DIRECTORY OF SOCIAL CHANGE

INFORMATION AND TRAINING FOR THE VOLUNTARY SECTOR

If the cap doesn't fit, give it up, George!

Exploring the evidence and theory behind the Chancellor's 2012 Budget 2012 proposal for an income tax relief cap to include charitable donations

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Summary

In the Budget 2012 the Chancellor casually announced, with no forewarning, a cap on income tax reliefs to include charitable giving schemes. A mad scramble for hard data on the potential effects of this ensued with little agreement on figures from either side. This paper summarises the issues involved and proposes some new figures based on our own and others calculations. We estimate that the proposed income tax relief cap could save HM Treasury £100 million in tax on charitable gifts, while charities could lose out by £500-£600 million in donations. And this may be a very conservative estimate, because donors don't just react to the price of giving, they are also influenced by the culture within which they are giving. We argue that the real effect could be multiplied many times due to the negative messages this cap is giving out about giving. It is this psychological effect of the proposed cap which is the hardest to quantify, yet potentially the most damaging, and the hardest to rectify if this situation goes on for much longer.

Background

It's been an incredible couple of months for charity tax experts and amateur enthusiasts. Rather like trainspotting becoming headline news. George Osborne's apparently throwaway line in the budget about capping the amount of income tax relief claimable by higher rate tax payers, including reliefs on charitable giving, has caused a furore. As the equivalent of whopping a tax onto charitable giving for the rich it's almost as bonkers as the pasty tax.

The basics are that there are a number of tax-efficient giving schemes in the UK which work in the following way: gifts of money, shares and property to charity attract a tax relief for higher-rate taxpayers (to offset against their income). The proposed income tax relief cap would mean that individuals would only be able to claim income tax relief against 25% of their income or £50,000 (whichever is greater), effectively lowering the amount which qualifies for tax relief (in both charitable and non-charitable schemes).

Against a backdrop of Big Society and policies and rhetoric designed to encourage charitable giving and a strong and healthy voluntary sector in the UK, this is a very strange move by the Treasury, and one which seems to have come out of the blue, catching almost everyone offguard.

It all started as a simple tax-avoidance measure, to counter "*unlimited income tax reliefs*", and the situation where: "*Currently individuals can offset their entire income against income tax reliefs, and as a result pay no income tax at all.*" No arguments there, however the inclusion of charitable donations and community interest tax relief (CITR) in this measure has turned it into a whole different ball game.

So why include charitable giving in this? Has it just been caught in the crossfire as so much collateral damage in a bigger war HMRC and the Treasury are fighting against tax-avoidance? Yes, quite possibly, but does this excuse it? No. Especially when HMRC and HMT seem unwilling to exclude it, committing only to:

> ***The Government will explore with philanthropists ways to ensure that this measure will not impact significantly on charities that depend on large donations. (Red Book 1.193).***

The outcry from the voluntary sector has been immense. The *Give it Back, George* campaign, headed up by NCVO, CAF and the Philanthropy Review has gathered nearly 3500 supporters[1], and HMRC, the Treasury and the Office for Civil Society have been deluged with lobbyists from charities across the country. The Labour party has even threatened to table a Finance Bill amendment to block the cap until the Government can prove that it will not adversely affect charities. Even Tony Blair's been wheeled out to urge a U-turn while there is plenty of onside opposition too; for example Lord Wei, former architect of Big Society, has said that it is further proof that the Treasury oppose the concept of Big Society as a "*threat to its central control*"; while Stanley Fink, Tory Party Treasurer, said that it would definitely "*put people off*" donating.

PR lessons: how to turn a bad day into an 'omnishambles'

As the *Give it back, George* campaign pressure mounts with the PM being hounded 'from Derby to Indonesia' for comments, a special Newsnight report, and even making the front page of Private Eye, Treasury and HMRC have been backed into a corner from which position they appear to have resorted to name-calling. They seem not to have followed the old adage 'when you're in a hole, first stop digging.' From a starting point of equating charitable giving as tax-dodging you wouldn't have thought it could get much worse, but you'd be wrong as no less than the PM's spokesman then came out with the line that some of the wealthy are giving to "*charities that do very little charitable work*"[2].

In a stroke the messaging had gone from giving = tax evasion to charities = fraud; all in complete contradiction with the Government's own agenda to incentivise and promote charitable giving[3].

Of course it's not that the voluntary sector isn't against tax avoidance by the rich (or anyone for that matter), far from it; more that the message coming out of Government with this policy equates charitable giving with tax avoidance; and as many have been quick to point out: there's a big difference between a gift to charity and an offshore bank account (such as those favoured by many of our high street banks and big name businesses (as I pointed out in a previous blog)).

But the fact is that there is an extremely rigorous system of checks and balances in place in the UK to make sure that registered charities do charitable things for the public benefit. It's called the Charity Commission (or OSCR in Scotland, CCNI in Northern Ireland[4]). Not only

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[1] As at 14th May 2012.

