



**INSURANCE
COUNCIL**
OF AUSTRALIA

**SUBMISSION TO SENATE
SELECT COMMITTEE ON
STATE GOVERNMENT
FINANCIAL MANAGEMENT**

APRIL 2008

EXECUTIVE SUMMARY

General insurance plays an important role in the health and well being of communities. After a natural disaster or major weather event, the presence of private insurance serves to manage the after effects of loss and to expedite recovery. The availability of general insurance can also compensate for any harm or impairment arising from personal injury or trauma. Along with the “peace of mind” that general insurance can bring, insurance enables households and business to purchase and accumulate assets safe in the understanding that insurance can assist them when they experience loss or misadventure.

Adding to these important society and community goals, general insurance has a vital role to play in the wider economy. Insurance “monetises” risk and in so doing, facilitates efficiencies in the allocation of resources. General insurance allows new ventures to proceed with the added confidence that would otherwise not be available in the absence of such a safety net. And just as importantly, general insurance provides governments with financial security and stability, secure in the understanding that in the event of a major catastrophic event, the cost of assistance and recovery will not be met by government alone with the resultant straining of government capacities and resources.

At a time of increasing concern over climate change and the accompanying need for a public policy framework that encourages adaptation, policy settings that enable private insurance markets to operate effectively become fundamental to the needs of individuals, businesses and communities. As more erratic weather patterns are experienced, the public interest is well served from policy settings that strengthen community resilience. Reform of taxes on insurance, including reform of the fire services statutory contribution system, is integral to this challenge.

The Australian general insurance markets suffer from the distortions created by existing State taxation regimes. In the two largest States, NSW and Victoria, the general insurance sector is subject to the cascading effects of three types of taxation – fire contributions, GST *and* insurance stamp duties. Together, these tax on tax effects can add over 40% extra to the cost of a basic household property premium and up to 60% for a commercial insurance premium in the case of Victoria. This punishing tax regime, which was the subject of a recommendation for change from Justice Owen in his report of the HILH Royal Commission, discourages adaptation behaviours on the part of individuals, businesses and communities.

In 2006/07 State stamp duties on general insurance amounted to some \$2.6 billion. Since fiscal 2000, stamp duties on insurance have increased by over 76% compared with an increase in overall State taxes of around 29%. State governments now accrue more in insurance duties than they do in taxes on gaming machines. And notwithstanding the impacts they have on the affordability of insurance and the concerning features of non insurance, the States are now in the unfortunate position where they are structurally dependant on inefficient State insurance taxes to the extent that around 8% of all State taxes are drawn from insurance premiums.

The Insurance Council submits that the 2000 Intergovernmental Agreement between the Commonwealth and the States resulted in substantial reform of hitherto inefficient State taxes. The Insurance Council contends that the absence of insurance tax reform in this original agreement was regrettable and a significant policy oversight. Vis a vis other State taxes, stamp duties on general insurance result in large deadweight costs and retard economic efficiency. Reform of insurance taxes would significantly improve economic welfare and boost growth. According to research from Access Economics, reform of stamp duties on general insurance would deliver a permanent increase in real household consumption of 0.48%. As Access Economics have stated *“the combined benefits to be derived from using more efficient bases for funding emergency services and from lowering or removing stamp duties on general insurance would be substantial, adding perhaps 0.5% (or \$2.6 billion) to real household consumption over time”*.¹

¹ Access Economics 2007 “Analysis of State Tax Reform Including Taxes on General Insurance”.

The Insurance Council submits that from a broader national perspective, future programs of microeconomic reform will be heavily dependant on action from State governments. Reform of insurance taxation falls into this responsibility. According to Access Economics, the net cost to the States of abolishing all stamp duties on general insurance is \$1.7 billion after allowing for revenue claw backs to the States from efficiency gains. The Insurance Council contends reform of insurance taxes is affordable and at the very least, should be included as part of any discussions on Commonwealth State Financial relations.

INTRODUCTION & BACKGROUND

The Insurance Council of Australia Limited is the representative body of the general insurance industry in Australia. Insurance Council members represent more than 90 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, represent a major part of the financial services system.

