Strengthening Australia's community organisations

Reforming taxation concession arrangements

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Report by Access Economics Pty Limited for

Community Council for Australia

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Abbreviations

ABN	Australian Business Number
ABS	Australian Bureau of Statistics
ATO	Australian Taxation Office
CCA	Community Council for Australia
DGR	Deductible Gift Recipient
FBT	Fringe Benefits Tax
GST	Goods and Services Tax
NFP	Not-for-profit
PBI	Public Benevolent Institution
TCC	Tax concession charity

Definitions

Charitable purpose	Includes the relief of poverty, the relief of the needs of the aged, the relief of sickness or distress, the advancement of religion, the advancement of education, other purposes beneficial to the community, and the provision of child care services on a not-for-profit basis.
Charity	An organisation that exists for the public benefit or relief of poverty, is also a trust fund or institution, is not-for-profit, has charitable purposes and its sole purpose is charitable (common law definition). 'Charity' is used in this narrow context throughout the report. Some community organisations may also be charities, but not all community organisations are charities.
Community organisation	A not-for-profit organisation that does not operate in the market and has a community focus. Community organisations include social services, arts and culture, recreation, environment, education and philanthropic organisations. They do not include not-for-profit organisations that operate in the market, such as hospitals and trading cooperatives. Community organisations form one component of the wider not-for-profit sector.
Community sector	A collective term for all community organisations. 'Community organisations' and 'community sector' are used interchangeably.
Funding	This term is used inclusively to refer to both full funding and subsidies. Funding may be direct (provided through government grants or service contracts) or indirect (provided through the tax system). References to 'public support' and 'government support' mean government funding.
Third sector	The entire not-for-profit sector.

Foreword

Australian taxpayers support many community and other not-for-profit (NFP) organisations. The activities of these organisations have considerable social impact and touch the lives of many Australians, including some of the most disadvantaged members of the community.

The Australian Government has recently undertaken a 'root and branch' review of the tax system (the Henry Review). The recommendations of the review together with the Government's formal response are due for imminent public release. It is possible that the Henry Review will recommend changes that affect public funding of the NFP sector — either by directly targeting concessions available to the sector or as a by-product of broader structural changes to the tax system. Some of these reforms may be long-term, perhaps for implementation over the next 10 years or so.

In this context, Access Economics was engaged by the Community Council for Australia (CCA) to examine tax concession arrangements applying to community organisations and to identify directions for reform in light of possible recommendations of the Henry Review.

This report does not itself make recommendations for reforming funding arrangements for the community sector. Rather, the intent has been to 'stand in the shoes' of the Henry Review and, through an economic framework, consider potential reforms that may arise. In doing so, the report aims to provide the community sector with a robust and economically credible basis on which to engage in the national debate on tax reform that is likely to follow release of the Henry Review and the Government's response. A set of high-level principles to help frame the CCA's advocacy during the tax reform process has been developed and presented in the report.

Reforming government funding arrangements for the community sector will always be a difficult and sensitive issue. Indeed, at a certain level, it will touch on fundamental and emotive matters of altruism and philanthropy. This was highlighted during the limited consultations undertaken by Access Economics for this study, where many stakeholders voiced their concerns about changes to current funding arrangements. These concerns should not be taken lightly; they reinforce the considerable difficulties and uncertainties that will be involved in reforming the mechanisms by which taxpayer support is provided. The issues will need to be addressed by the Government in its response to the Henry Review.

Some definitional matters

The NFP sector is not only large and diverse but has somewhat 'fuzzy' boundaries separating its various components. These delineations are more than academic; they have legal and regulatory implications and play a part in differentiating the challenges and issues facing constituents. In line with the direct interests of CCA, this report concentrates on community organisations rather than the wider NFP sector, where 'community organisations' are taken to be not-for-profit organisations that do not operate in the market and have a community focus. Such organisations encompass many social services, arts and culture, recreation, environment, education and philanthropic organisations.

Reforms flowing from the Henry Review provide an opportunity to improve funding and regulatory arrangements to the benefit of both community organisations and taxpayers. Such reforms will be pivotal in ensuring that the community sector is well-placed to meet future challenges, in turn enhancing social capital and promoting the wellbeing of all Australians.

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Key messages

- Community organisations make an important contribution to Australian society in areas such as social assistance, health, education, arts and culture, and emergency relief. In doing so, they help build a stronger, fairer and more inclusive community.
- Recognising their social contributions, Australian governments provide a range of financial support to community organisations. This includes indirect assistance through the tax system, as well as more direct forms of support (for example, acting as a 'buyer' of certain services).
  - As part of the overall assistance given to the community sector, the Australian Government estimates it will provide around $2.35 billion in tax concessions in 2009-10.
- The current arrangements for assisting community organisations through the tax system have a range of shortcomings. The system is complex, lacks transparency and certain aspects of tax relief are less than efficient. Such issues create problems for both the sector itself and for government, making reform in the area a key issue for public policy. Importantly, these issues are now being examined as part of the Australian Government's review of the tax system.
- There are strong economic reasons for maintaining a combination of indirect assistance through the tax system coupled with direct forms of support which more closely target particular social priority areas. Within such a framework, substantial improvements are possible.
- Major deficiencies of current support arrangements could be addressed by three key measures:
  - streamlining administrative and compliance requirements;
  - extending tax concessions for donors and tightening forms of input tax concessions (such as certain exemptions from fringe benefits tax); and
  - greater reliance on more direct forms of public support.
- It is possible that some, if not all, of these reforms will be included (in varying degrees) as part of the Government's long-term tax reform agenda.
- Such changes will have substantial funding and operational implications for community organisations and the entire not-for-profit sector. In this regard, it is essential that government adopts and articulates a clear and coherent policy approach in devising any reform program — especially in the context of the broader evolution of the tax framework. Difficult and sensitive reforms can become more palatable when the sector and the broader community are given an opportunity to recognise the trade-offs involved.
- Major considerations in implementing reform will include ensuring that an adequate funding base for organisations is maintained (including through the transitional phase), that the service delivery capacity of organisations is not undermined — particularly their ability to attract and retain high-quality staff — and important socially innovative activities are not discouraged.

High-level principles for reform

- Some high-level principles underpinning a financial assistance framework that effectively and efficiently supports the community sector are:
  - *First do no harm:* Reforms to funding assistance mechanisms should be structured with the continued support and sustainability of the sector as a fundamental priority.
  - *Strive to avoid unintended consequences*: Reforms need to consider dynamic interactions between support measures, including potentially adverse effects on operational flexibility and social innovation.

Key messages (continued)

- *Revenue-neutrality for the sector is important*: Reforms should reinforce the community sector's capacity to provide important services. Proposals to limit certain aspects of financial support should be broadly offset by increases in alternative forms of assistance.
- *Support arrangements should be transparent and simply administered*: Funding mechanisms — whether provided through the tax system or on the expenditure side of the budget — should be clear and simple to administer.
- *Taxpayer interests should be safeguarded*: Reforms should provide a role for governments in setting social priorities, supported by robust reporting and accountability arrangements for recipient organisations.
- *Establish an appropriate lead time for reform*: Extensive lead time — possibly in the vicinity of two to five years — should be provided to minimise adjustment costs while implementing fundamental public funding reform within the sector.

■ A key aspect of these principles is minimising risks to the sector associated with changing financial support mechanisms. While there are compelling reasons to reform present arrangements, it is important that the transitional challenges and structural adjustments associated with funding reform are not underestimated. Many parts of the sector are long-established and thrive under the present support framework.

■ Initiatives to reform funding arrangements for community organisations form a central part of a broader agenda to improve the regulation and operation of the not-for-profit sector. Other aspects of this agenda include harmonising regulatory frameworks within and across jurisdictions, streamlining fundraising legislation and capability-building to maximise the sector's social contribution to the community. These reforms are critical to ensuring that the sector is well-placed to meet future challenges, such as an ageing population, changing (perhaps concentrating) patterns of disadvantage and new requirements for service delivery.

Executive summary

The community sector plays an important role in Australian society, providing a range of essential community services, including social welfare, education, health, and culture and recreation. Much of the sector focuses on enhancing social inclusion, both in Australia and overseas. For this reason, community organisations are cherished by many people.

Substantial government support is provided to community organisations. This occurs through direct government funding, say for actual service delivery, as well as indirectly via taxation concessions.

A comprehensive 'root and branch' review of Australia's taxation and transfer system, *Australia's Future Tax System* (the Henry Review), has recently been completed and delivered to the Australian Government. The review's report and the Government's formal response will be released together (most likely before the 2010 Budget).

While the particular reform recommendations flowing from the Henry Review are currently unknown, it is likely that tax concessions provided to community organisations and other parts of the not-for-profit sector will be scrutinised — either specifically or as part of wider tax design considerations.

Current arrangements for supporting community organisations through the tax system suffer a range of shortcomings. The system is complex and lacks transparency. Such issues create problems for both the sector itself and for government, making reform a key priority for public policy.

Given such issues, and in the context of the forthcoming Henry Review, this report examines how government support for the community sector is currently provided and used by community organisations, with a focus on indirect subsidies through the taxation system. The report also considers how more direct forms of assistance might affect the community sector and how transitioning to different models of support could be facilitated.

This report does not set out a precise suite of reform options. Rather, it presents a set of guiding principles to help frame responses to possible taxation reforms as they affect the community sector.

Advancing community welfare

Australia's community sector is diverse. It encompasses a wide range of not-for-profit organisations in areas such as culture and recreation, health, social services, the environment, development, housing and philanthropy. Activities undertaken by these organisations are often vital to the individuals directly assisted or affected, but there are also broader benefits in terms of social cohesion and community participation.

A strong rationale for government involvement

It is largely because of their important social contributions that governments have an acute interest in the activities of community organisations. Governments themselves intervene in markets to achieve particular social policy objectives such as health improvement and to tackle poverty and other forms of disadvantage. Much of this is aimed at establishing an adequate social safety net. A variety of interventions and policy programs are involved, including social security arrangements (e.g. unemployment and aged pension benefits), provision of public health and aged care, and minimum wage regulations. These are managed and financed by both Commonwealth and State governments.

It is through their compact with the community that governments have a responsibility to ensure equity of access to social services and adequacy of service quality, as well as the allocation of resources to meet relevant social priorities. This has implications for community organisations because their own activities cross over with government-sponsored programs. And in many areas community organisations do much of the 'heavy lifting' to relieve difficult social problems.

At a fundamental level, there are important issues of complementarity and substitutability between the social services delivered by government and community organisations. In some areas governments have delegated responsibility for actual service delivery to community organisations. In other areas, it is recognised that community organisations follow autonomous priorities, which nonetheless involve delivering socially important services. Such operational independence can have certain advantages, potentially allowing organisations to respond to changing community needs in a more responsive, targeted and flexible manner.

Importantly, both facets enable governments to further their social objectives and thus provide a legitimate basis for government financial support. Where direct service provision is undertaken by community organisations on behalf of government — whether by convention or contract — governments have attendant obligations to finance and support those organisations, and put in place appropriate accountability arrangements for access to taxpayer funding.

Where social services are provided by community organisations without direct government participation, governments also have a role in providing financial support because of the broader community benefits yielded by these activities. As 'spill-over' benefits are not entirely captured by delivery agencies and clients themselves, these services tend to be underprovided from society's perspective if left to the private market and unassisted by government.

How is public support provided?

Government funding in many cases is a major source of revenue for community organisations. Yet while the economic and social basis for taxpayer support for community organisations is well-established, there are issues surrounding how support is best provided. A key aspect is whether there is scope to better deliver assistance to community organisations to enable them to provide more effective services to the community, and at least cost to taxpayers.

Currently, much public support is provided through the taxation system via concessional arrangements at both Commonwealth and State levels. Community organisations providing direct social services receive the most generous taxation arrangements. These include exemptions from fringe benefits tax (FBT), goods and services tax (GST) and other State taxes like payroll tax and stamp duties, all of which reduce input costs. They also qualify for deductible gift recipient (DGR) status which encourages private donations by allowing philanthropic gifts to be paid out of untaxed income.

Granting tax concessions means that governments need to raise money from other sources, for example, by increasing tax rates on non-exempt companies, goods and individuals, to reach their revenue targets. Concessions are a departure from a benchmark system of taxation. They represent forgone taxation revenue and are equivalent in effect to budgetary expenditure. This is the approach of the Australian Treasury (see 2009 Tax Expenditures Statement). Such 'tax expenditures' must be considered alongside other forms of assistance to determine the most cost efficient use of government funds.

The Productivity Commission (2010) provided the following estimates of taxation support for the community sector:

- As of June 2009, 52,149 NFPs were registered as tax concession charities — 40% were also endorsed as having DGR status. There are 26,123 NFPs with DGR status, of which 19,212 are also charities.
- FBT concessions amounted to around $1 billion in tax expenditures for 2008-09.
- State payroll tax concessions for NFPs are greater than $800 million per annum.
- Australian taxpayers claimed $1.8 billion for deductible gifts in 2006-07, with an estimated cost to tax revenue (tax expenditure) of $860 million.

