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UNFAIR OR UNWANTED? COMPETITION BETWEEN CHARITIES AND FOR-PROFIT BUSINESSES IN CANADA

Discussion Paper

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Competition Between Charities and For-Profit Businesses in Canada

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01 CANADIAN CHARITIES FACE A LONG-TERM CRISIS OF FINANCIAL SUSTAINABILITY

Slower long-term economic growth will inevitably squeeze the charitable sector's sources of revenue. Donors will find their disposable incomes growing more slowly, threatening a source of funding that is already showing signs of weakness; governments struggling for revenue will be stingier with grants; earned income activities will compete in a tougher marketplace. At the same time, social and demographic changes are likely to increase demand for the services charities provide. This will result in a growing gap between the needs Canadians expect charities to meet and the resources available to charities to meet these needs. It is estimated that this "social deficit" will reach \$25 billion by 2026 (Emmett, 2016).

With traditional revenue sources declining, charities are increasingly looking at ways to finance their nonprofit activities through business income (Aptowitz & Dachis, 2012). "Charities and nonprofits rely on three core sources of revenue: government funding, philanthropy, and earned income. Of these, only earned income offers any prospect for long-term growth" (Mendelsohn, Mulholland & Shamshiri, 2011, p.5). At the same time, for-profit businesses have become more active in areas once thought to be the unique domain of charities.

On September 15, 1996, ...the New York Times carried an article that sent shock waves through the nonprofit community. Lockheed Martin IMS—a division of the defense giant Lockheed Martin—Electronic Data Systems, and Andersen Consulting were each preparing to bid for the management of \$563 million in welfare operations in Texas...further blur(ring) the lines between the nonprofit, for-profit, and public sectors. ...The real message of Lockheed Martin's move into nonprofit work is that just about everything affecting the provision of social services—the government agencies that award contracts, the political environment in which they operate, and the preferences of clients—has profoundly changed (Ryan, 1999, para. 1 & 3).

The prospect of more competition with the private sector brings with it increased attention from policy makers who have expressed concerns about “unfair competition between for-profit businesses and tax supported charities” (Aptowitz & Dachis, 2012, p.2).

This paper will argue that competition between charities and for-profit businesses is a fact of life that is not going away; that tax support for charities is broadly comparable to subsidies provided to for-profit businesses; that tax policy has little, if any, effect on the market shares and earnings of for-profit businesses; and that the relative positions of charities and for-profit business in social markets is determined by the nature of the market and the people in it rather than by the character of the services brought to it. The “levelness” of the playing field is not a major or even important factor. Rather, the essential policy question facing governments is what set of policies will best serve the needs of Canadians both now and in the future.

02 A “MARKET ECOLOGY” IS RAPIDLY DEVELOPING IN WHICH FOR-PROFIT BUSINESSES AND CHARITIES CO-EXIST IN MANY MARKETS

To these social marketplaces, for-profit businesses and charities bring different values and characters. For-profit businesses tend to specialize in data, quantitative analysis, volume and cost efficiency. Charities tend to bring compassion, links to community, inclusivity and quality to the marketplace. Like any market, the success of each sector will ebb and flow with economic, cultural and social conditions and of course with government policy and incentives. The latter include tax policies and subsidies as well as government policies with respect to procurement and the delivery of social programs.

03 BOTH FOR-PROFIT BUSINESSES AND CHARITIES BENEFIT FROM GOVERNMENT SUPPORT

Charities in Canada benefit from two important tax incentives/expenditures: 1) exemption from corporate income tax; and 2) the ability to issue receipts that allow donors to claim non-refundable tax credits when filing personal income taxes. This support is designed to help charities provide social, cultural, environmental and other services important to Canadians. In turn, charities provide a social benefit to society greater than the cost of the tax subsidy. Table 1 shows the cost of tax expenditures supporting the charitable and nonprofit sector. These expenditures assist the financial sustainability of a sector with about 86,000 charities producing 8.1% of GDP and accounting for 2 million jobs (Emmett & Emmett, 2015).

TABLE 1: TAX EXPENDITURES: CHARITIES AND NONPROFIT ORGANIZATIONS, 2017 PROJECTIONS

| Tax Credit | \$ millions |
|--|--------------------|
| Charitable donation tax credit | 2,905 |
| Non-taxation of non-profit organizations | 130 |
| First time donors' super credit | 5 |
| Total | 3,040 |

Source: Government of Canada, *Report on Federal Tax Expenditures*, 2016b, p.32.

