

5.2 Competitive neutrality

The Commission has provided:

Comments are also invited on experiences in relation to the relative treatment of for-profit and not-for-profit providers in competing for government contracts. Do arrangements at the Commonwealth and State/Territory levels provide competitive neutrality? If not, what features result in unequal treatment and how could this be addressed?

In commenting on these issues, it is worthwhile setting out the issue of competitive neutrality in the context it generally is raised in relation to NFPs.

(a) The competitive neutrality issue

Competitive neutrality is an issue that has been raised over the years in relation to NFPs engaging in ‘commercial activities’. From time to time, for profit organisations argue that they are disadvantaged when compared against NFP’s and that the principles of competitive neutrality should apply to NFPs.

Competitive neutrality was originally a concept most relevant to government, and arose as a result of a perceived need to create a level playing field in relation to the participation of government businesses in contestable environments. Governments enjoy a significant number of potential advantages over private sector competitors including exemptions from taxes, cheaper debt financing, absence of any requirement to make a commercial rate of return on assets or equity invested, exemption from some regulatory constraints or costs, and a reduced level of financial reporting. In order to offset these potential advantages, the Commonwealth government introduced a policy on competitive neutrality to:

- (i) ensure that significant government business activities do not enjoy net competitive advantages over their for profit competitors simply by virtue of public ownership;
- (ii) eliminate potential resource allocation distortions arising from the public ownership of significant business activities operating in contestable environments; and
- (iii) to encourage fair and effective competition.

This policy only applies to significant business activities of agencies, and does not apply to non-business, non-profit activities.¹ Similarly, proponents of the competitive neutrality argument only take issue with the profit-based operations of NFPs. However, we suggest that the distinction between profit-based and non-commercial (or perceivably “charitable”) operations is not easily made. For example, it is incorrect to characterise a flight to a regional centre as generating “profit” for the RFDS and a flight to a remote community as resulting in “loss”. This is because each flight is dependent upon RFDS infrastructure and overheads which are funded by both government funding and the public contributions. Any attempt to distinguish the operations of the RFDS in this way would require fundamental organisational

¹ Finance Circular No. 2004/01 and *Australian Government Competitive Neutrality Guidelines for Managers* February 2004 (Financial Management Guidance No.9).

change and undermine our ability to provide emergency services regardless of geographical location.

A separation between commercial and non-commercial activities would also seriously compromise the efficiencies we have developed at a national level in our operations across the country. These are efficiencies that are requirements of our Commonwealth, State and Territory government contracts and have in part been the result of ongoing dialogue with government about the appropriate structure and operations of the RFDS. To change this now would, we submit, be a significant retrograde step and be contrary to principles of good governance and economic policy.

The RFDS submits that NFPs do not enjoy the same potential advantages over for-profit organisations as a government business, and not all NFPs enjoy tax concessions. However, proponents of the argument that principles of competitive neutrality should be applied to NFP organisations, will argue that to ensure competitive neutrality between NFPs and for profits, NFPs should have any concessional taxation treatment removed for their commercial operations. In particular, that income from commercial operations should be subject to income tax and that fringe benefits tax exemptions be removed.

(b) Is there in fact a competitive neutrality issue?

RFDS believes that there is significant and persuasive evidence to show that:

- (i) **that there is no real competitive neutrality issue arising from the more limited tax concessions received by NFPs in relation to their commercial operations; and**
- (ii) **to remove these tax concessions would, based on experiences overseas, result in significantly greater compliance costs for NFPs and no real increase in government revenue, and consequently result in a reduction in funding available to NFPs to apply to the objects of their cause.**

The “competitive neutrality” argument has been scrutinised and dismissed by a number of previous inquiries, as demonstrated below. Accordingly, the RFDS submits that it is unnecessary and of limited benefit to return to this issue.