Issues with taxation concessions

Supporting community organisations indirectly through the tax system has a range of disadvantages. It is an imprecise policy instrument, with support not closely linked to service outcomes. Tax concessions are open-ended and government cannot control the public money spent through them. Accordingly, they can cost the government more than anticipated, and obscure the total level of expenditure on particular parts of a government's policy program.

Moreover, the flexibility of policy is diminished through this concessional mechanism. A reduction or increase in targeted support cannot be achieved easily when subsidies are provided through tax exemption.

There are also transparency and accountability disadvantages associated with indirect funding. The community often has far from ideal information (in terms of both detail and timeliness) with which to assess the proper level of public support.

In addition to issues concerning policy control and transparency, tax concessions also increase the complexity of the tax system, adding to the stock of regulation — this is an area that will be examined closely by the Henry Review. Such arrangements also encourage special interest lobbying (both within a particular sector and more broadly) for new concessions or existing concessions to be extended more broadly.

Many of these issues can be addressed through greater reliance on direct forms of assistance. Support provided directly can be targeted closely to particular priority areas. And this support can be adjusted according to requirements or if the functions of delivery organisations change. Expenditure programs are also fully transparent through the budget process and are subject to Ministerial and/or Parliamentary scrutiny.

This form of support has additional advantages, favouring those organisations that provide higher quality or more cost effective services. It can also have benefits for those organisations whose functions may have less fundraising appeal and are less popular with donors.

That said, there are strong economic reasons to maintain a level of indirect taxation support. Encouraging private donations through the tax system promotes pluralism by giving the community an opportunity to assist specific organisations. Tax concessions essentially fund organisations that do not receive government support directly. This may be because the government is pursuing alternative priorities or perhaps because government is unaware of the issues addressed by the organisations.

Indirect funding is relatively simple to administer — notwithstanding its role in increasing the complexity of the tax system — and a separate bureaucracy is not required, unlike direct expenditure programs. Through the DGR mechanism, indirect funding can also have fiscal benefits for government, potentially leveraging additional private assistance for priority areas and reducing budgetary outlays compared with direct spending.

Broader tax reform considerations

In principle, tax design is largely guided by criteria of efficiency, equity and simplicity. (The Henry Review's terms of reference contained guiding principles of equity, efficiency, simplicity, sustainability and policy consistency.) These considerations form core components of a framework for tax analysis rather than an all–encompassing theory. The objective is, fundamentally, to minimise economic efficiency costs and maximise simplicity subject to broader equity considerations.

A range of tradeoffs exists among the criteria and in practice tax policy rarely achieves all of these goals. For instance, much of the complexity in the current tax system has arisen from preferential treatment and concessions for specific activities and interest groups — in large part aimed at achieving social and policy objectives.

There are a number of deficiencies in current arrangements for supporting eligible community organisations:

- The present framework is fragmented and administratively complex — cutting across the Commonwealth and the States. This adds additional administration and compliance costs to the sector and governments.
- Arrangements can lack transparency and policy accountability. There is often insufficient information with which the community can gauge whether appropriate levels of public support are provided to different social causes. The open-ended nature of concessional arrangements also imposes additional challenges for fiscal management.
- Certain aspects of tax relief are less than efficient. Under input tax concessions, businesses and individuals face incentives to derive income from certain sources simply to obtain a tax advantage. For example, where FBT exemptions apply, resources will tend to flow to businesses and sectors which are better able to remunerate their staff in fringe benefits rather than cash.

What reforms might emerge?

Such concerns provide a backdrop to the Henry Review and the Government's policy response. There is nevertheless a strong economic rationale for maintaining indirect assistance through the tax system coupled with direct forms of support which more closely target particular social priority areas. Within such a mixed framework, however, substantial improvements are still possible.

Deficiencies of current support arrangements could be addressed by three key measures:

- Streamlining administrative and compliance requirements.
- Re-calibrating aspects of tax concessional arrangements, principally:
  - extending tax concessions for donors — say, through greater use of DGR status for organisations; and
  - tightening (or dismantling) forms of input tax concessions like exemptions from FBT — say, through more restrictive eligibility and/or reduced allowances.
- Placing greater reliance on more direct forms of public support.

It is possible that some, if not all, of these reforms will be included (in varying degrees) as part of the Government's long-term tax reform agenda.

While the precise reform prescriptions will emerge in due course, there are obvious challenges. Likely reforms will have substantial funding and operational implications for community organisations and the entire NFP sector.

Reforms to tighten concessional input tax treatment of eligible organisations like FBT exemptions, will affect the costs borne by community organisations. A major consequence will be the need to increase employee remuneration, affecting the ability of organisations to attract and retain high-quality staff.

Importantly, however, there are also opportunities to improve public support mechanisms. For instance, reforms to improve the simplicity of the tax system and streamline administrative requirements have the capacity to reduce compliance costs, allowing organisations to place more focus on their core functions.

Reforming support arrangements

While there are compelling reasons to reform present arrangements, it is important that the transitional challenges and structural adjustments associated with funding reform not be underestimated. Many parts of the sector have been established for a long time and thrive under the present support framework.

Many community organisations receive support through FBT exemptions. This input concession is estimated to total around $930 million in 2009 -10. The extent and size of this support indicates the magnitude of the reform undertaking. It will be extremely challenging, both administratively and operationally, to restructure support away from this method and potentially towards more direct means. This places an increased emphasis on carefully managing transitional issues to ameliorate the adverse effects of change and weaken resistance to reform initiatives that have community-wide benefits.

Reform programs that facilitate efficient adjustment from well-entrenched forms of financial support are difficult to design and implement, with issues of timing and sequencing paramount. Devising a robust implementation program will also require other forms of transitional assistance to be considered as a means of facilitating a more 'seamless' adjustment path. A particular issue will be to identify where adjustment costs are likely to concentrate.

High-level principles for reform

A key part of taxation reform is to improve resource allocation to address social issues and problems. In this regard, instituting a framework that effectively and efficiently supports the community sector should be a high priority.

Major considerations in implementing reform (in whatever guise) will be to ensure that an adequate funding base for organisations is maintained, that the service delivery capacity of organisations is not undermined — particularly their ability to attract and retain staff — and important socially innovative activities are not discouraged.

Some high-level principles that will help achieve these objectives are set out below. A key aspect of these principles is minimising risks to the sector associated with changing financial support mechanisms.

- **First do no harm**
  - As an overarching principle, reforms to funding assistance mechanisms should be structured with the continued support and sustainability of the sector as a fundamental priority.
  - This should recognise the potential for considerable adjustment and dislocation, as well as other transitional effects for both large and small organisations. Having full regard to the adjustment implications of funding reforms will be a major issue for government.
- **Strive to avoid unintended consequences**
  - Reforms, especially broad-ranging programs, often have unintended impacts which can detract from their overarching policy objectives. Sometimes addressing one set of funding issues and taxation distortions can give rise to others, owing to the interplay of different policy levers.
  - Reforms need to consider the dynamic interactions between support measures, including potentially adverse effects on operational flexibility and social innovation.
- **Revenue-neutrality for the sector is important**
  - Tax concessions currently provide significant and broad-ranging support for community organisations. Reforms to funding arrangements should reinforce the community sector's capacity to provide important social services, including to the most disadvantaged members of the community.
  - Proposals to limit certain aspects of financial support should be broadly offset by increases in alternative forms of assistance.
- **Support arrangements should be transparent and simply administered**
  - A key reform priority should be to reduce complexity and streamline administrative and compliance requirements associated with support measures — thereby helping to lower costs for both the sector and governments.
  - Funding mechanisms — whether provided through the tax system or more directly through the expenditure side of the budget — should be clear and simple to administer.

- **Taxpayer interests should be safeguarded**
  - The provision of taxpayer support comes with attendant obligations for transparency and good governance of community organisations.
  - Reforms should provide a role for governments in setting social policy priorities, supported by robust reporting and accountability arrangements for recipient organisations.
  - Careful consideration needs to be given to the design of all support measures, including their efficacy, the ability of government to calibrate support according to different circumstances, and interaction with other policy measures.
- **Establish an appropriate lead time for reform**
  - To manage transitional issues, extensive lead-time should be provided before fundamental reforms to funding mechanisms are implemented. This might be in the vicinity of two to five years to allow organisations sufficient time to minimise dislocation impacts.
  - It will also allow more specific and detailed analysis of the implications of concrete reform proposals to the sector. Such undertakings will be crucial in reducing the scope for unintended consequences.

Reforming support arrangements for community organisations will necessarily involve a range of structural adjustments for both organisations and governments. This report examines some reform options and related transitional issues.

Any changes to present arrangements will have implications for the overall level of taxpayer support given to community organisations. Such considerations have many public interest dimensions and are appropriately made by governments. As such, the focus of the report is on improving the means through which support is provided rather than advocating for greater funding.

It is essential that government adopts and articulates a clear and coherent policy approach in devising any funding support reform program for community organisations — especially in the context of the broader evolution of the tax framework. Difficult and sensitive reforms can become more palatable when the sector and the broader community have the opportunity to recognise the trade-offs involved.

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1 Background

Access Economics was engaged by the Community Council for Australia (CCA) to analyse taxation concession arrangements applying to community organisations. The CCA is a newly created non-partisan, independent and member-based organisation. It represents a hub for a diverse range of not-for-profit (NFP) organisations and a focal point for common broad-based issues for the sector, including regulation and taxation.

This report aims to identify economically credible options for addressing taxation reform issues, particularly in the context of the Australian Government's current review of the tax system. It should be noted that the scope of this report is limited to the tax concession arrangements applying to community organisations rather than the NFP sector in its entirety. Nevertheless, many of the issues analysed in the report have broader relevance to the wider NFP sector.

Community organisations are defined as organisations that:

- have a community focus – they may provide services to a local community or the wider community, represent a community of like-minded people, or are perhaps a combination of these; and
- operate on a not-for-profit basis in a non-market environment (as opposed to the market environment within which for-profit private enterprises operate).

Community organisations include social services, arts and culture, recreation, environment, education and philanthropic organisations.

Not-for-profit market organisations such as hospitals, trading cooperatives and licensed clubs are not analysed in the report. It is recognised that some community organisations also operate in the market, such as retail outlets run by social welfare organisations. However, the primary function of these organisations, namely the provision of community services, occurs outside the market.

1.1 Strategic context for taxation reform

The impending release of the Australian Government's review of the taxation system (the Henry Review) and the recent publication of a Productivity Commission report on the contribution of the NFP sector provide a strategic context for the reform of tax concession arrangements for the NFP sector. These two studies are discussed in further detail below.

However, it is important to outline other NFP sector studies that have been undertaken over the past 15 years, including:

- *Charitable Organisations in Australia* by the Industry Commission in 1995.
- *Inquiry into the Definition of Charities and Related Organisations* in 2001.
- *Disclosure Regimes for Charities and Not-for-profit Organisations* by the Senate Standing Committee on Economics in 2008.

The recommendations flowing from these studies have been broadly similar, such as the need to clarify and simplify the definition of a 'charity' and to create a single national regulator for NFP organisations.

With regard to taxation, the Senate Standing Committee on Economics noted that the tax system for NFPs is confusing:

> *Tax concessions for the Sector seem to represent historical accidents rather than any rational plan (Senate Standing Committee on Economics 2008: para 8.45).*

It recommended that the Henry Review, which commenced in 2008, include an examination of tax measures affecting NFP organisations with a view to simplifying these arrangements and reducing the cost of compliance.

Australia's Future Tax System (the Henry Review)

In May 2008 the Australian Government announced a review of Australia's tax system headed by Treasury Secretary Dr Ken Henry. The review will look at the current tax system and make recommendations to position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century.

The Henry Review represents the most comprehensive examination of Australia's tax system in many decades. As such, it provides an opportunity to reshape the structure of the Australian tax framework in the context of longer-term social and economic pressures.

There are a number of facets to the review that support such objectives and help provide a feasible long-term reform path:

- It is a comprehensive 'root and branch' examination of Australia's tax system. This allows constraints and shortcomings of the tax and transfer framework to be reviewed together, along with consideration of compensatory trade-offs. This will go far in dealing with conflicting issues and interest groups that can frustrate a more narrow reform program.
- It will be a long-term program — perhaps in the order of 10 to 15 years. This will allow some of the risks of reform to be managed better. Importantly, the review has the potential to lay the intellectual foundations for future tax reform beyond its more immediate recommendations.
- At least when the review was conceived, Australia's fiscal position was strong, making it an opportune time to act on tax reform.

What will be the focus of the review?

The review will encompass Australian Government and State taxes, except the GST, and interactions with the transfer system.

