

Defining, Taxing and Regulating the NFP Sector: Where to from here?

Dr Joyce Chia

Research Fellow, Not-for-Profit Project

Australian Charity Law Association conference

Melbourne, 23 September 2011

THE NOT-FOR-PROFIT PROJECT AND THE REFORM PROCESS

The Not-for-Profit Project is the first comprehensive and comparative investigation of the definition, regulation, and taxation of the not-for-profit sector in Australia. The Project is funded for three years by the Australian Research Council and began in May 2010. The Project has three Investigators, two of whom are speaking today, together with Associate Professor Matthew Harding and myself, the Research Fellow on this project.

So far, the Project has produced a variety of papers and submissions [on slide]. We have also hosted a workshop on NFP reform and a public forum on the Aid/Watch case. These are all available on our website. We are also publishing an article on the recent Aid/Watch case in the next issue of the Melbourne University Law Review.

Today, I want to begin by answering the question: what can the Project bring to the table in the regulatory reform project? Personally, I think there are two key principles of the Project, which are key advantages to the upcoming reforms. These are 1) this is a holistic project, looking at the legal regulation of the NFP sector as a whole; and 2) it aims to look at the regulation from 'first principles', to reflect on the why as well as the how of reforming NFPs. Today, I will reflect on the application of these principles to the reform project, and use as an extended example the issue of the premises on which regulatory reform should proceed, drawing upon the Working Paper we have just published on the subject. Ann will then focus more closely on the question of the statutory definition and Miranda will talk about the taxation of business income.

HOLISTIC OVERVIEW

The Project covers the disparate areas of law that govern the regulation of NFPs—equity; taxation; corporations and associations law; and its occasional interface with constitutional law.

It has been my privilege to read across a vast body of literature in the emerging field of NFP studies, most of which has been conducted in the US and, to a lesser extent, in the UK. This broad-ranging overview has led me to several insights about the nature of debates about NFP reforms that are probably most easily gained by coming fresh to these debates, as I did.

Perhaps the first thing I noticed was that the 'not-for-profit' label was a convenient label for the purposes of advocating for the sector—for emphasising its importance and its prominence—including for the field of NFP studies itself. However, the label had little analytical value because, in truth, the sub-sectors of the NFP sector differ in so many ways.

Using the label tends to emphasise the distinctiveness of the sector, but at the expense of obscuring the differences between subsectors. Further, it highlights one feature of the structure of the NFP organisation, which de-emphasises what most would think of as its most important feature—namely, its purpose. Another implication is that, too often, we talk about NFPs thinking about a ‘typical’ NFP—generally, a large brand-name social welfare charity—and fail to think through the consequences for other types of NFPs.

One important implication of this insight is that, for the purposes of regulation, we need to ‘disaggregate’ the sector. Each subsector has specific characteristics that distinguish it from other sectors, including (for example) mission, competition with public or private organisations, funding patterns, and—perhaps most importantly—accountability relationships with its stakeholders. Each of these features are relevant to regulation, and a sector-by-sector approach is the obvious solution to this diversity. In particular, we need to remember that the other models that we often refer to regulate only charities, and not other NFPs.

A second insight that can be gained from a broad overview is the influence of history. An interesting example is religion, which was the original source of so many of the legal privileges of charity, including its earliest tax exemptions. The break with the Catholic Church in England had far-reaching effects on the scope of the nature of charity, ironically expanding the scope of the legal definition of charity. The growth of religious pluralism and the rise of secularism has undermined public support for tax exemption for religions, with potential consequences for the sector, as seen in last year’s Public Benefit Bill.

Embedded within history, too, are changing perceptions and conceptions of the State, market and NFP sector. Historically, the English State provided only very limited welfare, and the State was thought to have no real business in fields such as education and health. The capitalist market, often thought of as the ‘default’ sphere for the provision of all services, developed quite late and usually long after NFP institutions had developed in all kinds of fields. The idea that the NFP sector exists mostly to ‘supplement’ market and government defects, which has retained significant influence in NFP theory, flies in the face of this history. Yet throughout public policy debate, ideas of what constitutes the ‘appropriate’ scope of the NFP sector lurk in the shadows—in (for example) the question of how much advocacy NFPs can engage in, or the extent to which NFPs should be allowed to compete with business.

A particularly interesting example is the question of tax exemptions for NFPs [refer to taxing history paper]. Much of the policy discussion of these exemptions is premised on an idea that tax exemptions are a ‘subsidy’ by the government which requires justification in the same way as expenditure does. Yet this analysis is the opposite of that which prevailed when the exemptions were introduced, together with the taxes themselves. The original taxes in fact spared the vast majority of the population, and the debate was rather over whether the tax itself could be justified at all. Remarkably, there was no real discussion of the tax exemptions for NFPs themselves, almost certainly because these were thought to be entirely sensible. Indeed, originally the tax exemptions were more generous because all not-for-profits were exempt in the 19th-century State income taxes.

So another benefit of a broad-ranging, and historically attuned, overview is to enable us to question both the historical and ideological assumptions that underlie so much of the contemporary debate.

A final insight that grows out of a historically and politically attuned perspective is that debate about the NFP sector is often ‘fuzzy’ because it lacks a strong, unique, identity. The sector has three key disadvantages. It has been articulated only recently, mostly in terms of what it is not, and – critically – it does not have a unifying principle. The State, for example, has a clear (contemporary) rationale—to govern for the welfare of its people. The market is governed first and foremost by the principle of profit for company shareholders—a principle that has many qualifications but which does provide a strong analytical coherence.

