The case for retaining the FBT concession for not for profit Hospitals/Aged Care and Public Benevolent Institutions (Charities)

April 2010
Executive summary

When initially undertaking this project, Lateral Economics informed its client, McMillan Shakespeare that it was likely to be sympathetic with the case for reforming the FBT. We indicated that we would be happy to provide the client with analysis of the policy arguments, but that we were unlikely to put our name on a document that defended the FBT concession.

On having explored the issues further, our conclusion is that while the current arrangements are not without drawbacks, we think the dividend from any wholesale removal of the concession would be meagre at best, and that quite possibly reform would lead to worse results, even over the long term.

Since the inception of the FBT in Australia in 1986, the tax system has provided exemptions from FBT to not-for-profit organisations including hospitals, aged care service providers and charities. These exemptions provide substantial support to the NFP sector by, amongst other things, enabling them to:

- attract staff by offering them access to the exemptions in a manner that increases their after tax real wages; and
- reduce their operating costs by providing these benefits in lieu of higher pre tax wages.
- deliver community support programs that would not otherwise be possible.

From an economic perspective, it is also generally accepted that the provision of some form of government assistance or subsidy to NFPs is warranted as many of the services they provide are of a type which are not provided by government or the private sector.

The Productivity Commission has recently considered the FBT Exemptions in its Report entitled Contribution of the Not-for-Profit Sector, Research Report. It argued that the concession was inefficient but at the same time made no clear recommendation to abolish it. Many believe that the as yet unreleased Henry “Review of Australia’s Future Tax System” contains similar arguments.

The argument for the abolition of the FBT concession is based on the principle of competitive neutrality. One might express the principle thus: Other things being equal, policy should treat similar activities similarly. If one organisation is more profitable than another simply because it receives a subsidy that another one does not, it is not surprising that it can pay more to attract

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1 Productivity Commission 2010, Contribution of the Not-for-Profit Sector, Research Report, Canberra
resources to its own operations. Because it is so advantaged, where it expands at the cost of other organisations there arises a presumption that the movement of those resources reduces efficiency – because rather than being the product of superior performance it is simply an artifice of an arbitrary advantage that the favoured firm enjoys.

However, our central argument is that the reformers have not convincingly demonstrated the case that direct subsidies are superior to the FBT concession and that the concession should be preferred on pragmatic grounds. Additionally, we argue that the relevance of the principle of competitive neutrality to the NFP sectors is tightly constrained.

It would be easy to dismiss the NFPs’ alarm at the proposals for reform as special pleading. No-one, however, proposing reform has argued that the NFP sector should receive less support. Rather, they have argued that the distorting FBT concession should be dropped and replaced with non-distorting direct subsidies or grants. Indeed, given the political difficulty of achieving reform in this area it is likely that reform would increase net support to the sector to enable the number of losers from the reform to be minimised. Given this, the unanimity of NFP opposition to this reform is remarkable. We conclude that this unanimity provides a valuable insight, which policy makers should not ignore lightly.

Given that the principle of support to the NFP sector is endorsed by all sides of the debate the issue in contention is one of which support delivery mechanism is to be preferred. In considering these matters we have concluded that the reformers’ enthusiasm for abolishing the FBT concessions arises from salience bias. Reformers’ economic models tend to highlight competitive neutrality as an issue whilst downplaying other issues of great practical importance. For instance:

- the fact that NFPs and for-profit organisations tend to service different markets with different needs;
- the importance of intrinsic or philanthropic motivation of those in the NFP sector;
- the benefits of encouraging a plurality of approaches to difficult problems;
- the inefficiencies associated with alternative means of allocating subsidies to NFPs and the pathologies which accompany politically difficult reform – which can lead to unpredictable and unintended consequences; and
- the potentially large adjustment costs and risk associated with a policy change as fundamental as that implied by the Productivity Commissions analysis.

Further, the focus on the FBT concession ignores the multiple influences of the numerous government interventions in the NFP sector and the for-profit hospital and health care sector. The
influences of multiple interventions are extremely difficult to disentangle and make arguments about the effects of the FBT concession at best partial.

A particularly pertinent example of the negative efficiency impacts of a grants or subsidy scheme is on the capacity of NFPs to undertake effective long term planning. Any government grant or subsidy scheme will introduce uncertainty in relation to ongoing funding, impose political risk and generally reduce the independence of NFPs. Long term planning will be affected to the extent that any grant or subsidy scheme does not provide guaranteed long term funding. Uncertainty may also flow due to the ‘bureaucratic risk’ involved in a grant or subsidy assessment and administration program. It is also likely that these uncertainties will encourage some NFPs to engage staff on shorter contracts rather than by more certain, long term arrangements. This will lead to NFPs under-investing in staff career in skills development to the long term detriment of service delivery.

Competitive neutrality is only of significance where non-neutrality can draw resources from one activity to another. In the case at hand the Productivity Commission itself indicates that non-neutralities are not a major issue in most areas in which NFPs operate.

> While inequitable and distorting, such concessions are an important and reliable source of support for many NFPs, especially to attract and retain staff. Most of these NFPs do not compete directly with for-profit businesses, and for the few that do, they tend to be delivering government services.\(^2\)

The Commission found that competitive neutrality was only a substantial issue “in a small number of areas, notably hospitals”. It would be foolish to argue otherwise. Yet it is also easy to overestimate the extent of the problem. For even within the hospital sector there are important differences between NFP and for-profit employees, patients and clinical activities. NFP clientele tend to be less well off, they tend to be located in less affluent areas and their clinical, community and educational activities are likewise more tightly focused on need rather than motivated by profit.

While the above point suggests that the benefits from addressing competitive non-neutralities are likely to be meagre, a range of additional considerations tend to suggest that, for all its obvious imperfections, the FBT concessions may achieve their objective of support more efficiently than the reformers’ preferred option.

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\(^2\) Productivity Commission 2010, Contribution of the Not-for-Profit Sector, Research Report, Canberra, p. xxxi.
The FBT concession provides the sector with greater autonomy and certainty to plan its operations into the future than would be provided by increased reliance on grants. The Productivity Commission has indicated that while “a move to more direct and transparent grants would be more efficient than the input tax concessions, and show the full extent of government and taxpayer support of NFPs, it would be unfortunate if such grants were used to impose bureaucratic controls over NFPs”. We consider that it would be more than unfortunate. It would risk undoing and possibly outweighing any good that the reform would do – possibly by a significant margin. It is perhaps for this reason that, while it expressed in principle support for reforming the FBT concession, the Commission did not feel strongly enough to recommend the abolition of the FBT concession for the sector.

We do not know a lot about the way in which the intrinsic worthiness of work in the NFP sector affects employee morale and motivation and we are not well informed about how extrinsic rewards interact with intrinsic motivation. However, the studies that have been done suggest that gestures of gratitude and reward – such as the FBT concession – may be less likely to ‘crowd out’ intrinsic motivation than straight financial payments. This tends to be the case with volunteers and is a reason why incentives for volunteer aged care tend to be rewards ‘in kind’ such as respite care, rather than cash payments.

In the particular case at hand, those who work in the NFP sector especially in the Social and Community services (Charity) sector typically receive substantially less take home pay than they would in the for-profit sector even accounting for any FBT concessions they receive. Some managers in the sector believe that the FBT concession is overestimated by employees. If so, and there is some evidence of this, it would be a super-efficient means of assisting the sector and its work.

The results of a survey conducted for this report indicate the importance of the FBT concession to employees in the sector. To the question “how important are the benefits of the FBT concession in influencing whether you remain employed in the health and aged care sector?” 82 percent answered “Very important” or “Quite important”.

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In addition, in response to the question “If the FBT concession was discontinued for workers in the charitable sector and no compensating changes were made to your remuneration, would you continue to work in the sector?” only 18.2 percent said “Yes” with the remainder split roughly evenly between those who thought they’d leave the sector and those who were unsure.
These responses indicate that the removal of the concession without adequate compensation would be likely to have large impacts on the sector. Of course the intention would be to compensate the sector for the loss of the concession. But, as mentioned above, this attracts a range of other risks.

More generally, we would do well to recognise our own ignorance in this area. The notion of competitive neutrality is ultimately grounded in models of activity in which competition takes place between like firms performing like activities. This is clearly wide of the mark. An alternative model is that of pluralism, where different systems and different activities are supported in pragmatic ways so that they can go about their activities which, while they will sometimes be competitive, will in very many cases, be complementary.

In short, while it would be a ‘courageous’ thing to do – in Sir Humphrey’s sense of that term – substituting FBT concessions with grants or some similar mechanism is unlikely to produce economic benefits of any magnitude and could very easily produce net costs. The government would be better advised to spend its political capital on reform that generates clearer and larger economic and social benefits.
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1 Introduction

1.1 This paper

Two significant Federal Government reviews, both now complete but only one yet published, could significantly affect the operation of Australian not-for-profit (NFP) organisations (Hospitals, Aged Care, Charities) and the vital services they provide – overwhelmingly to those in our community who are in most need.

The Productivity Commission’s recently completed report \(^3\) on the contribution of the not-for-profit sector to the Australian economy argues that the FBT concession distorts the way labour and other inputs are used and that this in turn leads to economic inefficiencies or losses in what economists call ‘social welfare’. Notably however, it did not feel strongly enough about this position to recommend that the concession be removed.

The objectives of the Henry Review are to advise on how to improve the Australian tax system based on the principles of efficiency, equity, simplicity, sustainability and policy consistency. In theory and in practice, most forms of tax impose costs by introducing extraneous considerations of tax minimisation into the production and consumption choices made in the economy (the main theoretical exceptions being taxes on pure rent and ‘bads’).

For this reason it should be emphasised that when it comes to reforming taxation we need more than an exposition of the problems with a particular kind of taxation. Taxation is not popular and attempts to avoid, evade and minimise it impose diverse costs on the economy even where taxation systems are relatively efficient in comparison to others around the world. To advance a new approach one needs to demonstrate how the approach being proposed is clearly the lesser of two evils.

Reform advocates do not question the case for subsidising the NFP sector nor its current level of subsidy. This is an important proposition for the discussion which follows as it sets the context of concern.

This paper is not a challenge to the principle of competitive neutrality on theoretical grounds. It is a principle which is well-established in economic theory. This paper also accepts as a basic principle that taxation systems need to be effective and involve minimum distortions. Taxation systems need

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to be efficient (minimise misallocation of resources), equitable (ensure that the taxation burden is borne on a fair basis) and administratively cost minimising.

Many arguments are made by the NFP sector in relation to the FBT tax concession being retained. These arguments usually concern the broader issues of government support to the NFP sector and its business objectives and needs. Such arguments include:

- the FBT concession is an essential form of support to the NFP sector to remain viable and/or maintain the delivery of services

- the FBT concession is essential to enable NFP organisations to attract and retain labour.

The critical distinction is that these types of arguments concern how and why the FBT concession generates benefits to organisations in the NFP sector and in turn benefits to the users of their services. In contrast, this paper contests the position of the Productivity Commission which argues that the use of the FBT concession as a mechanism incurs social welfare losses that could be avoided by using an alternative mechanism, that is, direct subsidies.

In essence, this paper addresses the question from an economic efficiency perspective of which is the better mechanism – FBT tax concession or direct subsidy – in support of the NFP sector.

