

<b>Institution: University of Warwick</b>
<b>Unit of Assessment: 18 – Economics and Econometrics</b>
<b>Title of case study: Tax Policies towards Charities and the Financial Sector</b>
<p><b>1. Summary of the impact</b> (indicative maximum 100 words)</p> <p>Professors Kimberley Scharf and Benjamin Lockwood have influenced public and policy debate leading to tax policy changes in the UK and EU. Scharf estimated the impact of proposed reforms to the UK Gift Aid program, research that improved public understanding, led to the creation of an open discussion forum for affected parties, and shaped NGO/charity campaigns. Lockwood estimated the tax effects of removing VAT exemption from firms offering financial services in the EU. The methods developed were adopted by EU analysts and underpinned EU estimates of the tax advantages enjoyed by the sector, leading to the 2011-12 imposition of a Financial Transactions Tax within 11 EU member states from 2014.</p>
<p><b>2. Underpinning research</b> (indicative maximum 500 words)</p> <p>Charitable organisations have long enjoyed tax exemptions, since charitable activities substitute for government services, generating a public benefit and relieving the public purse. Professor Scharf's early research provided a critical assessment of the tax treatment of charitable donations in Canada (CPRN, 1997), showing how tax incentives for giving can be used by a low-income majority to shift the burden of public good provision towards higher-income minorities (2000, JPubEcon), and how their presence can promote economic segregation along income lines (2007, JPubEcon).</p> <p>UK income tax relief for donations was introduced in 2000 with the Gift Aid scheme. It has since become the largest source of tax relief for charitable activities. Gift Aid grants tax relief both in the form of a 'match' that is paid directly to charities and, for high-rate taxpayers, and as a tax rebate for a portion of the tax due on the value of the donation.</p> <p>Initially it was assumed that the match and the rebate would provide equivalent incentives for giving decisions, but in 2007 HMRC commissioned Professor Scharf and Professor Sarah Smith (Bristol University) to measure how giving might vary with changes in Gift Aid rules and report on alternatives for Gift Aid reform. This research found that the "price elasticity of giving" for the UK was in line with corresponding US estimates where the rebate component of Gift Aid was concerned, but was significantly higher for the match component. This implied that a shift in the delivery of tax relief from one method to the other may have sizeable effects on the volume of private donations. It also implied that reallocating one pound from funding public provision to funding tax relief could raise the combined volume of public and private provision if that relief was delivered in the form of a match rather than a rebate.</p> <p>The financial services sector has also enjoyed special tax treatment, via an exemption from Value Added Tax (VAT). The exemption was granted largely for practical reasons: since roughly two-thirds of all financial services earn profit based on a margin (e.g. a bid-ask spread) rather than a posted price, it is more difficult to implement the invoice-credit system of VAT collection. The industry benefits from not having to charge VAT to its ultimate customers, but suffers from not being able to claim tax relief for the VAT it pays on inputs, so-called 'Stuck VAT'. Following the 2008 financial crisis, policy-makers began to question the merits of VAT exemption of financial services.</p> <p>In an influential 2010 paper in <i>Fiscal Studies</i>, de la Feria and Lockwood (2010) use OECD input-output data to estimate Stuck VAT for the financial services sector in six EU countries, finding it accounted for between 0.4 and 1.5% of sector tax revenue. In 2011, PricewaterhouseCoopers asked Lockwood to extend his analysis of a financial service sector VAT to 26 EU countries, to a time frame of 2000 to 2007, and to estimate the tax revenue gains and thus the net effects of a</p>

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financial sector VAT (Lockwood (2011)). Given assumptions about cost pass-through and the tax-cascading that would cause any equilibrium effects, Lockwood predicted that a financial services VAT would *lower* ultimate tax revenues as the losses in Stuck VAT exceeded the gains from taxing retail financial services.