2007 Australian Prudential Regulation Authority statistics show that the private sector insurance industry (both direct and reinsurers) generates gross premium revenue of \$28.9 billion per annum and has assets of \$83.6 billion. The industry employs approximately 43,000 persons nationally, and on average pays out about \$70 million nationally in claims each working day. Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

The main objectives of the Insurance Council are to:

- Represent members' interests in both domestic and international issues.
- Represent the general insurance sector to Government and the community.
- Anticipate, and assist the industry to meet the needs of consumers and the community.
- Improve the industry's image.
- Promote community awareness of the role and benefits of insurance.
- Encourage improved service standards across the insurance sector and promote appropriate self-regulation.

The general insurance industry plays a critical role in the Australian economy through the provision of risk protection for economic activity and through the pricing of risk, ensuring that scarce resources are allocated to their most efficient use.

Effective and efficient insurance markets remain a fundamental feature of developed economies. The provision of insurance enables economic agents to cost the risk of a given activity and if appropriate, transfer this risk according to a given risk profile. This profiling of risk enables economies to more flexibly and efficiently allocate resources, thereby encouraging stronger investment/growth and higher living standards.

In other words, general insurance serves as an economic enabler, with its contribution to economic growth being:

- The important task of pricing risk and "monetising" risky activity.
- Facilitating the allocation of resources across the wider economy.
- Reducing transaction and friction costs as parties seek to transfer risk from the adverse to those more willing to take on risk.
- The ability to support economic development by facilitating activities/investment of a higher risk.
- Reducing the burden on Government/public sector resources in the event of a major event or catastrophe, thereby transferring the cost of recovery from the public to private sector.
- Supporting the principle of mutual obligation and personal responsibility within individuals and communities by encouraging risk adaptation and risk mitigation strategies.

FUNDING OF THE NSW & VICTORIAN FIRE SERVICES

How the Statutory Contributions System Works

The States of NSW and Victoria both fund their respective fire services utilising a system known as the statutory contributions system

In the case of NSW, both the NSW Fire Brigades (NSWFB) and the NSW Rural Fire Services (NSWRFS) are funded by contributions outlined under Section 54 of the *NSW Fire Brigades Act 1989* and Section 111 of the *NSW Rural Fires Act 1997*. These statutory provisions require insurance companies to meet 73.7% of the cost of the fire services. The remaining share of the NSW Fire Service funding is borne by NSW local authorities and the NSW State government.

Similarly, Victoria uses a statutory contribution system to fund its fire services. Under Sections 37 and 40 of the Victorian *Metropolitan Fire Brigade Act 1958* insurers are required to contribute 75% of the Metropolitan Fire Authority costs. Insurers contribute 77.5% of the costs of the Victorian Country Fire Authority as a consequence of Part 4, Section 76 and 77 of the *Victorian Country Fire Authority Act 1958*.

The amount of statutory contributions payable to the fire services by each insurer is determined by three factors – the size of the budget to be funded; the aggregate market share of the insurers; and, the insurance company's mix of classes. The latter is particularly significant as not all insurance policies are weighted equivalently for the purpose of contribution levies. For example, contribution charges are greater on commercial classes of insurance than for residential or motor classes.

Insurers recover the fire services contributions they make to the fire services through imposing a levy on their insurance policy holders, colloquially known as the Fire Service Levy. A failure to recover fire services contributions from policy holders would otherwise require such funding to be internal to the insurance companies, severely compromising their profitability and draining their shareholder capital.

The actual process of determining the appropriate recovery charge for fire contributions is administratively complex for insurers. Given that contributions are sought by the fire services in advance (thereby leaving insurers with the task of forecasting the market) and that any insurance recovery takes place on the insurance premium base, fluctuations in both the market (ie mixes of business) and the premium levels (ie hardening or softening markets) results in insurance companies bearing all collection risk for the fire services.

The complexity of the system together with the inherent uncertainty of forecasting results in inevitable movements in collections which is a weakness and a failure of the current system - unreasonably and inappropriately placing the risk of over and under allocation firmly with the insurer and detracting from the core principle of tax certainty for the consumer. The statutory funding process results in confusion and frequent discrepancies for consumers who compare and contrast their recovery charges (ie FSL charge) over time, across other households and between comparable insurance policies and with other statutory set taxes and levies. Further, consumers can be reasonably expected to review any such charges against hitherto published rates.

