Governance, Regulation and the Third Sector:
Responsive Regulation and Regulatory Responses

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> [I]f one thinks about it, there are many political institutions that are interesting precisely because if we look at them today we are struck, simultaneously, by how little *and* how much they have changed over time.
>
> (Thelen, 2003: 211)

Debate around the regulation of the third or voluntary sector has been a sleeper issue in Canadian public policy and administration. While the third sector has been actively pressuring for changes to public policy – and specifically regulatory reform – for the past decade, there has been little political or public interest in such reform. This is not surprising, one might say, for a small sector that is driven largely by well intentioned people doing good work, often on a volunteer basis, for the benefit of others. This stereotype of the third sector is badly outdated, however, if not plain wrong from the start. While the contributions of the voluntary sector as an integral part of the welfare state and the broader delivery of public services have come to be quite widely recognized, recent studies are demonstrating its economic significance as well. Comprised of over 160,000 organizations, Canada's third sector represents a workforce roughly equivalent to that of the construction or the oil and gas industries (NSNVO, 2004; McMullen and Schellenberg, 2002),[1] and by international comparisons, ranks as the world's second largest relative to population (Hall et al., 2005).[2]

The concern over regulatory reform is not simply that the third or voluntary sector is, in fact, much bigger than common stereotypes suggest; rather it goes to fundamental aspects of democratic practice. Some but not all voluntary organizations have access to the tax system to issue receipts for donations, and thus are bestowed a large measure of state-sanctioned legitimacy. Is the basis for determining which organizations have such access and legitimacy congruent with the values and myriad of means of serving a collective public benefit in a diverse society? Does it serve 21st century models of shared governance? To what extent should voluntary organizations that are authorized to issue tax receipts (known as 'registered charities'), and thus produce tax expenditures, be able to participate in public policy debates and advocacy?

Some of the implications of this sleeper issue have recently been awakened by an unlikely source, the debate around same sex marriage. As legislation on the same sex marriage bill made its way through the parliamentary process, leaders of the Catholic Church and other religious congregations, all registered charities, have been very vocal on the issue, making use of websites and other media and encouraging members of their congregations to write letters to voice their opposition to the legislation. The federal government has told them to "butt out" (Thompson and Dawson, 2005: A1). How dare the government, responded church leaders, "suggest that the Catholic Church does not have a role in public debate" (Thompson and Dawson, 2005: A1). Many Canadians might agree, but political activity by registered charities is nevertheless highly restricted. While other charities have been arguing for years that the regulations on advocacy are too stringent, are we to allow certain types of charities, those that bring a moral claim perhaps, to operate under different standards than others? Suddenly, the inherent fairness

and effectiveness of the entire regulatory system for Canadian charities is a very serious public policy issue. To reflect on Thelen's (2003) paradox, however, the regulation of Canadian charities is a good example of how much can change and stay the same simultaneously.

The issue of institutional change – when it occurs, under what conditions and whether its results are marginal or transformative – has become a topic of renewed interest in public administration (Streeck and Thelen, 2005). Although the subject of policy and institutional change is a well-travelled one in this field, what is new is a shift of focus from large-scale, 'big bang' or discontinuous change to an interest in incremental, endogenous changes that have transformative potential (Crouch and Keune, 2005; Jones and Baumgartner, 2004).

This paper draws on the actor-centred institutional literature to examine change – and resistance to change – in the federal regulation of Canada's charitable sector. By way of definition, the voluntary or third sector can be thought of as the entire constellation of roughly 160,000 autonomous organizations which operate on a nonprofit basis and thus are exempt from income taxes. The charitable subsector, approximately 80,000 organizations, is comprised of those organizations that have eligible charitable purposes as defined under the common law and that are registered by the Canada Revenue Agency (CRA), and are thus able to issue receipts for donations that can be claimed as tax credits.[3] This charitable subsector is enormously diverse, including large institutions, such as universities and hospitals, as well as very small largely volunteer-run groups.

In recent years, the regulatory regime governing charities has been off kilter, tilting in favour of the regulator, in ways that diminished its legitimacy, that was heavy handed and inconsistent in its application and that strained the capacity of voluntary organizations to comply. The regulatory system has been under enormous pressure for reform, but so far the record on reform is mixed. The Charities Directorate of the CRA, which for the past decade was so severely criticized by the voluntary sector that its demise was being actively planned and designs floated for its successor (Drache and Hunter, 2001), is reinventing itself through major continuous changes to administrative practices. It is in the process of becoming the kind of responsive regulator advocated by the Smart Regulation movement (External Advisory Committee, 2004). Can the CRA reform itself to the satisfaction of the sector it regulates? As this process unfolds, its key challenge will to become less rule based and, while by no means abandoning its role as enforcer, to become more of an educator and enabler of the charitable sector and, more importantly, to find the right balance between these roles.

The paper first outlines how the evolution in ideas about regulation, particularly the recent interest in responsive and smart regulation, apply to the third sector. Regulation of this sector necessarily entails a balance between governmental rules and self-governance and between rules and responsiveness. Because the voluntary sector depends fundamentally on the maintenance of public trust for its viability, the regulatory regime must thus facilitate a rather delicate balance. It needs to: provide sufficient rigour to maintain public trust, but enough flexibility to enable compliance by big and small organizations; weigh provision of support through tax expenditures against protection of the integrity of the tax system; and balance fairness in the application of rules with the

diversity of organizations and causes that might test these rules. Although the literature on regulation has evolved significantly in recent years and Canada has been a leader in the movement toward smart regulation in other industries, it has been slow to come to the third sector.