**3. References to the research** (indicative maximum of six references)The research:

1. Scharf, K., "Tax incentives for charities in Canada," 1997, Canadian Policy Research Networks Working Paper No. 03 (1997), URL: <http://www.cprn.org/doc.cfm?doc=1059&l=en>.
2. Scharf, K. and S. Smith, 2009, Gift Aid donor research: Exploring options for reforming higher-rate relief, Research Report 91, HM Revenue and Customs, December 2009, URL: <http://www.hmrc.gov.uk/research/report91.pdf>.
3. Scharf, K., 2000, "Why are tax expenditures for giving embodied in fiscal constitutions?" *Journal of Public Economics*, v75, pp 365-387, DOI: [http://dx.doi.org/10.1016/S0047-2727\(99\)00071-7](http://dx.doi.org/10.1016/S0047-2727(99)00071-7).
4. Horstmann, I., A. Silvinski, and K. Scharf, 2007, "Can private giving promote economic segregation?", *Journal of Public Economics*, v91, pp 1095-1118, DOI: <http://dx.doi.org/10.1016/j.jpubeco.2006.10.006>.
5. De La Feria, R. and B. Lockwood, 2010, "Opting for Opting-In? An Evaluation of the European Commission's Proposals for Reforming VAT on Financial Services," *Fiscal Studies*, v31n2, pp 171-202, DOI: <http://dx.doi.org/10.1111/j.1475-5890.2010.00111.x>.
6. Lockwood, B., 2011, "Estimates from National Accounts Data of the Revenue Effect of Imposing VAT on Currently Exempt Sales of Financial Services Companies in the EU," Appendix 2 in PricewaterhouseCoopers, 2011, "How the EU VAT exemptions impact the Banking Sector," URL: <http://www.pwc.com/qx/en/financial-services/the-real-impact-of-the-vat-exemption-on-eu-banks.jhtml>.

Evidence of research quality:

For Professor Scharf, there are two academic papers published in a top field journal, a working paper, and a research report sponsored by Her Majesty's Revenue and Customs office. The *Journal of Public Economics* is ranked 28<sup>th</sup> in the Association of Business Schools (ABS) rankings, 19<sup>th</sup> in the Kalatizidakis et. al. (2003, *JEEA*) rankings, and 29<sup>th</sup> in the REPEC rankings. For Professor Lockwood, there is one academic paper and one sponsored research report. *Fiscal Studies* ranks among the 2\* journals at 99<sup>th</sup> in the ABS rankings and 173<sup>rd</sup> in the REPEC rankings. Lockwood (2011) was research sponsored by a leading business consultancy and was the primary piece of evidence used in their analysis of the effects of introducing VAT in the banking sector (PwC (2011)).

**4. Details of the impact** (indicative maximum 750 words)

Professor Scharf's research shaped public and policymakers' views about Gift Aid reform and the favourable tax treatment of charitable contributions.<sup>1</sup>

Jeremy Sherwood, Branch Head, Charity Tax at HM Treasury, stated "[the Scharf and Smith] research provides very valuable evidence on a topic where robust UK data is surprisingly scarce... The research has been enormously helpful in providing analytical information to help explore the various proposals and their likely impacts on donor behaviour" (2009). In response to the Report,

<sup>1</sup> Note that, but for some blog posts by Scharf alone, the impact of the Scharf and Smith research for HMRC described here is equally shared between the two authors. For convenience, we will report this as "Scharf's research," with the equal contribution of Smith implied but not stated.

HMRC and HM Treasury officials invited sector representatives to participate in an open forum (HM Treasury (2010)), and the final report of this forum drew on the 2009 report to outline proposals for Gift Aid reform (Fanning (2010)). More recently, Scharf's research underpins the entire section of "Coalition Government proposals to encourage philanthropy" in their plans regarding Gift Aid reform (House of Commons (2012a)).

Scharf's research also triggered a spirited public discussion about the role of charitable donations in public life and their tax treatment. This came to a head in late Spring 2012 when the Government proposed to cap tax relief for deductions, *including* charitable deductions.

The uproar from charities and their donors was immediate. 19 charities cited Scharf and Smith (2009) in making public statements or policy proposals since 2008 about Gift Aid or the cap on charitable deductions. Scharf provided non-academic presentations and blog posts, several of which were prominently reported in the media. The Guardian editorial of 17 April 2012 concluded Scharf and Smith (2009) offered the "best evidence" on tax incentives (Guardian (2012)) and both authors discussed their research on the Today programme (BBC Radio 4). In response to the uproar, the Government did a quick U-turn: while the cap on deductions was indeed introduced in April 2013, charitable deductions are excluded from this limit (House of Commons (2012b)).

Karl Wilding, Head of Policy, Research, and Foresight at the National Council for Voluntary Organisations, reflected, "The recent disagreement between HMT and the charity sector in relation to unrestricted tax reliefs and Gift Aid highlighted the ongoing difficulties faced by the sector in the battle for evidence-informed policy... The sector needs... more work such as the economic analysis by Smith and Scharf on the price of giving... Smith and Scharf had an impact on the debate by providing a balanced, independent commentary. I am confident that Smith and Scharf made a contribution to the debate and, as such, ... had a real impact in the charity sector" (Wilding (2012)).

Lockwood's methods for estimating the impact of a financial services VAT also had an immediate effect on government policy, this time in the EU. Lockwood's methods for analysing the costs and benefits of a VAT were adapted by the European Commission (EC) to calculate whether the financial sector receives favourable tax treatment. Finding that it did, the EC subsequently used this result to justify a novel Financial Transactions Tax (FTT). Mr. Gaetan Nicodeme, Head of Sector in the Directorate-General for Taxation and Customs Union in the EC, noted "The approach taken in [Annex 5 to the 2011 FTT proposal] to calculate the share of irrecoverable VAT is similar to the one taken by De la Feria and Lockwood (2010) in Appendix A of their study. The only difference is that they used OECD IO tables instead of Eurostat's tables" (Nicodeme (2013)). It concluded that the financial sector has a tax advantage of at least €14 billion, or 0.11% of Euro area GDP.