In the context of the income tax exemption, the 1995 Industry Commission Report *Charitable Organisations in Australia* (“**the 1995 Report**”) clearly stated that the “income tax exemption does not compromise competitive neutrality between organisations.” This conclusion recognised in the *Inquiry into the Definition of Charities and Related Organisations, 2001* (“**the 2001 Report**”). The 1995 Report suggested that the income tax exemption did not compromise competitive neutrality because the payment (or non-payment) of “after-profit” taxes “should not affect the behaviour of an organisation when deciding how to set its prices and how to minimise its costs.”² This is because all organisations make business decisions which aim to maximise profit and minimise costs, regardless of their taxation status.

In addition, the 1995 Report acknowledged that whilst NFPs receive certain advantages (such as cash flow), profit driven organisations also receive advantages (such as easier access to capital). Significantly, the 1995 Report concluded that “the overall situation is unclear” and did not propose any changes³. This suggests that for profit organisations are not disadvantaged, and, we submit, the competitive neutrality argument has no merit. The Inquiry

² 1995 Report at XXXI.

³ 1995 Report at XXXII.

also noted that, since the 1995 Report, other tax concessions available to not-for-profit organisations have been considerably reduced. In particular:

- (iii) the abolition of sales tax and its replacement with the GST (the GST exemption is only available for supplies not provided commercially); and
- (iv) various limitations that have since been imposed on FBT concessions.

There has also been a substantial body of international economic research showing that NFP market participation does not inevitably create an unlevel playing field. Namely that:

- (v) NFPs do not enjoy an unfair advantage over for profit competitors because of tax concessions. An NFP is unlikely to underprice its for profit competitor or accept a lower return on its investments due to any tax concessions; and
- (vi) tax concessions do not distort market competition because all organisations, regardless of their tax status, aim at maximising profits.⁴

Therefore, the RFDS believes there is no real competitive neutrality issue which private organisations claim arises because of the current tax concessions enjoyed by NFPs. Indeed, there is evidence based on the experience of the United Kingdom and the United States (both of which levy income tax on the commercial arm of charitable bodies) that the introduction of income tax on NFPs commercial activities would result in significantly greater compliance costs for NFPs and no real increase in government revenue.⁵ Greater compliance costs and any tax paid will only result in a reduction in funding going to the NFPs relevant cause (and would significantly impact smaller NFPs). This was also acknowledged by the 1995 Report.

If the income tax exemption is to be treated as some form of impediment to competitive neutrality then a company with substantial income tax losses could also be regarded as having some form of advantage.

The RFDS believes that the Australian income tax legislation does already contain some restrictions that could be argued as assisting with providing an equalisation between NFPs and for-profit entities. Division 250 of the *Income Tax Assessment Act 1997* (Cwlth) restricts the depreciation deductions available to for profit financiers and suppliers of depreciable assets where those assets are used by entities that are income tax exempt.

The effect of these provisions is to raise the effective cost of the finance to the NFP with the object of the similar outcome whether the NFP acquired the asset (and did not obtain an income tax deduction) or whether the financier as a for profit enterprise acquired the asset and leased it to the NFP.

Division 250 ensures competitive neutrality in respect of assets acquired and financed where those assets are used by a tax exempt NFP.

In considering the question of competitive neutrality, other issues of a broader nature need to be considered in any comparison between NFPs and other business structures.

(c) Different types of "commercial operations" undertaken by NFPs

It is also worthwhile noting that the term "commercial operations" is one that requires careful definition. The extent and manner in which NFP organisations engage in commercial

⁴ Dalton, Bronwen and Casey, John, Innovation or ill-gotten gains? Interpretations of nonprofit business venturing in Australia, the United Kingdom and the United States, Paper given at the ANZTSR Eighth Biennial Conference, pp24-26.

⁵ Dalton, Bronwen and Casey, John, Innovation or ill-gotten gains? Interpretations of nonprofit business venturing in Australia, the United Kingdom and the United States, Paper given at the ANZTSR Eighth Biennial Conference, pp8-11.

operations vary enormously, and there are perhaps as many variations on the theme as there are not-for-profit organisations.

