



KANSAS LEGISLATIVE
DIVISION *of*
POST AUDIT

A Performance Audit Report Presented to the Legislative Post Audit Committee

Study of Taxation and Exemption Issues

January 2022

Report Number: R-22-002

Introduction

Senate Substitute for House Bill 2313 requires this audit, which the Legislative Post Audit Committee authorized at its June 29, 2021 meeting.

Objectives, Scope, & Methodology

Our audit objective was to answer the following question:

1. What are the economic impacts of tax or exemption differences for government and non-profit organizations that compete with similar for-profit businesses?

The scope of our work included reviewing academic research on the competition between government, non-profit, and for-profit businesses. We also reviewed state tax law and interviewed Kansas Department of Revenue staff. We interviewed several for-profit and non-profit business owners and other stakeholders. Last, we surveyed owners or operators of fitness centers, childcare centers, and mental health centers in Kansas.

More specific details about the scope of our work and the methods we used are included throughout the report as appropriate.

Important Disclosures

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We encountered significant data problems that prevented us from answering the audit question. Auditing standards require us to obtain sufficient, appropriate evidence to support our audit findings. However, we could not get the evidence needed to answer the audit question for a couple reasons. First, tax information collected by the Department of Revenue does not have sufficient detail needed for analysis. Additionally, we do not have access to private business records. Because specific business tax and exemption data was so essential to answer the question, we simply did not try to draw any findings or conclusions.

Audit standards also require us to report limitations on the reliability or validity of our evidence. We received a very low response rate on our survey of business owners, which limited the conclusions we could draw from the results. We describe both of these issues in more detail later in the report.

Our audit reports and podcasts are available on our website (www.kslpa.org).

We could not determine the effect of taxes or tax exemptions on government and non-profit organizations that compete with for-profit businesses because of data limitations.

Background

The research we reviewed found that although some businesses may appear similar, slight differences in services or location can affect the level of any competition.

- It can be difficult to determine which businesses compete with each other. For example, in a large city, fitness centers likely compete with other similar nearby centers rather than all the fitness centers in the city. However, we lacked the data to determine which businesses compete. As a result, we looked at the existing research to understand how similar government, non-profit, and for-profit businesses may compete.
- We reviewed 4 studies that evaluated competition between government, non-profit, and for-profit businesses in the United States. We looked for the most recent research available. However, most of the studies were 15 or more years old because very little new research is being done in this area. A complete list of the research we reviewed for this audit can be found in **Appendix A**.
- Based on the available research, competition between government, non-profit, and for-profit businesses may exist in some industries, but it is likely minimal. This is because they offer different types of services and serve different customer bases. For example:
 - A study of hospitals found that government hospitals were more likely to provide services that are disproportionately needed by the poor and underinsured (e.g. emergency psychiatric services). However, for-profit hospitals were more likely to provide specialty services such as open-heart surgery. Because the hospitals provide such different services, competition between them is likely minimal.
 - A study of fitness centers suggested there was little competition between for-profit and non-profit fitness centers. This was, in part, because for-profit and non-profits focus on different types of consumers. Non-profits focused more on services that low-income households use such as afterschool programs. However, for-profit centers focused more on serving the needs health-conscious consumers.
 - Another study that looked at substance abuse centers found competition in some markets but not in others. For example, there was less competition between public and for-profit substance abuse centers in

markets with larger minority populations. However, competition was more likely in other types of markets.

- Much of the literature we reviewed evaluated only specific industries. As a result, we can draw no conclusions about the competition between government, non-profit, and for-profit businesses in other industries.

Additionally, the research shows government and non-profit businesses have some advantages over for-profit businesses, but the effect on for-profit business is unclear.

- A competitive advantage is a factor or attribute that allows a company to provide a good or service at a lower price or higher quality than its competitors. Some advantages, such as efficient production strategies or good leadership, come from how a business operates. Other types of advantages can be conferred on the business by government. This can include things such as tax exemptions, regulatory exceptions, or access to certain types of funding.
- A competitive advantage has many potential effects. For example, businesses with advantages might gain greater market share or stay in business longer. The purpose of this audit is to examine how one type of advantage available to government or non-profit businesses (tax exemptions) might affect for-profit businesses. Due to data constraints, we were unable to determine the effect of that advantage on for-profit businesses in Kansas.
- We looked at the existing research to understand the effect of government or non-profit advantages on for-profit businesses. Some research looked specifically at the effect of tax exemptions. However, most evaluated the effect of advantages generally rather than the effect of any specific advantage. We reviewed 7 studies that assessed the effect of competitive advantages. Most of the research was at least 15 years old.
 - The research that quantifies the effect of tax exemption advantages is limited. The two studies we reviewed focused on tax exemptions for non-profit businesses. They both found that tax exemptions do provide an advantage. However, the effect of that advantage was mixed. A study looking at non-profits generally, found that non-profits had a greater market share in areas with higher taxes. This is likely because the value of a tax exemption is greater in higher tax areas. Conversely, a study examining the fitness industry found that tax exemptions for non-profit fitness centers did not lead to fewer for-profit fitness centers. We did not find any research that examined the effects of tax exemptions on competition between government entities and similar for-profit entities.
 - Some research found that government and non-profit businesses have competitive advantages, but the effect on for-profit businesses varied. These studies did not study any specific advantage (e.g. tax exemptions).