Under the review's terms of reference it should make coherent recommendations to enhance overall economic, social and environmental wellbeing, with a particular focus on ensuring appropriate incentives for:

- workforce participation and skill formation;
- individuals to save and provide for their future, including access to affordable housing;

- investment and the promotion of efficient resource allocation to enhance productivity and international competitiveness; and
- reducing tax system complexity and compliance costs.

In addition, the review's consultation paper specifically raised the issue of complexity of FBT concessions for the NFP sector and sought options to improve equity and simplicity of these arrangements. It posed two specific questions in relation to NFP organisations:

- What is the appropriate tax treatment for NFP organisations, including compliance obligations?
- Given the impact of the tax concessions on NFP organisations, regarding competition, compliance costs and equity, would alternative arrangements (such as the provision of direct funding) be a more efficient way of assisting these organisations to further their philanthropic and community-based activities?

The review and the Government's formal response have yet to be publically released.

Productivity Commission study

In March 2009, the Australian Government directed the Productivity Commission to undertake a study on the contribution of the NFP sector. The purpose of the study was twofold:

- to improve measurement of the sector's contribution, in turn allowing government to devise and deliver enhanced policy and programs for the sector; and
- to examine ways to maximise the sector's contribution, particularly by removing any unnecessary impediments to the efficient and effective operation of NFPs.

The study's terms of reference included an examination of the impact of the taxation system on the ability of NFP organisations to raise funds and how tax treatment of the NFP sector affects competitive neutrality. The Productivity Commission was also asked to have regard to the findings of the Henry Review (although these are not yet publicly available).

The findings and recommendations of the Productivity Commission are outlined in Box 1 below. Some of the key tax-related recommendations are explored in later sections of this report.

Box 1: Productivity Commission findings and recommendations

The final report on the contribution of the NFP sector was released by the Productivity Commission on 11 February 2010. The Productivity Commission concluded that wide-ranging reforms were necessary to remove obstacles faced by the NFP sector and to improve its accountability.

The Productivity Commission made a number of recommendations, such as the creation of a Registrar for Community and Charitable Purposes to consolidate regulatory oversight at the federal level and the national harmonisation of fundraising legislation.

Specific tax-related recommendations include:

- One national registrar (i.e. the Registrar for Community and Charitable Purposes) to register/endorse NFPs for concessional tax status.
- Progressive extension of DGR status to all tax-endorsed charities.
- Increased clarity about funding commitments to help close wage gaps for NFP staff.
- Review of the feasibility of including input tax concessions (such as FBT) in 'value for money' assessments for organisations competing for government-funded services (to restore competitive neutrality).

1.2 The third sector

NFP organisations are part of what is often called the 'third sector' — that part of society which is not private business (first sector) or government (second sector). The third sector comprises community organisations, churches, advocacy groups, cooperatives, trade unions, trade and professional associations and chambers of commerce.

The remainder of this section canvasses the entire third sector, detailing its important economic and social contribution to Australia. It also outlines the significant diversity of the third sector. Community organisations, as one component of the wider third sector, are discussed in Section 1.3.

Economic and social importance of the third sector

According to the Productivity Commission (2010) there are around 600,000 NFP organisations in Australia. The vast majority of these organisations (approximately 440,000) are unincorporated associations, for example, small organisations that rely on volunteers and usually lack legal status, such as a hobby group.

The ABS (2009) estimated there were about 59,000 'economically significant' NFP organisations in Australia (on the basis that these organisations employed staff or accessed tax concessions). In 2006-07 these organisations contributed around $43 billion to the Australian economy, or about 4.3% of gross domestic product (GDP).

In 2006-07 the third sector employed almost 890,000 people (8.5% of total employment) and used the services of about 4.6 million volunteers. From 1999-00 to 2006-07, there was an average annual growth in total employment in the sector of 5.7%, demonstrating the expansion of the sector throughout this period.

For those economically significant NFP organisations, Table 1.1 shows that about half of all revenue is self-generated, one-third is sourced from government and just under 10% of revenue comes from philanthropic sources.

Table 1.1: Revenue sources for NFP organisations in 2006-07

Revenue source	Amount ($b)	Proportion of total (%)
Self-generated income	38.0	49.6
Government	25.5	33.3
Philanthropy	7.2	9.4
Other	5.9	7.7
TOTAL	**76.6**	**100**

Source: Productivity Commission (2010)

The social contribution made by the sector is equally as important as its economic contribution. As a whole, the third sector acts to increase the social capital of Australia. In the case of some organisations, this can be through increasing overall *economic* welfare (for example, organisations that work with the poor and homeless) or directly influencing overall *social* welfare (action to improve the quality of the environment).

However, these social benefits primarily arise from less tangible social cohesion elements. Third sector organisations, merely by their existence, help to improve social cohesion and create a sense of belonging amongst those aided by an organisation's activities. Almost all third sector organisations operate within a social inclusion framework and are focused on contributing to the development of a more caring and inclusive community. These benefits are almost impossible to value quantitatively.

The economic and social importance of the sector is reflected in the newly-created National Compact between the Australian Government and the third sector. The National Compact aims to establish a framework for greater cooperation between government and the third sector in a range of priority areas such as regulatory arrangements, advocacy and workforce issues (see Box 2 below).

Box 2: National Compact with the third sector

The *National Compact: Working Together* was launched by the Prime Minister on 17 March 2010.

As part of the Australian Government's Social Inclusion Agenda, the National Compact sets out a framework for future cooperation and partnership between government and the third sector.

The National Compact was developed through consultation with stakeholders, including community sector organisations, and outlines eight priority areas:

- Document and promote the value and contribution of the sector.
- Protect the sector's right to advocacy irrespective of any funding relationship that might exist.
- Recognise sector diversity in consultation processes and sector development initiatives.
- Improve information sharing including greater access to publicly funded research and data.
- Reduce red tape and streamline reporting.
- Simplify and improve consistency of financial arrangements including across state and federal jurisdictions.
- Act to improve paid and unpaid workforce issues.
- Improve funding and procurement processes.

The National Compact sets the tone for the relationship between government and the third sector and is important in achieving cultural change. However, the implementation of detailed action plans is vital to effect change 'on the ground'.

Significant diversity within the third sector

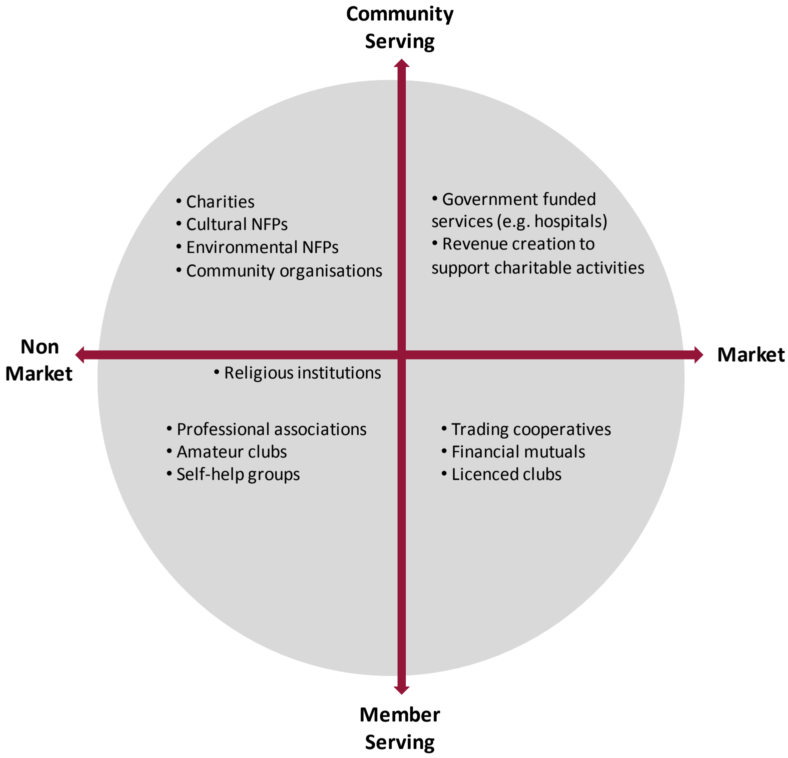
The third sector is characterised as much by its diversity as its commonalities. NFP organisations vary in terms of:

- organisational structure — ranging from small unincorporated associations to companies limited by guarantee, cooperatives and incorporated associations;
- employment — some organisations have no employees, whereas others may employ thousands (e.g. NFP hospitals);
- turnover — more than 60% have a turnover of less than $150,000 (as reported in their Australian Business Number (ABN) application) whereas some have revenue in excess of $25 million (Productivity Commission 2010);
- type of activity undertaken — including culture and recreation, education and research, health, social services, environment, housing, law and advocacy, philanthropy, religion, international, business and professional associations; and
- funding structure — many organisations access a variety of funding sources (e.g. government, self-generated and philanthropic donations) whereas others use one primary funding source.

The diversity of the third sector is reflected in Figure 1.1, which highlights several key distinctions between NFP organisations: whether they are member- or community-serving and market or non-market. Most NFP organisations fall within the non-market, member-serving category, e.g. amateur clubs and self-help groups.

These distinctions can be nebulous — for example, many religious institutions are both community-serving (through agencies that provide care for the disadvantaged and vulnerable) and member-serving (by providing a place of worship and sense of belonging for individual members of the religion).

Figure 1.1: Diversity of the third sector



Source: Adapted from Productivity Commission (2010)

1.3 The community sector

Community organisations — or the 'community sector' — form one component of the broader third sector. As noted above, community organisations:

- have a community focus — they may provide services to a local community or the wider community, represent a community of like-minded people, or are perhaps a combination of these; and
- operate on a not-for-profit basis in a non-market environment (as opposed to the market environment within which for-profit private enterprises operate).

Community organisations include social services, arts and culture, recreation, environment, education and philanthropic organisations.

The significant diversity of the third sector funnels down to the community sector. Organisations vary in terms of structure, employment, turnover, type of activity undertaken and funding structure. A snapshot of some of the organisations that fall within the community sector can be found in Box 3.

Box 3: Diversity of the community sector

The community sector is united by its community focus, yet the range of organisations is highly diverse. Activities undertaken by community organisations include:

- Arts and culture — performing arts, literary societies, media and communications.
- Health — aged care services, mental health services.
- Social services — child welfare, services for the disabled, disaster relief, refugee assistance.
- Environment — animal welfare, wildlife preservation, natural resources conservation.
- Development and housing — community and neighbourhood organisations, job training.
- Law, advocacy and politics — victim support, consumer protection.
- Philanthropic — grant-making foundations, volunteerism promotion.
- International — development assistance, international human rights.
- Religion — congregations.

This list is not exhaustive and only provides a snapshot of the plethora of community sector activities.

Source: Productivity Commission (2010)

The social contribution made by the third sector equally applies to the community sector – perhaps even more so, given the community focus of these organisations. The value of this social contribution is difficult to measure, in terms of the nature and scope of benefits. The intangible nature of the benefits, which manifest in enhanced social cohesion and social inclusion, cannot be quantified. Similarly, the flow-on impacts of these benefits often extends to future generations.

For example, an environmental organisation that advocates for the protection of a threatened species makes an invaluable contribution to the community by enhancing social cohesion, through the coming together of caring individuals who may then work together on other environmental causes. The organisation also contributes to the future well-being of the community, possibly by saving the species from extinction or even by promoting awareness of the need to preserve bio-diversity and vulnerable ecologies.

In terms of funding, community organisations rarely, if ever, reach a stage where they receive funds surplus to requirements. Rather, they may continue to provide additional services with additional funding almost without bound.

The 2010 Australian Community Sector Survey, completed by 582 community services and welfare organisations, reported that 69% receive their primary funding from government (Table 1.2). Funding by State/Territory governments was most likely to be ongoing or recurrent whereas corporate funding was least likely to be ongoing or recurrent.

Table 1.2: Revenue sources for community organisations in 2008-09

Revenue source	Primary source of funding for organisation (%)	Funding is ongoing/recurrent (%)
Commonwealth Government	23	72
State/Territory Government	40	80
Local Government	6	52
Client Fees	10	68
Donations	10	44
Corporate	3	36
Other	8	77

Source: ACOSS (2010)

Note: These data are largely drawn from social services organisations – for example, environment, arts and culture and philanthropic organisations are not included in this survey.

Community organisations may also receive indirect support from government through tax concessions. The key federal tax concessions are income tax exemptions, FBT exemptions and goods and services tax (GST) concessions. Some organisations may also be endorsed as having deductible gift recipient (DGR) status, allowing donors to claim an income tax deduction for their donation. Tax arrangements for the community sector are analysed in detail in Section 3.

Operational pressures and challenges

Community organisations often face significant resource constraints. Organisations have reported that government funding does not cover the true cost of delivering contracted services and that funding arrangements do not allow them to plan adequately for the future (generally because ongoing funding is not guaranteed).

The regulatory framework applying to community organisations is complex and burdensome. For example, there are 15 pieces of Commonwealth legislation and 163 pieces of State/Territory legislation under which an organisation must be determined to be 'charitable' in order to receive a benefit or other legal outcome (Productivity Commission 2010: F.2).