The NFP sector lacks such a coherent principle and, as such, ends up in the netherlands between the State and the market. There is an abundance of political theory and economic theory, and the relative absence of NFP theory means that very often political and, more especially, economic theory is inappropriately applied to the sector.

A practical example of this is the confusion that exists because charities are both private and public—it is initiated by and maintained by private individuals, but its aim is to benefit the public, and often it relies on government funding or tax concessions. Yet too often NFP monies are conceived as fundamentally ‘public’ monies that should be regulated to the same extent as taxpayers’ money.

Another example is that of the Productivity Commission’s terms of reference which required it to consider the ‘contribution’ of the sector. Interestingly, when the Industry Commission, the predecessor of the Productivity Commission, first undertook the task of examining charitable organisations, it caused a scandal that a body of economists was charged with such a function. It is a mark of how dominant the language of economics has become that the ‘economic’ contribution of the NFP sector has become virtually a starting point for all government policy. There is an irony here, because the very point of many NFP subsectors is to cater for human needs and desires, such as creativity and spirituality, which cannot be defined or confined by economics.

‘FIRST PRINCIPLES’

The second key principle of the Project is to consider the issues from ‘first principles’. This does not mean that all the progress and work so far done needs to be thrown out. Rather, it means that policies should be grounded on the right premises.

There seems to me to be three key gaps in the current debate that animate so many of the specific reform debates we are having. First, and most important, is the question of why we value the NFP sector. Charity law talks rather vaguely about ‘public benefit’, and while there is consensus that this is the key, analytically it does not advance us far. One of the project investigators, Matthew Harding, is seeking to explore this issue in a forthcoming book.

Second is the question of the purpose of the tax concessions for NFPs. This is a topic that has been examined in great detail in the US [refer to Tax literature review], but sadly without advancing us much beyond the ‘public benefit’ answer of charity law itself. These two questions are, in the end, tied up together.

Third, and this is the question I want to focus on today, is the question of the purpose of regulating the sector. The first, and most important, point is that the ultimate goal of regulating the sector is to facilitate the sector to fulfil, in diverse

ways, their goals for the public or community benefit.¹ There is a lot of debate about whether a regulator should be facilitative or just 'regulate', in the sense of controlling behaviour. However, this distinction fails to recognise that all regulation is ultimately designed to promote the benefits of the activity being regulated, just as corporate law is also ultimately concerned with enabling corporate activity to facilitate commercial risk-taking and business.

In our Working Paper, we talk about a 'pyramid' of goals, objectives, and design principles. At the base of this pyramid is the ultimate goal of facilitating the public benefit activity. This is the ultimate measure of all regulatory measures.

Above this base are three 'second-order' goals:

The promotion of public trust and confidence in NFPs;

Ensuring the commitment of NFPs to purposes for the public benefit; and

Improving the effectiveness of NFPs.²

Analytically, these goals can be distinguished from 'third-order' objectives such as Ensuring appropriate transparency and accountability to donors, beneficiaries, other stakeholders, and the public;

Promoting compliance with legal obligations;

Ensuring efficient and effective allocation of resources;

Preventing abuse, self-dealing or other misuse of NFPs; and

Ensuring the sustainability of community organisations.

Promoting capacity building within the sector;

Promoting a strategic, enterprising approach to management.

These goals and objectives are distinct from good principles of regulatory design, which apply to all regulatory contexts:

The minimum necessary to achieve objectives;

Not unduly prescriptive;

Accessible, transparent and accountable;

Integrated and consistent with other laws;

Communicated effectively;

Mindful of the compliance burden imposed; and

Enforceable.³

¹ See also volume 2 of Ontario Law Reform Commission, *Report on the Law of Charities* (1996). This is summarised in Appendix B.

² See Ontario Law Reform Commission, *Report on the Law of Charities*, above n 20, 17. This identifies the last two underlying objectives.

The reason this framework is helpful is because it clarifies the relative importance of the objectives and principles, and so clarifies the appropriate scope. Very often, we see free references to labels such as accountability and transparency. What this framework does is help us judge whether a particular measure ultimately assists in achieving the second-order goals: does the measure assist in promoting trust and confidence, loyalty to purposes, or effectiveness? Otherwise, there is no principled limit to the extent of information (for example) that can be demanded.

However, it is also important that there will be a diversity of opinion on the interpretation of these second-order goals, and latitude must be given to organisations in interpreting and pursuing those goals. For example, the question of 'effectiveness' is a fraught issue because the impact of an NFP is difficult to measure or evaluate. Regulation to improve effectiveness might usefully set minimum standards, but further regulation must weigh in the balance the need to ensure the autonomy of NFPs, facilitate innovation and respect the diversity of opinion and missions of NFPs. In addition, the principles of regulatory design require the benefit of regulation to outweigh the burden.

These premises for regulatory reform reflect, in my view, one of the great advantages of the Not-for-Profit Project's approach, namely the 'first principles' approach. The Working Paper proceeds to examine a range of other questions about regulation, including identifying the regulatory interests, which we don't have time for here.

In the context of the upcoming reforms, it seems to us clear that there is a pressing need for a principled and holistic approach to regulatory reform. For example, as we explored in detail in our submission, the recent proposals for restating the 'in Australia' conditions unfortunately represent a piecemeal approach to reform that fails to distinguish between issues of taxation and regulation. It also reflects a failure to ask the underlying policy question of why it is appropriate to confine tax concessions primarily, and in some cases solely, to Australian activities and beneficiaries, particularly in a globalizing age. In conclusion, I suggest that as this process of reform continues, we all take a moment to reflect on the bigger picture, and to ask always the question why, as well as how.

³ Spindler, *Improving Not-For-Profit Law and Regulation: Options Paper*, above n 10, v, 37.