One study found that large for-profit daycare centers were more likely to go out of business than government centers. However, another study that looked more generally found that the effect of non-profit advantages on for-profit businesses varied by industry.

- Another study found that non-profit's primary advantages were not conferred by government (e.g. tax exemptions or regulatory exceptions). That study found that the primary advantage of non-profits is their ability to offer services at lower prices because they do not need to make a profit. This advantage can have a negative effect on for-profit businesses. The lower prices that non-profits may offer can reduce the viability of their for-profit counterparts.
- We spoke to four professors who have studied the effects of competition between non-profits, for-profits, and government in the United States. They noted a couple additional things. First, two professors thought the value of tax exemptions may be too small to provide much of an advantage to non-profits. Additionally, they told us that research into this issue is lacking although there are many unanswered questions.

In Kansas, for-profit fitness centers, daycare centers, and mental health centers generally pay taxes that similar government and non-profit businesses do not pay.

- We looked at differences in statutory tax rates in three industries in Kansas: fitness centers, daycare centers, and mental health centers. We chose these industries because in many parts of the state, government, for-profit, and non-profit businesses exist in close proximity and may offer similar services. For example, in some of the more populous parts of the state, for-profit fitness centers, non-profit fitness centers (e.g. YMCA) and fitness centers operated by local governments all operate in the same city.
- In some cases, state law exempts governments and specific types of non-profits from certain taxes. **Figure 1** compares the different types of state and local taxes that non-profits, government, and for-profit businesses pay in Kansas. As the figure shows:
 - Non-profit and government fitness, daycare, and mental health centers are exempt from paying real and personal property taxes. Generally, for-profit businesses must pay this tax.
 - Certain non-profit and government mental health centers are exempt from paying sales tax on the items they purchase. Non-profit fitness and daycare centers and for-profit businesses must pay this tax on certain goods. Further, non-profit and government fitness, daycare, and mental health centers are not required to collect sales tax on the services they provide. For-profit fitness centers must charge and collect this tax.

- Non-profit and government fitness, daycare, and mental health centers are exempt from paying a state tax on taxable income. Generally, for-profit businesses must pay this tax.

Figure 1. For-profit fitness centers, daycare centers, and mental health centers pay taxes that similar government and nonprofit centers do not.

		Property Tax		Sales & Use Tax		State Income Tax
		Real Property	Personal Property (1)	Paid on Purchases (2)	Collected from Customers	
Fitness Centers	For-profit	✓	✓	✓	✓	✓
	Nonprofit			✓		
	Government					
Daycare Centers	For-profit	✓	✓	✓		✓
	Nonprofit			✓		
	Government					
Mental Health Centers	For-profit	✓	✓	✓		✓
	Nonprofit					
	Government					

(1) Commercial equipment/machinery purchased after June 30, 2006 is exempt.

(2) The purchase of goods for resale is exempt. Additionally, only certain types of non-profit mental health centers are exempt from paying sales tax.

Sources: LPA analysis of Kansas tax statutes

Kansas Legislative Division of Post Audit

Limitations to our Analysis

We couldn't determine how taxes or exemptions effect competition in Kansas because of data issues and time constraints.

- We lacked the information and time to fully assess which for-profit industries compete with non-profits and government. As the research showed, it is not clear what types of for-profit businesses truly compete with non-profits or government run businesses.
- We worked with Kansas Department of Revenue officials to understand the data they have. However, the data available on tax returns was not adequate

for us to determine the magnitude of the statutory tax differences or their effect on competition between Kansas businesses.

- How much a single business pays in taxes is not always clear. For example, a business incorporated as a limited liability corporation does not pay a corporate income tax. Instead, income from these businesses is taxed on the owners' individual tax returns. As a result, it is difficult to know how much of the tax on a return was related to the relevant business. Additionally, how much a business spends in sales tax is not collected at all.
- Our audit authority does not extend to the private sector. K.S.A. 46-1114 allows LPA to audit state agencies, school districts, and local governments. Further, K.S.A. 46-1106 requires those entities to provide the documentation we request. However, we have limited authority to audit the private sector and cannot compel private entities to provide information to us. As a result, we had difficulty getting the necessary information from non-profit and for-profit businesses.
- We tried to collect tax data by various industries but the codes that would allow us to do that are too broad. Businesses are assigned a code that identifies its industry. However, those codes are quite broad and often include businesses that are not similar. For example, the code that fitness centers use also includes karate and gymnastics centers, ice skating rinks, and swimming pools. The variation in those businesses was too broad to be useful.
- We tried several ways to answer the audit question, but time constraints prevented further efforts. Statute requires us to submit the audit to the Legislature by January 15, 2022. As a result, we were only able to provide a limited answer to the question in the time we had.

