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Taxation and the Rural Sector

Substantial changes to the Australian taxation system in recent years suggested the desirability of a review of current tax issues as they affect the rural sector. The following two papers were commissioned for this Forum.

Fringe Benefits Taxation and the Rural Sector

D. J. Collins*

1. Introduction

The two and a half years since the 1985 National Tax Summit have seen the most intense period of tax reform in Australian history. No other single tax reform implemented in that period has provoked anywhere near the public comment and opposition that arose from the implementation in July 1986 of the Fringe Benefits Tax (FBT). The tax appears, particularly in the first two years of operation, to have been highly unpopular and yet it is a tax which most tax economists and lawyers would support, at least in principle.

The objective of this paper is to review the issues of principle and practice involved in the taxation of fringe benefits and then to evaluate the application of FBT to the rural sector. Issues of principle which are considered in this paper include:

- Who benefits from untaxed fringe benefits?
- Who should pay the fringe benefits tax?
- Which benefits should be taxed?
- How should the benefits be valued?
- What should the tax rate be?
- Should the tax be tax-deductible?

Many of these issues were faced for the first time in Australia in the Draft White Paper (1985, Chapter 8).

2. The Nature of Fringe Benefits

The Taxation Review Committee (1975, p. 117) defined fringe benefits as referring to "any benefit, other than salary and wages, derived from an employment". In its regular surveys the Australian Bureau of Statistics (ABS) defines employment benefits as "concessions, allowances or other privileges received by or

provided to employees . . . in addition to wages and salaries" (ABS 1986 (a), p. 1). The types of employment benefits (in cash and in kind) included in the ABS surveys are holiday expenses, low interest finance, goods and services, housing, electricity, telephone, transport, medical, union dues, club fees, entertainment allowances, shares, study leave (*i.e.* time off granted by the employer for attendance at classes during working hours), superannuation, children's education expenses, sick leave, annual leave, and long service leave.

Not all of these employment benefits have been defined to be fringe benefits for the purposes of the current FBT legislation, and some benefits which have been included in the tax base are not included in the ABS definition or, it could be argued, are not genuine fringe benefits.

3. The Legislation

The Fringe Benefits Tax is implemented by four related Acts:

- *Fringe Benefits Tax Assessment Act 1986*, which provides for the assessment and collection of the tax.
- *Fringe Benefits Tax Act 1986*, which formally imposes tax liability on employers and declares the rate of tax applicable.
- *Fringe Benefits Tax (Application to the Commonwealth) Act 1986*, designed to ensure that Commonwealth government departments have the same tax obligations as other employers.
- *Fringe Benefits (Miscellaneous Provisions) Act 1986*, which contains consequential amendments to the Income tax Assessment Act and other tax legislation.

Section 136 (1) of the Fringe Benefits Tax Assessment Act 1986 defines a benefit as

any right (including a right in relation to, and an interest in, real or personal property), privilege, service or facility and, without limiting the generality of the foregoing, including a right, benefit, privilege, service or facility that is, or is to be, provided under

- (a) An arrangement for or in relationship to—
 - (i) the performance of work (including work of a professional nature, whether with or without the provisions of property;

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- (ii) the provision of, or the use of, facilities for entertainment, recreation or instruction; or
- (iii) the conferring of rights, benefits or privileges for which remuneration is payable in the form of royalty, tribute, levy or of similar exaction;
- (b) a contract of insurance; or
- (c) an arrangement for or in relation to the lending of money.

Ten specific categories are dealt with, together with the eleventh "residual" benefit designed to catch all other fringe benefits. The eleven categories are car benefits, debt waiver benefits, loan benefits, expense payment benefits, housing benefits, living-away-from-home allowance benefits, airline transport benefits, board benefits, property benefits, and residual benefits.

There are specific provisions containing benefits which are also exempt or subject to concessional treatment. These include benefits associated with superannuation fund contributions, employee share acquisition plans, use of staff canteens, and free or discounted use of commuter transport systems.

The Act provides valuation rules for the various individual benefits, the rules varying for the different benefits but adopting the approach of either market value, cost of provision or formula. There is provision in determining the taxable value of the benefit for the deduction of contributions made by or on behalf of the employee. If the employee would have been entitled to a deduction from assessable income in respect of the benefit had the employee provided the benefit for himself, the taxable value of the benefit is reduced by the amount of the notional deduction. In these circumstances employees are required to provide a written declaration to their employers concerning the notional deductibility (a provision which appears to have imposed considerable costs on employers).

The fringe benefits tax is payable by the employer and liability is assessed by applying the company tax rate of 49%. The FBT payment is not allowed as a deductible expense to the company, and the tax is payable whether or not profits are made and whether or not the employer is a tax exempt body (with certain exceptions).

Tax liability is assessed on an annual basis, with employers self-assessing their liability for FBT. The tax is payable in four quarterly instalments over a tax year ending 31 March.

4. The Case for Taxation of Fringe Benefits

The basis for the taxation of fringe benefits lies in the Haig-Simons comprehensive income base (Haig 1921; Simons 1938). Haig (1921, p. 7) defined income as "the increase or accretion in one's power to satisfy his wants in a given period in so far as that power consists of (a) money itself, or (b) anything susceptible of valuation in terms of money". In other words, "Income is the money value of the net accretion to one's economic power between two points in time".

This concept of income is based upon the "accretion" principle—the accretion in the taxpayer's command over economic resources. In principle, any current receipt, in cash or in kind, net of the costs incurred in generating that receipt is an accretion to economic power and so should be included in the income tax base and taxed at the appropriate rate.