[2] This line was repeated by Dave Hartnett, Permanent Secretary for Tax at HMRC, in his address to the Charity Tax Group when he talked about "*charities with inappropriate beneficiaries*" and that "*some activity was simply fraudulent*" and gave some off-the-cuff no-names examples (Hartnett, 2012).

[3] And as for the recent 'revelation' in the press that many rich people pay little tax (given as one reason for the proposal) much to the apparent consternation and shock of Chancellor George Osborne (despite many of them being close friends and colleagues) well it's beyond parody really.

[4]Something those in power would do well to remember as they continue to carry out swingeing cuts of 30% to the charity policeman's budget.

that, but HMRC also has a track record of hunting and capturing those who attempt to defraud the system using charity tax reliefs using existing anti-avoidance legislation, and last year brought in the controversial 'fit and proper persons' test to add another layer of scrutiny to Gift Aid. HMRC's repeated regulatory land-grabs are legendary in the charity sector; their duplication of existing checks and systems making a nonsense of the Government's 'one out, one in' rule for new regulation.

Where's the evidence?

So where's the evidence to show how many are and how much is involved in tax avoidance through charitable giving; or the impact assessment of the likely effect on charities; or how much tax revenue is expected to be raised by such a measure?

....Silence…

…Nada…

…Nothing…

And therein lies the heart of the problem. There is a dearth of real evidence, one way or the other. As ever, the Government's tactic in fending off criticism has been to demand evidence from charities of the impact – as opposed to basing their policies on sound evidence in the first place. So much for evidence-based policy.

While it might seem churlish to point out that the sector can barely sneeze into a Government-funded hanky without being asked for an impact assessment of the trajectory, penetration and likely reach of the germs, they have been less than forthcoming with any solid basis or reasoning behind this little piece of kitchen sink policy-making.

So it's really hard to assess whether in reality this is all a storm in a teacup, as the Minister for Civil Society, Nick Hurd, has tried to reassure us in Third Sector, saying that: "*For the vast majority of the sector....it doesn't have much impact.*" Or whether we should rather believe surveys by the Charities Aid Foundation which found that 37.5% of (183) high net worth donors giving more than £50,000 per year would reduce their giving because of the cap, and that 55% of the general public thought the Government should rethink the cap, and that 93% of backbenchers agreed that the Government should do all it can to use the tax system to encourage charitable donations from the wealthy, while 65% thought charitable donations should be exempt.

We were told (off the record), after the budget that HMRC didn't anticipate that charitable giving would be much affected as it makes up only a small portion of this whole income tax avoidance issue – about 20% it has been estimated (by Faisal Islam); and much later the Treasury revealed that it expected to raise a mere £100 million in this way. Which makes it even harder to fathom why charitable gifts haven't been excluded from this proposal.

HMRC have denied that the whole thing is in retaliation for the controversial EU Persche ruling which allows UK taxpayers to donate to charities abroad (although senior sector lawyers BWB swear that senior insiders told them that it was). There have been allusions to a confidential report which is HMRC eyes only.

Quite frankly it's all getting a little bit James Bond (or should that be Johnny English?) So the only conclusion we can come to is that HMRC really didn't think about the consequences on charitable giving or truly thought that it would be negligible without actually providing any impact analysis[5]. But like they say, 'no evidence is good evidence'.....Oh no, hang on, they don't say that do they?

What they do say involves things like sledgehammers and nuts and wrong mechanisms. The Chartered Institute of Taxation (CIOT) had this to say to the Select Committee on the Budget:

> ***"118. CIOT was generally critical of the cap:***
>
> ***We can understand the desire to tackle what is seen as excessive reliefs offsetting. We do think the route chosen is the wrong one. If, as we understand it, the mischief being targeted revolves around 'sideways loss relief' (loss relief from business investments), it would be better to adjust the already manifold controls on loss offsets. Although that would add more complexity to an already involved area, it is likely that the new rules will be complex anyway."***

Because from all the hue and cry in the sector, you may have gathered that many people think that the effect on charitable giving will NOT be negligible. The simple argument behind the *Give it Back, George* campaign is that in order to claim tax reliefs, these donors have to give at least four times what they would be saving in tax, so there is no net gain to them. Their giving is still 'altruistic', even if it is incentivised.

In lieu of data from HMRC and HMT the sector has attempted to fill in the void and calculate the potential effect of the proposed cap. However it is notoriously difficult to give evidence in this area. Why? Because there is so little evidence about high net worth donors and big gifts to charity, and I suspect this is part of the problem – it is a bit of a black hole whose murky depths look somewhat...well, murky. This opaqueness could, in certain lights, seem impenetrably suspicious.

We are told stories by both sides about what high net worth donors do (they donate the extra tax relief back to the charities; they give to 'dodgy' charities; they only give as a way to avoid paying income tax and to benefit their own pet projects or personal foundations) but can't verify or quantify any of this easily. So what are the facts?

Watch out, here comes the science bit… Concentrate!