Governments at both State and Commonwealth levels regularly require arrangements with service providers including the RFDS to enter into contractual arrangements. These are often offered as a tender process in which both an NFP and a traditional business can compete. The services provided under this contract will be consistent with those provided by the NFP as part of its charitable activities. The funds received under these contracts may be likened to a contribution to costs.

This style of commercial operation can be distinguished from the situation where a business providing different services or goods to those that form part of the activities of the NFP is owned by the NFP, and the proceeds / profits that the business generates are used by the NFP to further its objects. It is in relation to this latter type of commercial operations that much of the concern about a lack of competitive neutrality arises.

The RFDS “commercial operations” are the first category, namely on a similar type to those provided to the community at no charge, albeit with support from Government and the public.

To conclude that all NFPs are obtaining an advantage (or even an unfair advantage) over their for-profit competitors is a significant over-simplification, and ignores the vast diversity of the sector. In relation to its operations, the RFDS disagrees that NFP organisations which undertake activities that are similar to their regular charitable activities enjoy an unfair advantage over for-profit organisations in this way, and suggests that imposing tax on commercial operations would only reduce the funding available for charitable activities and increase the reliance of the NFP sector on government funding.

This seems counter to government policy in recent years, of seeking to reduce the extent to which NFP organisations are reliant on government funding, and to have a strong NFP sector that has developed a number of different sources of income.

If there is a concern that there is inappropriate competitive behaviour, or unfair advantage, in some parts of the NFP sector, we suggest that should be addressed by the introduction of greater transparency and accountability in commercial activities, not by the removal of tax concessions. Competition law will also provide a framework for activities undertaken.

There are a range of other reasons for not taxing the commercial activities of NFP organisations, which include that charities are unable to raise equity or debt in capital markets unlike their for-profit competitors. This is partly because NFPs cannot appeal to their shareholders to raise funds. Instead, NFPs can undertake capital works and support longer term commitments by generating surplus funds from grants, donations and net income from commercial activities. Accordingly, commercial activities are an important source of funding for longer-term planning by NFPs and increasing the size and scale of their charitable activities. This was acknowledged in the 2001 Report⁶.

(d) **RFDS’s experience in competing for government contracts**

The RFDS’s experience of the relative treatment of NFPs and for-profit organisations has been very much one of a level playing field. The RFDS operates along very similar lines in terms of governance standards, application of business concepts and principles in conducting its operations to reflect a normal commercial basis used by a for-profit organisation in the search for the most efficient method of operation. For example, the RFDS has established key management structures, formal board governance standards, compiles annual audited

⁶ 1995 Report at XXXI-XXXII.

reports, maintains payroll records no different to any other enterprise and maintains the strict documentation requirements applicable to the medical profession and to the aviation industry.

As outlined above, the Royal Flying Doctor Service provides emergency aeromedical evacuation services and healthcare clinics in rural and remote areas, and inter-hospital air ambulance services, across the country. Our operations are funded in part by:

- (i) Commonwealth funding for rural and remote services;
- (ii) State/Territory funding for air ambulance services; and
- (iii) public fundraising.

Some of the State and Territory services are tendered for commercially, in competition with private operators. The remainder of our services are not provided in competition with private operators, and there is probably no private organisation that could provide the same coverage as the RFDS in the remote areas.

All activities within the broader RFDS organisation are conducted in a business style. A term that has been used to describe participants in the NFP sector is that it should be described as a Not for Loss Sector. That is the NFP organisation sets its budgets and direction each year with the goal that it will finish the year with a surplus of income over expenditure. This surplus is essential if the NFP is to be able to acquire additional assets for use in its activities and to fund the continued expansion and provision of services.

The RFDS's commercial operations are conducted on a commercial basis, and it tenders a commercial price and margin, as it believes that it needs to make a commercial return to properly price the risk of these operations. In New South Wales and Victoria, there is no cross-subsidisation between this and the other parts of the organisation, and the aircraft, pilots and other personnel and infrastructure required are sourced under separate arrangements from the rest of our activities. The RFDS's operations in Queensland have also started to move in this direction, and we suspect this will be the trend for the rest of the organisation in the coming years.