We will argue that proposing the abolition of the FBT concession on these grounds represents a case of theoretical correctness displacing practical utility. Enthusiasm for reform appears to arise from salience bias. Reformers’ model of the world highlights one issue – competitive neutrality – and crowds out other equally, possibly more important issues – such as intrinsic motivation, adjustment costs, the poor-substitutability of similar inputs and outputs, the benefits of pluralism and the inefficiencies associated with alternative means of allocating subsidies to NFPs and the pathologies which accompany politically difficult reform – which can lead to unpredictable and often undesirable outcomes.

Put another way, the reformers’ arguments have an obvious validity to them other things being equal. But other things are not equal. There is an obvious validity to their arguments but their significance is nowhere quantified and if it were it seems likely they would be minor. When the various caveats outlined above are taken into account the benefits of reform drop away becoming meagre, or quite possibly negative.

We show that the principle of competitive neutrality is of limited relevance to not-for-profit organisations because they deliver their services to markets that to a substantial extent are clearly delineated from the markets that are served by for-profit organisations. We demonstrate that
arguments about the high compliance costs of FBT concessions compared with direct subsidies are not only partial and unsubstantiated but unlikely to be true – at least when compared to the alternatives. Direct subsidies carry with them a range of potential negative qualitative impacts on the NFP sector that have been given relatively little weight in advisors’ deliberations.

Again the reason is salience bias. Such impacts are difficult to incorporate into the neoclassical economics framework and if they are incorporated quickly lead to analytical complexity and indeterminate conclusions and policy implications. We argue that these qualitative factors are not peripheral but rather are central. An example of the negative impact of a move to a direct subsidy system is a loss in NFP organisations to undertake long term planning in the face of short funding cycles and the additional exposure of funding to risks associated with the political cycle.

These negative qualitative effects could cause debilitating impacts on not-for-profit organisations leading to reductions in or even discontinuation of essential services to Australia’s most needy recipients. In addition, qualitative impacts could undermine the independence and autonomy of the not-for-profit sector and lead to a degradation in its capacity for long-term planning, social innovation, diminish its efficiency and impair its ability to deliver its essential services.

In short, the argument is that the disadvantages of the FBT concession from a tax effectiveness and social welfare maximisation perspective are unsubstantiated and probably overstated, and that the potential disadvantages of the alternative presumably grants based funding scheme have been understated. Alternative support mechanisms that, on the surface look to be more efficient will, in fact, have qualitative and dynamic implications that will almost certainly over time put the value created by the sector at risk. This will place unintended and potentially very large pressures on Government budgets and/or on the costs of services to recipients.

Stakeholders in the sector that receives FBT concessions are unanimous in voicing this view. It will be tempting to discount this unanimity as special pleading or instinctive conservatism. Yet while such simple motivations might explain the general tendency of the sector to be suspicious of the reform they fall a long way short of explaining the unanimity with which such views are held within the sector.

Firstly not everyone is instinctively conservative. But the sector is unanimously conservative on this point, suggesting something more than a temperamental issue. Secondly those who are making it are demonstrably motivated by the welfare of others. So while they will be particularly mindful of the interests of their own organisations, those organisations themselves do not typically exist for the self-interest of those within them. We should concede at least some genuine public spiritedness of at least some of the advocates for the NFP sector in this matter.
Thirdly and much more powerfully, given that reform is habitually promoted as something that would and should be at least revenue neutral for the sector (and the suspicion is that to be politically viable it would have to be revenue positive for the sector), why should there be such unanimity in the desire to hang on to the current FBT arrangements? If the change were to be revenue neutral then if simple self interest were guiding each agency’s position one would expect to see the potential ‘winners’ supporting it against the opposition of the potential losers. Given the partial use of the concession one would expect those sectors who don’t use the concession much to benefit from over-compensation and those sectors who use it a lot lose from under-compensation.

We also argue that the costs and risks of changing the current concession regime are very high with potential costs including, destabilisation of NFP organisations and disruption, even termination of essential services. The social cost of such disruption is potentially enormous and dwarfs the potential social welfare gains from correcting alleged distortions arising from the FBT concession.

We note that the Productivity Commission has taken the view that the current system is “entrenched” and that removing it “could impose hardship and would need an appropriate phasing out period and a means of providing intended support to those NFPs not competing in the market”\textsuperscript{4}. Thus, the Commission does not include the abolition of the concessions in its formal recommendations but foreshadows that its abolition is preferred in the long term. It is arguable the Commission has softened its position between the draft and final versions of its report. Numerous submissions from the NFP sector argued for the retention of the FBT concession on the basis of the benefits it generates for the sector although some of the more sophisticated submissions did focus on issues of the practical relevance of competitive neutrality to the sector.

Given that the Commission maintains that a transition in the future is desirable, it would seem that the softening of its position is mostly in response to submissions that emphasised the practical consequences of the FBT concession’s removal – ultimately the risk of a significant degradation of services provided by NFPs. In the upshot, while putting the case for reform, the Commission has not made concrete recommendations to change the current FBT concessions.

### 1.2 Methodology

There are three main components of the research for this paper:

1. desk research, including a survey of the relevant Australian discussion on the FBT issue

\textsuperscript{4} Productivity Commission, NPF Sector, p213.

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2. a series of phone interviews with senior managers in the not-for-profit sector

3. an online survey of not-for-profit sector workers and an analysis of the data obtained.
2 Background: The NFP sector in Australia

The Productivity Commission reports that there are some 600,000 NFP organisations in Australia. Of these some 59,000 are deemed to be economically significant. The sector accounts for 4.1 per cent of 2006-07 GDP and 8.5 per cent of total employment.

Organisations in the not-for-profit sector are diverse in structure and size. Table 1 shows the numbers of entities under various structures.

Table 1: Number of NFPs

<table>
<thead>
<tr>
<th>Type of Organisation</th>
<th>1995-96</th>
<th>2008-09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies limited by guarantee</td>
<td>9 000</td>
<td>11 700</td>
</tr>
<tr>
<td>Incorporated Associations</td>
<td>120 000</td>
<td>136 000</td>
</tr>
<tr>
<td>Cooperatives</td>
<td>3 000</td>
<td>1 850</td>
</tr>
<tr>
<td>Body Corporates</td>
<td>180 000</td>
<td>103 000</td>
</tr>
<tr>
<td>Organisations incorporated by other methods a</td>
<td>8 000</td>
<td>9 000</td>
</tr>
<tr>
<td>Unincorporated associations b</td>
<td>360 000</td>
<td>440 000</td>
</tr>
<tr>
<td><strong>Total third sector</strong></td>
<td>700 000</td>
<td>~ 700 000</td>
</tr>
<tr>
<td>Excluding body corporate entities</td>
<td>180 000</td>
<td>103 000</td>
</tr>
<tr>
<td>Financial and insurance mutuals d</td>
<td>2 000</td>
<td>2 000</td>
</tr>
<tr>
<td>Trading cooperatives d</td>
<td>700</td>
<td>450</td>
</tr>
<tr>
<td><strong>Total not for profit sector</strong></td>
<td>517 300</td>
<td>~ 600 000</td>
</tr>
</tbody>
</table>

a Including those incorporated under industrial legislation (such as trade unions and employer associations); the Aboriginal Councils and Associations Act; Friendly Society Acts; Education Acts; and specific acts of parliament. b The 2008-09 total for unincorporated associations is estimated from the Lyons and Hocking estimate for 1995-96 adjusted for population growth. c Reflecting the uncertainty involved in some of the 2008-09 estimates, totals are presented as approximate values only. d The number of financial and insurance mutuals and trading cooperatives is taken from the industry classification provided by Lyons and Hocking (2000). Numbers are rounded to the nearest hundred.

Sources: Lyons and Hocking (2000); Commission estimates; State and Territory Fair Trading Offices (or equivalent); ASIC (pers. comm., 18 September 2009); APRA (pers. comm., 10 September 2009).

Source: productivity commission report, p58
Not-for-profit organisations are active in a wide variety of fields as shown in Table 2.

Table 2: Not-for-profit organisations, 2006-07 (economically significant organisations)

<table>
<thead>
<tr>
<th>Organisation Category</th>
<th>Organisations at end June</th>
<th>Total Employees '000</th>
<th>Volunteers '000</th>
<th>Gross value added (satellite account basis) $b</th>
</tr>
</thead>
<tbody>
<tr>
<td>Culture and recreation</td>
<td>11 610</td>
<td>102.1</td>
<td>2 072.3</td>
<td>12.2</td>
</tr>
<tr>
<td>Education and research</td>
<td>6 621</td>
<td>218.4</td>
<td>608.0</td>
<td>11.7</td>
</tr>
<tr>
<td>Hospitals</td>
<td>102</td>
<td>55.7</td>
<td>41.4</td>
<td>3.6</td>
</tr>
<tr>
<td>Health</td>
<td>919</td>
<td>99.7</td>
<td>369.8</td>
<td>4.4</td>
</tr>
<tr>
<td>Social services</td>
<td>7 811</td>
<td>221.5</td>
<td>1 474.6</td>
<td>10.6</td>
</tr>
<tr>
<td>Religion</td>
<td>12 174</td>
<td>40.7</td>
<td>npd</td>
<td>npd</td>
</tr>
<tr>
<td>Associations b</td>
<td>3 224</td>
<td>22.5</td>
<td>102.6</td>
<td>2.3</td>
</tr>
<tr>
<td>Environment et al. c</td>
<td>11 972</td>
<td>110.5</td>
<td>344.0</td>
<td>4.7</td>
</tr>
<tr>
<td>Not elsewhere classified</td>
<td>4 446</td>
<td>18.3</td>
<td>npd</td>
<td>npd</td>
</tr>
<tr>
<td>Total</td>
<td>58 779</td>
<td>889.9</td>
<td>4 616.1</td>
<td>55.8</td>
</tr>
</tbody>
</table>

a Includes non-market output and the values of volunteer services. b Business and professional associations, unions. c Environment, development, housing, employment, law, philanthropic and international NFP organisations. d Not available for separate publication but included in total (np).

Source: productivity commission report, p66

An obvious and important feature of the not-for-profit sector is the large number of volunteer workers that it attracts. The participation of volunteer workers creates significant leverage for the funds that government contributes to the not-for-profit sector. For example, it can be seen that there are almost 4 times as many volunteer workers in the health area than there are employees.

Government funding makes up more than one third of total revenue for the not-for-profit sector with almost 50 per cent being derived from self generated sources (mainly fees for service). Revenue through philanthropy and income from related or affiliated organisations makes up the balance. These proportions are roughly aligned with those in other countries, in particular, New Zealand, United Kingdom and United States.

The FBT concessions are available only for a subset of the not-for-profit sector and can be used by organisations that provide community-based services that are charity or health and aged care related. Therefore the relevant sectors from Table 2 are hospitals and health, and to some extent religion. From the table above, there are a smaller number of organisations in the hospital and
health sector, and they tend to be bigger than in the other sectors in terms of employment and value added services.

