The savoury flavour of a tax-deductible meal

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There are some who believe there should be such a thing as a free lunch — as long as someone else pays.

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Deepening recession and tumbling profits have generated cries for assistance or intervention from virtually all segments of the economy. The most audacious of the calls for help must surely be that of the restaurant and entertainment industry, which continues to lobby for reinstatement of tax deductions for the cost of business meals and entertainment. It is a cause they have pursued with vigour since that fateful day of 19 September 1985 when Paul Keating, then Treasurer, announced that the costs of meals and entertainment incurred after that date would not be recognised as deductible business expenses.

Keating's initiative mirrors a global trend to deny or restrict the deductibility of meals and entertainment expenses as part of the base-broadening tax reform programs adopted in many nations during the latter half of the 1980s. While tax policy experts agree the deduction denial makes sense, the entertainment industry has pushed strongly for a partial reversal of the reform, with the crusade showing no signs of abating. Last year's campaign by the National Restaurant and Caterers' Association called for a tax-deductibility limit of $25 per person on 'business' lunches or dinners.

The arguments for???

There are four distinct strands to the arguments raised by those seeking the re-introduction of an entertainment deduction. Three are based on alleged tax policy grounds; the fourth relies on the case for a subsidy or tax expenditure.

The first claim made by supporters of a tax deduction is the direct nexus between the cost of entertainment and the conduct of business — in other words, the claim that the entertainment was just a background for conducting business: 'What we really did was negotiate a contract while we were eating or, [less plausibly,] watching the game'.

Quite clearly this is a difficult claim to sustain. Even if one was willing to buy the assertion that business was conducted, the case for allowing a deduction for the cost of entertainment is, at best, terribly weak. The facilities relevant to the conduct of business are the seats in proximity to each other. But the costs incurred are for the food and wine or the view of the match. The charge for sitting in the stadium when there is no match on or sitting in the restaurant when there is no food being served is minimal, if anything. Thus, even if the claim that the entertainment was the occasion for conducting business were accurate, the things to which the expenses are attributable are irrelevant to the business.

A second, and far easier to sustain tax policy argument made in favour of deductibility is the claim that the outlay is a necessary expense of carrying on a business in a competitive environment: 'Everyone takes clients (or potential clients) out to dinner and to the cricket — if we don't, we'll be at a disadvantage to everyone else'.

There is no doubt that this claim is both sincere and quite possibly true. It also exposes neatly the real problem with entertainment expenses. If all other factors were equal, why would a businessperson decide to transact with the firm that provided her or him with regular entertainment in preference to the one that provided none? The obvious answer is that the entertainment constitutes a benefit to the recipient which she or he considers of value. There is every reason to tax the recipient on the extra benefit that person derives and while no country has devised a practical way of taxing business people on the entertainment benefits they derive, many agree an equally effective surrogate is the deduction denial.

Tax policy critics point out further in support of the deduction denial for entertainment expenses that much 'entertainment' is in reality personal consumption by the host. Often, people in business relationships are also friends and entertainment of a customer or supplier is also entertainment of a mate. It would be perverse in the least if ordinary people were expected to pay for their entertainment out of their own pockets but business people, because they know their friends in a business context as well as a personal one, were able to subsidise their entertainment with help from the public purse by means of tax deductions.

Compounding the personal consumption problem is the fact that, in very many cases, entertainment is a reciprocal affair — one week I take you out to dinner and the next week you take me. This fact highlights the personal consumption nature of much entertainment and the danger of allowing a deduction for a hybrid expense, that is one which is possibly relevant to business and at the same time contains a significant consumption element. Moreover, if the deduction were available, it would be exploited almost exclusively by high income earners for whom a personal entertainment and food consumption subsidy is least justifiable.

