax-free donations to charity by scheme
(£ million, 1998 prices)**



Source: Inland Revenue, 1998b.

²³The minimum that must be donated each year is smaller with a covenant, but Gift Aid has the advantage of allowing individuals to make one-off donations and to avoid the administrative costs of drawing up a covenant (although in practice these may be small). Gift Aid would be attractive to anyone who was already giving more than the lower limit through covenant.

There is only scant information in household surveys on who contributes through these tax-favoured schemes. In the Family Expenditure Survey (FES), it is impossible to separate covenants from other regular gifts by standing order, and similar problems occur separating Gift Aid from other one-off gifts. Banks and Tanner (1997) show that 'regular givers' (many of whom will be using covenants) are, on average, concentrated amongst middle-aged, highly educated households in the upper part of the income distribution. These are also the households for which the tax advantage will typically be greatest. Many of these households also report substantial levels of prompted, typically taxed, giving.

Banks and Tanner (1998) present some descriptive statistics from the FES on those currently contributing through payroll-giving schemes, although Figure 5.1 shows that this group is small. Those in payroll-giving schemes are concentrated amongst the middle-aged, with over 57 per cent between the ages of 30 and 49. By far the large majority of participants are men (74.4 per cent) despite the sample of individuals in PAYE being almost half women. Nearly all are in full-time as opposed to part-time employment. More striking, though, are the patterns by education, earnings and region. Unlike other forms of giving, which increase with education and income, individuals making gifts through payroll-giving schemes tend to come from less-educated, middle-earnings groups. In particular, the bottom three-tenths of the earnings distribution, as well as the top tenth, are under-represented in the payroll-giving sample. This is likely to represent the profile of employees who currently participate in payroll-giving schemes.

6. Implications for reform

The current system of income tax relief for charitable donations in the UK is complicated. There are three ways individuals can give to charity tax-free, all slightly different, but all restricted to particular types of giving. Tax-free giving requires a long-term commitment (covenants), a one-off gift of £250 or more (Gift Aid), one of £100 or more to education or anti-poverty projects in 'poor countries' (Millennium Gift Aid) or working for an employer offering a payroll-giving scheme. Not surprisingly, therefore, most money donated is not tax-free.

The objective of the government's reform of the taxation of charities is a tax system that

- *is more coherent and consistent,*
- *is simpler to administer,*
- *reduces charities' compliance costs,*
- *reduces the scope for the charity tax reliefs to be exploited for tax avoidance purposes,*
- *is more receptive to the needs of today's charities'.*

(HM Treasury, 1997)

These are valid goals for the system as a whole, but it is also fairly clear that the system of tax relief on individual donations, in particular, currently fails to meet these objectives.

The introduction of Millennium Gift Aid takes us even further away from a system that is coherent and consistent by introducing a tax-free giving scheme for specific types of giving only. Furthermore, there is a danger that Millennium Gift Aid will not result in any increase in total giving, but will simply mean individuals switching from giving in other areas. Millennium Gift Aid is the first non-neutral tax relief, in the sense that the 'price' of giving to some charities has been changed relative to others.

A targeted tax relief such as Millennium Gift Aid is likely to be attractive to the government. It will be reasonably cheap because of its limited coverage and it can be neatly packaged and easily sold to the public. It is, however, likely to draw money away from other good causes by making it relatively cheaper to give to the targeted good causes. Before introducing such a policy, therefore, there should be a very precise idea of the underlying economic rationale. One reason might be that education and anti-poverty projects are, in some sense, more meritorious than other good causes. But this is a difficult issue to judge. If it is not the case, the government is introducing a distortion into individuals' choices between different good causes. Furthermore, as we have argued, allowing individuals to express their preferences for the level (and type) of charitable goods and services that should be provided is one reason for granting tax relief rather than giving support through direct grants. By targeting tax relief explicitly, this rationale for tax relief disappears. At the end of the day, giving grants out of tax revenue to these particular good causes might be a more effective way for the government to achieve the same goal.

An alternative reform that has been proposed is a move to ‘US-style tax deductions’. In the US, almost all donations are tax-free to all taxpayers, who can deduct charitable donations from their taxable income. All individuals who claim itemised deductions (and corporations) are allowed a federal income tax deduction up to 50 per cent of their taxable income. Non-itemisers can claim up to a certain threshold or choose to become itemisers.