Actually I'm not going to blind you with the maths which, as Cathy Pharoah so neatly put it, has been "doing your head in". It certainly has had many of us in the sector tied in hypothetical, assumption-based, knots. I have done the maths myself about what would potentially happen to individual donations of £X magnitude, many time over, but others have

[5] I'm reminded of that annoying Direct Line advert where the customer keeps asking "what's really going on here?" as he suspects all manner of dodgy sales techniques behind the simplistic assurances the salesman is making.

already blogged about it (e.g. Rhodri Davies (of CAF), More Partnership, Kim Scharf (of CMPO) so I won't rehash yet more calculations here.

The basics are that the proposed income tax relief cap would mean that individuals would only be able to claim income tax relief against 25% of their income or £50,000 (whichever is greater), effectively lowering the amount which qualifies for tax relief (on both charitable (e.g. Gift Aid and gifts of shares & property) and non-charitable (e.g. certain business investments) schemes). But what would be the overall resultant effect on donations if this proposal is made law?

What's it worth?

HMRC's latest estimates of how much Gift Aid charities will claim in 2011/12 made Third Sector headlines (probably for the first and last time ever) this week, when they revised estimates downwards to an expected £1.075 billion.

In 2010/11 (the last year for which complete figures are available (although they are still estimates)) HMRC 'donated' £3.64 billion in total tax reliefs to charities and donors. Of this, £360 million was income tax relief for higher rate taxpayers using Gift Aid and £60 million on gifts of shares and property. That's £420 million worth of tax the HMRC could have received in one year: This is relatively small beer even as a percentage of the total tax reliefs on charitable giving. However, on the back of that income tax relief the voluntary sector benefitted to the tune of around £1.95 billion in gross donations[6]. That equates to 5% of the total donations to the sector in 2009/10 (the latest figure available from NCVO's UK Civil Society Almanac) which is a not negligible amount if you believe it might be under threat.

And it's not just straightforward donations which might be under threat. There is genuine fear that this proposal may affect endowments to set up or maintain and grow grant-making foundations which, in their turn, give our money to other charitable groups – often small community groups who rely on such grants. Again, it's hard to estimate exactly how many foundations this might affect or the knock-on on small grants but the ripple effect could run a long way into an already beleaguered sector. Matthew Bowcock, Chair of Community Foundation Network, estimated in a letter to The Evening Standard that the knock-on effect of the tax relief cap could cost the sector up to £1 billion while netting HMRC only £200 million; although he admitted that his calculation was based on: "very simple, high-level analysis, because we don't have the details we need". This kind of calculation is useful in giving us a context (even if it is just illustrative of the fear generated by the proposal) but without hard evidence is virtually useless. So what are the facts?

How much do wealthy donors give?

Some people seem to think that the rich in the UK are stingy and don't give as much as people earning lower incomes. This is a misapprehension which stems from the well-proven research fact that lower income earners give more as a proportion of their income than people earning higher income, although a greater proportion of higher income households give and in absolute amounts richer givers give absolutely more. NCVO's *UK Civil Society*

[6] £1.8 billion = the estimated gross amount charities would have received under the Gift Aid scheme while £150 million is the estimated total value of shares donated at the time they were given.

Almanac 2012 reports that only a very small proportion of donors (7%) give over £100 per month but that these donations represent 45% of the sector's money[8].

But the tax relief cap won't kick in until you donate over 25% of your income (or make a gift of £200,000 or more) so how many donors will that affect? Again, we can't be totally accurate here, but in 2009/10 it is estimated that there were 80 donations of over £1 million from wealthy individuals into personal charitable trusts or foundations (Breeze, 2011); together these were worth £782 million in 2009/10.

It has been estimated that the 1,000 most wealthy people in the UK have increased their wealth by £155 billion over the last three years – enough to pay off the national debt with enough change to spare to buy a few more nurses for the NHS. Yet, as Cathy Pharoah points out, although there is a proven link between higher incomes and higher giving amongst donors:

> ***"The lack of reliable data on major giving is a huge gap in our understanding of giving. We still know little about whether the wealth generated over the past few decades has led to more giving or generosity."***

Are donations from the wealthy really under threat?

Just as the state of knowledge about giving by higher net worth givers is parlous, so is the state of knowledge about the effect of tax incentives on charitable giving. As with many economic issues, a lot of theory abounds, but relatively little proof; and there are those who argue that tax reliefs don't really make that much difference.

However, what there is suggests that, as DSC outlined in our submission on the Giving Green Paper whether people give is relatively unaffected by economic factors – people are either givers or non-givers in the first place – but how much people give is very much affected by macro-economic factors such as income levels, housing markets, etc. Income levels, in turn, are obviously affected by tax rates and tax reliefs. Economic psychologists will additionally tell you (and I am telling you, because I am one) that people are swayed by all sorts of psychological factors, including their political views and their attitude towards charitable versus state provision (*see Walker, 2002, for more detail on motivations for giving*).

The most cogent arguments I have seen put forward in this arena come from Sarah Smith at the Centre for Market and Public Organisation (CMPO) and Kim Scharf who report evidence taken both from studies of CAF donors and from a study undertaken with HMRC and HM Treasury in 2009. Smith & Scharf's research shows firstly that, if CAF donors are typical of all wealthy donors giving large, regular amounts over £200,000, then a large number of them will be affected by the proposed cap.