The second section briefly reviews recent institutional debates about models of policy change in order to establish a framework for understanding the change that is occurring in regulation of the third sector. We then take a critical look at the current process of change to the administrative practices, regulations and the regulatory body itself that is unfolding. The changes in administrative processes that have occurred do have transformative potential, but they alone cannot fix the incongruities between the changing role of the sector in governance and the limitations of the current regulatory regime. Further change, to legislation and to institutions, not merely to process are still needed. Nevertheless, we should not underestimate the extent of change that can occur in incremental steps. In conclusion, the next steps for smart regulatory reform of this sector and what can be learned from progress to date for both further change and about the change process itself are considered.

Toward Smarter, Responsive Regulation

As a policy tool, regulation involves rules, standards for compliance, sanctions for non-compliance and an administrative apparatus to enforce the rules and administer sanctions as required (Doern, 2003; May, 2002). In recent years, thinking and practice related to regulation has begun to change with the goal of making it more responsive and 'smarter,' that is, to think beyond rule making. This reframing of regulation is a response

to evolving modes of governance in which governments (supposedly) are working in more collaborative and interdependent ways with a variety of nongovernmental actors and in which governance is more multi-level (Doern, forthcoming; Hill and Lynn, 2005; Rhodes, 1996; Salamon, 2001). In the context of 'governance,' regulation entails not only governmental rulemaking, but the involvement of nongovernmental bodies and co-governors, as well as considerable scope for private governance and self-regulation (Doern, forthcoming; Webb, 2003). The theory of regulation is thus increasingly concerned with designing institutions and processes that stimulate and respond to the capacities of both the regulators and the regulated sector (Parker, 2002; Scott, 2003). This is embodied in the concept of "responsive regulation" in which a fruitful combination of advice and sanctions are given to the regulated and are increased as necessary within an "enforcement pyramid" (Ayres and Braithwaite, 1997). To be sure, rules still have an important place, but responsive regulation embodies an enabling function through communication, advice and support. From this perspective, the enforcement pyramid is built on a broad base of education and self-regulation with a smaller space needed for more traditional command regulation.

The Smart Regulation movement combines concerns with responsiveness with those of efficiency in a multi-level, global environment. 'Smart regulation,' as defined by the federal government's Advisory Committee on Smart Regulation, is understood to encompass both protecting and enabling, to be results based but in ways that are more flexible in how results are achieved, to be responsive to the regulated, and to facilitate continuous improvement. In short, "[i]t is about making regulation as effective as possible — and making sure it is never more complicated or costly than it has to be"

(Smart Regulation External Advisory Committee, 2004). The push toward responsive, smart regulation presents a new set of challenge for regulatory bodies: how to define, manage and balance the role of enforcer of rules with that of enabler.

This emerging view of regulation is compatible with contemporary views of the voluntary sector that have evolved from a model based on charity to one based on civil society. In contrast to the view of 'cold charity' that emanated from Victorian England in which the main role of the voluntary sector was to help the less fortunate by providing services and support, the emerging approach emphasizes empowerment by which communities have the resources, the political voice and are capable of representing and helping themselves (Phillips, 2003: 18; Deakin, 2002; Warren, 2001). One signal of this change is the fact that most voluntary organizations eschew the language of 'charity,' struggling to find labels with less baggage. A key to achieving such empowerment and community development is to promote active participation by citizens who in the process of such voluntary participation build social capital – the networks of trust that come from voluntary association (Putnam, 2000) – which in turn contributes to a health democracy and active citizenship. In a civil society model, then, voluntary organizations are more than providers of services. They also have a legitimate role as participants in policy development and as fundamental elements of citizenship regimes. As we will see, however, the regulatory model was founded on and still remains largely rooted in a vision of charity.

Understanding Change: The Matters at Hand

An interest in why and how change in policy and institutions occurs has been a long standing theme in public administration as the field has struggled with explaining some of the

dramatic, sometimes abrupt changes that have occurred in public policy and institutional development.[4] The dominant models of change have been either variants of punctuated equilibrium, critical junctures or paradigm shifts, all of which assume that long periods of relative stability and institutional stasis are broken by some sort of exogenous shocks or fundamental changes in exogenous conditions that produce moments in which ideas, interests and actors can be realigned, often resulting in quite rapid and dramatic institutional and policy change. While these approaches are useful in explaining big-bang and radical shifts in policy, this type of change is in fact quite rare. What is new to this field is a focus on a greater range of processes and, in particular, a (re)focus on endogenous and incremental change. This shift in focus is an interweaving of three inter-related themes of institutionalism.

'Institutions Matter'

The notion that we should take institutions seriously as both structural constraints and as actors with differential capacities and varying degrees of autonomy was the key idea behind the push in the 1980s to bring the state back in policy analysis (Skocpol, 1985; see also Weaver and Rockman, 1992). Undoubtedly, neo-institutionalism has forced policy analysis to take the effects of institutional settings and constraints seriously. One critique of the way in which the institutionalist literature has evolved over the past twenty years is that the casual arrows are often too uni-directional, flowing from the state and the structural determinants of policy, rather than as a more complex strategic, political and symbolic interaction (Dobrowolsky and Saint-Martin, 2002). There has begun to be a much more agency-centred turn in institutionalism in which institutions are seen to be "fluid, continually

created and recreated by a great number of actors with divergent interests, varying normative concerns, differential power and limited cognition (Streeck and Thelen, 2005). Institutions do more than set the constraints and conditions to which actors respond. Rather, agents are innovative in adjusting to conditions and in changing these conditions (Crouch and Keune, 2005; Greif and Laitin, 2004). In effect, structure and agency are co-constituted.