Table 3: not for-profit organisations, 2006-07 (economically significant organisations)

<table>
<thead>
<tr>
<th>Type of revenue</th>
<th>Amount</th>
<th>Proportion of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government — volume based</td>
<td>17.6</td>
<td>23.0</td>
</tr>
<tr>
<td>Government — non-volume based</td>
<td>7.2</td>
<td>9.4</td>
</tr>
<tr>
<td>Government — for specific capital items</td>
<td>0.7</td>
<td>0.9</td>
</tr>
<tr>
<td>Total government</td>
<td>25.5</td>
<td>33.2</td>
</tr>
<tr>
<td>Philanthropy</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Donations from philanthropic trusts/foundations</td>
<td>0.3</td>
<td>0.4</td>
</tr>
<tr>
<td>Donations from businesses/organisations</td>
<td>0.6</td>
<td>0.8</td>
</tr>
<tr>
<td>Sponsorships</td>
<td>1.1</td>
<td>1.4</td>
</tr>
<tr>
<td>Donations from individuals(^a)</td>
<td>4.2</td>
<td>5.4</td>
</tr>
<tr>
<td>Other fundraising</td>
<td>1.0</td>
<td>1.3</td>
</tr>
<tr>
<td>Total philanthropy</td>
<td>7.2</td>
<td>9.4</td>
</tr>
<tr>
<td>Self generated income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Membership fees</td>
<td>3.7</td>
<td>4.8</td>
</tr>
<tr>
<td>Sales of goods</td>
<td>6.8</td>
<td>8.9</td>
</tr>
<tr>
<td>Income from services</td>
<td>23.4</td>
<td>30.5</td>
</tr>
<tr>
<td>Rent, leasing and hiring</td>
<td>1.5</td>
<td>2.0</td>
</tr>
<tr>
<td>Investment income</td>
<td>2.6</td>
<td>3.4</td>
</tr>
<tr>
<td>Total self-generated</td>
<td>38.0</td>
<td>49.6</td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income from related or affiliated organisations</td>
<td>3.6</td>
<td>4.7</td>
</tr>
<tr>
<td>Other</td>
<td>2.3</td>
<td>3.0</td>
</tr>
<tr>
<td>Total</td>
<td>76.6</td>
<td>100</td>
</tr>
</tbody>
</table>

\(^a\) Includes donations, bequests and legacies from individuals. \(^b\) Totals may not add due to rounding.

Source: productivity commission report, p72

An important source of income from government, in addition to direct funding, is indirect funding mostly in the form of tax concessions of various kinds.

The NFP sector also receives indirect support from Australian governments through tax concessions. The Commission estimates that the value of tax concessions given by all Australian governments to be at least $4 billion in 2008-09 and could realistically be twice this amount when non-estimated expenditures are included. Fringe benefits and payroll tax concessions are estimated to be worth at least $1 billion and $766 million respectively, with income tax deductions for approved donations equivalent to over $1 billion in foregone tax.
It is not possible to determine the value more accurately as much of the data required to construct an estimate is not required to be submitted to the Australian Taxation Office (ATO) or jurisdictional revenue offices.

This paper primarily deals with the FBT issues which apply to a subset of the NFP sector. However, to place the value of the fringe benefits tax concession in perspective in the context of this study, it is worth noting that the estimated $1 billion FBT concession-related cost to revenue, if correct, is equivalent to less than one-seventy-fifth (1.33 percent) of the total value of not-for-profit sector revenue.

Further, the cost to employers in the sector of replacing the FBT concession with higher wages in lieu of the FBT concession is likely to be considerably greater than the revenue the current concession costs the government.\footnote{The Productivity Commission have that the estimated FBT and payroll tax forgone tax revenue is at least $1 billion 50-60 percent of employees are estimated as salary packaging.}
3 Competitive neutrality and the NFP sector

3.1 What is competitive neutrality?

The Commission’s terms of reference for the Report included an examination of “the extent to which tax exemptions accessed by the commercial operations of not-for-profit organisations may affect the competitive neutrality of the market.”

From the perspective of government policy interventions, the principle of competitive neutrality counsels that government should avoid policy that delivers competitive advantages to some organisations but not others within a particular market.

The Commission states that “The violation of competitive neutrality is only distortionary where government policy provides a systematic advantage to some organisations over others competing in the same market.”

The case for competitive neutrality rests on the efficiency benefits of competition. The theory of perfect competition demonstrates that in a perfect market competitive pressure will cause firms to allocate various inputs between alternative uses in such a way that those inputs are used in the most efficient way possible to deliver goods and services to consumers.

One of the many assumptions on which this important efficiency conclusion is based is that all the markets that firms trade in – on the output and input sides – are competitive. In competitive markets the prices at which goods and services (and inputs) are offered reflect their underlying costs (because of the pressure of competition). In a situation where a policy which breaches the principle of competitive neutrality is imposed on a particular market the prices faced by some firms in that market will no longer reflect underlying costs. If the policy intervention, for example, makes a particular input cheaper to some firms then those firms will buy more of that input than they would in the absence of the policy. In an efficiency sense these firms will use ‘too much’ labour and as a result, others will use too little. This is the distortion that is identified in critiques of the FBT concession.

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6 Productivity Commission, NPF Sector, p198
7 Productivity Commission, NPF Sector, p 198
The competitive neutrality principle is that sellers of goods and services should compete on a level playing field; that is, one provider should not receive an advantage over another due to government regulation, subsidies or tax concessions.

Competitive neutrality removes artificial advantages and allows businesses to compete on a basis that offers the best cost and quality combinations to customers. This is likely to result in more effective competition and more efficient outcomes.

Concerns about competitive neutrality are most likely to arise in an environment where one or more competitors receive significant government benefits — direct or indirect — not available to other competitors.8

The argument with respect to the FBT concession and the not-for-profit sector is that the concession lowers the cost of labour for NFPs and that this leads to a distortion of the allocation of labour and also a misallocation between capital and labour.

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8 Productivity Commission, NPF Sector, p 198
Input tax exemptions are distortionary because they change the relative price of inputs. The exemption lowers the price of some inputs and presents an incentive to Community Social Welfare Organisations CSWOs to favour the use of those inputs over other, relatively higher priced, inputs. Given that CSWOs are labour intensive — that is, they rely more on people to achieve their outcomes — the exemptions from taxes on labour (FBT and pay-roll tax), may create significant distortions, particularly for the larger organisations. This could affect efficiency because it may mean that CSWOs, because of the tax exemptions they receive, favour the use of tax exempt inputs over other, more efficient, mixes of inputs.

The size of the distortions created by input tax exemptions are currently unknown. As CSWOs are labour intensive, and are likely to be so regardless of tax treatment, the costs of the distortion may not be significant.

Input tax exemptions are also inefficient because they allow certain tax-exempt organisations to attract resources away from organisations that are not tax exempt. By lowering the costs faced by exempt organisations, less efficient organisations are able to survive — and perhaps even expand — often at the expense of firms that may be relatively more efficient but do not have access to the same competitive advantages.  

3.2 Is competitive neutrality relevant to the not-for-profit sector?

This paper does not argue against the principle of competitive neutrality on theoretical economics grounds. The main themes that are pursued in support of the retention of the FBT concession for the NFP sector are:

- the principle of competitive neutrality is of limited relevance to the NFP sector because to a substantial extent they service markets that are distinct and separate from markets served by for-profit organisations
- on the input side, not-for-profit organisations draw on labour resources which have distinct characteristics from those drawn on by for-profit organisations and therefore there are issues of market definition on the input as well as the output side which make the applicability of the competitive neutrality principle questionable
- there are significant practical benefits in the real-world operation of the FBT concession which arise from a number of qualitative characteristics which are not fully acknowledged: they are important benefits and likely exceed the magnitude of losses due to any distortion arising from a lack of competitive neutrality

Productivity Commission, NPF Sector, p 204
• The FBT concession has been embedded in the operations of the not-for-profit sector since the 1980s. Its removal would cause significant dislocation and disruption of services and it is far from clear that the potential costs associated would be justified by the gains, if any, of its removal.

3.3 NFP sector is diverse

Understanding the structure of the not-for-profit sector in Australia is central to the discussion of competitive neutrality and the FBT concession. As we have seen in Section 2, the NFP sector is large and diverse. For the purposes of this paper the NFP sector is most usefully categorised into two main groups:

• the charitable sector - community-based organisations that provide services to the disadvantaged (for example, The Royal Flying Doctor, The Red Cross, LifeLine, Catholic Social Services, Salvation Army, Uniting Care, Anglicare)

• the not-for-profit hospitals and aged care (for example St Vincent’s, St John of God).

We will use the term ‘charitable sector’ to mean those organisations that are community-based and provide goods and services to the disadvantaged – the ‘sick and the poor’ – at no or very low charge.

The not-for-profit hospitals and aged care category refers to a range of, often religious-based, organisations that provide a broad range of health care and aged care services that are charged for or not depending on the particular needs and capabilities of individuals.

3.4 Market definition issues

One of the essential characteristics of the competitive neutrality principle is that it applies to organisations in a single market.

Defining markets is a much more complex problem than most people assume. This problem is central to the area of competition policy. In determining, for example, whether a particular merger or acquisition should be allowed to take place, competition authorities must determine if it would be likely to cause a substantial lessening of competition in the market. If the market is defined broadly it may appear that a particular merger may have little impact on competition but if a narrow market definition is adopted, the impact of the merger may be judged to be substantial. Market definitions are complex because it is difficult to determine the extent to which a particular good or service is similar to another, that is, the extent to which to goods are substitutes. For example, is a cinema ticket a close substitute for a DVD hire or a movie on television?
This problem of market definition is imbedded in the application of the principle of competitive neutrality to any particular situation because it can only be applied to organisations that are within the same market. To the extent to which it could be shown that the charitable sector and the not-for-profit hospitals and aged care sector occupied distinct and separate markets then the principle of competitive neutrality could not be invoked to argue that the FBT concession caused distortions in these markets. Alternatively, if it could be shown that, for example, not-for-profit hospitals occupied the same market as private for-profit hospitals then, because the FBT concession applies to not-for-profit hospitals but not private hospitals, then the principle of competitive neutrality may indeed be an issue.

3.4.1 The charitable sector
In the previous section we discussed the distinction between the charitable sector and the not-for-profit hospital sector. We argue that the market for services from the charitable sector is a distinct market, that is, the charitable sector does not compete directly with for-profit organisations in the provision of charitable services. It is true that there are a number of edge issues in defining the charitable sector as a distinct market. The charitable sector provides a relatively broad range of goods and services including counselling, accommodation, food and clothing many of which are provided by the private sector (although, critically, providing a different combination of services – a key point that we will return to in Section 4.2.4).

Notwithstanding these complicating factors, the distinguishing characteristic of the charitable sector is that it provides services free of charge (or at least well below cost) to a particular set of clients – the disadvantaged. One of the general principles motivating this provision is that disadvantaged persons would simply not have access to the goods and services if they were not provided by the charitable sector.

3.4.2 The NFP hospital and aged care sector
If competitive neutrality is of limited relevance to the charitable sector, is it relevant to the NFP hospital and aged care sector? The potential problem of distortions arising in the hospital and aged care sector is greater than in the charitable sector because, ostensibly at least, there are three major categories of hospitals in the sector: private NFP hospitals, private for-profit hospitals and public hospitals. Much can be said of the current structure of the aged care sector.
Abstracting from the complications due to the presence of public hospitals, the critical question is: are NFP hospitals and for-profit hospitals operating in the same market?