[8] It's hard to be very accurate about such estimates since most surveys of giving do not sample enough wealthy or big givers.

The second piece of research found that while higher-rate taxpayers in general were less responsive to hypothetical changes in the rebate relief they received on charitable gifts, the more people gave, the more responsive they were to changes; i.e. rich givers respond differently to other givers. New analysis of the data, however, suggests that the group of donors who would be affected by the cap would decrease their donations by more than the tax revenue gained by the HMRC, making the situation rather untenable, although this is still based on a hypothetical situation, or as Scharf puts it:

> ***"Whatever choices the taxpayer makes, public finances will be affected in unintended ways as the cap will create a chain of interdependent and distortionary changes in donation and borrowing decisions and their timing. But what should we do? The government should scrap the policy, not even discuss it... And everything I've said here is speculative so whether or not we should worry about any of it is an empirical matter, we need evidence. But we don't have it and it is for this reason that everyone – including charities – should care about the cap."***

This does however echo other US studies by Bakija & Heim (2008) who found that donors with incomes over $200,000 do react to a change in tax incentives where lower income donors do not; while Clotfelter, the über Professor of tax reliefs, (2012) found that deductible contributions (those attracting tax relief) rise with incomes over $200k-$500k. Which results led Cathy Pharoah, Co-Director of the Centre for Giving and Philanthropy (CGAP) to conclude in a paper published two years ago:

> ***"This result, combined with the HMRC/Treasury estimates for the reactions of higher-rate taxpayers who donate large sums of money, would suggest that any policy change that removes the tax rebate could lead to a substantial reduction in the amount these donors give to charity."***

McKenzie & Pharoah, 2010.

So while it seems unlikely that richer givers will stop giving altogether, evidence suggests that the cap would have some impact on their level of giving.

There is also evidence from the US where they are a bit more au-fait with the effect of tax on giving. Two main effects are noted: the income or wealth effect, and the price or discount effect of tax reliefs. Paul Schervisch, the director of the Center on Wealth and Philanthropy at Boston College, and author of many reports on the subject believes that lowering overall tax rates on the wealthy increases their tendency to give, because they have more money to spare. Schervisch has found that the higher a UHNW donor's income, the greater proportion they are likely to give to charity. On top of this, wealthy givers are also incentivised by tax reliefs:

As the Boston Globe puts it:

> ***"philanthropic decisions are also driven by tax breaks, especially at the upper registers of the income scale. People with enough money to hire estate planners know about something called the "discount effect'' — the higher***

> ***their tax bracket, the bigger their break for making tax-deductible contributions."***

As Clotfelter (2012) concludes, given these two effects:

> ***"Another clear implication is that eliminating the deduction altogether, as has been suggested [in the US] in numerous proposals in the past couple of decades, would raise the price of giving....implying (in the absence of large changes in total taxes) a long-run level of contributions lower than what would [otherwise] have been the case"***

A JP Morgan survey of 100 ultra high net worth individuals (UHNWI) last year (with a combined wealth of £6 billion) found that nearly 30% said they would be more charitable if they were provided with better tax incentives. Indeed some commentators believe that the main reason giving by UHNWIs in the US is so much higher than in the UK is because of the more flexible tax measures in the US.

There is also some indirect evidence from the US where the introduction of a tax policy which lowered the tax deductions (reliefs) available on the donation of works of art to charity led to a fall in such gifts. In a 2011 statement to a Senate hearing (cited in Clotfelter, 2012), the Association of Art Museum Directors said this:

> ***"The tax treatment of gifts of art has been altered several times since 1969, and donors' behaviour has responded directly, immediately and always negatively."***

Jones & Posnett (1991) found that charity income increases by 50% of any additional tax relief; while research by CAF/NCVO/IR (2000) into Gift Aid found that givers would give up to 25% extra on top of their original gift as a result of tax incentives (quoted in A Lot of Give, 2002).

Oxford Economics have estimated that the cap could lead to a drop in donations from richer givers of around £500 million. The figures, released by Charities Aid Foundation are based on David Gauke's (Exchequer Secretary to the Treasury) estimate that the Treasury expected to save around £100 million in income tax relief as a result of introducing the cap. That's around one quarter of the total currently given by higher rate taxpayers (according to our calculations above). This ties in nicely with some research I was a part of in the year 2000 when Gift Aid went through its last radical overhaul, and which suggested that higher rate taxpayers on average gave around 25% more when there was a tax incentive to do so (CAF/IR/NCVO, 2000).

However the Oxford Economics (OE) calculation can be improved on, as there are several complicating factors here. Firstly, the OE calculation seems to be based on higher rate taxpayers paying 40% tax and does not take account of the fact that a minority will be paying the new 45p tax rate in 2013 when the proposal would take effect. Also, the example above seems to be based purely on Gift Aid when in fact gifts of shares and property make up around 15% of the tax relief bill to HMRC (if we exclude payroll giving where it is impossible to tell what percentage of donors are higher rate). Taking these two factors into account we can surmise that the total loss to the sector might be even greater.[9]

So the Treasury could save £100 million in tax, while charities could lose out by at least £500 million in donations. And this may be a conservative estimate, because donors don't just react to the price of giving, they are also influenced by the culture within which they are giving. The real effect could be multiplied many times due to the negative messages this cap is giving out about giving.