As an example of this principle, if the value of the taxpayer's consumption over a particular period was \$20,000 and the value of assets increased over the same period of time by \$25,000 the taxpayer's income must have been \$45,000. The concept of comprehensive income indicates which receipts in cash or in kind should be included in the income base. Such receipts include wages, salaries, capital gains, non-pecuniary income (such as the services of a housewife, the imputed rent of owner-occupied dwelling and the value of leisure), bequests, gambling winnings and *fringe benefits*. They do not include the proceeds from the sale of assets since this would merely involve the exchange of one form of asset (the physical asset) for another (money). If the receipts from the asset sale were spent on consumption, the increase in the value of consumption would be exactly matched by the decline in the value of assets.

The desirability of a comprehensive income base is fundamentally grounded in issues of equity in the distribution of the tax burden and efficiency in the allocation of productive resources.

(a) Equity

We shall take *horizontal equity* to imply that persons in the same economic situation should be equally treated by the tax system and vertical equity to imply that persons in different economic situations should be differently treated with those more favourably placed being required to pay more tax. The exclusion from the income tax base of certain types of Haig-Simons comprehensive

income has favourable implications for both horizontal and vertical equity, since the proportions of total income received in untaxed forms will vary between individuals and between income classes, as will abilities to determine the form in which income is received. Unless the non-taxation of fringe benefits is a deliberate policy by the legislature, it will almost certainly lead to a pattern of tax incidence different from that originally by the legislature. In practice, the effect of widespread exploitation of the non-taxation of fringe benefits may well be to shift tax burdens down the income scale, although the tax incidence issues here are more complex than they appear at first sight. Furthermore, there is no reason to suspect that opportunities to take income in fringe benefits form, or to benefit in other ways from the non-taxation of fringe benefits, are equally distributed among taxpayers with equal incomes.

(b) Efficiency

The preferential tax treatment of some types of income as defined by Haig-Simons will, inevitably, involve reallocation of productive resources in such a way that income receipts are biased towards the favoured form. For example, *Income Tax Assessment Act* s. 10BA concessions to the film industry have diverted resources towards the industry, an effect which was in this case generally intended. The absence of an effective capital gains tax resulted in much higher levels of investment in housing stock than would otherwise have been the case. The allowance for tax purposes of entertainment expenses would imply much higher levels of such expenditure, since the effective (net of tax) cost of entertainment would be below its true resource cost, the difference being borne by the taxpayer. The non-taxation of the private use of employers' cars has almost certainly led to the purchase of more expensive vehicles since the private car has been subsidized by the taxpayer, with the employer being able to determine the extent of subsidy from the public purse through the ability to determine the outlay on the vehicle.

To the extent that non-taxation of fringe benefits permits reduction of employers' total labour costs it will represent discrimination in favour of employment of labour. Further, some types of skills will be more heavily subsidized than others because the extent of the subsidy will be arbitrarily determined by the extent to which employers are able and willing to exploit the use of fringe benefits.

A narrow income base distorts relative rates of return since the tax concessions produce artificially high after-tax rates of return in some areas. Thus the allocation of productive resources is distorted, and productivity will decline since resources will shift from areas of high gross rates of return to areas of relatively low gross but relatively high net rates of return. At the same time, a deadweight loss is being experienced because the value of the subsidized fringe benefit to the recipient will usually be less than the resource costs to the community of producing that benefit. All other things being equal, the recipient should prefer a benefit in cash to a benefit in kind *provided at the same cost* because the recipient has the discretion to spend the cash in accordance with his or her own preference patterns.

The comprehensive income base provides the theoretical justification for fringe benefits taxation but there is, of course, no guarantee that the base of an FBT *as implemented* necessarily conforms to the theoretical ideal. This has been one of the objections which the rural sector has put forward to FBT.

In relation to taxes on business generally, the argument is often put that the level of taxation is too high and that the absence of taxes such as those on fringe benefits or capital gains is desirable on allocative grounds because of the resulting lower level of business taxation. If the desirability of lower levels of business taxation is, for the purposes of argument, accepted it can still be shown that *partial* and *discriminatory* tax concessions are inferior to the application of lower rates to a more comprehensive income base. This is an argument about the inefficiency of "taxation expenditures".

Taxation expenditures are defined by the Draft White Paper (1985, p. xiii) as "reliefs of concessions in the tax systems (not being a basic component of the taxation structure) which reduce tax liability and have an effect on the Government's budget similar to direct expenditure". Examples of such tax expenditures are tax concessions for superannuation and for the film industry. In terms of efficiency, the use of tax expenditures is inferior to direct expenditures or to equal tax rate reductions.

Although FBT is clearly turning out to be an important revenue-raiser, the case for FBT does not rest solely on revenue-raising considerations. Advocacy of the taxation of fringe benefits is not inconsistent with support for lower levels of business taxation and support for lower levels of business taxation provides a weak case for the

non-taxation of fringe benefits. Similarly, the suggestion that a broad-based consumption tax could be used as an alternative source for the revenue yield of the FBT misses the point that the FBT's rationale is not simply revenue-raising.

5. The Incidence of FBT

The issue of who bears the FBT is a complicated one and remains largely unresolved. Most of the public discussion on this issue has been unduly simplistic. The application of the economist's standard tax incidence analysis can at least indicate some areas in which conclusions can be drawn.

Tax incidence models, at their current state of development, cannot cope with tax changes which produce a widespread reallocation of productive resources. For example, if an FBT significantly changed the patterns of demand for labour, for intermediate products and for goods and services for final consumption, it would be virtually impossible to quantify those changes and to identify their effects upon the distribution of after-tax income. Tax incidence analysis therefore tends, implicitly or explicitly, to assume that the tax change has produced only limited effects on resource allocation.