The Commission acknowledges submissions from the sector that highlighted the motivation of the NFP hospital provider — public benevolence — in contrast with a for-profit hospital's profit maximisation as a justification for differential treatment. However, the Commission asserts in its Report that in practice ‘Private hospitals — for-profit and NFP — treat much the same patients, receive much the same fees and provide much the same services.’ This assertion is at odds with a recurring theme in our discussions with stakeholders. That is, that to a substantial degree not-for-profit and for-profit hospitals service different sectors of the market.

This is a critical issue in judging the question of market definition and therefore the economic significance of competitive non-neutralities across the hospital sector. It is not a question that can be settled by assertion. Clearly, it needs to be acknowledged that, in some areas, the different types of hospitals will compete with each other but the degree to which they service distinct markets needs to be appreciated.

For example, Epworth HealthCare states that:

> Public hospitals are able to provide services to both public and private patients whereas private hospitals generally only service private and compensable patient’s needs. The exception to this is if a public hospital decides to contract some limited work to private hospitals.12

In a similar vein Friendly Society Private Hospital states:

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10 Productivity Commission, NPF Sector, p 204.
11 Productivity Commission, NPF Sector, p 216
12 Epworth HealthCare submission, p3.
NFP hospitals fill an important gap in the health industry in areas that may be deemed to be financially unviable for a for-profit entity to establish a hospital due to the lower financial targets that are set by an NFP entity.\textsuperscript{13}

The 2009 report for Catholic Health Australia by KPMG identifies the following services that are provided by NFP hospital that generate low margins:

- emergency departments
- palliative care
- Chemotherapy
- chronic disease management
- some birthing services
- services in smaller regional areas of the community – (community healthcare)

In fact, the services that are provided by hospitals are highly diverse and targeted at different clients, from different socio-economic backgrounds and from different geographic locations.

It is interesting to compare and contrast (see table below) the range and type of services provided by a for profit hospital and a NFP hospital operating in the same geographical locality (within 3 klm).

\textsuperscript{13} Friendly Society Private Hospital submission, (sub. DR217, p. 1) p 201
## Table of Services

### The Avenue for profit hospital (City of Stonnington Melbourne)

<table>
<thead>
<tr>
<th>Medical/Surgical</th>
<th>Community Programs</th>
<th>Research and Education</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bariatric (Obesity Surgery)</td>
<td>Nil</td>
<td>GP Seminars and discussion groups</td>
</tr>
<tr>
<td>Cardiology</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ear Nose and Throat</td>
<td></td>
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<tr>
<td>Endoscopy</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ENT Surgery</td>
<td></td>
<td></td>
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<tr>
<td>Gastroenterology</td>
<td></td>
<td></td>
</tr>
<tr>
<td>General Surgery</td>
<td></td>
<td></td>
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<tr>
<td>Gynaecology</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Infertility Services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Obesity Surgery</td>
<td></td>
<td></td>
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<tr>
<td>Ophthalmology</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oral Maxillofacial Surgery</td>
<td></td>
<td></td>
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<tr>
<td>Orthopaedic Surgery</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pain Management Pathology</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Radiology – Inc MRI</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plastic and Reconstructive Surgery</td>
<td></td>
<td></td>
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<tr>
<td>Urology Surgery</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Endocrinology</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Cabrini not for profit hospital (City of Stonnington Melbourne)

<table>
<thead>
<tr>
<th>Medical/Surgical</th>
<th>Community Programs</th>
<th>Research and Education</th>
</tr>
</thead>
<tbody>
<tr>
<td>Breast Surgery</td>
<td>Programs for:</td>
<td>Clinical Research</td>
</tr>
<tr>
<td>Cardiotoracic Surgery</td>
<td>Homeless</td>
<td>Undergraduate and Graduate Post teaching</td>
</tr>
<tr>
<td>Colorectal Surgery</td>
<td>At Risk Youths</td>
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</tr>
<tr>
<td>ENT Surgery</td>
<td>Family Counselling</td>
<td>Research Grants</td>
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<tr>
<td>General Surgery</td>
<td>Overseas Health and Social Outreach Programs</td>
<td>Nursing Deakin University</td>
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<tr>
<td>Hepatobiliary/Pancreatic Surgery</td>
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<td>Gastrointestinal Surgery</td>
<td>Indigenous Health</td>
<td>Surgery Monash University</td>
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<td>Ophthalmology</td>
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<td>Oral Maxillofacial Surgery</td>
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<td>General Medicine Monash University</td>
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<td>Orthopaedic Surgery</td>
<td>Development Program</td>
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<td>Urology Surgery</td>
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<tr>
<td>Vascular Surgery</td>
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<td>Obstetrics</td>
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<td>Endocrinology</td>
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<td>Haematology</td>
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<td>Oncology</td>
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<td>Infectious Diseases</td>
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<td>Neurology</td>
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<tr>
<td>Psychiatrists</td>
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<tr>
<td>Rehabilitation Medicine</td>
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<tr>
<td>Respiratory</td>
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<tr>
<td>Rheumatologists</td>
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<tr>
<td>Dental</td>
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<tr>
<td>Laparoscopic Surgery</td>
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<td>Medical Imaging</td>
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<tr>
<td>Pathology</td>
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<tr>
<td>Emergency Departments</td>
<td></td>
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<tr>
<td>Aged Care</td>
<td></td>
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<tr>
<td>Home Care</td>
<td></td>
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<tr>
<td>Palliative Care</td>
<td></td>
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<tr>
<td>Rehabilitation</td>
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</tbody>
</table>
In contrast the Productivity Commission asserts:

in practice there appears little to distinguish the operations of a for-profit private hospital from most NFP private hospitals. Private hospitals — for-profit and NFP — treat much the same patients, receive much the same fees and provide much the same services. Both also provide pro-bono services to those in need.\textsuperscript{14}

The reference to provision of pro-bono services by for-profit hospitals is not sourced in the Productivity Commission report. A search of the annual reports of four for-profit private hospitals did not reveal a reference to any such programs. In contrast, as the above table clearly illustrates the not-for-profit hospital Cabrini, runs, for example, benevolent, pro-bono community welfare, justice programs that are extensive and far ranging that generate little or no revenue. While no doubt there is some pro-bono work in private for-profit hospitals, clearly it will be marginal to the central purpose of their existence which is to generate profits.

As in the above example, comparing The Avenue for profit and Cabrini Health, not for profit hospitals are sometimes in the same geographical areas. However typically, for-profit hospitals often operate in geographic areas of higher socio-economic status than not-for-profit hospitals.

These qualitative assertions do not definitively answer the question of whether these different types of hospitals are in the same market or not. However they strongly indicate significant differences and cast doubt on the Productivity Commission assumptions of for-profit hospitals and not-for-profit hospitals “treat much the same patients, receive much the same fees and provide much the same services. Both also provide pro-bono services to those in need.”

3.5 Labour markets

The argument that distortions arise from the existence of policies that violate competitive neutrality is not only relevant to the output markets firms trade in but also the markets where they buy their inputs.

In the case of the NFP sector and input markets the relevant question is: does the NFP sector draw labour from the same market as the for-profit sector? This appears to be a simple enough question but labour markets are even more complex than product markets. One of the main reasons that labour markets are complex is because of the very loose relationship between occupations and skills. For example, the occupation described as ‘registered nurse’ requires an individual with the appropriate qualification. Therefore, there is a limited pool of individuals with the appropriate qualification who could fill the role of a registered nurse. Defining the size of this pool, however, is difficult. Should someone who was once qualified as a registered nurse many years ago still be considered as being in the pool even though this individual would need

some retraining to fill the role today? Should someone who qualified as a registered nurse relatively recently but now works, say, as a senior management role in a hospital be considered as still being in the pool if he or she has no intention of ever returning to the role? Thus, it is far from obvious how to define the supply of a particular type of labour with a particular type of skill and thus it is similarly difficult to argue that the NFP sector draws labour from the same supply as the for-profit sector.

Another factor that is relevant in this context is the fact that for-profit and NFP hospitals represent very different working environments. The for-profit hospital working environment tends to be a less stressful and more predictable for employees. These very different work patterns will tend to attract different types of employees leading to another differentiator in the for-profit and NFP.

Further, let us concede – at least for the purposes of argument in this section - that if the advantages of the FBT concession allow the NFP sector to draw resources from the for profit sector that this reduces welfare by distorting the allocation of resources.\footnote{15} If this is the case, the costs of this will be offset or perhaps outweighed where some organisations in the NFP sector draw people out of leisure and low productivity (for example, home duties). The NFP sector tends to draw on groups of workers whose elasticity of labour supply tends to be high. The greater informality of the NFP health sector and its closeness to the community, it is also likely that this effect is not trivial. This effect will offset any losses from the NFP’s use of its access to the FBT concession to out-compete the for profit sector for labour. Although there may well be fewer workers in this category, each worker that the NFP sector draws into the labour force is likely to contribute more to social welfare than the decrement in social welfare involved in someone moving from the for profit sector to the NFP sector where they are (probably only marginally) less productive.

In order to determine the extent to which not-for-profit and for-profit organisations draw labour from a common pool we need to consider the characteristics and motivations of employees, in particular, whether employees in the not-for-profit sector have distinctive characteristics which, to some extent placed them in a separate labour market pool from employees who prefer working in the for-profit sector.

3.6 Motivations of NFP employees

The Productivity Commission recognises that employees in not-for-profit organisations may be motivated differently from employees in the for-profit sector. In discussions with stakeholders it

\footnote{15} This presupposes amongst other things that the work of for profit hospitals and NFP hospitals are equally valuable. Although this seems plausible where they do the same work, for-profit hospitals also tend to perform work which is less serious but more remunerative such as plastic surgery. NFP hospitals on the other hand tend to perform less remunerative work for those who cannot pay but who often need the treatment relatively more. Nevertheless this matter is not pursued further in this report.
was unanimously asserted that employees working in not-for-profit organisations could earn higher incomes doing the same work in the for-profit or the public sector. Of the respondents to the survey 76 percent believe that they would earn a greater income than they currently do in their current role in the charitable sector if they switched employment into another sector.

These differentials were claimed to be most pronounced in the provision of counselling and social welfare care services. The Productivity Commission reports that the differentials range up to $30,000 per annum.

Individuals working in the not-for-profit sector may have a range of non-monetary motivations such as a desire to assist the disadvantaged and to promote social welfare generally. In economist’s jargon the expression ‘psychic income’ (a particularly inapposite term in this context) is used to describe the non-monetary benefits that an individual receives and positively values in a particular occupation. The logic is that, to some extent, an individual is prepared to sacrifice some monetary income to access the beneficial attributes of a particular occupation. This theme is common in discussion of the economics of the arts. Artists are observed to earn less than average monetary incomes for a given skill level and this is attributed to a range of positive attributes associated with being an artist – ‘doing what one wants to do’, ‘expressing one’s self’ etc. Extending this type of thinking to the charitable sector, employees derive some extra benefit from ‘helping other’, making a contribution’ etc. In effect, to the extent that they could earn more monetary income doing the same work in the for-profit sector, employees who are so motivated are practicing philanthropy through their work,

Psychic income, however, does not ‘pay the bills’. For any particular individual there will be some threshold level of monetary income below which he or she is not prepared to remain in that particular occupation. In the case of workers in the not-for-profit sector, lower than average incomes can be, to some extent, offset by the FBT tax concession. The monetary value of the FBT concession varies according to employees’ income and other aspects of their employment contracts. The survey group estimated that the FBT concession was worth, on average, $5,650 per annum after tax or a little over $108 per week. The general consensus among stakeholders interviewed is that this figure falls well short of the earnings differential between NFP and for-profit employment.