The frame is bigger than the picture

Just as important as the price of giving (fixed by the level of tax reliefs) is the framing of the message here. There is some evidence to suggest that when the Government comes out in high support of the voluntary sector (such as it has with the whole Big Society agenda), this encourages charitable giving by signalling the worth of charities and their work (the 'demonstration effect' Jones et al, 1998; Walker, 2001; Pharoah & Walker 2000, 2002). Conversely, when the Government equates charitable giving with tax avoidance, and questions the worth and validity of some charities, then this rings alarm bells with givers and makes them question whether they should be donating.

Certainly the scale of the backlash from philanthropists and charities against this proposed move belies a fear that the effect and potential damage to the sector will be greater than that predicted by a purely economic model. For example, it has been in the sector press that Anorag Dikshit, the UK's top philanthropist as named by the *Sunday Time Rich List 2012* would be discouraged from investing more in the UK, along with his peers, despite not even benefitting from UK tax breaks. A spokesperson said:

> ***"Our founders chose the UK because of its strong regulatory environment, and, crucially, its culture of supporting philanthropy. This led to the creation of jobs here in the UK, with all of the benefits that brings to our economy."***

This goes part-way towards explaining why so many people have come out in outraged opposition to this proposed measure. As one philanthropist (who would prefer not to be named commented), 'it's amazing how many people have come out of the woodwork to protest about losing tax reliefs who have not come out in such enthusiastic support of actually giving more to charity and society'. But that's basic human psychology – we hate losing things more than we enjoy gaining things - psychologists call it loss aversion.

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[9] (1) The Institute for Fiscal Studies estimates that currently 8.3% of higher rate taxpayers (HRTPs) pay the 50p rate. If we suppose that the same proportion will pay the 45p rate next year, and that the same proportion applies to the amount of tax reliefs paid to HRTPs (in this case £100 million) then the amount lost to the voluntary sector would be around £500 million still (£491,700,000 – slightly lower because of the 8.3% getting reliefs at 25% instead of 20%). We know from other studies mentioned above, however, that more higher income donors will be likely to be giving tax efficiently and will tend to give more. So let's suppose, conservatively, that 15% of the tax reliefs to HRTPs are paid back to donors on the 45p tax rate with the rest at 40p that equates to a loss of £551,700,000 plus 15% of share & property gifts (£9 million) = £560,000,000. If we assume that 25% of the reliefs are made up of 45p HRTPs then this figure jumps to £606,700,000.

Another philanthropist (who also would rather not be named), commented that if it is now perceived that philanthropy is not one of the pinnacles of society then they would rather choose not to be a philanthropist and felt that this could apply to a whole new generation of would-be philanthropists as well.

It is this psychological effect of the proposed cap which is the hardest to quantify, yet potentially the most damaging, and the hardest to rectify if this situation goes on for much longer.

The knock-on effect on society

Not only do we have to take account of the knock-on effect of reduced giving, as a result of the tax relief cap, on small charities receiving grants from foundations, but also we need to take account of the added value charity work provides to society. Malcolm Hayday, Charity Bank chief executive, wrote to the *FT* and the *Daily Telegraph* to argue that:

> ***"A study on what is achieved by charities and community enterprises we support, using the government's own formula, showed an average £7 return to society for every £1 foregone by the Exchequer. If this is more than the government can achieve from spending the tax, we should encourage more use of tax reliefs for charity, rather than limiting it."***

Wider issues about tax and giving

Clearly the artificial choice being set up here between more tax revenue or more charitable donations has opened up a hornets' nest of fundamental issues to do with state versus charitable provision, the issue of what truly constitutes public benefit and confers charitable status, and fairness and equality in society. These are not issues which can or should be answered in this arena. Yet they are important, and much has been said about them in the wake of this issue therefore these are addressed briefly in Appendix 1.

Towards a mutually beneficial solution

The problem facing all sides here (and I'm not exactly sure how many sides there are nor who is on which one) is how to find a dignified exit strategy for all to maintain face. Can we hope for another policy U-turn from this navigationally-challenged Government? Unlikely. 'The lady's not for turning', parrots the PM & HMRC sources on Channel 4 news, Wednesday 11th April, as pressure mounts, although a 'compromise' might be in the wind. 'Talks' are ongoing, etc.

Meanwhile the Giving Summit – Government's idea to convene leading voices on giving and make progress in specific policy areas – was hijacked by the furore over caps on tax reliefs. Progress is anaemic and the future of engagement between Government and the voluntary sector on giving is uncertain. How will the giving agenda and Big Society progress in the wake of this storm? HM Treasury has told the sector that a consultation will take place in the summer, and that no policy change decisions will take place before then. However untold damage may already have been done by then as philanthropists make preparations to alter their donations in anticipation of the tax changes, or are put off giving until after this is settled. And let's not forget that, as the Red Cross pointed out, giving could be affected even if charitable tax reliefs are specifically excluded from the proposal – because higher-rate taxpayers will still be faced with a tax cap on other expenditures and may use up their 'quota' of relief on these before the year end (meaning their giving would not attract any tax relief) unless very careful pre-planning by charity-savvy accountants is employed.