The response rate to our survey of for-profit, non-profit, and government run businesses was too poor to draw any conclusions.

- We surveyed 751 for-profit, non-profit, and governments that operate childcare, fitness, or mental health centers in Kansas. We asked respondents about their opinions on competition and tax exemptions. 110 (15%) businesses or government entities submitted a complete survey.
- Due to numerous problems with survey responses, we are unable to draw any valid conclusions from the survey. Specifically:
 - We were unable to send surveys to all mental health and fitness centers. Due to time constraints, we could not gather email addresses for all mental health and fitness centers in the state. We sent surveys to 117 licensed mental health providers that state agencies provided during a previous audit. However, we sent only 47 surveys to fitness centers. This

was because a comprehensive list of fitness centers in the state was not available. We gathered contact information for as many centers as time permitted. The Kansas Department of Health and Environment provided email addresses for all licensed daycare centers in the state.

- The overall response rate to the survey is only 15%. Most survey recipients are in the private sector so we cannot require them to submit a response. Because the response rate is so poor, it likely does not accurately represent the opinions of the larger group of those we surveyed.
- The responses are not evenly distributed across the industries we surveyed. **Figure 2** shows responses by business type and sector. As the figure shows, 78% of the total responses were from daycare centers. Further, 60% of responses are from non-profits.

Table 2. Survey responses were not evenly distributed across the industries we surveyed.

	Government	For-Profit	Non-Profit	Total
Daycare Centers	3	30	56	89 (78%)
Fitness Centers	3	2	3	8 (7%)
Mental Health Centers	2	6	9	17 (15%)
Total	8 (7%)	38 (33%)	68 (60%)	114

Source: LPA survey of select industries in Kansas.

Kansas Legislative Division of Post Audit

- Although we cannot draw any conclusions from the survey, respondents did report a few relevant things:
 - Respondents disagreed about how much non-profits and governments compete with for-profit businesses. Only 58% (44 out of 76) of non-profit and government respondents reported that they compete with similar for-profits. Conversely, 82% (31 of 38) of for-profits thought they competed with similar government and non-profits.
 - 77% (24 of 31) of for-profit respondents thought their business was at a disadvantage when competing with non-profits or government run businesses. Nearly all these respondents (22 of 24) thought that tax exemptions allow their non-profit and government competitors to charge less for services and to pay staff more.
 - 54% (13 of 24) of for-profit respondents identified real estate property tax as the most burdensome tax to them. Nine said state incomes taxes and two said personal property taxes were the most burdensome. No respondent identified sales tax as the most burdensome.

Conclusion

Although government, non-profit, and for-profit businesses may appear to compete, the research indicates that true competition may be limited, at best. This is because different types of businesses that may appear similar actually offer different services and serve different populations. However, the research is limited to a few specific industries. Determining what industries and in what circumstances government, for-profit, and non-profit businesses compete is a task that requires more time and data than was available in this audit. Further, while government and non-profit tax and exemption status might offer an advantage over for-profit business, the issue has not been well-studied. Unfortunately, existing tax data in Kansas is not precise enough for us to reliably quantify the specific effect of tax or exemption differences.

Recommendations

We did not make any recommendations for this audit.

Agency Response

On December 15, 2021 we provided the draft audit report to the Kansas Department of Revenue. Because we did not make any recommendations, a response was optional. The department declined to submit a response.

Appendix A – Cited References

This appendix lists the major publications we relied on for this report.

1. Impacts of Tax Exemptions: An Overview. (January, 2004). *Steve Lerch*.
2. Nonprofit Tax Exemptions, For-Profit Competition, and Spillovers to Community Services. (September, 2017). *Teresa Harrison and Katja Seim*.
3. Making profits and Providing Care: Comparing Nonprofit, For-Profit, and Government Hospitals (May, 2005). *Jill Horowitz*.
4. Competition Between For-Profit and Nonprofit Organizations in Commercial Markets. (1991). *Jerry Schiff*.

5. Are Nonprofits Unfair Competitors for Businesses? (2004). *Yong Liu and Charles Weinberg*.
 6. Competition Between Non-Profits and For-Profits: Entry and Growth. (1990). *Susan Rose-Ackerman*.
 7. The Effect of Tax Exemption and Other Factors on the Market Share of Nonprofit Versus For-Profit Firms. (1987). *Henry Hansmann*.
 8. Child Center Closures: Does Nonprofit Status Provide a Comparative Advantage? (March, 2013). *Marcus Lam, Sacha Klein, Bridget Freisthler, and Robert Weiss*.
 9. Competition and Crowding -Out Among Public, Non-Profit, and For-Profit Organizations: Evidence from Outpatient Substance Abuse Treatment. (May, 2007). *Andrew Cohen, Beth Freeborn, and Brian McManus*.
 10. The Effect of Tax Exemption on the Market Share of Nonprofit Hospitals. (December, 1993). *O. David Gulley and Rexford Santerre*.
 11. Does State Preschool Crowd-Out Private Provision? (December 2012). *Daphna Bassock, Maria Fitzpatrick, and Susanna Loeb*.
-