Compliance with these legislative requirements can often result in high administrative costs for community organisations. For example, 51% of surveyed community organisations report that 'red tape' adversely affects their ability to deliver services (ACOSS 2010).

The current regulatory framework can also discourage social innovation. Access to growth capital (i.e. funding that allows organisations to invest in themselves) is important in building capacity for social innovation, yet funding arrangements for community organisations are usually quite prescriptive and linked to the way the service is delivered rather than to outcomes. Fear of failure ('reputation risk') and time and capacity constraints can also hinder social innovation within the community sector.

Box 4: Social innovation

Social innovation refers to new activities or methods of operation that are motivated by the goal of meeting social needs. It leads to increased productivity (i.e. greater efficiency and effectiveness) for community organisations and enhances community wellbeing.

The Smith Family defines social innovation as:

> *Connecting different people, in different ways to overcome an entrenched or emerging social issue.*

Social enterprise, where business models are used to deliver social outcomes, is one means of encouraging social innovation. Access to growth capital, for example through venture funds such as Social Ventures Australia, is another way to stimulate social innovation.

An example of social innovation is The Smith Family's *Learning for Life* program. This program has a preventive focus and is aimed at tackling the root causes of disadvantage by focusing on children's education.

Learning for Life has attracted substantial support from corporate foundations — for example, The Westpac Foundation contributed around $4.6 million to facilitate expansion of the program. These funds have provided The Smith Family with significant growth capital, enabling the organisation to address the causes (rather than the symptoms) of disadvantage within society.

Source: The Smith Family (2009)

2 Public support of the community sector

Community organisations provide a diverse range of services including support for the disadvantaged, shelter for the homeless and emergency relief. Beyond these forms of social service, they also promote various arts, cultural, environmental and recreational pursuits.

An important facet of these services is that they yield public benefits. That is, the services deliver benefits that are not restricted to the providers of these services, their users or clients, but also generate important social, economic and cultural benefits to the wider community. It is this outcome that is central to government support for the community sector.

This section outlines the underlying motivations for government support for community organisations. It should be noted that while the discussion focuses on the community sector, the arguments generally also apply to the wider NFP sector.

2.1 A strong rationale for government involvement

Governments and markets are inextricably linked. Markets do not always work effectively; and as a result governments play a crucial role in enhancing market effectiveness. A key way that governments intervene in markets is to influence market outcomes (another way is to set the framework in which markets operate). This is typically undertaken to address instances of 'market failure' or to achieve particular social objectives such as reducing disadvantage or to improve community health.

It is common for free markets to produce too little or too much of a good or service from a community-wide perspective. These externality or 'spill-over' impacts are a key source of market failure and essentially occur when the costs of production or consumption do not fully capture wider benefits or costs to society.

In terms of community organisations, the wider social and economic impacts they generate 'spill-over' across the community and, as such, are unable to be fully captured by organisations, their private donors (whether through financial contributions or volunteerism) and their clients. They will therefore tend to be underprovided (in both number and scope) from society's viewpoint if left entirely to the independent resources of those organisations. This provides a strong economic rationale for government support for these organisations, primarily as a means of encouraging the provision of additional community services for wider social benefit.

A range of social benefits are provided

The social benefits provided by community organisations are many and varied, reflecting the sector's diversity. A major benefit is that community sector organisations contribute to social cohesion. This arises from cooperative action, for instance individuals (perhaps from diverse backgrounds) coming together to provide services to those in need. Volunteerism is known to be associated with an increased sense of belonging to the community, both among volunteers and other members of society.

Community sector organisations also embody principles of pluralism (or individual choice). Where individuals give support to these organisations, either by private donation or volunteering, they are afforded the opportunity to take responsibility for their community, especially to those in need, and to assist important causes directly. This gives expression to diverse values and helps support a vibrant democracy and civic society, enabling people to better participate in engaging and solving local and national issues.

It is important to note that many of the social benefits yielded through community organisations (and other NFPs) also have key economic implications. For instance, by supporting higher levels of social inclusion, cooperation and trust, they can:

- reduce the costs of conducting day-to-day affairs and doing business;
- facilitate the spread of knowledge and innovation;
- contribute to particular aspects of wellbeing such as improved employment and housing outcomes (which are generally higher in individuals who enjoy good access to social capital); and
- play a role in lowering health and welfare expenditures, and supporting higher tax receipts.

Conversely, lower levels of social capital may well encumber civic life, limit social and economic opportunities and reinforce existing inequalities.

Improved social cohesion and pluralism are desirable outcomes for the community and provide a powerful justification for ongoing public support of the sector.

2.2 A social compact with the community

Governments have a responsibility to ensure a safety net is provided for all members of society. In order to accomplish this, governments themselves intervene in markets to achieve particular social policy objectives such as health improvement, and to tackle poverty and other forms of disadvantage. These interventions and policy programs include social security arrangements (e.g. unemployment and aged pension benefits), provision of public health services and aged care and minimum wage regulations. They are managed and financed by both the Commonwealth and State governments.

Governments also have a responsibility to ensure equity of access to social services and adequacy of service quality, as well as the allocation of resources to meet relevant social priorities. In many areas, therefore, the activities of community organisations cross-over with government-provided services. A key implication is that social services delivered by community organisations and governments can be both substitutable and complementary.

Many community organisations provide services that the government would otherwise have to provide in their absence. This has clear budgetary consequences. A loss of revenue from providing tax exemptions is offset (to some degree) by shifting the financial burden for providing these services from government to tax subsidised community organisations.

Although government provides certain social services, these may be under-provided due to imperfect knowledge about the extent and type of assistance required. Community organisations, on the other hand, have 'on the ground' or local knowledge that enables them to target resources where they are most needed. They also have advantages in being able to operate in a more decentralised fashion, whereas governments are somewhat hindered by existing bureaucratic structures. This can often lead to a more efficient use of resources by community organisations to deliver objectives, especially given that the operating structures of many community organisations are relatively low-cost (e.g. overheads and staff costs).

2.3 Direct and indirect funding

Government can support community organisations either directly or indirectly. Both funding avenues allow government to meet its responsibility to provide a social safety net. However, the question arises as to which form of support (or combination of forms of support) is most effective in assisting community organisations to deliver services at least cost to taxpayers.

- **Direct funding** occurs through government grants and contracting for services. This form of funding is transparent as the extent of total government support can be clearly measured in dollar terms. It also provides the government with policy flexibility, as the direction and level of support can be adapted to changing circumstances. However, direct funding can lead to problems with selection bias and there may be additional administration costs for government. Direct funding can also cause uncertainty for community organisations due to the political cycle i.e. ongoing funding cannot be guaranteed. In addition, good program design is required to encourage social innovation.
- **Indirect funding** occurs through the taxation system via concessional arrangements. Indirect funding provides community organisations with operational flexibility and is relatively simple for the government to administer. In addition, no upfront outlays are required by government to deliver this form of funding. Indirect funding through donor tax concessions can also promote pluralism and civic responsibility, and can have fiscal benefits for government by leveraging philanthropic assistance for priority areas. However, indirect funding can lack transparency and accountability. It can also distort the operation of the tax system.

The current tax concession arrangements applying to the community sector, including the advantages and disadvantages inherent to each type of tax concession, are analysed in the following section of this report.

In nearly all cases, a combination of direct and indirect funding is essential to ensure that both government and community organisations retain sufficient flexibility to maximise their core objectives. For government, direct funding provides policy flexibility and support can be targeted to specific areas. For community organisations, indirect funding provides them with operational flexibility and allows them to undertake socially innovative activities. For these reasons, direct and indirect funding should not be viewed as mutually exclusive options.

3 Current taxation arrangements

Tax concessions at the federal level include income tax exemption, fringe benefits tax (FBT) concessions, goods and services tax (GST) concessions and deductible gift recipient (DGR) status. State and Territory governments also provide tax concessions related to payroll tax, land tax, gambling tax and stamp duties. Local governments may also provide general rate concessions.

Eligibility for tax concessions varies depending on the type of exemption and jurisdiction. For example, only certain types of organisations such as public benevolent institutions (PBIs) are eligible to receive FBT concessions. Generally, those community organisations that provide most benefit to the community through the alleviation of disadvantage receive the most generous tax concessions.

In this section, an economic framework is used to analyse current taxation arrangements applying to community organisations. The advantages and disadvantages of three types of tax concessions are outlined:

- income tax concessions;
- donor tax concessions; and
- input tax concessions.

For each category of tax concessions, the impacts on community organisations and government are considered. These impacts are summarised in Sections 3.5 and 3.6.

3.1 Value of tax concessions

When they grant tax concessions, governments need to raise money from other sources, such as through increasing tax rates on non-exempt companies, goods and individuals, to reach their tax revenue targets. Such concessions represent forgone taxation revenue and are therefore essentially the equivalent of real budgetary expenditures. As such, these outlays should be considered alongside other forms of assistance when determining the most cost efficient use of government funds.

Measuring the value of tax concessions is complex. There are issues in establishing a 'neutral' taxation benchmark with which to measure tax expenditures. This involves measuring the difference in tax paid by taxpayers who receive a particular concession (both community organisations and individual gift providers) relative to similar taxpayers who do not receive the concession. That said, there appears to be a consensus among treasury departments to consider tax concessions to NFP organisations as tax expenditures and it is a useful approach to estimate taxpayer support and compare and evaluate alternative options.

This approach is reflected in the 2009 *Tax Expenditures Statement* which shows the tax concessions provided to the community sector by the Commonwealth Government. Table 3.1 sets out the value of these concessions where dollar estimates are available. However, the full expenditure statement also lists, but does not quantify, other tax concessions like income tax exemption for charitable funds. Such tax expenditures are real but cannot be measured due to limited data or the nature of the tax expenditure itself (which highlights issues with budgetary transparency).

In 2009-10 the value of tax concessions for community organisations is estimated to be around $2.35 billion. This represents an increase of about 55% from the value of tax concessions provided in 2005-06.

It should be noted that these numbers do not include tax concessions provided by State and local governments.

Table 3.1: Commonwealth Government tax concessions provided to the community sector

Tax expenditure	($ million)							
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Deduction for donations to Private Ancillary Funds [A66]	90	160	210	325	410	380	370	365
Deduction for gifts to approved donees [A67][a]	730	710	810	920	970	1,070	1,080	1,170
Income tax exemption for recreation-type not-for-profit societies [B31]	20	20	20	20	20	20	20	20
Capped FBT exemption for public benevolent institutions (excluding public and not-for-profit hospitals) [D11]	500	790	710	740	760	800	860	910
Capped FBT exemption for charities promoting the prevention or control of disease in human beings [D30]	40	65	60	60	65	65	70	75
Exemption for fringe benefits provided to employees of religious institutions [D32]	75	95	80	80	85	90	95	100
FBT partial rebate for certain not-for-profit, non-government bodies [D50][b]	45	30	30	20	20	25	25	30
GST – Religious services [H18]	20	20	20	20	20	20	20	20
Total	**1,520**	**1,890**	**1,940**	**2,185**	**2,350**	**2,470**	**2,540**	**2,690**

Source: Treasury (2010)

Note: Some tax expenditures applicable to the community sector are not included as the value of these expenditures cannot be estimated. References in square brackets relate to the category reference numbers in the *2009 Tax Expenditures Statement*. [a] This concession also include some non-community sector organisations such as public hospitals and universities. [b] This concession also includes some non-community sector organisations such as trade unions and employer associations.

3.2 Income tax concessions

Income tax concessions for community organisations are currently provided through tax concession charity (TCC) endorsement or through self-assessment under the *Income Tax Assessment Act 1997*. Income tax exemption means the organisation does not need to pay tax on its earnings, which supplements organisational resources.

If a community organisation is a charity (as defined in tax law), it must apply to the Australian Tax Office (ATO) to receive TCC endorsement. The following types of charities are eligible for endorsement:

- charitable funds;
- charitable institutions;
- public benevolent institutions (PBIs)[1]; and
- health promotion charities.

This is a separate application process to that required for DGR status (see below), and not all organisations that are eligible for TCC endorsement will be eligible for DGR status (and vice versa). To receive endorsement, organisations must also have an ABN.

Other categories of community organisations specified in the *Income Tax Assessment Act* can 'self-assess' that they meet the specific requirements for an exemption category. These categories include:

- community service organisations;
- certain types of cultural organisations (art, literature, music and musical purposes);
- income tax exempt funds;
- religious organisations;
- resource development organisations; and
- sporting organisations.

In addition, community organisations with income below $416 a year that are not otherwise income tax exempt are entitled to receive an income tax exemption.

Income tax exemption explicitly recognises that certain community organisations generate a social benefit. Consequently, monies that are not paid to the government as income tax can instead be used for the advancement of the cause for which the organisation acts.

Advantages

Income tax concessions do not present the same problems of distortion as other concessional arrangements. There is no need for operations to change in order to take advantage of an income tax concession. Instead, community organisations are able to focus on using available funds to achieve their objectives, rather than concerning themselves with minimising tax obligations.