In effect, the US system is identical to the operation of payroll giving in the UK for those employees working for an employer participating in the scheme. The two differences are, first, the lack of binding upper limits on deductible gifts and, second, that the tax deductibility of donations is not dependent on the money being channelled through an employer. This would allow those such as the self-employed to benefit.

It is important to draw a distinction between the administrative features and the practical consequences of US-style tax deductions. The UK has a very different tax administrative structure from the US. This means that simply implementing the administrative features of the US system would not achieve the same end result. Writing from a US perspective, Gale (1997) commented that ‘the most interesting aspect of the British income tax is that very few citizens actually have to file tax forms’. Applying the US system to the UK would not make almost all donations tax-free to all taxpayers. Only those who filed tax returns — mainly the self-employed and higher-rate taxpayers — would benefit. Currently, this group represents approximately one-third of all taxpayers.²⁴

The practical consequences of US-style tax deductions for the minority of taxpayers who do file tax returns would be to extend tax-free giving to almost all types of giving.²⁵ These individuals can currently give tax-free, but only if they want to give to the same charity for four years or give more than £250 (or have access to payroll-giving schemes). The introduction of US-style tax deductions would benefit those who currently give, or want to give, one-off donations of less than £250.

It is not clear, however, that a radically new form of tax relief is required to achieve the same end result. Changes to the current schemes of tax relief to extend their coverage could have the same practical consequences. One possibility would be to make covenanted giving more flexible. This process has already started with the introduction of charity accounts which, while keeping a longer-term commitment, allow individuals to give by covenant to a wide range of charities and to make one-off gifts. Reducing or even abolishing the time-limits on covenants (presumably substituting a minimum and/or maximum threshold to keep the costs down) would extend covenanted giving further. A second possibility is to further reduce the minimum threshold on Gift Aid. This has been done before, in 1992 and 1993, when the threshold was reduced to £400 and £250 respectively.²⁶ One obvious option would be to extend Millennium Gift Aid to donations to all good causes, i.e. reduce the threshold to £100 for all donations and allow

²⁴Basic-rate taxpayers can always request to file tax returns, although the extent to which the numbers doing this would increase just to claim a tax deduction on small irregular gifts is debatable.

²⁵Presumably there would be a minimum and/or maximum donation to reduce costs and keep the scheme administratively feasible.

²⁶It should be noted that reforming either of these schemes along these lines would make the other effectively obsolete.

Table 6.1. Estimated annual donations to charity

Estimate of total annual giving	Percentage of givers
Less than £50	35.6%
£50–£100	20.8%
£100–£250	21.1%
£250–£400	10.7%
£400–£600	4.4%
More than £600	7.4%

Source: Authors' calculations from Family Expenditure Survey, 1996–97.

individuals to reach the threshold in instalments. Data from the FES (summarised in Table 6.1) show how much, on average, people give to charity in a year.²⁷ Less than one-quarter of donors give £250 a year or more and would hence be eligible to make payments through Gift Aid. Reducing the Gift Aid threshold to £100 would increase the number eligible to around 45 per cent (although more than half of donors give less than £100 a year).

It may be argued that US-style tax deductions have an additional psychological effect, but we are unaware of any evidence for this one way or the other. There may also be an information effect associated with government backing for a new scheme, but this is not unique to the nature of US-style tax deductions: the argument applies equally to increasing the level of information about the current ways of giving to charity. More importantly, the two alternative reforms — to covenants and to Gift Aid — are automatically available to all taxpayers, not just those who currently file tax returns. This is important if the government cares not only about increasing charities' incomes, but also about getting more individuals to give to charity.

²⁷The weekly figures are multiplied by 52. This is likely to overestimate the total amount that people give each year. Unless givers are committed to giving on a regular basis through payroll giving or covenanted giving, it is unlikely that they will give the same amount every week.

7. Conclusions

This Commentary has assessed the economic arguments relating to tax reliefs on individual donations to charity. We have taken as our starting-point that the government wants to support charities. Whether this is true of all ‘charities’ as currently defined is relevant to the debate, but is beyond the scope of this report. The taxation of giving and the role of government in the provision of charitable services are areas where it is important to distinguish economic and non-economic arguments and debate.