In any discussion of tax incidence it is important to observe the distinction between the legal incidence and the effective incidence of a tax. *Legal incidence* relates to the legal obligation to pay tax to the revenue authorities. For example, the legal incidence of the wholesale sales tax is on the wholesaler, who pays tax to the Australian Taxation Office. The *effective* (or *economic*) *incidence* of a tax describes who ultimately bears the tax after all the shifting behaviour has been worked through. Legal incidence of a tax may be on individuals or on companies, but effective incidence will always be on individuals.

As an example of the distinction between legal and effective incidence take the payroll tax, whose legal incidence in Australia is upon the employer of labour. The tax may be backward shifted on to labour (by paying wages or salaries lower than would have been the case in the absence of the tax), forward shifted to purchasers of the firm's output (by charging output prices higher than those without the tax) or not shifted at all (reducing profits, share values and, probably, dividends). The final incidence outcome, which would probably be some combination of all three, would depend upon demand and supply conditions in the factor and product markets. For example, if the labour, to whose wage and salary

costs the payroll is applied, is in excess supply and if money wages are flexible downwards as well as upwards, a high proportion of the payroll tax may well be borne by labour in the form of lower wages and salaries. (In practice it may well be the case that *money* wages cannot be adjusted downwards but that over time *real* wages can be reduced as prices rise. Thus the tax shifting behaviour may take some time to work through). At the other extreme, an employer faced with a tight labour market but with a product market which will readily absorb higher prices is likely to shift a high proportion of the tax forward onto the purchasers of the firm's output. If a firm is faced with an uncompetitive labour market but a highly competitive product market, a high proportion of the tax is likely to remain unshifted, thus being borne by the owners of the firm.

In the long term, when the tax shifting has had time to work through, the effective incidence of a tax is largely independent of its legal incidence.

This is illustrated in Table 1 which deals with an example of a stamp duty of five per cent on the transfer of ownership of real estate. The table shows the effect of shifting the legal incidence of the stamp duty from seller to buyer in two circumstances.

First, the seller is willing to accept \$100 000 after stamp duties have been paid and the buyer is a price taker (that is, is in strong competition with other potential buyers and so has to accept the going market price).

Second, the buyer is willing to pay \$100 000 including stamp duties and the seller is a price taker (that is, in strong competition with other potential sellers).

There has been considerable discussion as to who should bear the compliance costs of the FBT. From an incidence viewpoint these compliance costs are likely to be borne by the same people who bear the tax itself. For example, if the solicitor's costs relating to payment of stamp duty were, say, \$100, those costs would effectively be borne by the price taker (as opposed to the price

Table 1: Legal and Effective Incidence of a Tax

	Seller Willing to Accept \$100 000 net of taxes		Buyer Willing to Pay \$100 000 inclusive of taxes	
Legal Incidence on	Market Price \$	Tax \$	Market Price \$	Tax \$
Seller	105 263	5 263	100 000	5 000
Buyer	100 000	5 000	95 238	4 762

maker). If a tax can be fully shifted, the compliance costs of that tax can also be fully shifted.

Much of the discussion of the FBT has implied that the fringe benefits themselves accrue to the employee but that the FBT incidence (together with the compliance costs of FBT) falls on the employer. It is seen to be inconsistent and inequitable that employers pay the FBT but employees receive the fringe benefits. It is, however, by no means clear that the beneficiaries of the non-taxation of fringe benefits are in all cases the employees. The distinction between the *recipient* of a fringe benefit and its *beneficiary* is an important one.

If we assume a competitive circumstance such that the employee is able to set his own after-tax income but is indifferent to the proportion of that income which is received in terms of fringe benefits, the employee receives no advantage from the exploitation of fringe benefits. The employer, on the other hand, can reduce total labour costs with the cost savings being directly related to the level of exploitation of fringe benefits. The cost savings to the employer in these circumstances exactly match the loss to revenue (a reduction in personal tax revenue less than fully matched by an increase in corporate tax revenue).

On the other hand, if the employee is the price taker (the employer determines gross remuneration costs but gives the employee the choice as to the proportion of that remuneration which is taken in fringe benefits), the employee is both the recipient and the beneficiary of the fringe benefits. The employee's gain exactly matches the loss to personal income tax revenue.

In summary, where one party is dominant, in the sense of being a price maker, that party will be unaffected by the extent to which the employee's income is taken in cash or in kind. It is the subservient party, the price taker, who gains from the exploitation of fringe benefits and the greater the exploitation of fringe benefits the greater the gain. In less extreme competitive circumstances, in which neither employer nor employee is totally dominant, the gains will be shared between them. In all competitive circumstances those gains are financed by reductions in tax revenue. Exploitation of untaxed fringe benefit yields private benefits closely related to the resulting revenue loss. Taxation of fringe benefits can, then, be viewed as supporting the integrity of both the personal tax and corporate tax systems.

In one sense the above analysis overstates the advantages to employer or employee of the

exploitation of the non-taxed status of fringe benefits. In practice, it is likely that the value to the employee of a fringe benefit will be less than that of its cash equivalent. Income tied to a particular form of expenditure can be expected to have a lower real value to the recipient than would untied income provided at the same cost. This divergence in values would reduce, but would be unlikely to eliminate, the gains to employers and/or employees from the use of fringe benefits. On the other hand, the greater the divergence between values the greater the degree of resulting inefficiency.

What then, is likely to be the incidence of the FBT? Unfortunately, as is the case with so many taxes, this is not an easy question to answer. Competitive conditions vary from factor market to factor market and from product market to product market, and insufficient information is available about demand and supply elasticities in product and factor markets. Insufficient information exists as to the current levels of exploitation of fringe benefits in individual markets. In addition, such analysis should be on a revenue-neutral basis which implies knowledge of the revenue from which taxes the FBT revenue is to replace.