[1] A definition of PBIs can be found in Appendix A.

This arrangement can offer more operational flexibility to a community organisation. For example, there will be fewer concerns with matters relating to tax liability such as smoothing income over financial years, and the organisation will be better placed to allocate *and time* their expenditure for when it is most needed. Similarly, an organisation may be able to plan in advance with certainty that funds generated from philanthropic donations will be able to be used for philanthropic purposes.

Income tax concessions also reduce the administrative burden for government and community organisations. For the government, the concession simply represents income foregone rather than a system to be administered and regulated, and the only actual cost lies in ATO assessment of whether applicant organisations are eligible for the concession. For the community organisation, income tax exemption means they are not required to complete a potentially complex tax return.

Disadvantages

Income tax concessions add some additional complexity to the tax system, due to the unique classification criteria for income tax concessions by comparison with other tax concessions.

They can also lead to inequity amongst similar types of community organisations. For example, only organisations whose *sole* purpose is charitable are able to receive TCC endorsement. This means that an organisation that has another purpose in addition to a charitable purpose, such as government lobbying, is likely to be ineligible. These exemptions provide financial benefits to eligible organisations compared with their peers.

Income tax concessions also reduce the flexibility of government support, i.e. funding cannot be targeted either in direction or scope. Direct funding, in contrast, can be augmented in line with perceptions of community need and preference, and more easily reduced or increased if the activities of an organisation make this necessary.

Support provided by through income tax exemption is also open-ended, both within a financial year (in effect government support is limited only by the ability of an organisation to continue raising funds) and on an ongoing basis, with a presumption that this arrangement will continue in perpetuity. Many organisations operate with this presumption in mind, making eligible community organisations reliant upon the continuation of the concession. In turn, it becomes difficult for government to withdraw this kind of support, even if it is no longer effective.

The separate endorsement processes for TCC and DGR status also result in a higher administrative burden for community organisations. Additionally, the complexity of ensuring continuing compliance and undertaking regular self-assessment against two separate sets of criteria results in duplication of compliance efforts, which distracts an organisation from achieving its community-focused objectives.

3.3 Donor tax concessions

A donor tax concession is provided through DGR endorsement. Where an organisation is classified as having DGR status, donations to that organisation can be paid from untaxed income, i.e. the value of the donation can be deducted from the donor's income for the calculation of income tax.

To be granted DGR status, organisations must be endorsed by the ATO or listed by name in the *Income Tax Assessment Act 1997* or Income Tax Assessment Regulations 1997 (for prescribed private funds). Some DGRs listed by name in the tax law include Amnesty International Australia and the Australian Sports Foundation. Organisations that wish to be listed on certain DGR registers may also apply to the relevant department or agency and the Treasurer, in consultation with the relevant Minister, decides whether to enter the organisation on the register. For example, an organisation that wants to be listed on the Register of Harm Prevention Charitable Institutions must apply to the Department of Families, Housing, Community Services and Indigenous Affairs (FaHCSIA).

To receive endorsement by the ATO, organisations must fall within a general DGR category. There are more than 40 categories, including public hospitals and universities, health promotion charities, school building funds, scholarship funds and overseas aid funds. Generally, only community organisations that provide direct relief and care are eligible for DGR endorsement, e.g. PBIs, animal welfare charities and charitable services institutions.[2]

Almost 75% of organisations with DGR status are charitable organisations, as shown in Table 3.2. The majority of these charitable organisations are in the welfare and rights, education and cultural areas.

Table 3.2: Types of active DGR organisations as of June 2009

Category	Charitable	Non-charitable	Total
Welfare and rights	9,469	2,501	11,970
Education	4,143	1,456	5,599
Cultural	1,903	1,698	3,601
Ancillary funds	1,331	237	1,568
Health	993	459	1,452
Prescribed Ancillary Funds	639	106	745
Environment	251	229	480
Legislated	119	72	191
International Affairs	150	21	171
Other	214	112	326
Total	**19,212**	**6,891**	**26,103**

Source: Productivity Commission (2010)

To receive DGR endorsement, organisations must also have an ABN, acceptable rules dealing with the transfer of surplus gifts and deductible contributions on winding up or revocation of endorsement, maintain a gift fund (if applicable) and issue gift receipts correctly.

Organisations are also required to undertake regular self-reviews to check they are still entitled to DGR endorsement (the ATO suggests this be done annually).

[2] A charitable services institution is an organisation that would be a PBI but also promotes the prevention or control of diseases or harmful/abusive behavior (as a secondary activity).

Most gifts to organisations with DGR status are tax deductible and include:

- donations of $2 or more in money;
- property valued by the ATO at more than $5,000;
- property purchased less than 12 months before the gift was made;
- shares valued at $5,000 or less, and acquired at least 12 months before the gift was made;
- trading stock disposed of outside of the ordinary course of business;
- cultural gifts or bequests made under the Cultural Gifts and Cultural Bequests Programs; and
- heritage gifts of places included in the National Heritage List, the Commonwealth Heritage List or the Register of the National Estate.

Advantages

DGR endorsement of community organisations encourages philanthropic donations to these organisations by providing tax incentives to individual donors. The ability to make donations from untaxed income effectively lowers the price of philanthropic giving. For example, if an individual in a 30% marginal tax bracket donates $100 to an organisation with DGR status, the net cost to the donor is $70 (with the government effectively contributing $30 to the organisation in terms of foregone tax revenue). This reduction in the price of giving for individuals has a positive influence on the level of philanthropic donations.

Some economic analysis suggests that DGR endorsement, and the lower price of giving, stimulates individuals to make larger donations than originally planned (rather than having a neutral or negative impact on the net value of the donation). There is, however, some uncertainty about the precise impact and the Productivity Commission (2010) notes that international studies of donor tax concession programs have produced conflicting results about whether the net value of the donation increases, stays the same or decreases. They tentatively conclude that a lack of evidence of crowding out, combined with the relatively high marginal tax rates in Australia at the top end of the scale, tend to indicate that donor tax concessions encourage individuals to donate larger net amounts than they would without the inducement of the tax concession. Further details on the responsiveness of donations to tax incentives can be found in Appendix B.

Encouraging private donations through the tax system also promotes pluralism by giving the community opportunity to assist specific organisations directly. This provides funding for organisations that do not receive direct government support — for instance, because the government is pursuing alternative priorities or perhaps because the government is unaware of the issues being addressed by the organisations.

Causes that are not politically popular, for example, are able to receive indirect government support through DGR endorsement of organisations. The heroin injecting room in Sydney is not politically popular, but derives funding through donations to the Wayside Chapel, which has received DGR endorsement.

Private donations also reveal individual philanthropic preferences, and direct government funding in a way that better reflects individual preferences. For example, where an individual donates to an animal welfare organisation under the DGR arrangements, the government is (indirectly) directing funds towards animal welfare concerns. When governments distribute direct funding, they make value judgments about perceived need and community interests, and may not choose to fund certain organisations that individuals believe are worthy of support.

By encouraging philanthropic donations, donor tax concessions also provide greater funding certainty to community organisations. Philanthropy involves the planned and structured giving of resources to community organisations, allowing these organisations to concentrate on their core purpose rather than raising funds or adhering to administrative and compliance requirements associated with direct government funding. Some forms of philanthropy can also be perpetual, such as foundations established by will or charitable foundations, providing funding certainty over the long term.

The contribution made by one form of philanthropy — Prescribed Ancillary Funds (PAFs) — to the community sector is highlighted in Box 4 below.

Box 4: Philanthropic contributions through PAFs

Prescribed Ancillary Funds (PAFs) — previously known as Prescribed Private Funds (PPFs) — are the fastest growing form of philanthropy in Australia. PAFs are a type of philanthropic trust. The sole purpose of a PAF must be the giving away of funds to other deductible gift recipients.

PAFs are attractive to individual and family philanthropists as they are relatively simple to establish and provide the donor with a large degree of control over investment decisions. Donors are also entitled to receive a tax deduction for their philanthropic donations.

In 2001, when PPFs were first created under legislation, 22 PPFs were approved with a total of \$78.6 million under management. By 2007, there were 559 PPFs with just over \$1.2 billion under management and \$117 million issued to third sector organisations.

Source: Philanthropy Australia (2009)

Philanthropy is also important in encouraging social innovation. Donors generally have a high risk tolerance and are motivated to fund new ideas that may lead to social change, whereas government is usually risk-averse and reluctant to fund untested ideas or programs.

Indirect funding through DGR endorsement of community organisations can also have fiscal benefits for government. By potentially leveraging additional private assistance for priority areas, budgetary outlays can be reduced compared with direct spending. There may also be lower administrative costs for government through this form of indirect funding.

DGR is more equitable across eligible organisations. Unlike FBT, organisations are either 'eligible' or 'ineligible' — there are not multiple categories of assistance. This means that all eligible organisations are entitled to the same benefits.

Disadvantages

Encouraging plurality through DGR endorsement is not without limitations. Through its role in approving organisations eligible to receive tax exempt donations, government essentially selects which organisations it believes are most worthy of public support (to the detriment of other organisations which may be just as worthy).

In addition, community organisations that work to prevent disadvantage rather than provide direct relief of disadvantage are often excluded from DGR status. For example, neighbourhood houses and learning centres may be ineligible for DGR status, yet many of these organisations contribute to community wellbeing by helping to prevent social isolation.

Application of DGR status can also be inconsistent. For example, some peak bodies such as Volunteering Australia, Research Australia, National Disability Services and the Refugee Council of Australia all have DGR status, whereas other such as Philanthropy Australia and the Australian Council of Social Service do not have DGR status. This inconsistency gives rise to inequity within the tax system.

DGR endorsement as a form of indirect funding also gives rise to issues related to social equality. Tax concessions for eligible donations are of greatest value to higher income taxpayers with higher marginal tax rates. Lower income earners receive lower tax benefits for donations as they are on a lower marginal tax rate. This differential treatment also extends to individuals who do not pay income tax, such as many unemployed and aged pensioners, who effectively receive no taxation benefit for donations they make to DGR organisations. (It could be argued, however, that individuals on higher incomes have greater spending discretion and more scope to donate, and so should be encouraged through tax incentives that provide greater benefits to those with higher marginal tax rates.)

The complexity of the DGR endorsement process leads to increased administrative costs for community organisations, as outlined in Box 5 below. The separate endorsement processes for DGR and TCC also add to administrative costs for organisations that would like to apply for tax concessions.

Box 5: Complexity of the DGR application process

The Public Interest Law Clearing House notes that approximately half of the requests they receive for legal assistance from NFP organisations relate to tax concession eligibility and the process for obtaining tax concessions – in particular, DGR status:

> *Nearly all applicants are confused about the terminology and the categories that exist.*

It has also found that some organisations within the same 'group' have differential success in obtaining DGR or TCC status depending on which ATO office they have applied to.

Source: PilchConnect (2009)

3.4 Input tax concessions

The main type of input tax concession applicable to community organisations is FBT concessions. Fringe benefits are non-financial 'payments' (or payments in kind) made to an employee that increase the overall compensation received by the worker. For most employers, these non-financial benefits incur FBT. However, some community organisations are entitled to exemptions from FBT.

Within the community sector, the types of organisations that have access to FBT concessions are listed below.

- **Public benevolent institutions (PBIs)** and **health promotion charities** are exempt from FBT, with a cap of $30,000 of grossed up taxable value per employee. These organisations require ATO endorsement to be eligible for the exemption. A definition of PBIs can be found in Appendix A.
- **'Rebatable employers'**, which includes certain charitable institutions and NFP organisations established for community service purposes, are entitled to have their tax liability reduced by a rebate equal to 48% of the gross FBT payable, with a cap of $30,000 per employee. ATO endorsement is required to be eligible for the rebate.
- **Religious institutions** are exempt from FBT, with a cap of $30,000 per employee. Religious institutions that are not charities do not require ATO endorsement; however, those that are charities do require endorsement to be eligible for the rebate.

The caps do not include certain entertainment expenses such as food, drink and benefits associated with that entertainment, such as travel and accommodation.

Advantages

FBT concessions have played an important role in allowing eligible community organisations to attract and retain appropriately qualified staff. FBT concessions reduce the employment costs of eligible organisations and provide them with the ability to offer market value salary packages through the inclusion of fringe benefits that are tax exempt (albeit subject to a cap).

Given the resource constraints faced by most community organisations, FBT concessions enable eligible organisations to compete on a more easily with private sector organisations for the services of skilled labour. Many community organisations are confronted with the difficulty of recruiting workers with requisite skills, and while people who work in the sector are generally motivated to work for a 'good cause', the level of remuneration is also important in attracting staff.

Box 6: Importance of FBT concessions in attracting and retaining staff

Throughout the community sector, FBT concessions are recognised as a key mechanism for attracting and retaining staff.