The system of collection risk and the subsequent impacts on the transparency and simplicity of the contributions system was considered by both the NSW and Victorian reviews of fire services funding.² For example, the NSW Public Accounts Committee remarked:

"The nature of determining the fire service level of funding a year in advance can result in significant over and under collections. Where an insurer under collects, they are required to pay the difference

² See Public Accounts Committee (2004): "*Review of Fire Services Funding: Report no 5/53 (148)*" and Victorian Department of Treasury and Finance (2003) "*A Review of Victorian Fire Services Funding Arrangements*".

into the fund. Alternatively, if the insurer over collects the insurers retain the extra funds. The system therefore distorts efficiency for both the insurer and the insureds".³

Similarly, the Victorian Treasury when commenting on the statutory contribution system operating in Victoria stated:

"The Review concludes that the current funding system lacks transparency at both the individual and the aggregate level. Individual policy holders may be unaware of the extent to which they fund the Fire Services. Further, the amount that is collected as a FSL by insurance companies may not equate to actual contributions made".⁴

Both NSW and Victoria (and to a lesser extent Tasmania) retain statutory contribution funding systems for the funding of their fire services. This is despite the evidence that superior systems exist for the funding of fire and emergency services in other States. More recently, other State administrations have transitioned to systems where fire and emergency services levies are collected through charges on property value rather than on insurance premiums. This is by far a more efficient system.

For example, in Western Australia, the Emergency Services Levy (ESL) commenced on 1 July 2003 and replaced the prior system of fire services statutory contributions. Similarly, the Queensland Fire & Rescue Service is predominately funded through an urban fire levy collected through municipal rates.⁵ South Australia has adopted a system where emergency services (including the fire services) are funded through an Emergency Services Levy (ESL) collected through a property levy, and includes a levy on registered motor vehicles.

Is the Current Fire Services Statutory Contribution Funding System Fair?

The statutory contribution system of fire funding can inevitably lead to inequities. Principally, this arises from:

- premiums being assessed on a number of risks that reflect different socio-geographical risk factors that are independent of an insured's wealth and incomes and
- general insurance taxes are an ad valorem tax levied on the premium.

As a result of the above two factors, the tax burden on general insurance can vary considerably across and between the taxpaying policyholders. Notwithstanding that the taxpaying policyholders can pay differing amounts, *all* residents in NSW and Victoria benefit directly or indirectly from the fire fighting and prevention services provided by their fire services. To make matters worse, residents who do not take out insurance will benefit without making any contribution to the services. In other words, there is the ability to "free ride" the fire services system by not purchasing insurance.

These features of the fire services suggest that they may be properly considered as public goods. A public (or collective good) is defined as a good that is non-rivalrous and non-excludable in consumption.

Rival goods are goods whose consumption by one consumer prevents simultaneous consumption by other goods. Excludability is defined as whether or not it is possible to exclude people who have not paid for a good or service from consuming it. If a good or service is not excludable and can be consumed by non payer's then that goods or service suffers from the "free rider" problem.