Three tax shifting possibilities exist for an FBT whose legal incidence is on the employer:

- (a) backward shifting onto the employee;
- (b) forward shifting onto the purchasers of the firm's output; and
- (c) zero shifting.

Clearly some combination of these three is likely to be the overall outcome. The FBT is similar in effect to a form of payroll tax, although not levied as a fixed proportion of wages and salaries.

Each of the above possibilities will now be considered in more detail.

(a) Backward shifting

The simplest way for an employer to achieve backward shifting is to cash out the benefit—that is to provide the employee with the cash equivalent of the benefit in kind. The employee then becomes subject to the *Income Tax Assessment Act's* new substantiation requirements and the employer is subject to no obligations to the employee or the Australian Taxation Office other than to record the cash allowance on the employee's group certificate and possibly to implement a higher rate of PAYE deduction. Both tax and compliance costs have been fully shifted to the employee. If the employer

is unable or unwilling to cash out the benefits this will in some circumstances be a clear indication that the employer is in effect a beneficiary, to some extent at least, from the non-taxation of fringe benefits. This is not necessarily the case where fringe benefits are embodied in arbitrated awards, for example in *Rural Workers' Accommodation Acts*. In these circumstances, cashing-out of benefits will not be an option available to the employer. Rural employers are more likely than most to be subject to this type of constraint.

There is insufficient information available to indicate the incidence of a backward shifted FBT. For example, Australian Bureau of Statistics data indicate the type of employment benefits enjoyed by the Australian work force *but not their value*. As an illustration, Table 2 presents data from the only tabulation by the ABS of employment benefits classified by the earnings of the recipient (*from the main job only*).

Other data (see, for example, the Draft White Paper 1985, and Jamrozik et al 1981) are equally unsatisfactory. The above table provides some fairly slender evidence that the absence of an FBT would cut away at the progressivity of the personal tax system, *to the extent that the tax is backward shifted*. This conclusion is certainly intuitively plausible. One would have a strong, although quantitatively unsubstantiated, suspicion that availability of fringe benefits rises as income rises. There is little doubt that the *incentive* to exploit fringe benefits rises as the marginal tax rate rises. Increased incentive plus increased opportunity represents a powerful combination. It seems, therefore, reasonable to conclude that in relation to the backward shifted component of the FBT the incidence is likely to be relatively progressive. The usual argument that the non-taxation of fringe benefits reduces the

progressivity of personal income tax implicitly assumes that the recipient is the sole beneficiary.

(b) Forward shifting

The output whose price has been increased by the forward shifted component of the tax may be an intermediate good or service (*i.e.*, an input into the production process of other goods or services), or it may be a good or service for final consumption. In general it can be stated that the incidence of the forward shifted component of the FBT is likely to be similar to that of a sales tax. As both Bentley, Collins and Drane (1974) and Warren (1979, 1988) have shown, the incidence of sales tax in Australia is regressive. Thus the incidence of the forward shifted FBT is likely to hit the poor relatively hard.

(c) Unshifted

The unshifted component of the FBT would have the effect of reducing profits and so incomes to shareholders. The impact of this component of FBT is likely to be progressive.

The overall incidence of FBT depends, therefore, on the shifting behaviour adopted in response to the tax. Unsatisfactory as this incidence analysis is, it furnishes some important conclusions: the recipient of a fringe benefit is not necessarily its beneficiary; the effective incidence of a tax (and of the compliance costs of the tax) is, in the longer term, basically independent of its legal incidence; and incidence analysis of FBT should relate to the total FBT revenue, not simply the backward shifted component of the tax.

It would be difficult to draw specific conclusions on the incidence of the FBT in its Australian form from analyses of the incidence of payroll taxes in other countries (see, for example, Brittain 1972; Hamermesh 1979; and Musgrave and Musgrave 1980). There are two major reasons for this:

- the partial base of FBT in Australia. Varying degrees of exploitation of fringe benefits in different industries in Australia mean that there has been some (presumably unintended) determination by employers of the size of the FBT base. Cashing-out of benefits will reduce the FBT base but not the overall base for the taxation of fringe benefits.
- different rate scales in different countries. For example the United States Old Age, Survivors, Disability, Health Insurance (OASDHI) applies a flat rate tax to earnings up to a ceiling while the FBT has no ceiling.

Nevertheless, the general conclusion seems to

Table 2: All Employees Classified by Weekly Earnings in Main Job and Number of Benefits Received, August 1986

Earnings (Main Job) \$ per week	Total Employees '000	Receiving One or More Benefits %
0-119	538.5	35.8
120-199	595.2	77.5
200-279	944.0	90.1
280-359	1 323.3	95.7
360-439	882.0	96.8
440-519	562.3	96.8
520-599	353.4	96.8
600+	484.1	97.4
Total	5 683.4	87.7

Source: Australian Bureau of Statistics (1986(b), Table 3).

be that the burden of payroll tax is shared between employer and employee. For example Hamermesh (1979) suggests that, at most, only one-third of a flat rate OASDHI payroll tax increase is shifted by employees into labour.

It is interesting that, while employers in Australia have strongly argued that FBT should be levied on employees, business interests appear resigned to bearing the legal liability of State payroll taxes. I am not aware of any moves to require employees to pay the payroll tax, as they do in some other countries. Perhaps this is because the analogy between FBT and the payroll tax has not been perceived or perhaps it indicated that employer opposition to this aspect of FBT is quickly evaporating.

6. Is the FBT Base Comprehensive?

Lack of comprehensiveness of the base can arise from outright exclusion of some benefits from the tax base or from partial exclusion arising from undervaluation of benefits.

