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PHILANTHROPY, TAX EXPENDITURES AND COMPETITIVE NEUTRALITY

What are the dilemmas facing tax administration employees?

Tax expenditures shift responsibilities for policies promoting the public good to tax administrations. This poses practical difficulties to administrators who have to apply general rules and definitions to specific cases. The issue of competitive neutrality often proves decisive in granting the status of public utility.

1. INTRODUCTION

Tax expenditures are instruments of fiscal policy. For example, through deductions for donations, governments financially incentivise individuals to engage in particular behaviours aimed at achieving specific policy objectives, while tax exemptions are given to organisations because they pursue goals of public utility. In Switzerland as elsewhere, experts and politicians often praise tax expenditures as an efficient instrument for favouring philanthropy and promoting the public good. At the same time, the use of tax expenditure instruments has also been criticised, in particular with regard to issues of fiscal justice and their relationship to democratic processes of decision-making (see, for instance, Reich 2010, 2013; Peters 2009).

Clearly, tax expenditures constitute a significant shift compared with direct expenses. This has quite wide-reaching, yet often overlooked, political consequences (McDaniel 1989). First, all tax expenditure has automatic priority over any direct expenditure programme. All debates about direct spending priorities relate to the revenues that are left after all tax expenditures have been funded. This means that such charitable donations have a higher priority than direct subsidies to specific sectors (such as education, army, agriculture, etc.). Second, tax expenditures typically rely on private sector rather than government decision-making processes. Deductions for charitable contributions are akin to a government matching grant programme to encourage charitable giving, but the choice of charities to benefit is left to the individual donor. Finally, the decision to use the tax system to deliver financial assistance brings into play a different set of institutions and attitudes than are involved when the direct spending route is adopted: "The utilization of the tax system means that the program will be developed and administered by those whose primary expertise is not in the programmatic area under consideration. [Employees of tax administrations] are trained to be tax lawyers and tax collectors: they are not trained experts in environmental programs, housing, energy conservation, and all the other areas of social and economic life into which tax expenditure programs have been introduced." (ibid.: 175). As such, public utility tends to be approached as a tax issue and not as a question of whether or not the programmes promoted by a given organisation would pass democratic scrutiny if they were financed through direct subsidies.

In this article, we take up this last point by analysing the work of employees of cantonal tax administrations in Switzerland [1]. In Switzerland, it is the cantonal tax authorities that decide on granting the status of public utility to organisations, thus exempting them from paying taxes. Cantonal tax administrators are therefore central actors. What are the problems and dilemmas they face when evaluating applications for tax exemption? How do they get from the quite general rules and definitions laid down in the legal framework to a decision on a specific case?

For the purpose of the analysis presented here, we will focus on a particular issue that often poses problems to tax

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administrators: the question of "competitive neutrality", and as such the boundaries between organisations of public utility and market actors. Our fieldwork reveals that this question seems to be of increased importance in an era where philanthropic actors and social enterprises are gaining in interest and new hybrid forms of organisations have emerged (Sprecher 2013). Because the market sector spills over into tasks that have traditionally been the preserve of the state and third sector (social welfare, education, migrant help, elderly care, etc.), the question of possible competition between (tax-exempt) organisations from the third sector and for-profit organisations is today a frequent concern for tax administrations. Based on in-depth interviews with employees in charge of granting public utility status in the tax administrations of three cantons, we analyse how administrators decide, in this context, which organisations can be granted tax exemption and which cannot because that would constitute a form of competitive distortion.