From this perspective, change may occur not as a result of exogenous shocks, paradigmatic shifts in ideas or reconfigured structural constraints, but may be endogenously driven either directly or indirectly (Greif and Laitin, 2004). Unlike big-bang events, however, endogenous change may be much harder to identify, at least in its early stages, and more difficult to assess because the changes may come in the form of adjustments to administrative practices, rather than as major comprehensive plans for reform. As the second wave of literature on instrument choice (Salamon, 2001; Howlett, Elias and Hill, 2005) points out, *what* is being changed or the instruments used in the change process also matter. The introduction of legislation which presents formal requirements for debate and which opens representational spaces in which different sets of actors can engage this debate obviously poses very different constraints and opportunities for influence by nongovernmental actors than do changes to rules or administrative practices. Quiet, experimental revamping of service delivery methods and standards are more easily changed from within. However, they present the paradox that they may be simultaneously quite invisible to many audiences, yet for those who are directly affected by these practices, may bring significant improvements to service and to relationships.

'History Matters'

The rise of institutionalism in the 1980s was accompanied by an appreciation that institutions are situated in time and space which created a strong interest in comparative historical inquiry (see Hall and Taylor, 1996; Mahoney and Rueschemeyer, 2003: 4). While it has been widely recognized that, as Thelen (2003: 212) notes, "history matters" in understanding institutional and policy change, a rather narrow view has been entrenched of how the past weighs upon and affects the present. In particular, a backlash is aimed at the popular notion of path dependency in which the increasing returns and positive feedback that flow from choices made at certain switch points are seen to reduce the latitude for deviation from the path chosen (see Pierson, 2000). The way to explain what is new, then, is as a version of what is old. This account of historical institutionalism tends to impart huge inertia to the policy process from which it is difficult to readjust (Gamble, 2000: 294). For the most part, path dependency has been better at predicting reproduction and resistance to change, based on the argument that institutions or policies become increasingly channellized over time, than it has at explaining change *per se*.

The growing critique of path dependency has focussed attention on more informal, incremental change (that may nevertheless accumulate as major shifts) and has reinforced the interest noted above in exploring how agents make choices within paths. In his study of changes to the American welfare state, for example, Hacker (2004: 244) argues that the key source of change has not been large scale legislative reform, but a series of quite decentralized and discrete alterations within existing policy bounds. Change from within existing boundaries can take a number of quite different forms

including the *layering* of new policy into the old (creating new policy without dismantling the old), *conversion* (internal adaptation of existing policies) or *drift* (by which policy is adapted incrementally in response to changing circumstances while appearing relatively stable) (see Thelen, 2003; Hacker, 2004; Schickler, 2001).

In many respects, incrementalism in all of these various forms could be seen as enjoying a minor renaissance. But, the new incrementalism not only encompasses many variations in patterns, as noted above, but it is much more agency centred. In their model of "incrementalism with upward drift," for instance, Jones and Baumgartner (2005) demonstrate that, while policy today may be policy yesterday plus an adjustment, we should not assume that the increment is random or based on limited information. The challenge in contemporary policy making is not so much limited information than it is limited attention. Thus, Jones and Baumgartner (2003; 2005; see also Soroka, 2002) point to the need to pay much more attention to agenda setting and attention-allocation. In short, the admonition is to take more seriously agents and their choices, recognizing that contemporary policy environments present a wide array of choices and issues that compete for the attention of both policy makers and the public.

'Time Matters'

The time dimension entails not only historical context, but the embeddedness of a particular moment in time as part of a broader temporal process, a process in which sequence plays a crucial role in determining the meaning of events (Pierson, 2004: 171). In contrast to the considerable rigidity implied in his earlier articulation of path dependency in which the defining moment and positive returns were of paramount concern, Pierson (2004) argues that temporal context needs to pay more attention to processes, relationships, coordination, and

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veto as well as positive feedback. This process may involve both catalysts for change and resistors, and a struggle among them. One implication is that we may need to adopt longer term time horizons to understand change in order to witness and understand the full temporal sequencing: what may seem like a relatively rapid transformation may in fact be only the final stage of a much slower moving, dynamic process that has been underway for some time (Pierson, 2004: 141).

The speed and direction of change may in large part be influenced by the congruency between the political and the public agendas, and the nature of the representational spaces around the issue: who is being heard, at what stage, and by whom? (Jones and Baumgartner, 2003). These ongoing regularized patterns of interaction between public officials and the 'targets' or constituencies, particularly in the context of regulation, may give rise to distinctive administrative styles, logics or cultures (see Howlett, 2004). In regulatory relationships, Howlett (2004; see also Scholz, 1991) argues that two factors are critically important in defining a style: first, the capacity for action of the regulator and, second, the levels of trust between the state body and the sector being regulated. For collaborative or responsive regulation, Howlett argues that there needs to be both high levels of state capacity and high levels of trust. Where capacity is high, but trust is low, litigious relationships could be anticipated and where both are low, the regulatory style is likely to be quite ineffective.

The combination of these reactions to how institutions, history and time matter has produced a renewed interest in understanding different processes and patterns of institutional development and policy change and, in particular, of taking more seriously change that is endogenously driven and that occurs within existing boundary conditions. The growing convergence of ways of thinking about institutional change is a recognition that we need to

take account of a much broader set of causes and manifestations of change than early models

provided. As Hacker (2004: 244) argues:

> The central implication is that there is not one single pattern of
> institutional change, whether it be the 'big bangs' of sudden
> transformation or the 'silent revolutions' of incremental adjustment.
> Rather, institutional change takes multiple forms, and strategies for
> institutional change systematically differ according to the character of
> institutions and the political settings in which they are situated.