For-profit businesses also benefit from a variety of valuable policy instruments and for essentially the same reason as charities: support brings public policy benefits such as jobs, growth, regional development, innovation and so on.¹ Funding for the small business sector—the sector most similar to the charitable sector—accounts for the bulk of federal spending, supporting the health of an important sector with some 1.16 million firms, employing over 8 million people and producing roughly 30% of Canada's GDP (Government of Canada, 2016a).

¹ Tax incentives and program supports for business include: the small business tax credit, designed to support the health and expansion of this sector of the economy; the Scientific Research and Experimental Development tax credit to stimulate innovation and productivity; flow through shares to augment the supply of investment capital for resource exploration and development; support from the Business Development Bank to assist with liquidity and investment and many others. John Lester (2018) has estimated that the total value of these subsidies was some \$27 billion in 2017 in just four provinces: Ontario, Quebec, Alberta and British Columbia.

TABLE 2: TOP TEN BUSINESS SUBSIDY PROGRAMS, FEDERAL GOVERNMENT 2014-15

| Program | \$ millions |
|---|--------------------|
| Small Business Deduction | 3,225 |
| SR&ED Incentives – all firms | 2,800 |
| Farm Credit Canada | 1,161 |
| Business Development Bank – SME Financing | 1,070 |
| Farm Income Insurance Programs | 988 |
| Capital gains exemption – small business shares | 590 |
| Capital gains exemption – farm and fishing property | 525 |
| Hiring/job credit | 320 |
| Atlantic Investment Tax Credit | 225 |
| Investment in GM | 188 |
| Total | 11,092 |

Source: J. Lester, Business Subsidies in Canada, *University of Calgary SPP Research Paper*, 2016, p.27.

The total value of tax concessions enjoyed by the charitable sector amounts to about a third of the amount directed to for-profit businesses, which is in line with the size and public policy benefits of these sectors. However, one set of tax incentives—those for charities—has drawn particular attention from both government and the private sector, which have expressed concern that the charitable sector unfairly uses the economic benefits of tax concessions to subsidize their commercial activities.

04 TAX CONCESSIONS HAVE AT MOST A MODEST EFFECT ON THE PARTICIPATION OF CHARITIES IN THE MARKETPLACE

Quality statistical and analytical studies of the impact of tax concessions on competition between for-profit businesses and charities are scarce and dated. The most frequently cited evidence, generally considered authoritative in the research literature, comes from a study of the impact of U.S. tax concessions on the market share of several U.S. charities (Hansmann, 1987). Table 3 summarizes the results for a “what if” question: “what would be the impact on the market share of charities of eliminating tax concessions for the charitable sector?” With the nursing home sub-sector as an illustrative example, the table shows the extent to which nonprofit market share would decline with the elimination of tax exemption.² The analysis shows that, at a specific point in time, “[tax] exemptions significantly increase the market share of non-profit firms vis-à-vis their for-profit counterparts” (Hansmann, 1987, p.71).

² Hansmann reports results for a number of different sub-sectors. Nursing homes are chosen as representative.

TABLE 3: WHAT HAPPENS TO MARKET SHARE OF NONPROFITS IF TAX EXEMPTIONS ARE ELIMINATED?

| Tax | Impact on market share of nonprofits in nursing home services |
|---|--|
| Property tax | Elimination of property tax exemption would cause nonprofit market share to fall from 24% to 19% |
| Sales tax | Elimination of sales tax exemption would cause nonprofit market share to fall from 24% to 19.5% |
| Corporate Income tax (combined state and federal) | Elimination of corporate tax exemption would cause market share to fall from 24% to 15.5% |
| Combined tax effects | Elimination of all tax exemptions would cause market share to fall from 24% to 5% |

Source: H. Hansmann, The Effect of Tax Exemption and Other Factors on the Market Share of Nonprofit versus For-profit Firms, *National Tax Journal*, 1987, p.76-77.