2. LEGAL FRAMEWORK

The legal basis for the recognition of public utility, in the fiscal sense, consists of a series of laws and directives published by the Swiss Cantonal Administration Conference and the Federal Tax Administration [2]. Swiss federal law exempts legal entities that are pursuing public service or public utility purposes from federal income tax on profits that are exclusively and irrevocably affected to such purposes (Art. 56 lit. 6 DFTA) [3]. Cantonal legislations contain similar legal norms in relation to cantonal profit tax. Circular 12 details these provisions. An entity must simultaneously satisfy the following conditions: 1) purpose of general interest, 2) unlimited circle of beneficiaries, 3) exclusive and irrevocable contribution of the funds, 4) disinterestedness, 5) actual non-profit activity. In addition, this directive lists, as non-exhaustive examples, activity domains that can be classed as being of general interest. It gives the following examples: charity; humanitarian, sanitation, environmental, educational, scientific and cultural activities; public assistance, arts, science, education, promotion of human rights, heritage preservation, protection of nature and animals, and development aid. It ends by saying that the general interest of a given activity must be judged with regard to "the general conceptions of the population".

Although under this framework, economic goals cannot be considered public interest purposes, the acquisition and management of significant corporate equity can be admitted if the interest in holding such an entity is secondary to the public interest goals and if the exempted legal entity is not involved in the management of a corporate entity. A for-profit activity is thus possible as long as it does not constitute the final goal of the organisation but, rather, is subordinated to the altruistic activity. Sometimes a for-profit activity is even necessary to achieve a general interest goal, according to the Circular: "for instance, a special education institution may need an agricultural activity and a production workshop for apprentices." As a consequence, according to the law and the Circular detailing it, organisations that are recognised as being of public interest and tax-exempt may, in some cases, also pursue economic activities.

In 2009 and 2010, the *Conférence suisse des impôts* published two documents giving a more detailed account of the conditions under which tax exemption is granted for public utility goals, which address some specific sectors of activity. These documents were produced in response to a demand on the part of tax administrators for clearer guidelines. In these documents, one can see that the separation between the market and the (tax-exempt) third sector raises recurrent questions to which clarifications are sought. One finds an explicit discussion of competitive neutrality, addressing the issue through the angle of what kind of economic activity is admitted, while also discussing the potential overlap between the activities of organisations of public utility and markets. In particular, cultural organisations, elderly care institutions and childcare centres are discussed. These organisations can be tax-exempt, but they raise questions of competitive neutrality, since they operate in competitive market environments. And "as soon as several providers enter a same market and are in competition, they have the right to be treated neutrally from the point of view of competition." How do tax administrators decide upon these issues?

3. COMPETITIVE NEUTRALITY AND THE WORK OF TAX ADMINISTRATIONS

The interviews reveal that in spite of these guidelines, competitive neutrality poses problems for tax administrators. Of course, the administrators systematically examine all the criteria that need to be fulfilled to provide tax-exempt status (salaries, irrevocability, actual activity, etc.), and most refusals are due to non-conformity with one or more of these criteria [4]. Yet it appears that in the day-to-day work of tax administrators, the risk of breaching competitive neutrality with regard to market sectors is one of the main difficulties they face when making decisions. As such, it is on this point, and on this point only, that our interviewees said they have consulted federal tax authorities for advice.

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In face of such difficulties, on what basis do tax administrators make their decisions? The analysis of interviews leads us to distinguish three different scenarios, related to different arrangements with public administrations in charge of public action in the sectors concerned. In the first scenario, tax exemption for organisations potentially in competition with for-profit organisations is made possible by the existence of an agreement (often in the form of a contract or concession regulating a public-private partnership) between other state services and the organisation at stake. The second scenario concerns sectors where no such agreements exist and thus no other public authority regulates the organisations applying for tax-exempt status. The third and final scenario concerns the issue of economic activity and its subordination to general interest goals, where administrators favour the separation of activities into distinct accountability systems or distinct structures.

3.1 When an agreement by a government department guarantees competitive neutrality. Institutions such as childcare centres, museums and festivals operate in markets where they encounter private enterprises providing similar services. The question of the competitive dimension of their presence on markets can be resolved by public-private agreements. This is what happens in the case of nursing homes or childcare centres. In order to benefit from public subsidies, they sign contracts with the state containing stipulations on the distribution of profits. They fix tariffs for residents or children, salaries for employees through the need for a collective labour agreement, and the non-profit dimension of the establishment. In other words, through such an agreement, organisations accept limitation of their possible benefits and limits on the distribution of profits (Evers and Laville 2004). All these are elements that distinguish tax-exempt structures from other private actors and ensure that economic neutrality is respected.