Finally, there is much greater effort to differentiate the process of change from its

results.   The process may be discrete or continuous, and may be exogenously or

endogenously driven, and the results may be marginal or transformative (or something in

between).   A confusion between process and results had arisen due to an at least implicit

bias toward assuming that incremental processes produce minor change and that major

change occurs only as a result of exogenous disruption which renders current paths and

minor adjustments inadequate. As (Thelen and Streeck, 2005) argue, "equating

incremental with adaptive and reproductive *minor* change, and *major* change with,

mostly exogenous, disruption of continuity, makes excessively high demands on "real"

change to be recognized as such and tends to reduce most or all observable change to

adjustment for the purpose of stability."   Increasingly, the challenge is to understand

incremental, continuous change that has transformative potential. In the next section, we

examine the recent attempts at regulatory reform of Canada's third sector, and whether

they are indeed transformational.

Regulating Legitimacy through Access to the Tax System

Although an essential attribute of the charitable sector is its autonomy and self-governance, there remains an important role for governments in regulation. The rationale for government involvement relates, in part, to ensuring the perceived trustworthiness of voluntary organizations which, given their inherent non-distribution constraint, is seen to be a distinctive advantage over for-profits (Hansmann, 1980). In addition, governmental regulation serves as the counterpoint to the issuing of tax expenditures for donations.

An anomaly of government regulation of Canada's charitable sector is that, while jurisdiction is provincial under section 92 of the *Canada Act*, the federal government has assumed a *de facto* regulatory role for determining which voluntary organizations can be considered charities because of its tie to access to the tax system to issue deductible receipts. The determination of status as a charity is important because it enables such organizations potentially to have greater access to resources by providing incentives to giving, but also because it is an important indicator of legitimacy. Charitable status serves as a seal of approval and thus assists organizations in obtaining funding from foundations, lottery agencies and corporations, and it promotes public trust.[5] This puts an onus on the policies for determining such status to be fair and reflective of the values and means by which voluntary organizations serves a public benefit in a diverse society. Status as a registered charity brings with it reporting and certain other limitations on activities, one of which is a restriction on political activities. For the third sector, these two issues – the basis for determining charitable status and the limitations on public policy advocacy – has been the key concerns for regulatory reform over the past decade.

Regulating the 'Definition' of Charity

Within the federal government, regulatory responsibility for charities is divided between the Department of Finance which establishes policy through the *Income Tax Act (ITA)* and the Charities Directorate of the CRA which administers regulations under the Act, provides policy guidance through information bulletins, and enforces compliance. Nowhere in the *ITA* nor in other legislation is the definition of charity articulated. Rather, it is established through common law interpretation using an original list of charitable uses established as part of the 1601 Statute of Elizabeth and refined in a British court case in the late 1800s (Bromley and Bromley, 1999). The Pemsel case set out four main heads of charity that remain the benchmark for application of the common law: advancement of religion, advancement of education, relief of poverty, and other purposes beneficial to community. Under the Canadian system, a voluntary organization applies for registration to the CRA which determines whether its intended purposes are compatible with the common law and with recent cases. If rejected, the organization can appeal to the Federal Court of Appeal which requires representation by counsel and is thus both expensive and time consuming and where the primary onus is on the charity to defend its eligibility, not the CRA to defend its rejection.

Once registered, charities must report annually on their revenues, expenditures and activities on a form, the T3010, that until recently had been standardized for all charities. Charities must also meet a distribution quota to ensure that they actually spend their donated revenues on charitable purposes (thereby limiting the amounts that can be spent on salaries, administration and fundraising), and must adhere to certain limitations on their activities, notably that they do not engage in unrelated business or undertake political activities in excessive of a specified portion of their resources.

The CRA conducts audits of charities on both a complaints and a random basis, carrying out 356 in 2003. The only applicable sanction for any non-compliance has been deregistration, a veritable sledgehammer for minor offences. By far the main reason for deregistration is not fraud or intentional noncompliance, but relates to the limited capacity of so many organizations. In 2003, for example, the CRA deregistered six charities for cause and 1,127 because they did not file the annual report.[6] Under the *ITA*, the CRA can provide only very limited public information about its reasons for both denial and revocation of registration, however, so the degree of transparency about the regulatory system has historically been very limited.

A key issue concerns the ability of the common law to keep the interpretation of charity fresh and compatible with the values of the society in which it operates. In one respect, the beauty of the common law is that it is inherently flexible, setting new law based on the last case heard; in another respect, the common law can be quite calcified, depending on the last case heard. It places an emphasis on the rights and duties of individuals determined on a case by case basis that relies on precedent and, because it is fact-based rather than principle-oriented, the common law is typified by a certain rigidity of what can be specified or argued by analogy (for instance, allowing a Freenet association to be considered charitable because the information highway is analogous to an asphalt one).[7] By embodying a respect for the prevailing social order, the common law has an implicit bias toward maintenance of the status quo in society requiring, as O'Halloran (2002) observes, "an almost feudal respect for king and for country and for the institutions of the land."

By international comparisons, Canada is conservative in its determination of charitable status, in part because the tax agency as regulator is seen to be reluctant to hand

out tax expenditures and, even more significantly, because the appeal mechanisms are so expensive that they are seldom used. Without regular judicial review, the common law cannot remain current. As a result, groups promoting racial harmony, environmental protection, patriotism or volunteerism are likely to qualify as charitable in the UK or the USA whereas they are quite likely to be denied status in Canada. Greater flexibility and consistently has been obtained in other common law countries in one of two ways: by extending the common law with a legislated classification of charitable purposes that is based on a more modern test of 'public benefit' rather than charity or through an independent quasi-judicial body, such as the Charity Commission of England and Wales, that hears more cases on a regular basis (for instance related to wills and trusts as well as taxation purposes).