The results in Table 3 likely overestimate the impact of tax concessions for a couple of reasons. First, markets consist of people with different incomes, education levels and needs. Elimination of a tax concession may take a charity out of the marketplace, but that doesn't mean the private sector will move in. This is particularly true if the market includes difficult or hard-to-serve people. In this case, the market may simply go unserved. This is what Harrison and Seim (2012) found when they examined the fitness centre market in the U.S. Second, the results do not capture the impact of change in markets over time. Introducing proxies for change (e.g., the rate of growth of income and population and of competition from government) shows that changes in markets are an important influence in increasing the market share of for-profits (Hansmann, 1987).

On balance, then, taking account of the importance of segmentation in markets and the importance of change over time, "tax considerations are probably far less important than is commonly thought. ...[and the evolution of the marketplace over time] is strong evidence that the availability of an exemption is not the decisive factor in determining whether a given activity will be organized along nonprofit lines" (Hansmann, 1980, p.881 & 883).

05 OTHER GOVERNMENT POLICIES INFLUENCE THE EVOLVING SOCIAL MARKET IN IMPORTANT WAYS

Today, government is fundamentally changing the rules of the marketplace for charities and for-profit firms, often inadvertently tending to emphasize many of the qualities for-profit business bring to the table. In the U.S., governments have steadily shifted support for disadvantaged people from producer-side subsidies (e.g., funding an organization to deliver services) to consumer-side subsidies (e.g., subsidizing those who need services). This creates consumer choice and a marketplace where for-profits can compete. In 1980, the U.S. government made home health care a reimbursable expense under Medicare. This resulted in a huge increase in the demand for home care (Salamon, 2015). As *The Economist* (2017) notes, "voucher schemes, in which governments use tokens to be exchanged for services, ...turned a charity's clientele into customers with choices" (para.5).

Canada shows signs of moving in the same direction. Social programs delivered through the income tax system, such as the recent Canada Child Benefit, put purchasing power directly into the hands of taxpayers/clients (Government of Canada, 2018). A key component of the federal government’s recently announced housing strategy is a program to help families pay rent to for-profit landlords, not unlike a voucher scheme for rent payments (Zimonjic, 2017). In another departure, Veterans Affairs has awarded a contract previously delivered by a charity to a private-sector firm that brings different capabilities to help soldiers make a smoother transition into civilian work after leaving the military (Brewster, 2018).

Policy is expanding a market in which for-profit businesses and charities participate to provide services to clients in return for payment.

06 CHARITIES ENJOY TAX BENEFITS, BUT FOR-PROFIT BUSINESSES ENJOY COMPENSATING STRUCTURAL ADVANTAGES

Charities receive tax concessions, but this comes with a severe limit on financing options. “One of the biggest...differences between charities and businesses is access to capital. Unlike a business, a charity cannot sell shares...[and] few have steady income streams or valuable assets against which to borrow” (The Economist, 2017, para. 16). Private sector firms, in comparison, have access to risk tolerant equity capital to meet changing needs.

There is an “uneven playing field” that advantages for-profits (Salamon, 2015, p.42). If for-profits want to establish new facilities and operations in response to new opportunities, surges in demand, or technological change they can use “essentially ‘free’ capital that...[they] can generate merely by issuing and selling stock” (Salamon, 2015, p.42). Nonprofits and charities are confined to expensive bank financing at best (Salamon, 2015).

This in part explains the success of for-profit businesses in social markets. The ability to access capital gives for-profit businesses a built-in advantage charities lack: a degree of nimbleness and flexibility to respond to changes in the social marketplace and pursue innovative, often expensive, solutions to emerging opportunities.

From this perspective, exemptions from corporate income taxes and tax incentives for donations are attempts to offset the inability of charities and nonprofits to equity finance.

One rationale for exempting commercial nonprofits from corporate income taxes...is that exemption can help to compensate for obstacles that nonprofits face in raising capital. Such obstacles may impose inefficient constraints on expansion of the nonprofit sector (Hansmann, 1987, p.80).

07 BOTH CHARITIES AND BUSINESSES ARE GROWING IN IMPORTANT MARKETS BUT BUSINESSES HAVE AN ADVANTAGE THAT ALLOWS THEM TO ADAPT TO CHANGE MORE QUICKLY

Data show the market share of nonprofits in the U.S. shrinking across a number of social and health services sectors.³

In the social services, large for-profit corporations are now providing job training, child care, and rehabilitation services at ever greater levels. In health care, for-profit hospitals and health maintenance organizations (HMOs) are buying out nonprofit institutions and moving into new markets. In education, publicly-traded firms have actively staked out a significant portion of the expanding charter school market. ...In welfare-to-work services, several large defense contractors have begun to compete for and win contracts (Frumkin, 2002, p.1).