Implications of a fully comprehensive FBT base, to which is applied a rate consistent with tax rates elsewhere in the system, would be that:

- (a) tax revenues would be unaffected by the wages and salaries/fringe benefits proportions of total remuneration;
- (b) the tax system would not bias the decision concerning the proportion of total remuneration to be taken in fringe benefits; and
- (c) the tax system would not discriminate between the private and public sectors.

It is most unlikely that any FBT legislation could be drafted which would fully satisfy these three criteria and, even if it were possible, administrative and compliance criteria would dictate a more simple tax structure. A major problem that arises in this context is the valuation of fringe benefits. Section 26 (e) of the *Income Tax Assessment Act* acknowledged this issue by referring to the inclusion in the taxpayer's income of "the value to the taxpayer" of all allowances, gratuities, compensations, etc. As the Taxation Review Committee (1975, p. 118) says:

The intention in the use of these words is clearly to displace the general principle of the income tax law that a benefit must be valued by reference to the amount of money that could be obtained for it . . . But the precise method of valuation required by the words "value to the taxpayer" is unsettled. In the Committee's view the meaning to be given to the words should be what it would cost the employee to provide the taxable benefits for himself.

This approach would, however, create problems, as the Committee itself acknowledged.

The pattern of expenditure undertaken in a regime of tax-free fringe benefits will most likely be different from the expenditure pattern in a neutral tax system. As indicated earlier, the value to the taxpayer of fringe benefits in kind is usually likely to be less than the cost of providing those fringe benefits. There will, however, be problems in the use of arbitrarily determined valuation formulae to produce valuations appropriately discounted below the costs of provision. These valuations, while being appropriate on average, will be inappropriate for the vast majority of individual taxpayers (with individual valuations being too high or too low). The valuation of fringe benefits in kind by reference to their actual costs of provision (rather than their value to the taxpayer) would have the great benefit that a substantial incentive would exist to pay these benefits in cash. Costs of the provision of these benefits would be unchanged but the distortions induced by the use of fringe benefits in kind would be reduced. There will, however, be valuation difficulties if benefits as defined in the Act are, in fact, closely work related (for example, accommodation for rural employees). In these cases the value to the recipient is likely to be very substantially less than the market value.

To return to the question of the comprehensiveness of the base, there are clearly some important components of the ABS definition of employment benefits which are not included in the FBT base. The major ones are superannuation, sick leave, annual leave, long service leave, and study leave.

There is clearly already a move towards a greater superannuation component in employment "packages" and it can be expected that more generous leave provisions will also be incorporated in these packages since leave provisions do not attract liability to FBT.

Similarly the valuation procedures to be applied to the employee's private use of the employer's car still provide incentives for the provision of the car rather than the car allowance (particularly since the simplification of substantiation procedures announced by the Treasurer on 29 October 1986). Perhaps more than any other area, it is the administrative problems of the valuation of the private use of employers' cars which have provoked public opposition to the FBT. Why then are so many companies persisting in providing company cars rather than car allowances? The answer clearly is that, even after the administrative costs of the tax and the tax itself are taken into account, there still

remain cost benefits in the provision of this particular benefit in kind. It seems probable that the form of the FBT may even ultimately increase the incentive for the provision of company-owned vehicles for private use, because the generous nature of the formulae has made this one of the few tax attractive benefits available for employers to offer. The provision of employee discounts is another area in which the FBT is likely to be non-neutral in impact because of the comparatively generous tax treatment of this type of benefit.

The FBT certainly represents a move towards a more comprehensive income base but it is still a long way from the achievement of that goal. The new FBT provisions are clearly non-neutral in their effects on the structure of employment remuneration packages and total tax revenue is not independent of the structure of remuneration packages (see, for example, Holmsley 1986).

The tax-exempt status of certain private bodies creates non-neutrality problems with the FBT. For example, the denial of deductibility for FBT does not affect tax-exempt bodies who in any case are not subject to company tax. There is no way in which a fringe benefits tax can be designed which is neutral between tax-paying and tax-exempt bodies unless the effective incidence of the tax is fully on the employee (so that employers' cost positions are in no way affected by the tax).

7. The Revenue from FBT

The increase in total revenue resulting from the introduction of FBT comes from three sources:

- (a) The FBT itself, payable by employers at the prevailing company income tax rate on the total taxable value of non-cash fringe benefits provided to employees or associates.
- (b) A larger personal income tax base as a result of cashing-out of some fringe benefits in kind together with the substantiation provisions requiring employees to be able to substantiate the quantum and purpose of the claimed expenditure by receipts and other documentary evidence. Where recipients of cash allowances are not able fully to substantiate the expenditure from cash allowances, the balance of those allowances is taxed at personal tax rates. The FBT is, therefore, substantially increasing personal income tax revenue.
- (c) Disallowance of entertainment expenses. While this denial represents an increase in company taxation where business entertainment expenses were genuine, the measure

was adopted as a result of the apparent impracticability of distinguishing between the genuine and non-genuine components of entertainment expense claims together with the suspicion that a high proportion of claims related to expenses of a private or social, rather than business, nature. The denial of entertainment expenses is clearly one aspect of the policy to tax fringe benefits.

It is, in practice, likely to be difficult in future years to quantify the second and third components of the revenue increase. It is to be hoped that the Australian Taxation Office will in its future taxation statistics attempt to identify at least the cash allowance component of incomes to permit some estimation of the personal income tax revenue impact of the FBT. Where benefits have been cashed out as wages or salary, rather than as identifiable cash allowances, such estimation will be very difficult.