In the one case it has heard, the Supreme Court denied registration to the Vancouver Society of Immigrant and Visible Minority Women on the grounds that the kind of life skills and job training it provides does not qualify as advancement of education under the common law and that the category of people who benefit from its services (immigrant women) was not sufficiently broad to be considered under the fourth head of charity, other purposes beneficial to 'community' (see Stevens, 2000). Although the Supreme Court refused to expand the common law definition significantly, it openly invited Parliament to step in to expand eligibility through a legislated definition, an invitation that has not been accepted.

Exogenous Pressure for Reform: A Focus on Rules

Reform in the federal regulatory regime has come mainly from pressure from the regulated sector, rather than from any top down push for smart regulation, although the kinds of reforms that have been undertaken could all be seen as being smart regulation. Leaders from Canada's voluntary sector and charity lawyers had been pressing for some time for significant changes to how access to the tax system is determined and how it is administered. In 1999 an independent panel of experts, chaired by Ed Broadbent, was established by the voluntary sector to examine issues of accountability and governance. It strongly recommended among its top priorities that the federal government, in collaboration with the provinces and the sector, establish a task force that would help establish a legislated determination of which kinds of voluntary organizations could have access to the tax system and that the tax agency be replaced as the regulator by an independent commission. The Broadbent Panel advocated greater collaboration between the federal and provincial governments and argued that the regulatory body should assume greater responsibility for supporting and enabling charities in compliance efforts with federal regulations, thereby helping them indirectly to become more effective at self governance. Shortly after the Broadbent Panel issued its report, the federal government initiated a collaborative process with the sector called, *Working Together,* that provided further articulation of alternative models for a regulatory body and outlined in a background paper a new means of determining charitable status based on the concept of public benefit that is used in other countries (Government of Canada/Voluntary Sector, 1999; Broder, 2002).

It was at this time in early 2000 that the Supreme Court issued its decision on the Vancouver Society case. One might have expected this decision, which goes to the very essence of whether the common law interpretations of charity are adequately modernized to

address the needs of a multicultural society, to be the kind of exogenous shock that could have opened new paths for reform or led to a paradigm shift. The fact that it did not do so largely reflects the lack of interest and, indeed, resistance within the Department of Finance to open the issue for debate, fearing the fiscal impact a more liberalized definition of charity might have. Nor did a push for reform come from other federal departments or politicians which reflected a lack of appreciation of how the charitable sector is evolving toward a civil society model of engagement. Although it might be presumed that the third sector would be divided on the issue – that those already in the charitable tent would want to keep others out – surveys indicate that this is not the case. Rather there is strong apparent support across the sector for liberalizing the definition of charity (Muttart Foundation, 2004). Because third sector leaders were involved at this time in establishing a collaborative process of relationship building with the federal government, they chose not to publicly flog the full implications of the rationale of this decision to embarrass the government.

In June 2000, the Government of Canada launched the Voluntary Sector Initiative (VSI), a five year undertaking which for the first two years charged a set of Joint Tables (consistently of about 14 members chosen equally from government and the sector) with devising programs and projects for implementing many of the *Working Together* recommendations, including fleshing out proposals for regulatory reform. The Joint Regulatory Table (JRT) worked with the CRA to develop a shorter version of the T3010 and made a number of concrete recommendations regarding the compliance regime including: enhancing the technical, financial and human resources of the CRA; establishing intermediate sanctions; and providing greater ease of appeal for denial of registration by replacing the Federal Court of Appeal with the Tax Court. In addition to rules based

changes, the JRT stressed that the CRA had to become a more responsive regulator, providing information, education and outreach to the sector and the public, and it had to lead the way toward greater federal-provincial cooperation.

To the frustration of the voluntary sector (which came close to causing them to abandon the joint process), the mandate of the JRT did not include a review of the definition of charity nor an opportunity to make recommendations on institutional reform (it could again only outline alternatives). To many voluntary sector leaders, it appeared that the Department of Finance and senior public servants were resistant to considering these issues which they regarded as fundamental to the future of the sector. Indeed, many were resigned to the idea that serious regulatory reform would not be achieved for a long time to come, even though such reform was underway in many other countries and Canada's approach to charity lagged far behind.

In the 2004 budget, the federal government announced, to the surprise of many, that a number of the proposals put forward by the JRT for changes to the compliance regime would be implemented. Specifically, the changes include intermediate sanctions involving fines and suspension of tax receipting privileges; a change in the appeal process related to sanctions (only) that allows for appeals to proceed to the less cumbersome Federal Tax Court; and increased transparency on the kind of information that can be provided by the CRA. These legislative changes do not address the definition of charity nor facilitate easier access to appeals related to the registration process. While rationalizing the nature of sanctions and increasing transparency are useful, these measures could be seen as layering small rule changes into an existing regime without changing the fundamental parameters of that regime. These changes were announced before the requisite amendments to the *ITA* had

been drafted and it is expected to take some time to get the legislation in place (Drache, 2004). The need to amend the *ITA,* a cumbersome piece of legislation controlled exclusively by the Department of Finance, points to the desirability of establishing separate legislation for the governance of charities, as has been done in the UK. This would not only make amendment easier, but could give the CRA, which unlike Finance has an ongoing, client relationship with the charitable sector, a greater role in continuing to be responsive the sector and to drive change that modernizes the regulatory framework.

The budget also announced a reduced and more flexible disbursement quota (the amount of money that a charitable organization has to disburse on charitable activities each year). Unlike the other changes, this one emanated solely from the Department of Finance rather than from the CRA or the voluntary sector. While not a proponent of the change to the disbursement quota, the CRA has had to deal with considerable negative reaction to the effect that the changes are unduly complicated and unnecessary in the first place. It is a good illustration of the need for responsive regulation built on ongoing relationships between regulator and regulated and for policy coordination within the federal government. Making the regulator more responsive to the regulated sector, as the CRA has recently been working hard to do, is obviously undermined if the regulations it must administer are out of its control.