This discussion suggests that the difference between an individual’s income in the NFP sector inclusive of the FBT concession benefit and the income that can be earned in the for-profit sector is an indicator of the psychic income of that individual arising from that work in an NFP organisation.

Clearly, if the FBT benefit were to be removed then, at the margin, a number of employees would take the view that they were now below their threshold for monetary income and leave the NFP sector. In order to keep these employees in the NFP sector it would be necessary to
compensate them by the amount of the lost FBT concession. However, if the capacity to attract labour into the sector is the main issue, it is not specifically about the FBT concession as other mechanisms can be used to support the ability to be competitive in the labour market.

Discussions with stakeholders, however, indicate that the situation is actually more complex than this analysis suggests and these aspects favour the FBT concession as a support mechanism. A number of senior managers suggested that, on average, employees appear to significantly overestimate the value of the FBT concession to them.

Without being definitive, the results of the survey are suggestive of some overvaluation of the concession by employees. Respondents estimated that, on average, they packaged $15,900 per annum under the FBT concession. At a marginal tax rate of 30 percent which many of the employees would be on, this implies a benefit to the employee of $4,800 per annum.

Respondents were also asked to nominate a gross salary increase that would compensate them for the removal of the FBT concession. The average of responses to this question was $12,400 per year. The benefit of this to the employee of this compensating income change is the after tax value of the income or $8,700 per year. Therefore employees seem to overestimate the increase in income required to compensate them for the loss of the concession by $3,900 per year. There are a number of possible explanations for this difference. It could be, as suggested in some stakeholder interviews, that the value of the concession is being overestimated, though it seems implausible that it would be by as much as these figures suggest. It could also be that the concession is valued for other than its direct impact on take home pay – it may have some symbolic value to employees. It could also be that the result is a consequence of sampling error (for example some respondents only responding to one of the questions) or that employees are not able to accurately process the information required to produce consistent estimates. A further possibility is that respondents to the survey are facing higher marginal tax rates on account of the withdrawal of family allowances.

To the extent that an overvaluation does occur, the existence of the FBT concession creates a motivation for workers in the NFP sector over and above its simple monetary value and over and above its revenue cost to the Government. The implication is also that some employees might leave the sector if they better understood the value of the concession.

Employees may value the FBT concession for its symbolic value – as is a recognition directly from the State of their special role in providing services to the needy and of their preparedness to make some level of personal sacrifice in this role. As reported below (Section 4.3), over 52 percent of respondents either agreed or agreed strongly with the statement “I appreciate the FBT concession because it recognises my contribution”
To the extent that this idea of symbolic value is true, the FBT concession can be seen as a mechanism that, by recognising them, encourages individual workers to make philanthropic contributions. Removing the FBT concession would result in the loss of some of this philanthropic contribution. Given employees estimate that they are paid around $14,600 less than they could get elsewhere, as reported above, for the extra income employees could earn in another sector, this loss could be significant in total across the sector.

In addition, only around 50 to 60 percent of workers in the NFP sector make use of the FBT concession (almost 75 percent in the survey sample). This creates a particular problem for NFP organisations should the concession be removed. If NFP organisations sought to retain employees who had lost the FBT concession they would need to increase their explicit remuneration. This would create changes in remuneration relativities between employees within particular organisations and would likely lead to demands from employees who previously did not receive the FBT concession for increased incomes. This would mean that the financial impact on NFP organisations would be substantially greater than the lost value of the FBT concession and if government were to fully compensate NFP organisations for the loss of the FBT concession it would need to pay significantly more, the sector suggests almost double the current revenue cost of the concession (probably over $2 billion).

3.7 Are there other reasons that competitive neutrality is not relevant?

3.7.1 Multiple influences of government

The Productivity Commission argues that removal of the FBT concession would improve the application of competitive neutrality. It must be recognised, however, that multiple government policies, both at Federal and state levels, impact on the operation of hospitals and, more particularly, the cost of various inputs. “There are a number of potential input tax exemptions provided to NFPs, including FBT, GST, payroll tax, stamp duty, land tax ...”16 To this list must be added any other interventions that affect the price of inputs such as capital investment tax concessions which are available to private hospitals only. It is also worth pointing out that various regulatory interventions may impact the cost of various inputs. All of these various interventions will cause divergences from competitive neutrality to varying extent across multiple inputs.

Any analysis of competitive neutrality should take account of the three-way pattern of competition within which hospitals operate. The question of competitive neutrality of government policy with respect to hospitals should consider whether government policy is neutral between public, for-profit and not-for-profit hospitals. This raises questions of the

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16 Productivity Commission, NPF Sector, p206
range of government policies that affect hospitals. The issue of competitive neutrality cannot be dealt with by considering one form of tax at a time.\textsuperscript{17}

Thus, there is a complex matrix of influences on the price of inputs used by hospitals from multiple government interventions and concessions. It is the sum of all these influences on the relative prices of inputs that determine the net divergence from competitive neutrality in the hospital sector. Taking a partial approach (for example, by focusing only on the FBT concession) to this complex reality may result in perverse policy recommendations. For example, it is possible to imagine a situation where the removal of the FBT concession for NFP hospitals causes the extent to which competitive neutrality is violated to increase rather than decrease because of the complex influences on input costs of various other concessions and interventions.

\subsection*{Multiple inputs and organisational structures}

Even further complicating this already complex picture is the fact that NFP and for-profit hospitals have significantly different ownership structures which fundamentally determine very different levels of access, and therefore associated costs, of finance.

Private hospitals have access to debt funding and to equity markets. NFP hospitals have no access to equity funding and, in practice, have qualitatively different access to debt because potential lenders will understand that equity funding to buffer liquidity issues is not available. On the other hand, NFP hospitals have significant access to donor funds which is generally not the case for for-profit hospitals.

In addition to the differing terms of access to finance arising from structural differences, not-for-profit hospitals, in general, will face inferior terms in dealing with health insurance companies. Each hospital group must negotiate their terms with insurers such as the amount that will be rebated for a standard procedure, for example, a hip replacement. The large national private hospital companies will tend to have the greatest advantage in such negotiations because of scale and bargaining strength and therefore will be able to establish more favourable terms than the smaller independent religious order and not-for-profit hospitals.

Mason et al discuss the way that so called ‘Payments by results’ rates are determined. ‘Payments by results’ refers to payments made by the National Health System in the UK to private hospitals (both NFP and FP) for the treatment of public patients. The level of payments for specific procedures is defined by the NHS but variations to specific hospitals are made based on their ‘Market Forces Factor’ score which is intended to account for differences in input costs in different geographical locations.

\textsuperscript{17} Epworth HealthCare submission, p3
... the constraints that could cause public and private provider costs to differ for reasons outside their control. These constraints may be regulatory in nature, such as taxes and performance management regimens, or relate to the production process, such as input costs, the provision of emergency care, and case mix issues ... Most of these exogenous cost differentials can be rectified by adjustments either to the regulatory system or to the payment method. However, differences in capital costs appear less tractable and further investigation into possible solutions is warranted.18

In addition to these many cost factors that affect NFP and for-profit hospitals in different ways, there are additional considerations such as tax deductibility for philanthropic contributions from which the NFP sector draws around 10 per cent of its revenue.

It is reasonable to view the very structure of NFP and for-profit organisations as being responses to a range of opportunities to attract different kinds of inputs (this is discussed further below Section 4.3). The complex network of government interventions, concessions, philanthropy, motivations and inputs that these organisational types inhabit have involved over a long period in response to societies collective views about how to meet social needs.

It seems at best curious to single out the FBT concession for special attention. Why not remove all concessions and all other influences on the prices and quality of inputs available to NFP and for-profit organisations? Obviously this would be an impossible task. It could also threaten the distinctiveness of these two types of organisations which is the source of much of their social value.

3.8 In summary

The principal of competitive neutrality only applies to organisations within the same market. As the Productivity Commission conceded, to a substantial extent the charitable sector occupies its own market niche and the extent to which it competes with for-profit organisations in the provision of charitable services to disadvantaged Australians is quite limited.

The analogous argument for NFP hospitals and aged care and for-profit hospitals is more complex but is ultimately an empirical question of market definition. It is far from clear that NFP and for-profit hospitals occupy the same market – there many differences between the services they deliver, the types of clients they serve and the geographical locations they occupy.

With respect to labour markets there may be significant differences between the types of individuals who choose to work for NFP organisations and for-profit organisations.

18 Should prospective payments be differentiated for public and private healthcare providers? Anne Mason, Andrew Street, Marisa Miraldo and Luigi Siciliani, Health Economics, Policy and Law (2009), 4:383-403 Cambridge University Press
The complexity of governments’ influence on the not-for-profit sector and the many different inputs that the sector uses further complicates the application of the competitive neutrality principle. The ownership structures and the objectives and NFP organisations are quite different from for-profit companies. All of these characteristics make it very difficult to convincingly assert that simply eliminating a fringe benefit tax will make these markets meaningfully less distorted and efficient.
4 The FBT concession and the NFP sector in Australia

In this section we discuss the pragmatic role of the FBT concession in the Australian not-for-profit sector and the extent to which the FBT concession represents a source of value from the perspective of the Australian taxpayer and the potential costs and risks that emerge from changing the current system. We address the argument made by the Productivity Commission and, we presume, the Henry Review that the FBT concession is an inefficient mechanism to support the not-for-profit sector.

4.1 Flexibility of FBT concession

Several of the stakeholders interviewed emphasised that the FBT concession provided significant flexibility to organisations in funding particular projects or employment positions.

For example, a charitable organisation could leverage a donation with the FBT concession to create a new position or positions in order to staff a new project. This linking of a particular project with a particular donor with an interest in the project enables charitable organisations significant flexibility in deploying services and enables it to facilitate particular charitable interests of donors.

Thus, the FBT concession can be seen as an efficient mechanism for connecting philanthropic interest in specific areas with the capability to deliver services in those areas. The net result of this brokering role that has enabled by the FBT concession to be a greater flow of philanthropy in total and the delivery of a greater quantity and greater diversity of services that would otherwise be the case.

Stakeholders commented that this was a significant mechanism for funding the operations of organisations and that the removal of the FBT concession would significantly reduce this type of organisational flexibility and frustrate many donors.

The other way in which the FBT concession promotes flexibility is that, unlike direct subsidies, it does not require organisation to pre-commit particular sources of revenue to particular uses.
4.2 Are direct grants preferable to the FBT concession?

As indicated in the introduction, it is not the intention of this paper to argue against the theoretical preference for non-distorting subsidies over an input subsidy such as the FBT concession. It is necessary, however, consider a range of real-world factors that have to do with the implementation of direct subsidies that influence the attractiveness of subsidies in practice vis-à-vis the concession.

The Productivity Commission asserts:

> As a rule, it would be preferable for services to be funded in a transparent fashion and not rely on input tax concessions that can be relatively complex, costly and distortionary.

4.2.1 The comparative cost of the concession and grants programs.

Given the length it has been around, the current FBT concession is well understood by the sector. It’s administrative cost is moderate. Generally the cost of administering an employee’s salary packaging on behalf of their employer by an outsourced specialist company is around $160.00 per annum. This equates to around 1 percent for charitable employees or 1.75 percent of the salary packaging value for a NFP Health Care employee. However the correct measure is probably the cost of administering the concession compared with the after tax benefit of the concession which produces costs of around 5-8 percent of the employee benefits generated.