- (e) Do arrangements at the Commonwealth and State/Territory levels provide competitive neutrality?

To respond to this issue, the RFDS believes it is necessary to look at:

- (i) whether there is a competitive neutrality issue arising independently from regulatory (ie tax) concessions;
- (ii) the arrangements around tendering for government contracts; and
- (iii) other regulatory and external government arrangements placed on NFPs.

As discussed above, the regulatory concessions that NFPs enjoy (ie tax concessions) do not themselves create a competitive neutrality issue when NFPs and for-profit organisations compete for government contracts.

In the RFDS's experience, tendering for contracts for the government funded services it provides, the RFDS competes on a level playing field with its for-profit competitors. The RFDS tenders for these services on a commercial basis, as the RFDS believes it needs to make a commercial return on its operations (including properly pricing the risk of its operations). The only real difference between the RFDS and its for-profit competitors is that,

instead of profits being returned to shareholders, they are put towards funding the RFDS's other services, which are provided free of charge to the public (or at a subsidised rate).

In relation to other regulatory and external government arrangements placed on NFPs, the RFDS (as with many NFPs providing government funded services) has a number of regulatory and other requirements which are designed to ensure transparency and accountability in its activities in competing with for profit organisations for government funded services (and therefore promoting competitive neutrality). These include:

- (iv) **government oversight** - the RFDS underwent a government review of its cost structures preceding the latest round of Commonwealth funding, to ensure that there is a detailed understanding of what the Commonwealth is funding and how it dovetails into the State and Territory funding;
- (v) **government funding arrangements** - the RFDS's funding agreement with the Commonwealth contains requirements designed to ensure that Commonwealth funding is not used outside the Commonwealth-funded services, and State and Territory funding agreements contain similar requirements;
- (vi) **contractual obligations** - the RFDS has extensive transparency and accountability obligations in our government contracts. These are designed to demonstrate that the RFDS provide a value-for-money service, consistent with Commonwealth, State and Territory governance legislation and spending policies, administration costs are minimised, and the RFDS's services are run as an efficient national operation, with economies of scale, providing a seamless service across the country;
- (vii) **corporate and business regulation** - many large NFPs are corporations and subject to the Corporations Act and other legislation. In this regard, the RFDS is subject to financial accountability and audit requirements, in addition to more general requirements under occupational health and safety, workplace, environmental and other legislation; and
- (viii) **service specific regulation** - the RFDS is also required to demonstrate that its is meeting rigorous service standards and quality requirements, equivalent to for-profit operations. This is particularly so in the aviation and health sectors, where the RFDS is subject to extensive regulation of pilots, maintenance arrangements and flying operations on the aviation side, and the same is true for its medical operations. None of the RFDS's aircraft operations are run by volunteers, but by professional pilots, doctors and other staff, and therefore there is no advantage to being a not-for-profit organisation in this regard. Other large NFP organisations, particularly in the health sector, are in a similar heavily-regulated position to the RFDS, for example the private hospitals.

In addition, certain state government funding arrangements require the RFDS to demonstrate that no donation funds are applied to the state government contract. The RFDS understands that this requirement may exist as some form of measure to demonstrate competitive neutrality. However, the RFDS questions if this requirement should apply given that for-profit organisations are not required to demonstrate that funds from other business activities have not been applied to the contract. This disadvantages NFPs against comparable for-profit organisations. This disadvantage particularly applies to the RFDS as our main

sources of income are government contributions and public donations (being ordinary donations and bequests).

- (f) If not, what features result in unequal treatment and how could it be addressed

The availability of the income tax exemption and / or the application of funds generated through donations may be perceived as providing the RFDS as an NFP with some form of competitive advantage. However, a company which had tax losses would be in the same position from an income tax point of view, and a company that applied funds or cost savings from other business activities would be no different to the RFDS in applying donation sourced funds.

The risk is that this perception creates a reaction from government that actually creates a commercial disadvantage to the RFDS in favour of the for profit organisation.