Table 3 presents official estimates of tax revenue from measures related to the taxation of fringe benefits. FBT revenue forecasts should, however, be treated with considerable caution since it is doubtful whether they take into account in any systematic fashion changes in resource allocation and in the structure of remuneration packages resulting from the imposition of the tax. Allocative changes will result from the changes in relative after-tax prices induced by FBT. It would be difficult to quantify these changes since we do not have econometric models of the Australian economy which are sufficiently refined to permit this type of analysis. The changes in the structure of remuneration packages are arising partly as an intended effect of FBT, but also partly from the facts that FBT does not have a comprehensive base and that its rate is not necessarily consistent with the relevant personal income tax rates (for example, see Martini *et al* 1986).

Four major gaps in the FBT have been identified above—superannuation, leave provisions, motor vehicles and employer discounts—and others will probably emerge as the tax in its final form is more closely scrutinized. The greater is the exploitation of these gaps the lower will be the increase in revenue resulting from FBT.

A striking feature of Table 3 is the extent to which the original FBT revenue forecasts have proved to be underestimates.

It has been suggested that declining productivity and output resulting from the resource costs of administering and complying with FBT could substantially erode revenue but it is, in fact, difficult to believe that the resource

Table 3: Fringe Benefits Tax Revenue Estimates

Measure	Date of Introduction	Keating Statement (1985-86 Prices)		1987-88 Budget (Current Prices)	
		1986-87	1987-88	1986-87 (Actual)	1987-88 (Forecast)
		\$m	\$m	\$m	\$m
Fringe Benefits Tax	1.7.1986	320	515	750 ^a	750 ^a
Living-away-from-home Allowance	1.7.1986	10	15	Not estimated	Not estimated
Substantiation requirements	1.7.1986	—	105	200	200
Entertainment expenses	20.9.1985	310	330	310 ^b	330 ^b

Sources: Budget Statement No. 4, 1987-88, Estimates of Receipts 1987-88, AGPS, Canberra, p. 270.

(a) Excluding expected FBT liabilities of Commonwealth Government on-budget authorities (estimated at \$318m for 1986-87).

(b) Source: Budget Statement No. 4, 1986-87.

costs of FBT could be this high. The usual experience with the introduction of relatively complicated taxes such as VAT and FBT is that the implementation costs, both in administration and compliance, are high but that once the new system is established, understood and assimilated, both administration and compliance costs decline substantially (see, for example, Sandford 1981). The apparently false predictions of major job losses in the entertainment industry resulting from the denial of entertainment expenses suggests caution in the evaluation of such claims (see Anon 1986). This resource argument also ignores the neutrality benefits arising from a properly-designed FBT.

8. Indirect Implications of FBT

A considerable range of indirect effects of FBT have been suggested including higher prices, lower productivity, lower employment, and damage to specific industries. Any such analysis should be made in the context of a revenue-neutral change. Certainly this is the case in the situation of the Australian Federal Government which, as the recent Budget shows, conducts its macro-economic policy in the context of the objective of a deficit of predetermined size. The generation of increased revenue from one source can, in these circumstances, be expected to produce either reduced revenue from other sources or a matching increase in expenditure.

There is a body of opinion opposed to any form of tax reform which provides increased revenue potential, on the grounds that it increases the opportunity for public expenditure funding.

Higher levels of public expenditure are the main fear but another problem, presumably, is the excess burden of higher tax levels. Assertions about the inherently lower level of productivity of public expenditure compared with expenditure in the private sector should be treated with caution. The rates of return on some forms of public expenditure are clearly comparatively high (see, for example, Gruen's (1986) paper suggestion that a major reason for Australia's poor growth performance has been low levels of expenditure on education, and Bureau of Transport Economics (1984) estimates of the rates of return available for expenditure on roads). Similarly, there is no reason to believe that the social rates of return on all investment in the private sector are high. Public expenditure should be evaluated on an individual basis rather than simply condemned without trial.

Tools for the evaluation of the macroeconomic impact of tax changes have not proved particularly adequate for the task, which becomes even more complex when it is not clear whether the increased revenue will finance reduced taxes elsewhere (and, if so, which taxes), increased expenditure (and, if so, of which type), and/or reduction of the deficit.

In one sense the macroeconomic effects of FBT are irrelevant. To forego the use of FBT because of predicted macroeconomic effects would be to change microeconomic policies to achieve macro-economic effects. The taxation (or non-taxation) of fringe benefits would be a highly inefficient tool of macroeconomic policy. As Argy and Hooke (1986) suggest in relation to a change in the tax mix, it should be perfectly

possible to design a macro package to compensate for the macro impacts of FBT (insofar as they can be identified).

A similar defence can be claimed against suggestions that FBT will damage specific industries, the major one being the motor vehicle industry. If the objective of the non-taxation of motor vehicle fringe benefits is to protect the motor vehicle industry, then it is a very inefficient way of doing so. Industries Assistance Commission studies of the motor vehicle industry have not suggested this as a significant form of protection for the industry (see, for example, Industries Assistance Commission 1981). If the intention were to provide extra protection for the industry, this could be achieved much more cheaply and efficiently by direct subsidy. Tax expenditures of this type increase the real size of the public sector, and in a most inefficient manner, while reducing its apparent size. Proponents of a reduction in public sector size rarely call for a reduction in tax expenditures.

Fringe benefits taxation may well have an impact upon labour mobility, apart from through its effects on superannuation. Some industries have exploited their superior ability to offer fringe benefits in order to increase labour mobility into the industry and reduce labour mobility out of the industry. In other words, superior ability to exploit fringe benefits in a labour market situation in which those employers are not totally dominant has introduced an element of non-neutrality into the allocation of labour. The exploitation by financial institutions of low interest loans is probably the best example of this phenomenon. There may well also be cases in which exploitation of fringe benefits has been used to shore up uncompetitive market situations.