World Vision Australia (WVA) has PBI status and is entitled to an exemption from FBT, capped at $30,000 per employee. WVA believes the FBT concessions are a 'critical factor enhancing WVA's capacity to offer competitive remuneration to employees'.

WVA notes that, on average, its employees receive remuneration in the bottom quartile of salaries for the general industrial market and its executives receive remuneration in the 10th percentile of the general industrial market.

The FBT concessions are utilised by WVA to offer competitive salary packaging and attempt to 'bridge the wage gap' that arises between the private sector and the third sector.

Source: World Vision Australia (2009)

Disadvantages

Eligibility to receive FBT concessions is not universal across community organisations. The main organisations that are able to access FBT concessions are PBIs (a narrow category of charities that provide direct relief of poverty and sickness). Definitional complexity associated with the eligibility criteria also contributes to administrative costs for community organisations and the government. In addition, many organisations that have received DGR endorsement are ineligible to receive FBT concessions - an example is highlighted in Box 7 below.

This differential treatment of organisations within the community sector can lead to market distortions and inequity within the system. The favourable treatment accorded to certain organisations means the government may be seen as 'picking winners' at the expense of other, equally worthy, organisations.

As a form of input subsidy, FBT concessions can also give rise to inefficiencies. The concessions lower the cost base of recipient organisations, attracting resources and providing certain commercial and competitive advantages. Less efficient community organisations with access to these concessions may survive or expand at the expense of more efficient community organisations that are not entitled to FBT concessions.

For example, an organisation that can offer higher salary packages due to FBT concessions yet operates less effectively may be more likely to attract skilled employees. Conversely, an organisation that operates more effectively yet cannot access FBT exemptions may have less scope to offer competitive remuneration, adding to pressures to recruit and retain qualified staff. The more efficient community organisation may be required to reduce the function and scale of its activities, or perhaps even cease operations, because it is unable to attract enough skilled labour to achieve its core objectives. While not within the scope of this study, some of these distortionary effects can be seen in parts of the not-for-profit health sector.

FBT concessions can also create distortions in the mix of different resources used by organisations by encouraging the use of labour at the expense of other (perhaps more efficient) resources. The tax exemption lowers the cost of labour for those organisations able to access the concession, which may lead to over-reliance on labour even though there may be more efficient means of producing outputs. It is difficult to gauge the extent of this distortion but it may play a part in constraining various non-labour-related efficiency gains which are increasingly being achieved in many human service areas.

Box 7: Not all community organisations receive FBT concessions

The Royal Society for the Prevention of Cruelty to Animals (RSPCA) Australia is endorsed as income tax exempt and is a deductible gift recipient, yet it is not entitled to FBT concessions.

This discrepancy in the application of FBT concessions creates distortions in the community sector employment market. For example, an RSPCA employee on the same salary package as a PBI employee would not receive the same direct tax benefit as the PBI employee (and the RSCPA would not receive the same indirect benefit as the PBI). The RSPCA would need to raise additional funds, or divert resources away from its core activities, in order to match the value of the salary package offered by a PBI.

Assuming RSPCA was able to access FBT concessions, it calculated the benefit to be $3.4 million per annum in taxes saved (based on its current salary costs). By way of comparison, the RSPCA has an operational budget of $81 million per annum, with 98% of these funds derived from individuals and businesses.

Source: RSPCA Australia (2009)

FBT concessions are also expensive. In 2009-10, the value of FBT concessions provided to the community sector is estimated to be around $930 million. This figure is projected to reach $1.1 billion in 2012-13 (see Table 3.1). The open-ended nature of FBT concessions (i.e. eligible organisations may employ an unlimited number of staff) means the government is unable to control the extent of public money spent through them.

Furthermore, this form of tax concession is not directly targeted towards the provision of community services, which can lead to instances of 'misuse'. For example, the Productivity Commission (2010) notes that catering for weddings can be salary packaged by PBI employees, with the result that taxpayer dollars are subsidising non-charitable items. Such use of FBT concessions potentially casts the sector in a poor light and undermines public confidence.

3.5 Impact on the community sector

In summary, indirect funding through tax concessions provides a number of important advantages to community organisations. These include:

- **Operational flexibility**

  Community organisations have flexibility in terms of how resources are best deployed to achieve specific outcomes.

- **Greater funding certainty**

  Indirect funding can provide greater long-term financial stability for recipient organisations. In comparison, direct funding is subject to regular scrutiny as part of the budget cycle and is therefore heavily exposed to more immediate fiscal pressures.

  Tax concessions also provide funding for organisations that do not receive direct government support — for instance, because the government is pursuing alternative priorities or perhaps because the government is unaware of the issues being addressed by the organisations.

- **Promotion of social innovation**

  Community organisations are able to direct these funds towards the development of socially innovative activities, in turn building social capacity and enhancing community well-being.

- **Specific benefits linked to specific tax concessions**

  DGR endorsement encourages philanthropic donations and gives the community an opportunity to direct assistance to specific organisations that may not receive direct government funding.

  FBT concessions play an important role in enabling organisations to attract and retain appropriately qualified staff.

However, there are deficiencies in current tax concession arrangements that affect community organisations. These include:

- **Complexity of the system**

  The varying eligibility requirements for different types of tax concessions results in complexity and creates confusion within the community sector. The Public Law Interest Clearing House stated in its submission to the Productivity Commission:

  > *Even NFPs which do fall within the legal definitions of charity still find current charitable concessions applications so complex and confusing that they need to seek legal assistance. For example, the highly technical distinction between the definition of the 'health promotion' and 'harm prevention' DGR categories in the current regulations are difficult for many lay applicants to understand and apply to their NFPs circumstances (PilchConnect 2009: 16).*

  Community organisations must deal with multiple agencies within and across jurisdictions. The Productivity Commission (2010) notes that there are 19 separate agencies across all arms of Australian government that regularly make determinations about charitable status.

- **Additional administration and compliance costs**

  The complexity of the system leads to a high administrative and compliance burden on community organisations. Resources are often directed towards administrative tasks rather than community-focused purposes. Some organisations need to hire external financial consultants to ensure compliance. FBT concessions, in particular, often require eligible organisations to employ staff dedicated to managing salary packaging.

Box 8: Compliance costs for the community sector

Large compliance costs for community organisations stem from the complexity of the regulatory system:

- Good Beginnings, a national charity that provides community-supported early childhood intervention programs and advocates for enhanced capacity of parents and carers, currently deals with 80 different government departments around Australia.
- The Wesley Mission operates throughout Australia and provides a diverse range of services including aged care, counselling, disability support and employment services. It has around 400 contracts with various government departments with different compliance standards and requirements that must be met.

Source: Stakeholder workshop conducted by Access Economics

3.6 Impact on government

Indirect funding of the community sector through tax concessions is linked to several advantages for government:

- **Simplicity**

  Indirect funding is relatively simple for the government to administer — notwithstanding its role in increasing the complexity of the tax system — and a separate bureaucracy is not required, unlike direct expenditure programs.

- **Fiscal benefits**

  Indirect funding through DGR endorsement can have fiscal benefits for government, potentially leveraging additional private assistance for priority areas and reducing budgetary outlays compared with direct spending.

  In addition, government is not required to make any upfront outlays to provide this form of funding.

- **Enhanced social inclusion and cohesion**

  The community is given the opportunity to direct assistance to specific organisations, which promotes pluralism and civic responsibility. This in turn leads to improved social cohesion.

  Socially innovative activities that occur through use of indirect funding also lead to greater social inclusion and cohesion.

Nevertheless, there are also deficiencies in the current tax concession arrangements that affect government. These include:

- **Lack of transparency, accountability and flexibility**

  There is often insufficient information (in terms of both detail and timeliness) with which the community can gauge whether appropriate levels of public support are provided to different social causes.

  The open-ended nature of concessional arrangements imposes additional challenges for fiscal management. The government cannot control the amount of public money spent through them and they can cost the government more than anticipated, disguising the total level of expenditure on particular parts of the government's policy program.

  A reduction or increase in targeted support cannot be readily achieved through subsidies provided by way of a tax exemption.

- **Additional administration and compliance costs**

  For example, the lack of consistent criteria reduces the ability of community organisations to know their standing on eligibility for various concessional arrangements and increases the level of government oversight required.

- **Inefficiency**

  Under input tax concessions, businesses and individuals face incentives to derive income from certain sources simply for a tax advantage. For example, where FBT exemptions apply, resources will flow to businesses and sectors which are better able to remunerate their staff in fringe benefits, largely irrespective of their operational efficiency.

4 Potential reform options

The forthcoming Henry Review is likely to scrutinise tax concessions provided to community organisations and other parts of the NFP sector — either specifically or as part of wider tax design considerations. Although particular reform recommendations are unknown, analysis of the benefits and limitations of community sector funding options available to government, together with an understanding of best practice taxation principles, provides an indication of the potential direction of reform.

It should be noted that the options canvassed here are not recommendations for reform. Rather, the intent has been to 'stand in the shoes' of the Henry Review and, through an economic framework, consider potential reforms that may arise. A guiding principle is to ensure that community organisations receive effective support through the efficient use of taxpayer money.

Table 4.1: Community sector funding options

Support option	Advantages	Disadvantages
Direct funding	Transparent funding arrangements. Allows policy flexibility, support can be adapted to changing circumstances, including new social priorities or fiscal pressures.	Can be problems with selection bias — i.e. which types of organisations are funded. Additional program administration by government is required. Good program design is required to ensure social innovation is not unduly constrained.
Input taxation concessions (for example, FBT concessions)	No upfront outlays by Government. Can promote operational flexibility and social innovation for community organisations. Provides greater long term financial stability for recipients. Key means of attracting and retaining qualified staff.	Lacks transparency and policy flexibility for government. Support is open-ended and can be difficult to withdraw support. Can have serious distortions for the operation of the tax system.
Income tax concessions (currently provided through TCC endorsement)	No upfront outlays by Government. Can promote operational flexibility and social innovation for community organisations. Provides greater long term financial stability for recipients.	Lacks transparency and policy flexibility for government. Support is open-ended and can be difficult to withdraw support. Are less distortionary than input tax exemptions — especially in terms of competitive neutrality with for-profit firms.
Donor tax concessions (for example, DGR status)	No upfront outlays by Government. Can promote operational flexibility and social innovation for community organisations. Provides greater long term financial stability for recipients. Administratively simple. Promotes pluralism and civic responsibility.	Can disadvantage those organisations that are less popular with donors. Donor support may be poorly linked to policy priorities.

Table 4.1 above summarises the main community sector funding options available to government. It draws together the advantages and disadvantages of the main funding mechanisms that have been discussed in earlier sections of this report. These benefits and limitations are important when considering reforms that may flow from the Henry Review.

4.1 Framework for best practice taxation

Communities face important choices about how particular goods and services should be provided, the level of income redistribution and how society should operate. A fundamental choice concerns the balance between private and public provision of services. These choices have significant impacts on the size and role of government — with related consequences for government expenditure and revenue.

Within this public choice setting, the fundamental purpose of taxation is to finance government expenditure. Beyond this primary objective, modern tax systems are also largely guided by principles of efficiency, equity and simplicity. A range of tradeoffs exists among the criteria. There are instances where these three principles conflict with one another. For example, a measure designed to be more equitable may be less simple. There can also be conflicts between the principles and the revenue-raising purpose of taxation — that is, in terms of the 'adequacy' of the tax system to meet spending requirements.

Levying taxes involves costs to the economy. Each dollar raised is a dollar lost to the private sector of the economy. This includes taxation raised to fund concessions such as fringe benefits and income exemptions for community organisations.

There are a range of taxation costs which need to be considered.

A key cost component of taxation, although one notoriously difficult to quantify, is its disincentive effect, or 'deadweight' loss. This arises when people or organisations change their behaviour in response to the tax, substituting one type of behaviour for another which would have been preferred had the tax not existed. The deadweight loss is the value of unexploited opportunity as individuals divert economic resources from higher to lower valued economic activities. Typically, the higher the tax rate, the higher the loss.

Taxes also involve various transaction related costs:

- **Administration** — Collecting taxes (and administering tax subsidies) requires an institutional structure such as the ATO. The costs of running agencies can be large, with much depending on the policy and legislative environment, the complexity and design of tax systems and the efficiency of administrative practices.
- **Compliance** — These are costs incurred by taxpayers or third parties, notably businesses, in meeting the requirements of a given tax structure (excluding the payment of the tax itself). Such costs are part of the wider regulatory burden which governments impose on business.

  There are two main compliance costs to taxpayers. First, there are time and resource costs imposed on individuals and/or internal staff in collecting and maintaining tax information; learning about relevant tax matters; completing tax forms and necessary disclosures; and dealing with relevant government agencies like the ATO. Second, there are external financial costs of professional fees paid to tax-agents, accountants, lawyers, and other advisers in relation to tax – the requirement for which will be directly related to the complexity of the tax system.