Lockwood's *Fiscal Studies* article also formed the basis of a consultation with PricewaterhouseCoopers (PwC) on the appropriate taxation of the financial sector. Frans Oomen, partner for Indirect Taxes at PwC, concluded, "During the project, Lockwood added significant knowledge, insight, conceptual thinking, and quality in ... developing a conceptual framework as well as using statistical information to build an economic model and a methodology [to assess] whether the VAT exemptions for banking services in the EU lead to a lower level of VAT revenues as compared to a full VAT taxation system of banks. In [PwC's] view, the findings of the report have contributed to a wider and better understanding of the financial and economic implications of the EU VAT system and to the discussions around the EU's tax policy introducing a Financial Transactions Tax as an additional tax for the financial sector" (Oomen (2013)). Another project sponsored by a separate division within the EC also relied on de la Feria and Lockwood's methodology to quantify the effects of the taxation of financial services (IFS (2011)).

Scharf's and Lockwood's research have had significant and meaningful effect in debates about the tax treatment of charities and financial services. Scharf's research played a significant role in the debate that ultimately prevented charitable donations from being included in a deductions cap. It also has influenced public and policymaker understanding about the likely impact of changes in

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Gift Aid rules in an environment where more than 50% of UK residents make charitable contributions worth over £4 billion on an annual basis.

While the primary beneficiaries of Lockwood's research have been EC policymakers, the public at large will benefit from the increased tax revenues the FTT will bring. From 2014, the FTT will tax exchanges of shares and bonds at a rate of 0.1% and derivative contracts at a rate of 0.01% and is estimated to raise €57 billion annually, approximately 0.4% of EU GDP (EC (2012)).

**5. Sources to corroborate the impact** (indicative maximum of 10 references)

European Commission, 2011, "Is The Financial Sector Under-Taxed? Empirical Part," p2, Annex 5 in European Commission, 2011, "Proposal for a Council Directive on a common system of financial transaction tax." Available at ("impact assessment" link):

[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/other\\_taxes/financial\\_sector/summ\\_impact\\_assesmt\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/summ_impact_assesmt_en.pdf)

European Commission, 2012, "Revenue Estimates," Available at ("revenue estimates" link):

[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/other\\_taxes/financial\\_sector/act\\_sheet/technical\\_fiches.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/act_sheet/technical_fiches.pdf)

European Commission, 2013, "Implementing enhanced cooperation in the area of Financial Transaction Tax," 14 February 2013, p4. Available at ("presentation" link):

[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/other\\_taxes/financial\\_sector/ftt\\_under\\_ec\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/ftt_under_ec_en.pdf)

Fanning, P., 2010, Gift Aid Forum: Report to Economic Secretary to the Treasury, p21. URL:

<http://tinyurl.com/o96b9ct>

Guardian, The, 2012, David Cameron: charity case (Editorial), 17 April 2012. URL:

<http://www.guardian.co.uk/commentisfree/2012/apr/17/david-ameron-charity-case>.

HM Treasury, 2010, "Government response to the Gift Aid Forum," URL:

<https://www.gov.uk/government/news/government-response-to-the-gift-aid-forum>

House of Commons Library, 2012, "Gift Aid scheme for small donations," at 6. URL:

<http://www.parliament.uk/briefing-papers/SN06330>.

Institute for Fiscal Studies (2011), "A retrospective evaluation of elements of the EU VAT system," URL:

[http://ec.europa.eu/taxation\\_customs/resources/documents/common/publications/studies/report\\_evaluation\\_vat.pdf](http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/report_evaluation_vat.pdf).

Head of Sector, Directorate General for Taxation and Customs Union, European Commission 2013, email to Professor Gregory Crawford, Director of Research Impact, Department of Economics, University of Warwick, received 3 June 2013.

Partner for Indirect Taxes, PriceWaterhouse Coopers 2013, email to Professor Gregory Crawford, Director of Research Impact, Department of Economics, University of Warwick, received 16 July, 2013.

Sherwood, J., 2009, Gift Aid Donor Research, HM Treasury Presentation, URL:

<http://www.bristol.ac.uk/cmpo/events/2009/giftaid/hmtreasuryspeech.pdf>.

Head of Policy, Research, and Foresight at the National Council for Voluntary Organisations, email to Sarah Smith and Kimberly Scharf, received 26 June 2012.