³ Public Accounts Committee (2004), op cit, page 55

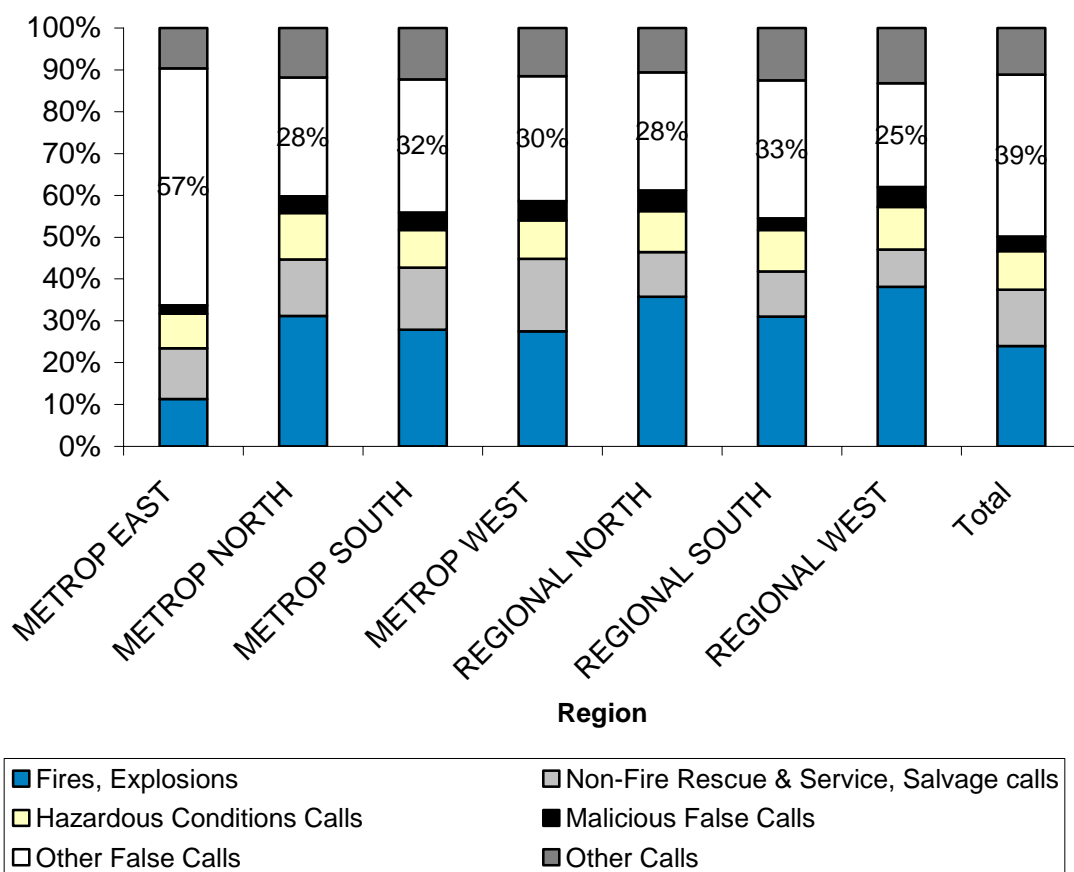
⁴ Victorian Department of Treasury & Finance (2003), "op cit" page 43

⁵ The Queensland government funds their Ambulance service through a charge on the occupants of residential and non residential property.

The community wide benefits of fire fighting and hazard reduction flow directly and immediately to individuals and the broader community irrespective. For instance, the benefits enjoyed by a property owner whose property is being protected from the immediate risk of fire are simultaneously being derived by that property owners neighbours. Alternatively, the extinguishing of fires in a national park provides a benefit to the broader community which benefits from the positive externality of later enjoying the surrounds of the national park or simply knowing it is there.

The fire fighting services also display non-excludable criteria in three other important contexts. Firstly, the simultaneous flow on of the benefits in having a burning property extinguished to neighbours makes it impossible to exclude the broader consumption of the benefits provided by the fire fighting services. Secondly and just as importantly, all fire services extinguish fires on properties of individuals and businesses *irrespective* of whether the beneficiary has paid for the service via the FSL or not. Thirdly, the fire services perform a range of services beyond pure fire fighting highlighting that the beneficiaries of the fire services are widespread in the community and not merely restricted to insurers and their policy holders. As the graph below demonstrates, the fire services offer a wide array of assistance including non fire rescues and attendance at hazardous spills. This broader level of assistance suggests that the costs of maintaining an efficient fire and rescue service should be more equitably distributed.

Primary incidents by region, NSW Fire Brigades, 2006-07



Source: New South Wales Fire Brigades.

As the above chart demonstrates, over the twelve months ended 30 June 2007, the NSW Fire brigades (excluding specialists units) attended 137,967 primary incidents. Of these 24.0% (33,129) were fire and explosions, 13.4% (18,501) were non-fire rescue and service salvage calls, 9.2% (12,720) were hazardous conditions calls, 3.5% (4,800) were malicious false calls, 38.7% (53,450) were other false calls and 11.1% (15,367) were other calls. In other words, only 46.6% of the incidents attended by the NSW fire brigades were for legitimate fire services while a majority, 53.4% were for false or other calls.