Endogenous Change: A Focus on Practice

As important as these formal changes to regulations are changes to the administrative practices and service standards at CRA that were launched in 2001 as part of their *Future Directions* initiative and that squarely address the function of regulation as service rather

than merely compliance. These changes include: a vastly improved website on which all registered charities are listed; enhanced service standards in responding to information requests and applications for registration; better information sharing through its charity bulletin; creation of the position of a complaints officer; and establishment of an advisory committee on charity law. In addition, the Charities Directorate is more actively engaging with voluntary organizations across the country by hosting regular "roadshows" that are seen to facilitate constructive, problem solving dialogues and it is beginning to use the information collected from consultations in more systematic ways. In May 2005, a new grants and contributions program to support projects related to development, education and evaluation of regulatory compliance mechanisms was established. The main value of this outreach program is that it may enable the CRA to create a new set of relationships with its constituency that are different from that of regulator and regulated, and thus give the Agency another avenue to engage with the voluntary sector. Finally, the CRA has also begun floating trial ideas for more fundamental reform of the definition of charity through policy papers on ethnocultural communities and on the concept of a public benefit test.

In effect, the CRA appears to be attempting to reinvent itself from within, thereby quelling arguments for the creation of a new regulatory institution. In both the formal and informal changes, the primary impetus seems to have come from senior management within the CRA who, through the collaborative process of the VSI, had the opportunity to work with and understand the views of the voluntary sector. In effect, the senior official responsible for the Charities Directorate who was new to the Agency and who participated in the Joint Regulatory Table of the VSI, quickly came to understand the importance of being a more responsive regulator and, within the limited policy levers available to the CRA, set about

instigating significant changes in practices, which have been carried on by her successor in the position. In one sense this could be read as endogenous change, but it probably would not have happened without the exposure of the Agency to its constituency through the joint process of the VSI. It suggests that in contemporary models of more permeable governance, the distinction between what is endogenous and what is exogenous is increasingly fuzzy.

Implementation of the new administrative practices and service standards involves significantly reducing the silos between policy, operations and compliance within the Charities Directorate and by affecting a major internal culture shift toward being more responsive and engaged with the regulated constituency. These communications and culture changes are still unfolding and still quite fragile as they are highly dependent on the personnel leading the change (see Evans, forthcoming). A key challenge in successful implementation will be finding the right people to staff the Charities Directorate.[8] As a small unit with a peculiar, somewhat contradictory mandate, situated within the much larger tax agency, there is considerable flow through of public servants in the Directorate. Unlike other regulatory bodies or charitable regulators in other countries, there is very little recruitment of 'experts' from the regulated sector into staff positions within the Charities Directorate. This means that the regulator is still quite isolated from the regulated sector, and must rely heavily on more formalized events (e.g. the 'Roadshows') and on programs (e.g. the new grants and contributions program) as the connective tissue, rather than having understanding of the sector ingrained within its own staff. In short, while the administrative changes have been a significant and impressive move toward more responsive regulation, the real test of their viability is yet to come.

Can administrative change alone go far enough? I argue it cannot. The question of which types of causes should be supported by tax expenditures and be bestowed a governmental stamp of approval is a policy question, and an increasingly important one under models of shared governance and devolved public services in a multicultural society. It is both substantive and symbolic, requiring serious political debate as has recently occurred in the UK, Australia and elsewhere. The introduction of a public benefit test for registration would ultimately require either amendment to the *ITA* or separate legislation. In this, the Charities Directorate will have to be able to bring the Department of Finance along, but it has at least taken the first important steps of reasserting some of its lost credibility with the voluntary sector and of testing possibilities in a serious way through trial policy balloons.

There are also two major incongruities in the overall federal regulatory framework for the charitable sector that will need to be addressed and reconciled with new legislation, however. The first is the shared jurisdiction with the provinces. Although policies for determination of charitable status are more or less harmonized, this occurs more by default than by active coordination. Indeed, the federal-provincial systems themselves are completely disconnected and any harmonization is thus potentially fragile. This lack of coordination leaves some serious ambiguities, such as jurisdiction over national organizations that operate in several jurisdictions. It also increases the compliance burden and creates public confusion over which government has responsibility for monitoring the actions of charities (JRT, 2004). A major barrier to federal-provincial coordination has been that the *ITA* prohibits disclosure of taxpayer information with only limited exceptions for charities, although the provinces are not so constrained in sharing information with each other (Oosterhoff, 2004). The need for greater multi-level coordination and the bias in favour

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of privacy in the *ITA* is an additional reason to consider the enactment of separate charity legislation. Although the CRA has begun liaison with provincial/territorial governments to bring about more multi-level coordination, this is progressing slowly due to the differences among and fragmentation of regulatory mechanisms within the provinces.

A second obstacle is the open ended liability and the chasm in a lack of trust created by the Anti-Terrorism law, complicated legislation involving changes to a number of federal statutes that came into force in December 2001. Because the Anti-Terrorism law casts such a broad net in its definitions of what kinds of actions contribute to and facilitate terrorism and because its enforcement mechanisms are so draconian, without requirements for respect of due process, it could catch almost any, including quite innocent voluntary organizations in its net. It also imposes a huge burden of administrative costs in attempting to meet the standards of due diligence it creates (see Carter, 2004; Phillips, forthcoming). It will be a real challenge to make a convincing case that the federal government has moved to become a more responsive regulator of charities when faced with the heavy-handedness of this legislation. The combination of fragmented institutional capacity and the ruptures in trust produced by the Anti-Terrorism legislation contribution to the conditions that Howlett (2004) argues lead to ineffective administrative styles.