It has been suggested that the FBT should be opposed on the grounds that it is likely to lead to

an increase in prices. However, the taxation of fringe benefits is a most blunt and ineffective anti-inflationary weapon. If reduced inflation were the objective, a markedly more effective policy would be to use FBT revenue to finance reduction in the rates of sales tax or excise tax.

9. The FBT Rate

One requirement of neutrality in the treatment of fringe benefits is that tax revenue should be independent of the wages and salary/fringe benefits proportion of total remuneration. This clearly implies that the rate of tax applied to fringe benefits should be the same as the rate applied to wages and salaries and represents a genuine argument for taxing of fringe benefits in the hands of the employee, where the tax rate on fringe benefits (correctly valued) would automatically be the same as on cash incomes.

The FBT is payable by employees on the total taxable value of non-cash fringe benefits provided to employees or associates. The tax rate is the company tax rate which matches the top personal tax rate, although the value of fringe benefits is not subject to the Medicare levy. The FBT payment is not allowed as a deductible expense to the company and the tax is payable whether or not profits are made.

Table 4 illustrates the case for non-deductibility of FBT. It presents the comparative costs to an employer and to revenue of \$20,000 being paid to the employee (whose marginal tax rate is 49%, the same as the company tax rate) in salary or in fringe benefits. The Medicare levy is excluded.

In the circumstances represented by Table 4, the tax system applies the same tax rate to wages and salaries and to fringe benefits as long as the FBT is not deductible. If the employee's marginal tax rate is below the prevailing company tax rate

Table 4: Revenue Neutrality of FBT

	\$20,000 increase in salary	\$20,000 increase in fringe benefits (FBT not deductible)	\$20,000 increase in fringe benefits (FBT deductible)
	\$	\$	\$
Gross Salary	20 000	—	—
Tax	9 800	—	—
Net Salary	10 200	—	—
Fringe benefits	—	20 000	20 000
FBT (gross)	—	9 800	9 800
FBT (net)	—	9 800	4 998
Total tax payment	9 800	9 800	4 998
Tax rate	49%	49%	24.99%

the system will discriminate against the use of fringe benefits. If the marginal personal tax rate is above the company tax rate (which it will still be for the top ratepayers when the Medicare levy is included) the discrimination will be in the reverse direction.

10. Should the Employer Pay the FBT?

As it is irrelevant, from the point of view of effective incidence, whether the tax is paid by employer or employee, the question of who should pay the tax should be determined on other considerations. Since, as argued earlier, the effective incidence of the compliance costs is the same as the effective incidence of the tax itself, the division of the legal incidence of compliance costs between employer and employee is irrelevant. It is only overall level of compliance costs which is a significant issue.

There are, then, three major issues to be considered in this context:

- (a) The achievement of an FBT rate consistent with the rate paid on the other income of the fringe beneficiaries,
- (b) The minimization of total compliance costs, and
- (c) The minimization of total administration costs.

In regard to (a), problems of consistency arise because of differences between personal and company tax rates, whoever pays the tax (and particularly where "wrong" valuation procedures are adopted).

In relation to (b), assertions that total compliance costs would be much lower if the employee paid the tax appear to be overstated. It appears that some type of PAYE system of FBT would need to be implemented to avert major evasion problems and this FBT PAYE system would involve employers in substantial compliance costs. Employers would be required to value the benefits and, if there were not to be substantial over-deductions of tax, make some judgment about allowable deductions. Even greater enforcement of the previous system would involve the same costs, contrary to the general belief that this enforcement would not adversely affect employers. Any system of taxation of fringe benefits will involve valuation problems, and so administrative and compliance costs. It has been argued that the current system requires record-keeping on the part of employees but provides no incentive for them to do so since it is the employer who apparently gets the benefit

of the records. This would not be the case if the employee paid the tax. On the other hand, the cashing-out of benefits would reduce compliance costs by minimizing valuation problems. The incentive for employers to cash-out the benefits would only exist if employers pay the tax.

One incidental, but marginal, benefit to employers of paying the tax (rather than the tax being paid by employees) is a liquidity benefit arising from the fact that PAYE tax is payable fortnightly whereas FBT is payable quarterly.

In relation to (c), it is difficult to perceive significant change in administration costs whether the tax is payable by employer or employee. Basically the same problems of valuation of benefits and of scrutiny of claims for allowable deductions would exist.

11. Other Administration and Compliance Aspects of the FBT

The major attack being mounted upon FBT is aimed at administrative and compliance aspects of the tax, particularly the costs involved and difficulties with the interpretation of the legislation in relation to anomalies and unintended consequences. There now seems little opposition to the principle of FBT—the broadening of the income tax—but it is still being strongly asserted that the taxation of the benefit should be in the hands of the recipient. In a letter to the Prime Minister, reported in the *Australian Financial Review* of 14/10/1986, Mr Ian McLachlan, President of the National Farmers' Federation said, "We are not opposed to the taxing of beneficiaries but we will never agree to a tax which becomes the responsibility of someone who is not the recipient of the benefit".

A trade-off almost always exists between the theoretical correctness of a tax and its administrative complexity. Theoretical purity should not be pursued at all costs. The adoption of industry wide averages for the private use motor vehicle benefits, for example, would not severely compromise the tax although it clearly would have a revenue cost. There will, however, always be anomalies and redrawing the boundary between liability and non-liability for the tax will, in removing some anomalies, create others. This is certainly not to deny the existence of the many "unintended consequences" of which so much political capital has been made.