Does the Current Statutory Contribution System discourage Stronger Accountability and Financial Rigour of the Fire Services?

There is evidence to suggest that the fire services funding system in NSW and Victoria serves to discourage tight financial discipline of the fire services in these States. This arises as a result of the governments being able to effectively limit the extent of their outlays through cost shifting to the insurance sector although the insurance sector is supportive of a well resourced and equipped fire service, the current system serves to act as a deterrent to more efficient management.

It can be argued that a given tax improves transparency and accountability when raised for a specific purpose and with that purpose well understood and endorsed explicitly by taxpayers. Commonly known as tax earmarking or tax hypothecation, such earmarking is often found in the developed world for such uses as funding health and welfare, designated infrastructure projects and the funding of fire and emergency services bodies. A key argument in support of tax earmarking is that the accountability and efficiency of the revenue "spend" is enhanced through the transparency of the earmarking.

A hypothecated tax regime will deliver an efficient allocation of resources if:

- The tax revenue raised fully funds the specific programme's expenditures.
- The level of expenditure is constrained to the amount of revenue raised.
- The tax is transparent and visible to taxpayers.
- The tax is equitably imposed on all beneficiaries and cannot be passed on, so only the beneficiaries pay the tax.

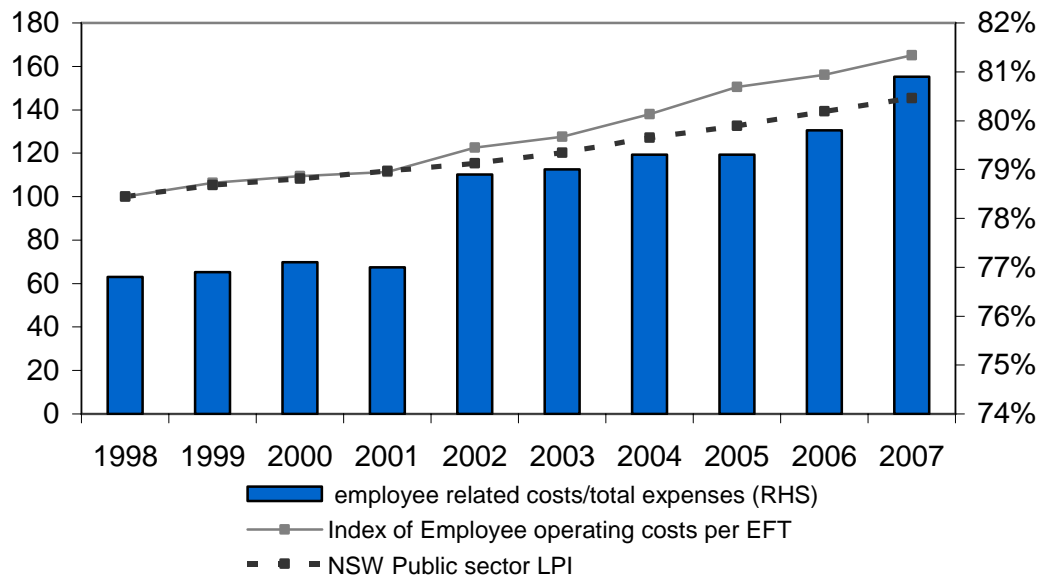
When combined, these conditions can ensure taxpayers remain correctly informed as to the true cost of the specific expenditure program allowing them to make informed fiscal choices and in turn, aligning the composition of government expenditures with taxpayer preferences.

At face value, the imposition of fire contributions on the general insurance sector and Local Councils as the primary means of financing expenditures of the fire services could be seen as a form of tax earmarking. Nevertheless, in its current form the application of the fire contribution represents a significant departure from the model and, contrary to best practice, results in a major misallocation of the States resources.