It should be noted that some types of taxes (or concessions) — such as the fringe benefits tax (or exemptions) — and their associated compliance costs, are incurred voluntarily when a business or eligible organisation decides to pay their employees fringe benefits. However, these costs are more relevant to policymakers when they are related to tax arrangements which have a central policy aim of supporting types of economic activity such as community organisations and parts of the broader not-for-profit sector.

- **Evasion** — There are also costs associated with the illegal evasion of tax. These relate to costs for government in enforcing the tax law and in prosecuting those caught engaging in unlawful activities (both intentionally and unintentionally). By first creating the 'temptation' for tax avoidance, the structure and complexity of the tax system is again an important determinant in these costs. For instance, lower tax rates and a broader tax base can play a role in reducing the incentives (i.e. the potential payoff) from tax evasion.

Issues with the complexity of the tax system

As noted, complex taxation policies add to administration and compliance costs. A complex tax system can also increase uncertainty, raising the cost and difficulty with decision-making.

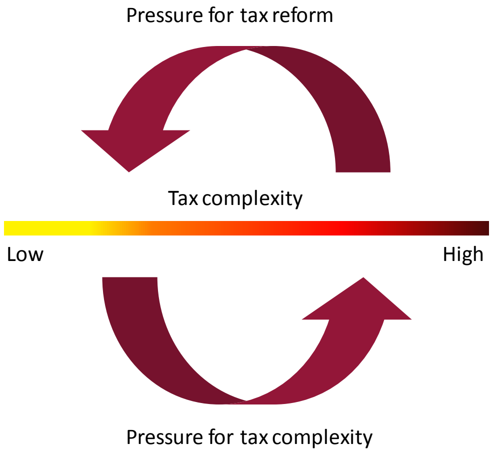
Simple tax policies can often be more transparent, but transparency as a tax policy goal has broader dimensions. It relates to the overall understanding people have about taxes and how they operate. These cover issues such as the point at which a tax applies, which level of government is collecting it and for what purpose. An overarching issue is whether tax policies are designed to enhance community understanding about the structure and operation of the tax system and the broader public policy issues concerning the taxes being raised.

A key implication is that using the tax system to deliver social policy objectives (such as supporting community organisations) has a direct impact on the complexity of the tax system. Moving these policy functions outside of the tax system would decrease its complexity. However, it would also serve to increase complexity in other non-tax related areas. For instance, greater government bureaucracy (and complexity) would be needed to administer direct funding support for community organisations if tax exemptions were discontinued. Such offsetting effects would need to be considered in developing proposals to simplify concessional arrangements.

A certain level of complexity and cost is required to operate the tax system — particularly in relation to achieving the equity objectives of tax policy. At a certain point, however, complexity in the tax system will exceed a socially optimal level.

In a tax reform context, there is a consistently observed 'cycle' of complexity (see Figure 4.1 below). As the costs and administrative burdens of additional tax complexity become increasingly evident to the community and government, pressure to simplify tax arrangements intensifies. Following reform (say, in a post-Henry Review environment), there will be more opportunities for tax savings by organisations and individuals and greater calls for new concessions or preferential treatment.

Figure 4.1: Cycle of tax complexity



Who bears the ultimate cost of tax depends on its nature and the activities and entities to which the tax applies.

While taxes may be spent by government in beneficial ways — including via concessions provided through the tax system itself — these benefits should be weighed against the various costs of raising taxes. From a community-wide perspective, there may well be better mechanisms available in which to discharge particular policy objectives.

As with any government intervention, there are a range of impacts. To ensure policy options deliver benefits greater than the costs they impose, it is important that there is a rigorous assessment of all economic benefits and costs, including the costs associated with raising taxes.

4.2 Potential direction of reform

Under its terms of reference, the Henry Review was specifically tasked with making recommendations for reducing tax system complexity and compliance costs. In addition, the review's consultation paper specifically raised the issue of complexity of FBT concessions for the NFP sector and sought options to improve equity and simplicity in these arrangements. On this basis, it is likely that the review will recommend reform in this area.

It is also possible that reforms relating to streamlining of administrative and compliance requirements, extending donor tax concessions and placing greater reliance on direct funding will also be included (in varying degrees) as part of the Government's long-term tax reform agenda.

This section examines these aspects of a potential reform program.

4.2.1 Streamlining administrative and compliance requirements

Complexity in the tax system adds to the administrative and compliance costs for community organisations and government. The current tax arrangements have been described as confusing, and uncertainty surrounding eligibility for various tax concessions adds to community organisations' costs. For example, many organisations are required to seek external advice in order to navigate their way through application processes.

Streamlining administrative and compliance requirements would therefore reduce associated costs, allowing community organisations to place greater focus on their respective core functions. It would also reduce administrative costs for government as less oversight and compliance-monitoring would be required.

The Productivity Commission (2010) recommended the creation of a 'national one-stop-shop for regulation and tax endorsement of NFP organisations' — the Registrar for Community and Charitable Purposes. The implementation of this recommendation would help reduce complexity in the tax system. Another key reform area would be to address cross-jurisdictional issues and ease the administrative burden on community organisations that operate in more than one State.

4.2.2 Recalibration of tax concessions

The Henry Review is likely to recommend that the parameters of some tax concessions be modified in order to increase the effectiveness of current arrangements and reduce the level of overall distortion and inefficiency in the tax system. In this respect, the Henry Review may recommend the extension of donor tax concessions and the tightening of input tax concessions.

Extending donor tax concessions

Expansion of the DGR eligibility criteria aligns with the Productivity Commission (2010) recommendation that the Australian Government progressively widen the scope for gift deductibility to include all endorsed charitable institutions.

The extension of donor tax concessions is a desirable reform option for government because it allows them it leverage additional private assistance (through philanthropic donations) for priority areas in the community sector. It also addresses problems related to inconsistent application of DGR status for similar organisations. If donor tax concessions were expanded to include community organisations that engage in preventive action, this would explicitly recognise the social benefits that arise through these types of activities.

There is some uncertainty surrounding the impact on individual organisations following an increase in the size of the 'recipient organisations pool'. There may be 'winners and losers', with some donors directing their philanthropic donations away from organisations that they currently support to other (newly DGR-endorsed) organisations. However, the total amount of funds received by the sector should increase, given that donor tax concessions are likely to encourage individuals to donate greater amounts than they otherwise would.

As part of its simplification agenda, the Henry Review may recommend the removal of the requirement for some taxpayers to lodge a tax return. These taxpayers would no longer receive a tax benefit for philanthropic donations made to DGR organisations. This may discourage some donors and this impact should be further considered in reform of donor tax concessions. The introduction of a rebate system may be one means of countering a possible decrease in donations due to limiting this incentive to donate. A rebate would lower the price of giving for low income earners but increase the price of giving for high income earners and these effects should also be taken into account.

Tightening (or dismantling) input tax concessions

Reform of input tax concessions would help minimise distortions related to:

- differential treatment of community organisations, with only a narrow category of organisations (i.e. PBIs) currently eligible to receive FBT concessions;
- competitive advantages provided to eligible organisations, as labour resources are attracted away from non-eligible organisations towards those that have access to the concession; and
- incentives for eligible organisations to use labour at the expense of other, perhaps more efficient, inputs.

The Henry Review may therefore recommend the winding back of FBT concessions in order to reduce the total level of distortion in the tax system. This could be achieved by restricting the eligibility for FBT concessions to a smaller number of community organisations or by reducing the 'per employee' allowance (say from $30,000 to $15,000). Over the longer term, FBT concessions may even be completely dismantled.

Beyond a pure efficiency standpoint, a crucial issue for reform will be to address instances of 'misuse' of FBT concessions within the NFP sector, without undermining the legitimate premise of taxpayer support.

Recalibration of FBT concessions would have a significant impact on the ability of some community organisations to attract and retain skilled employees. Many eligible organisations currently report that they experience difficulty in recruiting staff, and this would be exacerbated by a reduction in the availability of FBT concessions. Government needs to consider these impacts when devising a reform program (this is discussed further in Section 5).

4.2.3 More direct forms of public support

Increased direct funding as a reform option is closely linked to decreases in indirect funding that would occur through recalibration of some tax concessions. Direct funding also does not have the same inherent inefficiencies as tax concessions.

Direct funding can be delivered to community organisations through government grants or service contracts. In a variety of areas, including for certain social services, governments have sought to improve the efficiency and quality of services by devolving provision to non-government entities such as community organisations. Increasingly, greater emphasis has been placed on selecting providers on the basis of competitive tenders. Where government acts as a direct 'buyer' of these services, it is often referred to as a 'purchaser-provider' model.

Tendering for these services commonly has a variety of elements such as the ability to meet program objectives and quality benchmarks. It can also involve a large element of price competition. As noted, such arrangements have many advantages, especially in terms of ensuring funding is appropriately targeted and used as effectively as possible. However, it also has important implications for community organisations and other NFPs.

Some particular issues include:

- potentially reduced capacity to innovate and take risks in seeking to meet client needs;
- less scope for collaboration between providers, including across different service types;
- uncertainty for service providers caused by the need to 'compete' with other providers;
- increased administrative costs for both providers and government;
- a requirement for greater expertise in contract development and management within government agencies; and
- the potential for reduced accountability of government for service outcomes.

Any further shift to greater levels of direct funding (possibly as a result of the Henry Review) will require additional government resources and supportive procurement frameworks. In this regard, good program design will be essential to minimising any adverse effects on beneficial forms of social innovation and collaboration. It is important to recognise that there are likely to be certain services that will not be amenable to direct funding.

From the community sector's perspective, increased direct funding can also lead to greater uncertainty due to the nature of the political cycle, where ongoing funding cannot be guaranteed. Fluctuations in government policy and priorities, including through changes of government, contribute to this inherent uncertainty. These problems could be partly addressed through the implementation of longer-term funding arrangements.

In 2008, for example, the United Kingdom Government gave a commitment to three-year funding in its Third Sector Review. This decision was aimed at increasing the sustainability of the third sector, allowing it to engage in longer-term planning and investment. Other reasons for introducing this policy were to enable the sector to focus on social innovation and reduce time spent on year-to-year fundraising.

5 Managing the funding reform process

Reform of the current tax concession arrangements will have substantial funding and operational implications for community organisations and the wider not-for-profit sector. To manage these impacts, it is necessary for government to adopt a clear policy approach when devising its reform program. A number of high-level reform principles should underpin this policy approach to ensure an appropriate balance is struck between appropriately supporting the community sector and ensuring cost-effective use of taxpayer funds.

Recognition and management of transitional adjustments are also important aspects of reform implementation. Given the heavy reliance on some forms of indirect funding such as FBT concessions, transitional issues associated with any winding back of tax subsidies must be carefully managed to ensure there is minimal disruption to the sector and that it can continue delivering services that are vitally important to the Australian community.

5.1 High-level reform principles

A key part of taxation reform is to improve resource allocation to address social issues and problems such as the alleviation of poverty. In this regard, instituting a framework that effectively and efficiently supports the community sector should be a high priority.

Major considerations in implementing reform (in whatever guise) will include ensuring that an adequate funding base for organisations is maintained and that the service delivery capacity of organisations is not undermined — particularly their ability to attract and retain high-quality staff. In addition, socially innovative activities should not be discouraged.

An important aspect of reform is to maintain an appropriate combination of indirect and direct funding. There are particular advantages inherent to each form of funding which can only be realised if both forms are utilised:

- Indirect funding through the tax system — principally via tax exempt donations — provides operational flexibility for community organisations and does not require upfront outlays by government. It can also help harness private donations, encouraging greater collective responsibility for certain social issues and causes.
- Direct funding allows government to more closely target particular social priority areas, provides greater transparency and avoids the economic distortions that can result from tax concessions.

A difficult reform challenge for government will be to strike an appropriate balance between both forms of support that maximises these benefits (and minimises the deficiencies).

High-level reform principles that will help achieve these objectives are discussed in the remainder of this section. A key aspect underpinning these principles is to minimise risks to the sector associated with changing financial support mechanisms.

First do no harm

As an overarching principle, reforms to funding assistance mechanisms should be structured with the continued support and sustainability of the community sector as a fundamental priority.

This should recognise the potential for considerable adjustment and dislocation, as well as other transitional effects for both large and small organisations. Having full regard to the adjustment implications of funding reforms will be a key issue for government.

Reforms to tighten or dismantle input tax concessions, particularly FBT concessions, will affect the costs borne by eligible organisations. A major consequence will be through increased employee remuneration payments, affecting the ability of organisations to attract and retain high-quality staff. Without any offsetting support, these increased costs will affect service delivery, with funds diverted away from core objectives. In turn, this could have potentially negative impacts on social inclusion and community wellbeing. Policymakers must therefore ensure that reform of FBT concessions or other tax subsidies are considered within the totality of the entire support framework and that the operational capacity of the sector is not impaired.

Strive to avoid unintended consequences

Reforms, especially broad-ranging programs, often have unintended impacts which can detract from their overarching policy objectives. In many cases, addressing some funding issues and taxation distortions can give rise to other problems, owing to the interplay of different policy levers.