Add to the mix the fact that the Tories are already facing massive opposition accusing them of letting the rich grow richer and the poor poorer, any move which could be interpreted as not being tough on rich people's tax avoidance will leave them with more egg on their faces (see the furore over cutting the 50p tax to 45p in the Budget). So the Government, Treasury and HMRC really are stuck between a rock and a hard place.

If only we could reason with them on the basis of the evidence one thinks there might be a chance of reaching that elusive mutually beneficial solution. Karl Wilding of the National Council for Voluntary Organisations has lamented the situation thusly:

> ***"Successive governments in general and HMRC in particular would help public policy move forward as a whole if they produced more data on tax reliefs on gift aid and published the evidence we know they have collected or commissioned."***

So, George, perhaps before you make a decision you could just show us the envelope on the back of which one of the HMRC boys scribbled the numbers on which this mad-as-a-pasty-tax was based? After all, we're only asking that you do as the Select Committee on the Budget have asked:

> ***"120. We recommend that the Treasury soon ask HMRC to make an assessment and publish the impact of the cap on income tax reliefs, both on business investment and charities. A more detailed explanation of the problem the cap seeks to address is needed, along with consideration of other possible means of dealing with it as the Red Book proposes."***

Evidence-based policy-making is at the heart of a modern, forward-thinking, responsible government. Once the facts are on the table, a more enlightened discussion can surely take place of the specific pros and cons of this proposal. It is our hope that this paper can contribute something towards that debate.

Appendix 1

Fairness and taxation

Cameron says: "*a cap on tax relief is a fair thing*", echoed by Chloe Smith, Economic Secretary to the Treasury, who said at the Charity Tax Group conference in April: "*It is about a broader question of fairness*." Elaborating, Smith went on: "*This government's number one priority is tackling the deficit, and we cannot ask those on the lowest incomes to carry the biggest burden in that task. In the same way that it's fair to cap benefits, ensuring that we focus support where it is most needed, it is fair that we cap reliefs."* (Smith, 2012).

Even Nick Hurd, who has pledged to represent the views of the sector in this matter, said that: "*I think in their heart of hearts, most people will accept that the principle George Osborne is asserting is hard to argue against.*"

So what's fairness got to do with it? Well, we live in an unequal society which, many commentators believe, is getting more unequal rather than less. One way of countering inequality is the redistribution of income via proportionate taxes so that the rich pay more. This is the general basis of our tax system, however huge economic debates abound about the optimal level of higher rate taxes, especially since the main outcome of the introduction of the 50p tax rate seems to have been greater tax avoidance rather than greater tax revenue.

The argument extends to tax reliefs because these are, in effect, our taxes being used for another purpose outside of central government control and dictated by the individual or charity benefitting from the relief.

Hypothesising about hypothecation – who should decide where taxes are spent?

There is a moral and democratic argument for tax reliefs as a method of Government support for charities over grants and contracts: with tax reliefs the individual gets to choose where the matched funding goes. This was the argument put forward by New Labour for introducing more wide-ranging tax reliefs, and has been picked up by the Coalition under the banner of Big Society – tax reliefs allow the individual to feel more a part of society by being able to direct the matched funding where they choose. As Clotfelter puts it, it: "*allows the citizen to gain a sense of participation that they might not otherwise have*" (Clotfelter, 2012)[10].

This choice of where the tax relief goes is known as hypothecation.

However, the fact is that the biggest tax reliefs are realised by the biggest givers, the wealthy donors; and it is well established that wealthy donors tend to have different preferences to

[10] Yale Professor Stephen Carter: "The charitable deduction also helps resolve an informational problem: Government officials, no matter how well-intentioned, cannot know all the places where donations are needed, or the form that will be most useful. The deduction is democracy in action. By encouraging individuals to make their own choices in how to spend the money for the public good, the deduction make society as a whole better off." (Quoted in Clotfelter, 2012).

other, less well-off, donors. For example, wealthy donors tend to give to the arts and culture, education, recreation and leisure, the environment, and economic, social and community development; where less well-off donors tend to give most to international aid and animal charities (Banks & Tanner, 1998). Recent evidence shows this pattern has not changed much, except that international development is now also well supported by wealthy donors (NCVO Almanac 2012).