Our arguments have focused on whether tax relief (as opposed to direct grants of revenue, for example) is the most effective way for the government to support charities. We would argue that there is a case for introducing — or extending — tax relief when one or more of the following conditions hold:

- i. If tax reliefs have a big positive effect on individual donations. In this case, tax relief may be more effective than government grants at delivering increases in charities’ incomes. There is a danger, however, that givers will actually reduce their donations, knowing that the government is providing a top-up.
- ii. If the government wants to let individuals decide to which charities the pot of revenue should be allocated. Note, however, that this is likely to lead to a different distribution of resources within the charitable sector from the allocation of the same amount of money through government grants.
- iii. If the government wants to commit more resources to the charitable sector in aggregate, holding government grants constant.
- iv. If there are strong non-economic arguments, such as wanting to avoid potentially controversial grant-making decisions, believing that people react positively to tax reliefs for psychological reasons (regardless of the change in the ‘price’ of giving) or trying to create a society in which individuals are engaged with the charitable sector.

The evidence from the US suggests that the responsiveness of individual donations to the financial incentive offered by tax reliefs is small (and probably not enough to offset any revenue-neutral cut in government grants). Also, the current UK government has ruled out an increase in total resources allocated to the charitable sector. This leaves the second and fourth arguments as possible rationales for extending tax relief. The former argument is one about government preferences; the latter is essentially about government beliefs, since we are unaware of any evidence for or against such effects.

The government should be clear which, if any, of these arguments is motivating reform. It is important to have clear goals, particularly since the nature of the goals will affect the relevant policy prescriptions. For example, a desire to ‘let individuals decide’ would suggest widening the scope of existing tax relief to enable more people to give tax-free. Non-economic arguments, on the other hand, may be consistent either with raising more money for the charitable sector or with encouraging more people to give.

This clearly influences the debate over the introduction of ‘US-style tax deductions’. We could not achieve a scheme equivalent to a US-style tax deduction by having a system where individuals deduct gifts to charity from their taxable income on the tax form. After

all, only a minority of individuals currently fill in tax returns. We could, however, achieve a system equivalent to a US-style tax deduction (i.e. a system that encompassed all potential givers) by making Gift Aid or covenants less restrictive. Possibilities would be, for example, widening the types of charities covered by Millennium Gift Aid or reducing the time restrictions on covenants.

Appendix. The Family Expenditure Survey

The Family Expenditure Survey (FES) is an annual survey covering approximately 7,000 households each year. All household members are asked to keep two-week diaries detailing everything on which they spend their money, including giving to charity. Donations to charities²⁸ are aggregated across household members and averaged across the two-week period to provide a figure for household weekly spending on 'charitable gifts'. In addition to the information in the spending diaries, household members are asked in interview whether they make charitable deductions from their pay or payments to charities by bankers' standing order or direct debit. These are included in the total for charitable gifts. However, excluded is any charitable expenditure that yields something to the donor in return, such as spending on goods in charity shops and catalogues, payments for attending charity events or purchase of raffle tickets.

There may be a concern that a broad survey such as the FES may not capture all one-off, small donations. In fact, the FES records a lower level of giving than the other primary source of information on donations in the UK, the Individual Giving Survey (IGS). In part, the difference is likely to reflect a greater degree of probing in the narrower IGS, which will tend to reduce the extent of under-recording due to forgetfulness. But, with greater probing, there is a greater danger of telescoping: that is, individuals ascribing to the reference period events that may have happened in the more distant past. There is also a danger that the response rate is not random with respect to the likelihood of people participating in the activity that is being asked about. A priori, we would expect that those who do not donate would be less likely to respond to a survey that asks solely about charitable activities. It is also worth noting that the key issue in looking at trends across time is whether the survey data are collected in a consistent way across time. If they are, then changes in the survey data can be used to infer changes in behaviour, rather than changes in the degree of under-recording. In this respect, the FES has been collecting data on charitable giving in a consistent way across the period and the expenditure data have been shown to be reliable over time when compared against National Accounts spending totals (Tanner, 1998).

²⁸In the instructions to coders, the following categories are specifically mentioned to be included: 'Gold Heart (charity), Marie Curie memorial foundation, missionary box, mothers' union collection, poppy (charity), Red Cross donation, rugby life line, Salvation Army, school fund, sponsor money and Sunday school collection'.

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