The types of benefits being administered for those employees participating in salary packaging are illustrated in the graph below.
There may also be opportunities to improve the operation of the concession. Where compliance breaches are occurring or eligibility criteria need to be tightened, these issues should be addressed but do not invalidate the central point we are making in this paper that alternatives to the concession may not improve outcomes and may indeed impair them.

Direct grants also have costs of implementation and administration for both government and the organisations to which they are directed. The Commission notes in its Draft Report a pattern likely to be experienced with any move towards direct grants.

*Governments have sought to increase accountability in relation to direct funding, (grants and purchasing arrangements) to ensure agreed outcomes are being met. However, with some exceptions, reporting requirements associated with grants have become disproportionately more onerous without commensurate benefit.*

It is important in evaluating alternatives to compare the full system costs of alternatives. Direct funding measures will imply new overheads for NFPs in the preparation of submissions for grants and accountability reporting.

Direct grant systems also impose significant administrative costs on government. Over the grant’s life cycle, government agencies will are expected to develop criteria and advertise programs, submit or receive applications, evaluate proposals, inform successful and unsuccessful applicants, create and implement contracts between the grants body and

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19 Contribution of the Not-for-Profit Sector, Productivity Commission Research Report October 2009, pXXXIII.
recipients, manage appeals, manage payment schedules, check on progress and ensure adequate reporting and governance.

There are also a range of risks that will be borne by government in a direct grants system that are not present in the current system. There is some level of political risk that arises when public servants and politicians can be held accountable for choices regarding funding destinations or take more active participation in the delivery of programs. There are recent examples of poor delivery which has created community uncertainty and lack of confidence.

Many, if not most, not-for-profit organisations have inadequate reporting and tracking systems and processes to fulfill the criteria for grants. For example, last year the Australian National Audit Office found that the IT systems of the National Health and Medical Research Council did not adequately support grants of millions of dollars in research funds. The administration and technology/systems burden placed upon those organisations receiving grants is substantial.

In contrast, under the FBT concession regime, not-for-profit organisations access FBT concessions via well developed (20 years +) systems and processes that require minimal management and intervention and are very cost effective (low cost to administer).

Finally, if grants were to be an open to contest from other potential providers then the costs of unsuccessful bidders must be included in any comparison of costs as well as the costs of administering the scheme and any associated disputes and appeals mechanism. It is often argued that, in the case of a range of government tenders, the total cost of preparing proposals by all submissions exceeds the value, and certainly the profit, of the tenders themselves to the successful bidder. In this case the issue of the call for proposals and the implementation of the project potentially creates negative economic impacts.

Even given these considerations, the question of whether the FBT concession is more or less costly to operate than a grant scheme remains difficult to be definitive about. It has, however, been clearly demonstrated that the issue is complex and far from obvious. In that context the virtually unanimous views of those in the sector, and their lack of enthusiasm for greater reliance on grants should not be discarded lightly.

4.2.2 Is perfect compensation practically achievable?
We also emphasise that the Productivity Commission nowhere suggests that the FBT concession be removed without compensation to the NFP sector. The Commission is, in effect, proposing that direct subsidies would be preferable to the FBT concession and government support of the sector is appropriate; the implication being that if the FBT concession were to be removed that direct subsidies be increased to a level that would at least offset the losses to the NFP sector from the discontinuation of the FBT concession.
With respect to this implied principle it should be pointed out that identifying the net impact of the loss of the FBT concession and identifying the net impact and its distribution across various types of NFP organisations of an increase in direct subsidies is itself extremely complex and yet being able to determine a meaningful qualification of these questions is central to the practical efficacy of what the alleged superiority of direct grants proposes.

On the ground managers in the not-for-profit sector know that this question is complex and are therefore unsettled by the suggestion that it would be a straightforward routine process to close down the FBT concession and introduce subsidy scheme with no immediate impact on the organisations.

It is inconceivable that such a significant change in funding arrangements would not affect the composition of the sector – there would be winners and losers among NFP organizations. Large NFP organizations would be more likely to be able to manage the tendering and compliance processes associated with grant funding whereas smaller organizations might not survive. Smaller NFPs such as LifeLine provide important specialist services for which no alternative would be immediately available. Of course if this were a more efficient outcome it is appropriate that we move towards it. But it is more likely to reflect something more prosaic – the need for greater scale to meet the administrative and regulatory compliance burdens which accompany government funding.

### 4.2.3 Other qualitative aspects of concessions and grants

The point has been made above that direct grants also introduce a layer of bureaucratic decisions and intrusion and will make NFPs more directly dependent on the favour of officials. For those planning the work of NFPs, this introduces a significant new annual risk and new relationships to manage. To some extent this problem could be offset by making the funding cycles longer however, this would also serve to amplify compliance costs and risk at the point funding is renewed. The agency relationship issues, and the potential development of what could be quite significant agency costs means that care should be taken. Again it is noted that FBT concessions carry something of a market check - the payment of subsidies is dependent on demand for services. An entity must fund the majority of the labour costs, and that will only be generated if people choose to use the service.

One of the appeals of the FBT concession is that it is ‘hands off’ or non-specific with respect to particular organisations. A particular NFP organisation only needs to qualify for NFP status and then the FBT concession is automatic. As the Commission notes, for some NFPs distance from government is a key factor in their success, particularly in building the trust of client groups and contributing to social innovation. The existing indirect mechanism provides a means for directing community support to such ventures without compromising their independent position. A grants process is unlikely to replicate the existing pattern of support exactly.

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CAPABLE, INNOVATIVE, RIGOROUS
A number of submissions outlined the reliance of NFPs on tax concessions as a form of government assistance (box 8.5). While a move to more direct and transparent grants would be more efficient than the input tax concessions, and show the full extent of government and taxpayer support of NFPs, it would be unfortunate if such grants were used to impose bureaucratic controls over NFPs as noted by Epworth Health Care (sub. DR195).  

It is recognised that it is extremely difficult to value these types of qualitative attributes. Valuing, for example, the benefits of greater or lesser independence in the operations of charitable organisations is probably beyond any meaningful quantitative analysis. It is important to point out, however, that stakeholders were unanimous in emphasising strongly the importance of this kind of independence in the day-to-day operations and in being able to determine the strategic directions of their organisations.

THE SALVATION ARMY

The Salvation Army does not believe it would be possible to adequately perform the current services it provides if it were required to petition/apply to Governments for funding that is intended to compensate The Salvation Army for forgoing taxation concessions (of any kind). The Salvation Army believes such a system would be inefficient and result in increased administration costs and not be of any overall benefit to the Australian public.

These strongly voiced concerns should not be dismissed lightly and it is far from obvious that they should be dismissed in favour of gains which are hypothetical, not-quantified and are argued for from exclusively theoretical considerations.

4.2.4 Grants create uncertainty and uncertainty involves an economic cost

The FBT concession is legislated for and experienced as an ongoing entitlement by all who qualify for it, but grants are applied for. This captures the key reasons that grants foster a business environment that is uncertain, ad hoc, bureaucratic and diminishes the incentive and capacity to undertake long term planning and resource allocation. Even if grants are provided over a longer period, say, three years this is still insufficient to accommodate longer term planning especially within large organisations where capital decisions must be taken which are critical to the delivery of services. For example, an organisation will find it difficult to commit to acquiring debt for a building project which may have a life of 20 years in an environment where critical funding may be unexpectedly withdrawn within the next three years. To some extent this could be addressed through targeted capital funding but again this introduces further complexities, costs and uncertainty. Thus, moving to a uncertain grant scheme could be said to introduce allocated in efficiency in the form of an underutilisation of capital in not-for-profit organisations.

20 Productivity Commission, NPF Sector, p209.
Increased uncertainty will also make it difficult for not-for-profit organisations to enter into longer term employment contracts which will reduce the incentives they have to build employee skills and career development. These factors will make it extremely difficult for not-for-profit organisations to attract and retain skilled and management staff.

On the other hand, FBT concessions for the sector are legislated for and therefore the sector has certainty. Certainty means organisations can plan long term, offer ongoing permanent employment and are not distracted by the uncertainties and administration burdens imposed by grants.

These considerations go to the core reasons why it is far from obvious that grants are preferable to the FBT concession on economic efficiency grounds. Even if true that an FBT concession of itself and in isolation would create non-trivial labour market distortions (and in the context of earlier arguments this is not clearly defined) this does not establish that the FBT concession should be removed. Given, that it is universally accepted that support should be given to the not-for-profit sector and that, at least implicitly, the proposal to remove the FBT concession must be accompanied by an increase in direct grants so that the sector is no worse off, then efficiency implications of a direct grant system as it operates in the real world of existing not-for-profit organisations must be critically examined.

Grant funding introduces significant uncertainty for organisations in the sector. This uncertainty will impact on that capacity planning, will discourage capital investment, will tend to make employment contracts shorter term and reduce incentives to undertake skills and career development. These factors create increased inefficiency in the sector and will ultimately lead to a degradation in quality of services.

At this point in the debate it has not been demonstrated that be efficiency losses associated with the FBT concession are greater than the efficiency losses associated with a grant system.

Looking at this another way, stakeholders in the sector unanimously preferred certainty of a legislated FBT concession to the prospect of direct subsidies even if they are provided to a sufficient level to offset the loss of the FBT concession. This strongly suggests that there are attributes of the concession that are favourable over direct grants that are not captured in the reformers’ analysis.

4.3 Harnessing different motivations and diversity in service delivery

In some industries, perhaps most, it is common to find multiple production methodologies being employed – there is often no obvious ‘one correct way of doing things’. Take, for example, the development of concepts for movies in Hollywood. There are a number of different ways in which concepts for movies are ‘green lighted’ – funded for production:
• a major studio itself may develop a project and choose to fund it

• a project may be developed by an ‘on the lot’ producer (a producer exclusively tied to the studio),

• an independent production company may succeed in having a project approved

• a talent agency may assemble the key participants necessary for a project to be green lighted for production.

Each one of these processes results in similar (but not identical) outputs that are produced by organizations made up of different types of individuals who are differently motivated and who receive different types of rewards. Because of their different characteristics and different reward structures each of these types of organisations use different techniques and strategies to ‘search the possibility space’ to come up with fresh ideas for attracting the green light. The net result of the employment of these ‘multiple pathways’ is that a greater range of inputs, especially labour inputs, is used in a greater diversity of creative ways to produce a greater diversity of outcomes.

The provision of health care services by government, for-profit hospitals and not-for-profit hospitals is an example of this type of multiple pathway model. Charitable and not-for-profit organisations will tend to attract a type of labour that has different motivations to the labour attracted to for-profit organisations. Clearly, this is not an absolute statement – employees will and do move between the different classes of organization. This fact, however, does not contradict the proposition that having multiple organisational models generates positive social welfare. Employees have different preferences about services they wish to be involved in delivering and what types of organisations they wish to work for. Also, employees will be attracted to different sorts of organisations at different stages of their working careers. Stakeholders observed that charitable organisations attract younger workers who tend to leave for high-paying jobs as they form families and then return when older and more financially independent.