As the battle rumbles on and on it has opened up some very heated debate about 'public benefit' and the value of the voluntary sector versus the value we get out of our taxes paid to government; and the principles behind tax incentives. The issue has become a political one which pitches economic theory against notions of the state. These are complex and nuanced arguments, as respondents to last month's DSC e-news survey voiced very cogently, while, when forced to choose, they voted by a two-thirds majority that it is more important for society that wealthy people pay a fair share of tax rather than giving to charity. Here's what some of our respondents had to say on the subject:

> ***"Difficult one this. If people pay their taxes, distribution to charity could be decided centrally by the government based on their political ideas and priorities and there is a probability that it will be used for roads, MOD or whatever else. Alternatively, if people make direct contributions to charities perhaps it contributes more actual cash but is directed on a personal basis and targeted at more popular causes. I am really undecided on this but have chosen the option of people making their own choices, mainly because my expectation is that personal support will come with more than just money, in terms of ongoing support, promotion and so on. Whereas government finance tends to come with inane forms, reports and is relative rigid."***

> ***"Wealth is a privilege, & those who know that can be passionate about helping those in greatest need, and whose needs are rarely and poorly (if at all) catered for by governments. Passionate people often "go the extra mile" while Governments never do! Let the passionate, philanthropic wealthy choose how to "give of their best" by redirecting their money to wonderful charities instead of HMRC. The self-centred wealthy will find themselves paying taxes to the government by default! Many people feel robbed by taxes, especially those levied by bad governments, whereas charitable donors are overjoyed to learn of and see the good that their money has brought to those less fortunate than themselves."***

> ***"Wealthy people do not contribute to the smaller charities that really need the money so I would rather their money went to support the Country in taxes."***

"The use of income generated by taxes should be subject to democratic decision-making and accountability and the only way of ensuring this is for everyone to pay their fair share of tax. Allowing the wealthy to divert income that should be paid as tax to "charitable" causes does not encourage philanthropy it provides another lever for the wealthy to control the shape and delivery of public services."

"I don't think social welfare should be dependent on the whims of individuals and who they decide to give their money too. And I don't believe that we are currently able to provide the level of social welfare I think appropriate without wealthy people paying in more."

"Not all charities are of similar worth."

This last issue was a point picked up by Martin Narey (ex-chief executive of Barnardo's) in his opinion piece in The Times and Caroline Fiennes in her blog. Narey & Fiennes put forward a number of controversial opinions ("*There are charities that do so little in terms of charitable activity that, in effect, they are bogus*" being one), including that the tax relief cap should only be excluded for certain charities "*promoting the alleviation of human poverty or disadvantage*", like *Oxfam* and *Barnardo's*, but should apply to others such as the *Donkey Sanctuary*, *Eton College* and *The Royal Opera House*. Are we really reduced to weighing up the value of the arts in society versus the value of community development in Africa? That's like saying we endorse freedom of speech only for those groups of whom we approve[11].

Besides this, it has been suggested that withdrawing charitable tax reliefs for some causes or types of charity and not others weakens the whole sector:

"The social safety net has many strands; weakening any single strand only diminishes the safety net's overall integrity. Supporting the needy and supporting the arts are not mutually exclusive enterprises."[12]

And the problem with tarring the whole sector with the sins of the very very few transgressors is self-evident.

Karl Wilding has put it like this:

[11] There is precedent for this however. In the US, contributions to private foundations and certain other types of charitable organisation are limited to 30% of income, and gifts to some other types of organisations limited to 20% (Clotfelter, 2012). Saying that of course the two tax systems are very different and the scale of charitable giving vastly more elevated in the States.

[12] The Association of Museum Directors statement to a Senate hearing in 2011, cited in Clotfelter, 2012.

> ***"the one-sided approach to fairness and contributing to the common good that is being put forward by proponents of the cap strikes me as economically (and ideologically) illiterate."***

Perhaps the most interesting opinion to cross my desk on this subject as I researched this article came from Stephen King, the horror author, who was quoted in The Economist earlier this month as saying he didn't think he paid enough tax!

> ***"It's true that some rich folks put at least some of their tax savings into charitable contributions... All fine as far as it goes, but it doesn't go far enough. And what they do give away is—like the monies my wife and I donate—totally at their own discretion. That's the rich-guy philosophy in a nutshell: don't tell us how to use our money; we'll tell you."***

This is an argument that goes back a long way, since there have been tax relief for charities ever since the introduction of income tax in 1799. In 1863 William Ewart Gladstone proposed removing tax reliefs for charities, arguing that reliefs were unfair because they were paid for by other taxpayers. However his proposals caused a public outcry and the proposal was dropped (Hartnett, 2012).

This is taking us into the wider territory of what the higher rate of tax should be, and I don't want us to stray too far into that area, but it seems to me that the two are linked. And the fact that in the same budget the HMRC admitted that it had got it wrong over the 50% tax rate – that it hadn't yielded as much as they'd hoped (£1 billion instead of £2.5 billion), and that consequently they were downgrading it to a 45% rate must surely have also made people doubt their competence or attention to detail when it came to charitable tax reliefs and the proposed cap. In fact HMRC admitted that the 50% tax rate had merely pushed higher-rate taxpayers into greater tax avoidance - something they were now more than ever keen to crack down on, and further underlining the fact that people's behaviour does not always follow economic theory[13].