In the cantons where we carried out our research, we observed that agreements with the social services division of a canton often provide the basis for the status of public utility (or more precisely its "public service" dimension, as it is called in these cases), and by extension the possibility of being tax-exempt in spite of conducting commercial activity. The following interview excerpt expands on this:

"when we give tax exemption to nursing homes, we are in a public service approach… and there, we make sure that a given nursing home is under the control of some public administration; this administration will make annual checks, if I am not mistaken, and they will verify… the personnel… the funds… there are many things that are monitored. And thus what I want to say is… we delegate the task, but unofficially… we grant (tax exemption) but under the condition that you make your checks," (tax administration canton 2, interview 16.03.2017).

As the interviewee says, there is an element of delegation going on here. It is not the tax authorities themselves that make decisions and ensure there is both public utility and no distortion of the principle of competitive neutrality. This is assured by another administration, the one that signs the agreement, which is the specialised administration in charge of a particular public policy.

3.2 Public utility against the market: a symbolic boundary to be built. While departments of social affairs often make public-private partnership agreements with organisations, this is much less common in other domains of activity, such as the cultural realm. Here the delimitation of public utility and the respect of competitive neutrality is more complicated, with criteria that involve evaluating the qualities of the activities performed by the organisations applying for tax-exempt status. The CSI document from 2010 sets out a few elements in this regard, distinguishing cultural from entertainment goals. It states that in order to be granted tax exemption, an organisation in this realm must fulfil the conditions of general interest and disinterestedness (altruism), which is detailed as follows: "A general interest can be admitted in particular for productions of high artistic level offered to a large public, (productions) that have a general education character, favour the common interest, and those which, from a religious point of view, are character forming." However, "manifestations of pure entertainment are not of public utility. The same is true of manifestations that aim at a large public, such as cinemas."

Simply reading these words suggests that it is not easy to distinguish between goals of entertainment and goals of "cultural value", and indeed the document explicitly admits this. Furthermore, although the CSI documents says that "it is not the task of tax authorities themselves to pronounce on the value of cultural activities," in reality tax administrators do find themselves in this position. When they receive application files from cultural organisations, they have to make a decision, and in order to do so, they need to develop and apply criteria to distinguish between activities of "mere entertainment" and cultural activities of public utility.

A possible shortcut, somewhat analogous to the scenario discussed above, would be to take public subsidies as an indicator of public utility. According to this reasoning one could say that if an organisation receives subsidies from the state, then some competent state agency has decided that its activities are of a certain cultural value. However, the CSI document insists that there is no automatic link between subsidy and tax exemption, saying that receiving a subsidy cannot be considered a sufficient reason to grant tax exemption. Because they cannot rely on the decisions of other agencies, tax administrations develop their own rules. For instance, in the case of cinema, administrators try to distinguish between commercial and non-commercial films:

"Some films, you can clearly see that they are commercial… in other cases, when it is unknown directors, things like that, if a cinema shows directors at the beginning of their career… then it is maybe no longer entertainment but culture," (tax administration canton 3, interview 7.02.2018).

To decide, tax administrators apply the various criteria of public utility – for instance whether the ticket prices allow broad access and thus the criteria of the "open circle" is respected. In other cases, their arguments reflect the logic of

subsidies: does tax exemption allow the pursuit of activities that would not otherwise take place for lack of funding? Most critically, however, it is the issue of competitive neutrality that becomes important here: it allows for a distinction to be drawn between cultural activity – where there is no market because no profits can be made – and entertainment, where for-profit is the rule. One administrator, for instance, told us about a court case concerning an orchestra whose application for tax-exempt status was rejected by the tax authorities:

"For us, this orchestra operates in a market environment characterised by competition; our argument was that tax exemption would negatively affect the game of competition between cultural actors in the same domain. The court, on the contrary, observed that the list of exempted institutions in the canton included a large number of actors belonging to this sector." (tax administration canton 2, interview 16. 03. 2017)

In this case, as in others, the tax administrators and the courts can reach different conclusions as to whether or not there is distortion. One can believe that tax exemption would lead to competitive distortion, while the other party comes to the opposite conclusion. A decision also depends on previous decisions, rather than a judgment on a single situation. In this case, the court stated that in this given sector, many actors are already tax-exempt anyway.