Another way to appreciate the importance of harnessing a range of motivations is to consider the role of volunteers in the NFP sector, although this argument also applies to what we have called the philanthropic component of employees who choose to work in the NFP sector for less than they could earn elsewhere. Volunteers are obviously motivated by something other than cash payments – what economists call intrinsic motivation. Policymakers need to be aware that some forms of extrinsic motivation, particularly monetary income payments, tends to displace intrinsic motivation.21 In addition, there may be a range of discretionary qualitative

21 See eg.
aspects to what employees and volunteers bring to that tasks that are affected by the way in which extrinsic rewards are offered.

The survey found evidence that employees do value the FBT for symbolic as well as pecuniary reasons. Over 86 percent of respondents either agreed or agreed strongly with the statement “I appreciate the FBT concession because it increase my take home pay” but, in addition, over 52 percent either agreed or agreed strongly with the statement “I appreciate the FBT concession because it recognises my contribution”.

To this point, this argument provides a rationale for maintaining different kinds of motivations and organisations to deliver critical social services. It is not explicitly an argument about the merits of the FBT concession. Nonetheless, the points raised above regarding the flexibility of the FBT concession for employers, are relevant. The FBT concession enables employers to tailor their employment packages to maximise the attractiveness of the positions they offer given their financial constraints.

The results of a survey conducted for this report indicate the importance of the FBT concession to employees in the sector. To the question “how important are the benefits of the FBT concession in influencing whether you remain employed in the health and aged care sector?” 82 percent answered “Very important” or “Quite important”.


The concession enables any of these to attract a different kind of labour that is differently motivated and that is part of a system that delivers services that are qualitatively different from those delivered by the for-profit sector.

It is the quality of the service that is also critical in addition to the service itself. The fact that meals, medical care, counselling or assistance with accommodation are delivered by people who are motivated, at least in part, by compassion and a desire to do socially beneficial work, means that those services are qualitatively distinct and are a particular response to the disadvantaged social groups to which they are directed.

The qualitative characteristics of these services emerge from the motivations of the employees and the structure of the organisations themselves. These things cannot be separated and new structures and new reward systems risk losing is essential qualitative dimensions of the services provided by NFPs.

*Billis and Gennerster (1998) argue that NFPs have a comparative advantage in delivering services where the motivation to address disadvantage, and knowledge of and sensitivity to client needs, are in scarce supply.*

### 4.4 Consequences, costs and risks of change

In practice, complex real world effects will significantly influence the risks and returns of making changes to the existing system of FBT concessions. It is not possible to forecast with confidence that the benefits, if there are in fact benefits, of the Commission’s transparent alternative will outweigh the costs of change.

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22 Productivity Commission, NPF Sector, p 16
From the point of view of NFPs, there are significant risks with a transition to direct funding to replace the support afforded by input tax concessions. In addition to any long term issues any transition is likely to be costly and unless existing benefits were phased out slowly, delays while a new scheme is designed, built and put into operation might produce awkward funding shortfalls which might necessitate the termination of essential services.

The Commission acknowledges that ‘there are valid concerns in regard to the implications’ of any change to the tax concessions. It would, to some extent, concentrate decision making about which NFPs obtained support in the hands of a smaller number and a single type of decision-maker.

It is also pertinent to highlight the potential risks facing the recipients of charitable and NFP health-aged care services. Clearly, many individuals would face potentially life-threatening consequences are particularly critical services were unexpectedly withdrawn. The social costs of uncertainty and disruption in this particular domain are potentially very high.

In the broader context of Australia's ageing population and, pointedly, significant labour supply shortages in the healthcare and aged care sectors, particularly of nurses, the risks raised by creating financial instability for NFP organisations are particularly heightened.

If significant numbers of employees choose to leave the sector remedial action will be necessary by governments to maintain services. But it should be recognised that if the financial and operational integrity of charitable and NFP organisations is damaged by changes to the concession system, rebuilding the services may involve massive cost to the public. This is because donor funding may be lost as a source of support and because the cost of government provision is likely to be much higher than the cost of provision by the NFP sector.

There is a related argument that the more employees in the NFP sector (and also volunteers) are supported with gestures, such as the FBT concession or payments for costs incurred for volunteers, the more likely we are to motivate them. This is not rational from the perspective of a central planner, but may be important in reinforcing the ecology of volunteering by appealing to more subtle socially oriented motivations.

If one thinks about the Victorian bushfires or the Tsunamis in our region, people took pride in asking ‘what can I do’. This is generally regarded as healthy. People often feel more motivated and satisfied to contribute in a ‘hands on’ capacity, for example, helping cook food or distribution clothing and bedding rather than simply donating money. Often the cost of these hands on contributions greatly exceeds what the individual would be prepared to contribute in the form of a cash donation. It is an important aspect of motivating NFP employees and volunteers for them to feel connected to what they are doing. By the same token, a number of recognitions of voluntary action may well be better than a single (greater) payment of cash.
A similar approach is behind spending on volunteers to give them ‘respite care’ in aged care, rather than just handing them cash. The gesture is as important as the resource.

Again, this is not specifically an argument in favour of the FBT concession. These have been made above. It is an argument that cautions against discontinuous change for the sake of unqualified and unsubstantiated theory-driven claims of benefit.

The Productivity Commission acknowledges there are many uncertainties and unknowns in change. It recommends that no change should be made without thorough transition arrangements being put in place.

"There are undoubtedly better ways than the FBT exemption to deliver government support. But the current system is well entrenched so any change needs very careful consideration and an appropriate transition period. This is consistent with the recommendation of the Industry Commission’s Charities report to remove the FBT exemption from PBIs after a two-year phase out period (IC 1995)."  

While it is more or less a certainty that there are “undoubtedly better ways” to provide governance support, it is still far from clear that given the risks and costs of change and given the uncertainty of net benefit that the removal of the FBT concession and even, in principle, be justified. The Productivity Commission provides no clear outline of how progress can and should be made here. In fact, it did not make a recommendation to remove the FBT concession in its report.

4.5 Ageing population and growth in demand for health care

The enormous social challenges posed by our ageing population creating each to the problem of the potential disruption of NFP provided charitable and health and aged care in Australia at the current time and in the future.

Nursing and health care generally are sectors that are experiencing significant skills shortages and difficulties in attracting appropriate labour. This makes the current period are particularly hazardous one in which to incur risks arising from radical change in these industries especially those which go directly to the conditions under which labour is higher than remunerated.

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23 Productivity Commission, NPF Sector, p208
UNITING CARE AUSTRALIA

The effect of removing the FBT exemption, or continuing to allow the value of the exemption to decline, will be an exodus of staff to other sectors which would have a catastrophic impact on staffing levels, particularly in aged care. In recent discussions with community services providers in Western Australia it was stated that the period leading up to the global recession (where key management positions remained vacant for months due to the lack of available and qualified staff) should be seen as a window into the future of the sector’s staffing environment, as the baby boomer generation retires. Improving the FBT concession through indexation is one of a number of important strategies which will enable the community services sector to continue to provide vital programs and services. (submission to Henry Review)

It is worth observing that even with the increased capacity to attract labour that the FBT concession provides, the NFP sector continues to face a skills shortage. Exacerbating this challenge for the sector at a time when the demand for its services is set to explode creates significant risks for recipients of the NFP sector’s services.
5 Conclusion

Lateral Economics commenced this project sympathetic to the reformers in principle case for removing the disparate treatment of FBT in the hands of employees in the NFP sector and the treatment of FBT elsewhere in the economy. We indicated to the client that we would be happy to provide analysis of the merit of the arguments, but not to lend our name to advocacy against reform.

The project proceeded on that basis. However as we have looked more closely at the issues we have concluded firstly – and not dissimilarly to the Productivity Commission – that the costs of this non-neutrality look small. Sensible analysis can be conducted only if we compare alternatives on a like basis – in this case, as concessions and subsidies would operate in practice. It is the difference between policies in theory and in practice that leads to unforeseen consequences. If the FBT concession is removed it will be replaced by increased grant funding – which will bring its own inefficiencies. Those inefficiencies are unlikely to be trivial or completely predictable, particularly once they run the rough and tumble gauntlet of democratic politics. And given this there seems little reason to be confident that the inefficiencies of additional grant based funding would not outweigh the costs of the funding mechanism they replace.

The transactions costs of greater reliance on grants are likely to be similar or greater than the costs of the FBT and that is before allowing for other effects – such as the uncertainty NFP organisations will face in planning for the long term, a probable loss of independence and the possible negative effect reform could have on intrinsic motivation of NFP employees.

Managers in the sector also report fairly consistently that the concession appears to be valued by its beneficiaries at greater than its actual cost to government – either because employees overestimate its monetary value or because they appreciate it as a value laden gesture of support from government and/or the community.

The Productivity Commission did not look at all these issues, but it is instructive that despite its general inclinations and priors, the Productivity Commission held off from clearly recommending the abolition FBT concession as it had in an earlier review of the sector. Likewise as we looked at the situation more closely we felt it unlikely that any replacement for the FBT concession would be an improvement.
McMillan Shakespeare Limited commissioned this report to assist both those in the Not-for-Profit sector and those external to the sector, to understand the key arguments and issues for retaining the current Fringe Benefits Tax (FBT) concessions.

The report provides powerful and rational economic arguments that seriously question some of the economic theories and propositions proposed in the Productivity Commission Report (“Contribution of the Not-for-Profit Sector”).
6 References


KPMG (2009), Concessional Tax Benefits to Not-For-Profit Hospitals and Aged Care Services, Report for Catholic Health Australia.


Submissions to the Productivity Commission:

- Epworth HealthCare
- Friendly Society Private Hospitals
- The Church of Jesus Christ of Latter-Day Saints
- Uniting Care Australia
- The Salvation Army
7 Appendix 1
Summary of survey

7.1 Introduction
This section provides a summary of the results of a survey of employees in the charitable sector. The purpose of the survey was to gather information about the role of the FBT concession in the attraction of employees to the sector. The survey was conducted in the month of March 2010, in the form of an online questionnaire. Potential respondents were employees of organisations in the charitable and health and aged care sectors. There were a total of 288 respondents.

7.2 Demographic Characteristics
The core characteristics of the survey respondents include the following:

- 83 percent of respondents were female. This is relatively consistent with the observed proportion of 75 percent of employees being female in the Health Care and Social Assistance Sector and 79 percent being female in the Hospitals sectors in the 2006 Census for Australia as a whole, with an overall proportion of 78.5 percent for the more broadly defined Health and Community Services sector.

- 65 percent of respondents were 45 and over. This is a significantly higher proportion in the older age groups than observed in the 2006 census, where only 41 percent of employees in the Health and Community Services Sector were aged 45 or over.

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24 The survey data required some data cleaning. This was clearly necessary for some of the questions requiring numeric responses. For example, the questions regarding the amount of gross salary made up by the FBT concessions, the increase in weekly pay needed to compensate and the higher salary that could be earned in alternative employment. The major issues with the first two variables were provision of annual amounts rather than weekly (and vice versa) and in the last variable, provision of a total salary rather than an increase in salary. Data were adjusted to correct these misinterpretations.
• the majority of respondents have been in the sector for a relatively short period, with 38 percent employed in the sector less than 6 years, and a total of 54 percent less than 11 years.

• the majority of respondents have spent time employed in other sectors, with 10 percent having spent less than 20 percent of their working life in other sectors. Over half have spent significant time (greater than 60 percent) in other sectors.
• 58 percent have spent less than 6 years with their current employer, and 72 percent at less than 11 years. The average length of service with the current employer is 7.6 years, and as would be expected the average length of service increases the older the respondent.