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[13] For those who find it fun to look into such things the Select Committee notes to the budget 2012 on this discussion between HMRC, Treasury, IFS and other independent experts makes amusing reading:

"Mr Chote said that it was a "heroic exercise to try to disentangle" the forestalling effects and other behavioural responses to tax rate changes.[168] The OBR also listed the costing of this policy as one of six it highlighted as "areas of particular uncertainty".[169] The OBR states that:

> The estimate of the impact of this policy is based on the evaluation by HMRC of the revenue raised by the 50 per cent additional rate. As the HMRC report emphasises, the results of this evaluation are highly uncertain.

96. The IFS also highlighted some uncertainty surrounding the costing of this policy.[170] Mr Johnson told us that:

> The real issue is: does it look from what it has done that [the Treasury's] central estimate is broadly sensible? Probably, yes, but [...] it is incredibly uncertain, to the extent that we think that its estimate suggests there is only a two-thirds probability that a revenue-maximising rate lies between 30 per cent and 75 per cent. Those numbers are absurd in some sense, but that gives you a sense of the level of numbers of assumption and uncertainty that underlie what [the Treasury] has done.[171]
>
> A particular area of uncertainty highlighted was:

That there may be some significant asymmetry, in the sense that if you have, because of the 50p tax rate, invested in avoidance schemes, it is not clear you will just unwind them as soon as it goes.[172]

Appendix 2

What if the wealthy donated their tax relief to the charity?

Mark Astarita, Chair of The Institute of Fundraising and Director of Fundraising at The British Red Cross, instigated a call for a change to the Gift Aid system such that there was an option or a mandate for the higher rate tax to be donated to the charity as a compromise. In this way he hoped that the row could be ended and charities would end up better off.

However this move has been opposed by others, notably the *Give it Back, George* campaign who have argued a “no compromise” position. Besides this, there are some major issues with such a system: it doesn’t get around the issue of hypothecation since the tax is still following the direction of the donor, and it would take away the tax incentive for those higher income donors to whom it is an important and integral part of their tax planning[14].

While the estimates of what extra income such a system could raise for charities looked very inticing, a closer inspection proves that they are misleadingly high and based on calculations which would have HMRC paying out more than the basic and higher rates of tax put together. It also presupposes that donors would not notice that were no longer getting tax relief on their giving, and that they would knowingly or unknowingly be willing to give more. The proposal would put up the net cost of giving to anyone paying more than the basic rate of tax.

Other issues with the proposal are that it would be technically difficult to manage given the current three tax bands which change from Budget to Budget, meaning that forms and Gift Aid machinery would have to constantly change to keep up, and/or HMRC would be left with a mammouth pile of back-payments to calculate and pay out at the end of the year based on higher rate taxpayers’ marginal rates of tax.

Besides all this, something like this has already been tried, and failed. Self-Assessment (SA) Donate was introduced in 2004 – a system whereby higher-rate taxpayers could opt to donate any tax they were due to receive back from HMRC to a charity of their choice. The system was withdrawn last year after being judged to have been not well used, not cost-effective and open to fraud.

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97. The cost and benefits of reducing the additional tax rate to 45p are both highly uncertain, and could be significantly more or less than the cost included in the Budget. We recommend that HMRC publish in due course a comprehensive assessment of the effect on the Exchequer of the new 45p rate.”

[14] Remember Sarah Smith’s assertion that rich people are different when it comes to charitable giving, so while you or I might prefer the extra tax to go to the charity, a wealthy donor may have other thoughts, and to think otherwise is to fundamentally misunderstand the tax incentive on giving.

Appendix 3

Where and how did the income tax relief cap proposal originate?

We may never know the real reasons why this move was made – deliberate, accidental, thought-through, not thought through, and in the end it won't matter. But for the record it seems likely that this is a combined result of:

- the 50p tax rate itself which caused an unprecedented rise in more creative tax-avoidance schemes with a resultant crackdown by HMRC;
- the poor policy-making process in place in the Treasury with the Chancellor suffering from a lack of external scrutiny for his proposals;
- a desire to emulate US tax policy in this regard[15]; and
- a political ideal from Nick Clegg and the Liberal Democrats for a 'tycoon tax':

> ***"fair taxes… Paid for in full by closing loopholes that unfairly benefit the wealthy and polluters"***
>
> ***"Conservative and Labour governments have changed Britain into one of the most unequal societies in the developed world, where ordinary people struggle to make ends meet while the richest benefit from tax breaks. The poorest fifth of the population pay a higher proportion of their income in tax than the richest fifth."***

Indeed, further on in the LibDem manifesto there is specific mention of:

> ***"Reforming Gift Aid to operate at a single rate of 23 per cent – giving more money to charity while closing down a loophole for higher rate tax payers."***

So perhaps if we are looking for the ultimate origins of this move it can be traced both to here and to the studies HMRC was commissioning as long ago as 2009 (Scharf &Smith, 2009) in which, let's not forget, they were told that it would have a more detrimental effect on charitable giving than it would raise extra tax revenue.

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[15] Currently in the US, higher rate taxpayers are limited to claiming up to 50% of their income in tax reliefs in any one year, with any excess being allowed to be carried over for up to five years – this is way more generous than the system being proposed in the UK.

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