³ U.S. data are used in this section in the absence of available Canadian data.

TABLE 4: GROWTH IN FOR-PROFIT AND NONPROFIT SOCIAL SERVICE PROVISION, 1977-1997*

* Includes Individual and Family Services, Job Training and Vocational Rehabilitation, Child Day Care and Residential Care.

| | Nonprofit | For-profit |
|---------------------------------|------------------|-------------------|
| Number of Establishments | | |
| 1977 | 40,983 | 23,104 |
| 1997 | 92,156 | 69,713 |
| Change | +125% | +202% |
| Number of Employees | | |
| 1977 | 676,473 | 177,449 |
| 1997 | 1,586,186 | 662,201 |
| Change | +134.5% | +273.2% |
| Receipts (\$ Millions) | | |
| 1977 | 9,415 | 2,038 |
| 1997 | 75,683 | 18,894 |
| Change | +704% | +827% |

Source: Peter Frumkin, *On Being Nonprofit: A Conceptual and Policy Primer*, 2005, p.79.

Data assembled by Lester Salmon (2015) show a similar trend for a different time period.

TABLE 5: CHANGE IN NONPROFIT SHARE OF EMPLOYMENT, 1997 TO 2012

| Type of Organization | % change |
|---|-----------------|
| Kidney dialysis centres | -41% |
| Home care | -33% |
| Individual family services | -30% |
| Community care facilities for the elderly | -23% |
| Specialty hospitals | -20% |
| Outpatient care centres | -13% |
| Nursing care centres | -11% |
| Other residential care centres | -6% |

Source: Lester Salamon, *The Resilient Sector Revisited*, 2015, p.40.

08

SUMMARY AND CONCLUSIONS

An increasing number of markets are opening up to charities and nonprofits. Tax expenditures for charities have been singled out for special attention for somehow tilting the economic playing field against the private sector. However, there is a fundamental difference

between “unwanted” competition and “unfair” competition. Any time a charity competes in the marketplace with a for-profit provider, such competition might be unwanted. ...The issue, however, is not competition per se; rather, “unfair” competition presupposes that the exempt organization is somehow unfairly using the economic benefits of exemption to subsidize their commercial activities (Columbo, 2002, p.529-530).

Analysts are nearly unanimous:

Legal academics and economists who have examined the issue have reached an almost remarkable consensus that unfair competition in the form of predatory pricing or predatory market expansion simply is not a serious policy concern (Columbo, 2002, p.530).

The reality is that charities struggle to cope with a growing social deficit, straining their resources as their structures inhibit them from competing effectively with for-profit businesses. Policy thinking about “unfair” competition is wrong, unconstructive and deadens debate, providing an erroneous case for opposing the reforms charities need to remain sustainable.

Much of the data and analysis in this paper has shown for-profit

businesses growing more rapidly than charities in key markets. The key question is not unfair competition. Rather it is the worry that charities, with their special contribution to quality, are dwindling in markets and may even face extinction in a number of important areas.

It is clear that the scope and character of human services will be impoverished should nonprofits continue to lose out as the trend continues toward greater and greater business activity in fields traditionally dominated by nonprofits. ...With their unique commitments and value-laden missions, nonprofit service providers have the ability to continue to offer innovative approaches to public problems that are linked to community needs and standards. ...[G]overnment...should take...measures that will help preserve a mixed organizational ecology in which both nonprofit and for-profit providers play a role in the changing landscape of human service provision (Frumkin, 2002, p.23).

The useful policy question is: what mix of action on tax incentives, earned income, social investment, program design, and data collection is needed to preserve a highly beneficial mixed “ecology” in era of a social deficit?

09

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10 ABOUT THE AUTHOR



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In 2013, Brian Emmett joined Imagine Canada in the unique role of the Chief Economist for Canada's Charitable and Nonprofit Sector. As Chief Economist, Brian is tasked with measuring the impact of the sector and bringing economic issues facing charities and nonprofits to the forefront of public policy decision makers.

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