Regulating Political Participation

Regulation of the third sector has become more complex in the wake of the state restructuring of the 1980s and 1990s, in part because the sector itself has become more complex. When there was a fairly crisp divide, if it ever really existed, between those organizations devoted to charitable services and those centred on political action, the sector

could be fairly neatly divided into 'charities' and 'nonprofits.' Charities received the benefits of indirect funding through the tax system while giving up most of their latitude for participation in public policy; nonprofits did not receive full tax benefits, but were not restricted in their political activities. As governments offloaded a wide variety of services over the past two decades, however, many voluntary organizations which had been policy oriented, by necessity, became much more heavily invested in service delivery and contracting as a means of revenue generation (Laforest, 2005). Charities and other organizations that were created primarily to provide services increasingly found they need to have a policy voice because they know, often better than governments, what is really working and what is not based on their first hand experience with programming.

Through policies developed and administered by the CRA, political activity by registered charities is highly regulated in Canada.[9] As noted above, in order to quality for charitable registration, an organization must have charitable purposes according to the common law, thereby excluding advocacy as a primary purpose. In addition, regulations place limits on the activities of registered charities. No partisan political activity is permitted, although this is not seen to be particularly restrictive because voluntary organizations are rarely allied with political parties, nor do they feel any benefit to being partisan, nor do they expect the public to support partisan activity with the use of tax expenditures (Pross and Webb, 2003). At the other end of the spectrum, consultations invited by governments are unrestricted. There is a large swath of policy related activity between these two extremes, however, that conceivably includes coalition building, conferences, advertising, meetings with public servants and other conventional means of influencing public policy. Such activity must be ancilliary and incidental to the charitable purposes of the organization which is

interpreted to mean that no more than 10 percent (recently increased to 20 percent for small charities) of all of the financial, human and physical resources of a registered charity can be spent on public policy advocacy, a ceiling would be quickly hit by small charities with one newspaper ad.

The effects of this regulation are very real.[10] As Pross and Webb observe in a longitudinal study of voluntary organizations, they were struck by the number of times the charities said they restricted their participation in public policy advocacy for fear of jeopardizing their status as registered charities. Leaders from the third sector have been vociferous in their criticism of the '10 percent rule':

> The law in this field is unclear, badly dated, poorly reasoned, and poorly stated. As a result its application and enforcement by the CCRA are inconsistent and arbitrary. This causes uncertainty, disruption and additional administrative burden for charities. More significantly it creates undue restrictions on charities in terms of public policy debate that amount to "advocacy chill." This leaves charities to distribute band-aids rather than to speak freely on behalf of their clients and members to participate fully in the development of long-term solutions to important problems and issues. (IMPACS, accessed October 4, 2004).

The tight limitations on advocacy are also seen to be out of touch with the views of Canadians. A 2004 national survey on the roles of charities found that Canadians have higher levels of trust in charities than they do in governments and 78 percent felt that charities should be able to speak out on policy issues, with over 90 percent support in some fields such as social policy and health (Muttart Foundation, 2004).

In 2003, the Charities Director introduced new guidelines that are clearer and more specific than the ones they replace in defining political activity and that allow a sliding scale of up to 20 percent which allows more room for small charities. From the perspective of the voluntary sector, however, the new regulation does not give charities much more freedom to

be involved in public policy development or debate, and they continue to call for greater liberalization (Voluntary Sector Forum, 2004; IMPACS, 2004). On this point, however, the federal government has been entrenched, and in spite of strong exogenous pressure over the past ten years, there has been ongoing resistance to change. Sometimes, exogenous shock, rather than reason based pressure for change does make the difference, and in this aspect of regulatory reform, there is a new shock to the system.

The issue of same sex marriage is casting this debate in an entirely new light, as some religious leaders feel that they should not be bound by any limitations at all, that indeed they have a right and a responsibility to participate in public policy debate using whatever resources and means they deem necessary. The CRA has already issued a warning to the particularly vocal Roman Catholic Bishop of Calgary to refrain from engaging in partisan rhetoric on this issue.[11] If religious charities continue their extensive public policy advocacy, the CRA faces a dilemma. It could ignore them, which would imply there is a hierarchy of claims and rights and would surely lead to a backlash from other types of charities that have been complying with the rules. Or, it could investigate and potentially bring sanctions against the religious charities that overstep the 10 percent and nonpartisan rules. This latter course of action would probably create vociferous opposition. If it chose to go even further, as some countries have done, in questioning whether advancement of religion should still be a head of charity at all, the CRA will undoubtedly have a major political fight on its hands. A minority government is unlikely to want to take up this fight at a political level, so the regulatory body may be left to address the conflict through less visible, less political means.

Conclusion

The story that this paper has told of regulation of the third sector is one of both resistance and reform. So much has changed, but the fundamentals of the regulatory regime for charities remain relatively unchanged. In spite of a decade of pressure for reform, the federal government has resisted action on two of the key concerns of the voluntary sector: modernizing the definition of charity (or the appeal processes that would allow the common law to modernize itself) and liberalizing restrictions on public policy advocacy by charities. This is also a case study in how a regulatory body, the Charities Director of the CRA, can reinvent itself to become a more responsive regulator by working collaboratively with and listening to its constituency and by redesigning its operations and its culture. These reform initiatives are starting to pay off as the credibility and working relationships of the CRA with the voluntary sector have vastly improved in the past year or two. Only so much can be achieved by administrative reform alone, however.