A major factor in the reduction of total compliance costs would be the encouragement of cashing-out of the benefits. This process would

certainly be assisted by the application of valuation procedures such that both employers and employees are indifferent to the form (cash or kind) in which the benefit is conferred. In this context, there has been virtually no opposition to the substantiation provisions which are a crucial component of this policy.

The political difficulties of taxing the value of fringe benefits in kind in the hands of the recipient can be great as was shown with the attempt in 1980 to tax subsidized housing for coal miners. Since theory gives little indication as to where the *legal* incidence of the tax should lie, the question of who should be taxed (employer or employee) is a pragmatic one. The taxation of fringe benefits in the hands of the recipient has not been, and is not likely to be, successful. Calling for taxing in the hands of the recipient is, in my view, effectively calling for the non-implementation of the FBT, even though in many cases this is not the motive for seeking a change in legal incidence. I find it difficult to believe that any government in the near future will abandon FBT but I would expect that a conservative government would attempt to shift the legal incidence of the tax from employer to employee. In these circumstances, the practicality of taxing fringe benefits in the hands of the employee would be tested.

12. FBT and the Farm Sector

In the light of the above discussions of theoretical and practical issues involved in the taxation of fringe benefits we now proceed to examine the objections of the farm sector to FBT (as formulated by the National Farmers' Federation (NFF) in its May 1986 document *An Assessment of the Proposed Fringe Benefits Tax*).

(a) Existing provisions not adequately enforced

The National Farmers' Federation argue that "inability to tax fringe benefits under the current [*i.e.* pre-1986] arrangements is not an adequate justification for the proposed FBT because there has been insufficient attention to enforcing existing provisions". It is, however, extremely doubtful whether the existing provisions were in fact enforceable. What has dramatically increased the enforceability of the new FBT has been the shift of liability from employee to employer. The farm sector has been one of the most vocal in opposing this shift on grounds which can now be seen to be somewhat shaky.

The argument that the *beneficiaries* of the fringe benefit should bear the tax is seen to be irrelevant once the distinction between legal and effective incidence is comprehended, on the grounds that (i) the beneficiary is not necessarily the employee; and (ii) the effective incidence is independent of the legal incidence.

Employers, including those in the rural sector, have argued that the new arrangements place a greater administrative burden on employers than would enforcement of the pre-1986 provisions which required the employee to provide the information in his tax return. However, the taxable fringe benefits would still have been subject to valuation problems and employers would have had very substantial responsibilities in the provision of such information.

(b) FBT payments not tax-deductible and not related to profitability

FBT, unlike payroll tax, is not a tax-deductible cost of employment. Like payroll tax, it is payable whatever the level of profitability of the company. The NFF has argued that both these characteristics imply discrimination against the employment of labour.

In fact they represent discrimination against the use of labour whose remuneration has been biased towards the use of fringe benefits, and therefore in favour of labour employment where such a bias has not existed. The labour playing field has been levelled. It is notable that opponents of payroll tax (of which FBT is one form) rarely oppose tax concessions for depreciation on the grounds that, in discriminating in favour of the use of capital, they discriminate against employment. It is not possible in a revenue-neutral context simultaneously to discriminate in favour of both labour and capital.

(c) Taxability of benefits enjoyed by officers of private companies

The definition of "employee" for the purposes of FBT includes officers of private companies. Thus the owner-operators of private companies are liable for tax "on the use of their own property".

As the NFF points out

In the case of a farm operated in a company structure, the owners may be subject to tax for living in their own home; eating milk, meat or vegetables they grow; generating their own electricity; or taking their own money out of the company. this is a nonsense which cannot be accepted.

It is difficult indeed to see why this is a

nonsense. Payment in kind should be taxed consistently with payment in cash if a tax system is to be both efficient and equitable. There is, however, a certain consistency in the NFF's stance in that it appears to be arguing that rural cash payments should not be taxable either.

(d) Valuation of fringe benefits

Under the pre-1986 provisions fringe benefits were notionally assessed at their value to the employee. Under the new arrangements various valuation techniques exist, including the cost to the employer of the provisions or the market value of the benefit. The NFF argues, apparently correctly, that this may result in the significant over-valuation of benefits to rural employees where provision of these benefits is a *necessary* component of employment provisions and where market valuations are irrelevant since the employee has no effective choice as to whether to take the benefit. An obvious example is the provision of accommodation to employees on remote properties. Employers may be required by law to provide such accommodation (so that there is no opportunity to cash-out the benefits) and employees may have no choice but to take such accommodation. Valuation of such accommodation at market rates will almost inevitably involve excess FBT payments based on excessive valuation of benefits. There do appear to be clear inequities in the operation of these provisions of the FBT legislation and the discrimination is probably being borne relatively heavily by the farming community.

13. Conclusion

Currently, great attention is being paid, as a result of our balance of payments difficulties, to the achievement of more rational resource allocation policies and, in particular, to the promotion of a more efficient, comparative advantage manufacturing sector. Policies to achieve an improvement in the balance of payments on current account are essentially long term in nature. A crucial component of such a policy is a more efficient (that is, more neutral) tax system. Increasing the comprehensiveness of the income tax base can be seen as a policy consistent with that of deregulation in the sense that it removes policy constraints to competition so that resources can be used where their rate of return is the highest.

The rural sector as a whole has much to gain from implementation of a level playing field

approach to taxation, in which resources are allocated according to real rates of return rather than after-tax rates of return distorted by tax breaks or tax penalties. Farming has suffered, and continues to suffer, from public policy discrimination in favour of manufacturing industry, particularly as a result of high levels of protection. It has much to gain from the implementation of more rational resource allocation policies, including tax policies. FBT is a necessary component of such policies. It is heartening to see that the National Farmers' Federation is rapidly moving towards a full realization of this important reality.

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