A third argument put forward by proponents of the entertainment deduction suggests that whatever the position of self-employed or managerial business people, the situation is different when employees are considered. It is said that the benefit derived by employees is different because they are merely 'performing their duties' as employees when enjoying meals or entertainment. The assertion may be true, but it adds nothing to the case for deductibility. The benefits enjoyed by the employees substitute for consumption that would otherwise be paid for by the employees directly. Admittedly, the theoretical ideal would be to allow the employer a deduction for the expense while taxing the employee on the 'fringe benefit' she or he enjoys, but denying a deduction to the employer is a convenient and efficient alternative solution. The rationale for denying a deduction for what are essentially consumption expenses is strengthened by the fact that the benefit is not available equally to all employees. As Keating commented soon after announcing his reform proposals, why would we allow the toffs to deduct the cost of their lobster and champagne lunch when ordinary employees get no tax subsidy when they brown bag it.

The three 'tax policy' type arguments relied upon by those seeking repeal of the reform measure prohibiting the deduction of entertainment expenses for tax purposes are all feasible, but not terribly persuasive and at the end of the day they have had little impact on the debate.

The 'poor' restaurants

The fourth argument — the subsidy or tax expenditure argument has received a much more sympathetic hearing, at least in the press, and is now the principal plank in the industry's campaign to reverse the reform law.

At the heart of the tax expenditure argument in favour of deductibility is the assertion that the entertainment industry, and particularly restaurants, have been the unintended victims of the tax reform initiative. The change, it is claimed, has combined with the recession to generate severe hardship in the restaurant industry and substantial job losses. Allowing a deduction once again, even if it is limited by the $25 per person limit proposed by the National Restaurant and Caterers' Association, will relieve the hardship and cut the fall in employment.

Arguments of this sort are characterised as 'tax expenditure' arguments by Treasury officials responsible for evaluating proposals for changes to the tax law. The argument, in effect, calls for a subsidy (by way of tax dollars forgone — hence the term 'tax expenditure') to aid a supposedly hurting sector, namely the restaurant sector.

The most surprising thing about the industry's proposals is that they have received the publicity and, in some business circles, support that they have. Viewed from almost any objective perspective, they have little merit. In essence, the industry is calling on the Government to forego some $330 million annually in tax revenue to assist the restaurant sector, or at least that part of it that has been hurt by tax reform. It is a most perverse subsidy they seek. The benefit of the tax reduction will not go directly to the allegedly suffering restaurant industry. Rather it will go to business people who eat tax-deductible meals. The $330 million subsidy will trickle down to the restaurant trade if the people entitled to the tax deduction eat more restaurant meals than they otherwise would because the government is picking up about half the cost of their meals.

Of course there's no guarantee that business people will eat out all that much more if the deduction is reinstated — in these recessionary times they may continue their current eating patterns and simply pocket the 50% refund of the meal costs provided by government.

Is a deduction rational?

Even if the industry's hopes are fulfilled and the reintroduction of a business meal deduction encourages the beneficiaries of the tax subsidy to eat out twice as much or to consume twice as expensive meals, is the tax expenditure a rational policy choice for the Government? The simple fact is, the reform measure preventing taxpayers from deducting the cost of business meals has not hurt the restaurant and entertainment sector as a whole. Employment in the cafes and restaurant industry grew steadily during the 1980s and the tax change in the middle of the decade did nothing to slow that growth — in fact, employment increased by 18% in the first tax year following adoption of the change. Indeed, employment growth in the larger food and drink entertainment trade (comprising, restaurants, hotels and clubs) has continued almost unabated through to the present. By May of this year (the latest date for which statistics are available), employment had risen more than 60% from where it stood when the tax change was introduced.

No doubt the tax reform hurt some restaurants, particularly the carriage trade that relied primarily on business people who enjoyed the taste of tax-deductible meals. But changes to the tax law have not stopped people from eating; at most it has caused them to eat in different establishments. Employment growth suggests that in fact people are eating out now more than ever.

The owners of restaurants featuring high price menus may indeed be suffering. So too are the farmers, the car manufacturers, the miners, the builders . . . the list is endless. But government funds are limited. The case for government subsidies, be they delivered directly or via the tax system, for up-market restaurants in preference to all the other businesses that need help is difficult to fathom, particularly when the sector as a whole has weathered the recession much better than virtually any other industry. A positive response to the restaurant sector's lobbying campaign would expose a government pursuing a seriously flawed set of economic and social priorities.