Reforms need to consider the dynamic interactions between support measures, including potentially adverse effects on operational flexibility and social innovation.

For example, extending donor tax concessions might have distortions on the level of funding support and where it goes. Private donors may be more likely to favour fashionable charities rather than those that address more pressing issues of social disadvantage. These types of flow-on impacts must be taken into account when devising a reform program. This may be done by ensuring that government prioritises the provision of direct funding to organisations that are less popular with the general public yet make a substantial contribution to social capital.

Revenue-neutrality for the sector is important

Reform should be aimed at recalibrating the composition of funding mechanisms available to the community sector rather than simply limiting support provided through the poorest aspects of current funding arrangements. In a broad sense, the total level of government funding for the sector should remain 'whole', with a revenue-neutral approach to reforming government support having primacy. This will go far to reinforce the community sector's overall capacity to provide important social services, including to the most disadvantaged members of society.

Under such arrangements, any proposals to limit certain aspects of financial support should be broadly offset by increases in alternative forms of assistance. For example, any tightening of

FBT concessions and a subsequent decrease in the level of indirect funding should be broadly offset by increases in the level of funding provided through alternative mechanisms.

Support arrangements should be transparent and simply administered

A key reform priority should be to reduce complexity and streamline administrative and compliance requirements associated with support measures. This would help to lower costs for both the community sector and government.

Funding mechanisms — whether provided through the tax system or more directly through the expenditure side of the budget — should be clear and simple to administer. Consolidation of national regulatory arrangements for community organisations (and indeed, the entire NFP sector) would help reduce complexity. (This was a key recommendation made by the Productivity Commission.)

Bureaucracy and 'red tape' surrounding the administration of funding measures should be minimised to the greatest extent possible. For example, endorsement of organisations to receive tax concessions should be streamlined so that organisations can more easily determine whether they are eligible for a particular concession without having to engage professional advice.

Streamlined administrative and compliance requirements would also increase the transparency of funding mechanisms.

Taxpayer interests should be safeguarded

The provision of taxpayer support to community organisations comes with attendant obligations for transparency and good governance. Reforms to direct and indirect funding methods should therefore be supported by robust reporting and accountability arrangements for recipient organisations.

Taxpayers deserve to know precisely how their money is being spent and reforms should also provide a key role for governments in setting social policy priorities. In this regard, careful consideration needs to be given to the design of all support measures, including their efficacy, the ability of government to calibrate support according to different circumstances, and interaction with other policy measures.

Establish an appropriate lead-time for reform

To manage transitional issues, extensive lead -time should be provided before fundamental reforms to funding mechanisms are implemented. This might be in the vicinity of two to five years to allow organisations sufficient time to minimise dislocation impacts.

It will also allow more specific and detailed analysis of the implications of concrete reform proposals to the sector. Such undertakings will be crucial in reducing the scope for unintended consequences.

In particular, any reform of FBT concession arrangements would require a significant lead-time given the potentially large impacts on the ability of organisations to recruit and retain appropriately skilled staff. Without some smooth (incremental) unwinding of these employee benefits, highly employable and mobile staff could seek job options outside the sector, exacerbating operational pressures faced by organisations.

5.2 Transitional issues

While there are compelling reasons to reform present arrangements, it is important that the transitional challenges and structural adjustments associated with funding reform not be underestimated. Many parts of the sector have been established for a long time and thrive under the present support framework.

Reform of FBT concession arrangements would pose particular challenges. A significant number of community organisations receive support through FBT concessions, with about \$930 million estimated to be provided to the sector in 2009-10. The extent and size of this support indicates the magnitude of the reform undertaking. It will be extremely challenging, both administratively and operationally, to restructure support away from this method and potentially towards more direct means. This places an increased emphasis on carefully managing transitional issues to ameliorate the adverse effects of change and weaken resistance to reform initiatives that have community-wide benefits.

Reform programs that facilitate efficient adjustment from well-entrenched forms of financial support are difficult to design and implement, with issues of timing and sequencing paramount. On the basis of the size of this reform task, there are good reasons to consider a phased or graduated change to allow time for orderly adjustment or to meet equity objectives. This is especially the case for reforming FBT concessions.

A particular benefit of adopting a phased reform program is to enable ongoing evaluation of the operational impact of reforms. This would allow refinements or modifications to be made, if required, over the course of the reform program, thereby minimising the risk of unintended impacts.

The potential for distortions before tax concessions are changed also needs to be considered. It is possible that winding back FBT exemptions may lead to an unhelpful ramp-up in the use of this type of concession before the cut-off date. To avoid such (largely predictable) outcomes, many tax changes are announced and come into effect immediately (say on Budget night). For certain reform measures, such considerations could favour a 'big bang' approach rather than a more incremental pre-announced reform program as described above.

Devising a robust implementation program will also involve consideration of other forms of transitional assistance as a means of facilitating a more 'seamless' adjustment path. A particular issue will be to identify where adjustment costs are likely to concentrate. A key indicator will be the size of the tax concessions currently provided. For example, the size of FBT concessions provided to the sector (estimated to be about \$930 million in 2009-10) means that the magnitude of the adjustment in this area will be especially large.

The paramount concern is to ensure that community wellbeing is not adversely affected by any reform program. In large part, this can be ameliorated by supportive transitional arrangements that ensure the continued effective operation of community organisations. Indeed, Australia's enviable success at implementing wide-ranging structural reforms in the economy provides some useful lessons in minimising adjustment costs across a diversity of sectors and managing sensitive transitional issues.

6 Conclusion

Broad reform of the regulation and support of the not-for-profit sector in Australia has been a somewhat latent political issue for some time. This has been reflected in the slow pace of reform in the sector despite numerous reviews over the last decade or so.

A central theme for wider reform has been to address the fragmented system of regulation, especially across jurisdictions. A lack of coordination in policy development and regulation across the not-for-profit sector has led to a multiplicity of financing and legal arrangements. A result of this complexity is that community organisations are faced with large and excessive compliance costs which divert resources away from their particular community-focused objectives.

Going forward, community organisations will face a range of new pressures. Demographic changes, particularly the ageing of the population and increases in immigration, will likely induce profound changes in the nature and composition of services provided by the community sector. Philanthropic donations may also be impacted by population ageing, with a smaller proportion of Australians in the workforce and potential changes to wealth distribution. Further, community organisations will likely need to adapt to changing (perhaps concentrating) patterns of disadvantage and a requirement for new service delivery models — with a possible focus on more preventative interventions.

Against this broader setting, the Henry Review provides the best opportunity in many years to revisit the fundamental structure of tax assistance provided to community organisations. From the sector's perspective, this review is best considered as an important long-term opportunity to get funding structures right and to place the community sector on a sustainable footing.

To facilitate the design of an optimal funding regime, an enhanced understanding about how different tax instruments, particularly FBT concessions, affect the demand for and supply of third sector services is critically important. Notwithstanding that lack of transparency is an inherent deficiency of indirect funding, comprehensive information about the type and level of utilisation of tax concessions across the sector would be extremely useful in the development and implementation of an effective reform program. Quantifying the impacts of tax concessions across the sector, especially in terms of workforce retention and capacity, is therefore an important area for further analysis.

Funding reforms, including through the tax system, must provide a balance between effectively supporting community organisations and ensuring taxpayer funds are efficiently and transparently used. This will play a large part in ensuring the community sector has the capacities and flexibility to meet future challenges, further strengthening its contribution to Australian society.

Appendix A: Public benevolent institutions

A public benevolent institution (PBI) is a non-profit institution organised for the direct relief of poverty, sickness, suffering, distress, misfortune, disability or helplessness.

A PBI has the following characteristics:

- it is set up for needs that require benevolent relief (i.e. the condition or misfortune relieved by a PBI must be such poverty, sickness, suffering, distress, misfortune, disability or helplessness as arouses pity or compassion in the community);
- it relieves those needs by directly providing services to people suffering them;
- it is carried on for the public benefit;
- it is non-profit;
- it is an institution; and
- its dominant purpose is providing benevolent relief.

Examples of PBIs include organisations that:

- provide accommodation for the homeless;
- treat sufferers of disease;
- provide home help for the aged and the infirm;
- transport the sick or disabled, or
- rescue people who are lost or stranded.

Appendix B: Responsiveness of donations to tax incentives

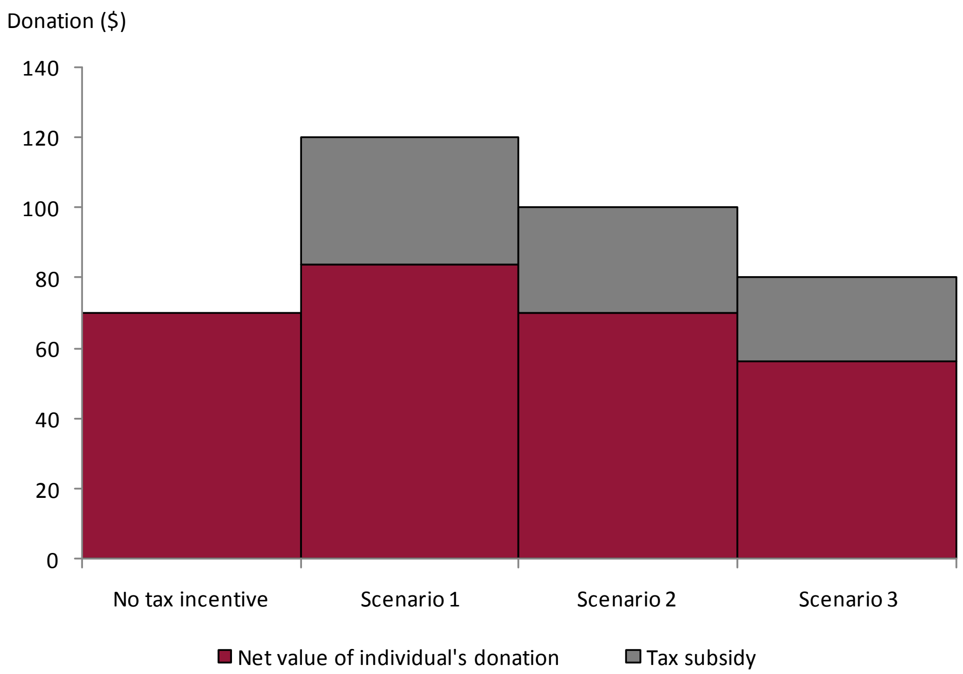
Donor tax concessions effectively lower the price of philanthropic giving by allowing individuals to make donations from untaxed income. However, the precise effect of this tax incentive on the total level of donations made by individuals is unclear. A brief discussion of these issues is provided below.

The Productivity Commission (2010) notes that international studies of donor tax concession programs have produced conflicting results about whether the net value (to the donor) of the donation increases, stays the same or decreases. They tentatively conclude that a lack of evidence of crowding out, combined with the relatively high marginal tax rates in Australia at the top end of the scale, tend to indicate that donor tax concessions encourage individuals to donate larger net amounts than they would without the inducement of the tax concession.

The impact of a donor tax concession on the total value of donations may be indicated by the price elasticity of philanthropic donations — in other words, the percentage change in the value of donations when the price of donating (as determined by the level of tax concession) changes by 1%.

Using the example of an individual whose income places them in the 30% marginal tax bracket and who would have donated $70 to a given DGR organisation in the absence of any tax incentive, there are three possible outcomes for the level of donations where a donor tax concession exists. The impact is illustrated in Chart B.1 below.

Chart B.1: Impact of DGR status on donations



Source: Productivity Commission (2010)

- **Scenario 1** — Where the price elasticity is greater than 1, the donor tax concession induces an individual to increase the value of their donation by more than the value of the tax subsidy. In this case, the DGR organisation receives a higher net donation from an individual in addition to the tax subsidy. For example, instead of donating $70, the individual would donate $120, effectively making an $84 contribution to the DGR organisation.
- **Scenario 2** — Where the price elasticity is equal to 1, the donor tax concession increases the value of the donation by the exact amount of the tax subsidy. The DGR organisation receives a higher level of donation than they would have without the tax concession, but the individual does not increase the net value of their donation. In this case, the individual would make a donation of $100, knowing that they are willing to contribute $70 themselves and that 30% of any donation made will come back to them in the form of a tax rebate.
- **Scenario 3** — Where the price elasticity is less than 1, the donor tax concession 'crowds out' the net value of the donation made by an individual. In this scenario, the net value of the donation falls, although the tax subsidy increases the total amount of the donation received by the DGR organisation than would be the case if the tax concession did not exist. For example, the individual who would have donated $70 may now only effectively give $56 after their tax rebate, knowing that the shortfall will be more than covered by the government contribution and that the organisation will receive $80 in total.

According to the Productivity Commission, it is likely that the price elasticity of philanthropic donations is greater than 1 and donor tax concessions encourage individuals to donate larger net amounts than they would without the inducement of the tax concession.

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