3.3 Separation of activities. Because the legal texts admit for-profit activities as long as they are subordinate to the altruistic activity, tax administration employees also have to evaluate the hierarchy in the subsidiarity of activities, deciding whether the mix between the public utility dimension and commercial activities is in conformity with the requirements of the law. In addition, the pursuit of commercial for-profit activities by a tax-exempt organisation contains, once again, the risk of "unfair competition". How do tax administrators evaluate such cases?

As in the above case, they cannot count on other administrations as resources to help them make decisions. Generally speaking, administrators tell us that they become particularly attentive as soon as organisations claim to produce something that is then sold on markets.

"Terms like 'production' ring alarm bells: is there a commercial activity behind this? We won't necessarily say no, we just say that there are question marks for us. (...) If it is membership fees, asset incomes, donations and inheritances or public subsidies: no problem. If it is the product of activities, then we are very attentive. For instance: how are the prices of services determined? Or is the activity competitive? For us it is very important not to favour an entity through tax exemption when it will operate on a market sector." (tax administration canton 1, interview 7. 04. 2017)

The solution that is often envisaged to decide on such cases is to separate the for-profit activity from the altruistic activities to avoid creating unfair market competition. For instance, in a case of a cultural organisation that also runs a small bar to finance its cultural activities, the tax administration determined that tax exemption would give the bar an unfair advantage over competitors in the neighbourhood. However, because the cultural activity clearly fulfilled public utility goals, the suggestion was to separate the two entities. In so doing, the administration considers that it minimises the risk of unfairly favouring some organisations over others.

4. CONCLUSION

In conclusion, and in addition to the traditional criticisms of tax exemptions, we see the practical difficulties that this tool can pose for employees of tax administrations. Following Salamon (1989:8), what makes the use of this instrument so significant is that it has "its own distinctive procedures, its own network of organizational relationships, its own skill requirements – in short, its own political economy." Favouring tax expenditure over direct expenditure as a public policy tool and entrusting tax exemption for public utility purposes to tax administrations rather than to the public administrations directly responsible for public policies in a specific sector of activity does not eliminate decisions in terms of public policy choices, but only changes the actors who make these choices first. ■

Footnotes: 1) The empirical results presented here are based on a research project funded by the Swiss national science fund entitled "The Boundaries of the Welfare State in Switzerland: Tax Authorities, Philanthropic Foundations, and the Recognition of Public Utility" (2016–2019, project 162836). **2)** Federal Act of 14 December 1990 on Direct Federal Taxation (DFTA); Federal Act of 14 December 1990 on the Harmonisation of Direct Taxation at Cantonal and Communal Levels (DTHA); Federal Tax Administration, Circular no. 12 of 8 July 1994, Tax exemption of legal persons pursuing public service or exclusively public utility aims (Art. 56 lit. g DFTA) or cultural aims (Art. 56 lit. h DFTA); deductibility of charitable contributions (Art. 33 al. 1 lit. i and 59 lit. c DFTA); Conférence suisse des impôts, information dated 18 January 2008; Conférence suisse des impôts, information dated August 2010. **3)** On this point, see Lideikyte Huber (2018). **4)** A reading of the court judgments concerning appeals lodged against refusals by the tax authorities to recognise public utility seems to confirm this. Having examined 32 judgments (i.e. all the judgments of the courts of the cantons studied and the Federal Court as a court of second instance for the period 2001 to 2015), we found that only four directly concerned the question of competitive neutrality.

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