Several important steps lie ahead. The immediate big tests for the CRA will be how it deals with religious or other charities that chose to ignore the rules on political activity and whether it can bring about reform that would introduce a public benefit test for determining which organizations gain access to tax system – reform that is likely to meet resistance from within the federal government. The CRA is in an anomalous position that it has no legislative tools to advance further reform as these reside with the Department of Finance. It administers the policies, but must convince Finance or merely hope that it has set appropriate policies in the first place. And, as recent reform suggests, Finance does not always defer to the CRA. Reducing this divide between policy and administration, and thus building greater overall institutional capacity is needed. New charity legislation could be a constructive next step.

Finally, public administration has much work yet to do in being able to effectively model and explain policy and institutional change. This work involves not only closer examination of different processes of change, but consideration of different combinations of causes and manifestations of change. Big exogenous shocks do not always lead to big change, and much can be achieved by working internally through incremental adjustments within policy boundaries. The challenge for both proponents and implementers of reform is to appreciate just how much can, and cannot, be achieved by working within established parameters, and how long this takes. In bringing about a shift to more responsive regulation, it is evident that changes to administrative practices and service standards that in fact provide better service and build stronger trust relationships with the regulated constituencies are vitally important. On the one hand, because such adjustments do not entail formal rule change, they can be relatively easily facilitated; on the other hand, to the extent that they necessitate a culture change, they may actually exact greater demands for accompanying institutional change and may result in significant changes over time in relationships between the regulator and the regulated. What such internal, layered adjustments do not entail is the opening of representational spaces for political debate. Given the fundamental changes that are occurring in both the third sector and in the process of governance – *and* in the connections between them – political debate about both policy goals and policy instruments is exactly what is needed.

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Notes

[1] Voluntary organizations can be defined as "organizations which are formal, nonprofit distributing, constitutionally independent of the state, self-governing and benefiting from voluntarism [at least for their governance][1] (Kendall, 2003: 6). According to the 2004 NSVNO, the largest categories in terms of numbers of organizations are (in order): sports and recreation; religion; social services; grant making, fundraising and volunteerism promotion; arts and culture; housing and development; education and research; health; environment; law, advocacy and politics; international development; hospitals; universities and colleges; and other.

[2] The Johns Hopkins Nonprofit Comparative Research Project includes 36 countries, of which the Canadian data were released in March 2005. The estimates of size are measured in terms of employment per population. Measured in these terms, Canada's sector ranks second to the Netherlands. See XX; Salamon, Sokolowski and List, 2004)

[3] Under the *Income Tax Act*, a registered charity is defined as one of three types: a charitable organization (that serves charitable purposes through the services it provides), a private foundation or a public foundation (both of which provide support to charitable organizations). For an introduction to the Canadian tax treatment of voluntary organizations, see Hayhoe (2004). Independent of this legal distinction, there is an enormous bifurcation between the very small slice of large organizations and a multitude of very small ones. The one percent of charitable and nonprofit organizations with over $10 million in annual revenues, mainly universities, colleges and hospitals, account for over 60 percent of the entire revenues of the sector, half the staff and a fifth of volunteers (NSNVO, 2004). By contrast, two-

thirds of voluntary organizations have annual revenues of under $100,000 and half are operated solely by volunteers.

⁴ See, for example, explanations of the differential adoption of Keynesianism (Hall, 1989), on changes to the Canadian party system (Brodie and Jenson, 1988) and reformulation of citizenship regimes (Jenson and Phillips, 1996).

⁵ Provincial governments make determinations of the status of charities, but other than Quebec which runs its own taxation system, they tend to do so in a passive rather than an active manner, mainly for purposes related to the use of charitable property, wills and trusts, accounting, complaints and fraud. With a few exceptional cases, provincial governments, including Quebec, have tended to harmonize their determinations of charity with those of the federal government (Fontaine and Tougas, 2005). This is extremely important to creating an efficient environment for charities because charitable giving and the activity of charities is not bound by geography.

⁶ See the CRA website, http://www.cra-arc.gc.ca

⁷ See Webb (2000) and Monahan with Roth (2000) for a discussion of interpretations by Canadian courts.

⁸ This is illustrated by the fact that, of the seven director level positions within the Charities Directorate, two are currently vacant and four are filled on an Acting Director basis. See http://www.cra-arc.gc.ca/tax/charities/mission_vision-e.html#chart.

⁹ There is also extensive indirect regulation of advocacy through a funding regime that is heavily dependent on project-based funding, not only from governments but from foundations and corporations as well. Policy advocacy is rarely funded by project funding from governments or foundations and is often specifically prohibited (Pross and Webb, 2003: p. 89, Scott 2003). More than that, many voluntary organizations remember well the lessons of the 1990s in which the funding of advocacy organizations was cut suddenly and dramatically, and are fearful of putting their funding at risk by being critical of governments. So, they keep their heads down.

¹⁰ The '10 percent rule' on advocacy is reinforced by requirements to register and disclose under the *Lobbyists Registration Act* and by limits on spending on advertising during election campaigns. Neither of these have significant effect compared to the restrictions on advocacy, however, because charities seldom hire third party lobbyists and by choice refrain from advertising during elections. Pross and Webb (2003) argue that together they do constitute a single regulatory regime, however.

¹¹ The warning came after Bishop Henry wrote a pastoral letter to his congregation (that was also posted on its website) during the 2004 election campaign that harshly criticized Paul Martin for claiming to be a devout Catholic given his position on same sex marriage and abortion . He made the news again in January 2005 when he issued another pastoral letter calling on the state to use its coercive power to curtain homosexuality. See Michael Valpy and Gloria Galloway, "Revenue Agent Threatened Tax Hit, Bishop Says," *Globe and Mail*, October 22, 2004, p. A7; Michael Valpy, "Bishop Blasted for Calling on the State to Target Gays," *Globe and Mail,* January 18, 2005, p. A1.