As indicated in Figure A5, 71 percent of survey respondents were in permanent full time roles, and 26 percent were in permanent part time. It is likely that the proportion of casual and contract workers in the sector is higher than that indicted in the respondent base. One explanation for this is that casual and part time workers group would not be as affected by the FBT concession and would therefore be less likely to respond to the survey. The ABS Census data for the Health and Community Services sector indicates that 68 percent of employees in the sector work in excess of 35 hours per work, which could be considered to represent full time employment equivalent. This suggests the charitable sector involves a similar distribution of full time to part time employment as the health and community services sector more generally.
The occupation question in the survey was an open ended question, and a large number of specific occupations were identified. To assist in the analysis, the detailed occupations were classified into four types, as below. The survey response seems to be largest in an administration role – representing 39 percent of the survey base. This is consistent with the proportion in administration (managers and clerical etc) for the Health and Community Services Sector as a whole from the 2006 Census. Similarly the proportion in service roles (coordination and provider) is consistent with the proportion of professionals and associate professionals for the Health and Community Services sector from the 2006 Census.

The proportion of full time respondents was similar across all employment classification except for service provider – where the proportion was somewhat lower (55 percent compared to 71 percent).

As Figure A6 illustrates, only a small proportion of the respondents came from previous employment in the NFP sector, and many had experience in either the for-profit, or government sectors.
Table A1 indicates the average wages by employment group (estimated from the mid-points of the ranges provided as possible responses in the survey). The average annual wage of respondents is $56,900 (standard deviation of $24,200) – while for full-time employees it was $62,900 (standard deviation of $22,800). Average wages were higher for administrators, and lowest for service coordinators (who presumably do not work shiftwork).

The demographics of the survey responses indicate that it is reasonably representation of the sector compared with the Census results. Occupation and gender profiles are similar, however, the survey respondents are older than in the sector on average. Employees in the NFP sector can be described as having had working experience in other sectors (for profit and government), and in many cases that experience has been relatively recent. Therefore they could be considered to be somewhat transient – willing to move between sectors. At the same time, however, as for the health and community services sector as a whole, the sample group is older and therefore perhaps at risk of more limited opportunities in finding employment elsewhere.

### 7.3 Key Results with respect to the importance of FBT concessions

Table A3 indicates that 75 percent of respondents have FBT concessions as part of their salary package. This is consistently the case regardless of role (and the higher proportion in technical support is possibly linked to the lower proportion of ‘don’t knows’). The proportion of FBT concession in the salary package was predictably higher at 80 percent for full-time employees and lower 63 percent for part-time. The salary of those whose salary package included FBT was higher than those whose didn’t ($60,700 compared with $46,700 though this would be partly driven by the part-time employment effect).
The literature generally acknowledges that wages are lower in the charitable sector than elsewhere, and that the FBT concession makes up for at least part of that gap. Figure A7 confirms the importance of the FBT concession in attracting or retaining workers to the sector as 60 percent of respondents suggested that a reason they would leave the sector would be poor wages. Significantly over 40 percent also suggested a reason to leave would be opportunities outside the sector. Therefore a clear conclusion is that long run wage competitiveness is essential for maintaining a skilled workforce in the sector.

**Figure A7: Reasons would leave the sector**

The survey set out to investigate the importance of FBT concessions to supporting employment in the sector. The results can be summarised as follows:

- Of the 71 percent of respondents who answered the question “If you were to work for a sector other than the charitable sector, which of the following would be the main reasons for moving?” 92 percent believe that the FBT is either quite important or very important. This result is consistent across age groups and across job areas. 86 percent said that it was appreciated because it increased the take home pay (agreed or strongly agreed) and 52 percent agreed or strongly agreed that it recognises their contribution as individuals.
There were 251 responses to the question “Would you continue to work in the health and aged care not for profit sector if the FBT concession was withdrawn without compensating changes to your salary package”. 95 of the respondents (38 percent) said that they would not. 115 respondents (46 percent said they were not sure). The balance of 41 (16 percent) said they would continue to work in the sector.

76 percent of respondents believe that that they would earn a greater income than they currently do in their current role in the charitable sector if they switched employment into another sector – and 20.1 percent were unsure. Of those who responded to the question of how much more – the average expected increased earnings in an alternative job in an alternative sector was 26 percent higher than current salaries ($14,600). There was a negative correlation (-20 percent) between the proportion of household income the charitable sector job represented and how much higher the estimated earnings were. This suggested that the lower income in the charitable sector was ‘tolerable’ because of income or earnings by other members of the household.

Respondents were asked “Approximately how much does the FBT concession increase your annual take home income?” 57 percent of those who responded said they did not know. Those respondents who provided an estimate indicated that the FBT concession increased their annual take home pay by on average $6,160), or 11 percent of annual income. This is broadly consistent with the amount being packaged (as estimated in the previous question) under a marginal tax rate of 30 percent.

In terms of how much salary would have to increase to compensate for FBT concession being withdrawn, 43.0 percent of those who answered the question said they did not know and 5.0 percent said it was not applicable. Of those who answered, the average required increase in salary to compensate was $240 per week or $12,400 per year, which represents 21.7 percent of current gross salary. It is important to note the high level of uncertainty reflected in “don’t know” response. It is clear that with or without compensating changes, the removal of FBT...
concessions will create significant confusion in the sector and this, in itself, could cause employees at the margin to exit the sector. There is a positive correlation of 60 percent between the response to this question, and the question as to the value of the FBT concession, although it is noted that there was a substantial difference in the sampling base for the two questions (with 77 respondents answering both questions, 16 answering only the question on value from the FBT concession, and 62 answering only the question on the salary required to compensate).

• The difference between this compensating change and the average of responses to the value of the packaged FBT concession could be explained by an undervaluation of the FBT concession by employees or by the fact that that regard untied income as preferable to tied benefits as part of a salary package.
8 Appendix 2
Survey instrument

Survey of Workers in the health and aged care sector – Fringe Benefits Tax Exemptions

We would like your help to learn more about the impact of FBT exemptions on the health and aged care sector

Why a survey of workers in the health and aged care sector?

Confidentiality

Your survey responses will be confidential, and your participation or non-participation will not affect your employment in any way.

Any reports of the results from this survey will not identify individuals.

Is the survey compulsory?

Participation in this research is voluntary. However, the information collected from the survey will provide valuable information [Simon to expand here].

Further information

For further information about the research, please contact [Simon to complete details].

I hope that you will participate in this important study.
1. **What is your gender? (please select one)**
   - Female
   - Male

2. **What is your age? (please select one)**
   - 19 or under
   - 20-24
   - 25-29
   - 30-34
   - 35-39
   - 40-44
   - 45-49
   - 50-54
   - 55-59
   - 60-64
   - 65-69
   - 70 or older

3. **In what year did you begin working in the health and aged care sector? (please specify)**

4. **Approximately what percentage of your working life has been spent working in the health and aged care sector? (please select one)**
   - 0-20%
   - 21-40%
   - 41-60%
   - 61-80%
   - 81-100%
   - Don’t know
5. **What is your current occupation?** *(please specify)*

________________________________________

6. **Approximately how many years have you been employed with your current employer?** *(total years, for partial years please round up)*

   [ ]

7. **Consider the time you spend each week in your current position. Before you started in your current position, what did you do with this time?**

   - [ ] you worked in another organisation in the **not-for-profit** sector
   - [ ] you worked in another organisation in the **for-profit** sector
   - [ ] you worked in another organisation in the **government** sector
   - [ ] you were in self employment
   - [ ] you were engaged in activities other than in paid employment (eg home and/or child care)
   - [ ] Other (please specify) ______________________________

8. **Imagine (completely hypothetically) that it was no longer possible to work for your current employer. In two months from now which of the following statements best describes what you think you would be doing with the time you now spend working for your current employer:**

   - [ ] you would be employed in another organisation in the **not-for-profit** sector
   - [ ] you would be employed in another organisation in the **for-profit** sector
   - [ ] you would be employed in another organisation in the **government** sector
   - [ ] you would be self-employed
   - [ ] you would not be engaged in paid employment
   - [ ] Other (please specify) ______________________________
9. What is your current employment status? (please select one)

- Permanent full-time
- Permanent part-time
- Contract
- Casual hours
- On extended leave

10. If you were to work for a sector other than the health and aged care sector, which of the following would be the main reasons for moving? (please select as many as apply)

- Poor wages in the health and aged care sector
- Too much work outside standard hours
- Not valued within health and aged care sector
- Less stress
- Other opportunities were more attractive
- Other (please specify) __________________________

11. Does the FBT concession make up part of your remuneration? (please select one)

- Yes
- No
- Don’t know

12. If yes, how important are the benefits of the FBT concession in influencing whether you remain employed in the health and aged care sector? (please select one)

- Very important
- Quite important
- Neither important or unimportant
- Quite unimportant
13. In terms of your attitude to the FBT concession, which statement is more true? (Choose your response on the basis of the strength of your agreement with the two statements)

I appreciate the FBT concession because:

- It increases my take home pay
- It recognises my contribution

<table>
<thead>
<tr>
<th>Strongly disagree</th>
<th>Disagree</th>
<th>Neither disagree or agree</th>
<th>Agree</th>
<th>Strongly agree</th>
<th>Don’t know/not applicable</th>
</tr>
</thead>
<tbody>
<tr>
<td>It increases my take home pay</td>
<td></td>
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<tr>
<td>It recognises my contribution</td>
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</tr>
</tbody>
</table>

14. What are the total gross wages/salaries, government benefits, pensions, allowances and other income you usually receive? (Please select one)

- $2,000 or more per week ($104,000 or more per year)
- $1,600 to $1,999 per week ($83,200 to $103,999 per year)
- $1,300 to $1,599 per week ($67,600 to $83,199 per year)
- $1,000 to $1,299 per week ($52,000 to $67,599 per year)
- $800 to $999 per week ($41,600 to $51,999 per year)
- $600 to $799 per week ($31,200 to $41,599 per year)
- $400 to $599 per week ($20,800 to $31,199 per year)
- $250 to $399 per week ($13,000 to $20,799 per year)
15. What percentage of your total annual *household* income does the amount you specified in Question 14 represent? (please select one)

- 0-20%
- 21-40%
- 41-60%
- 61-80%
- 81-100%
- Don’t know

16. Approximately how much of your gross annual income is packaged under the FBT concession?

- $___________ per annum (please specify)
- Don’t know
- Not applicable

17. Approximately how much does the FBT concession increase your annual take home income? (please select one)

- $___________ per annum (please specify)
- Don’t know
- Not applicable
18. If the FBT concession was discontinued for workers in the health and aged care sector and no compensating changes were made to your remuneration, would you continue to work in the sector? (please select one)

- Yes
- No
- Not sure

19. If the FBT concession were to be withdrawn, how much would your remuneration need to increase per week for you to stay in your current job?

- $___________ per week (please specify)
- Don’t know
- Not applicable

20. If you worked the same number of hours in another sector do you think you would earn a greater income than you currently do? (please select one)

- Yes
- No
- Not sure

21. If you answered yes to the previous question, approximately how much more do you think you would earn per annum (gross income) (please specify)

__________________________________________

Thank you very much for taking the time to complete this survey