The current funding arrangements of the Victorian and NSW fire services serves the purpose of shifting the fire services administrative arrangements outside of Government's budget accountability process, removing the usual budget checks and balances that would ensure a fiscally responsible allocation of expenditures and therefore resources. In turn, the system results in budget over runs and a misallocation of spending.

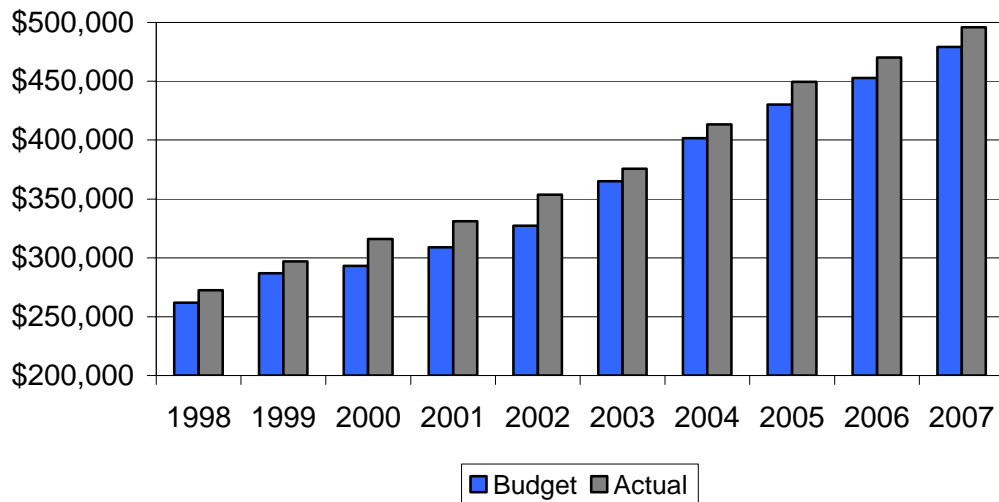
The lack of effective budget controls is demonstrated by the comparative growth in revenue and operating costs of the fire services and the general government sectors. Overall the expenses and revenues of the fire services have grown at a faster rate than the general government's revenues and expenses. This is demonstrated in the charts below which outline the financial rigour of the NSW and Victorian fire services.

NSW Fire Brigades Employee Costs



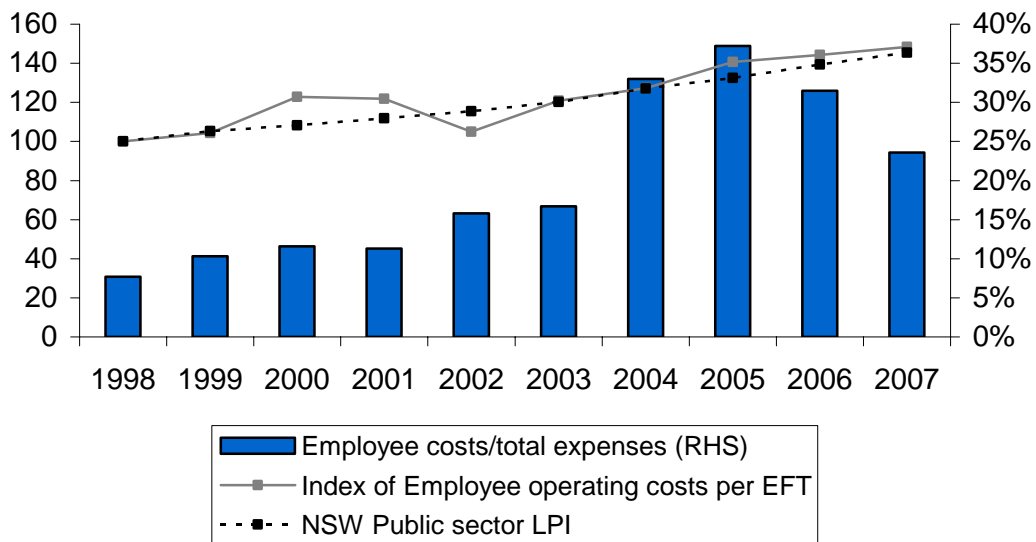
Source: NSW budget papers

NSW Fire Brigades Operating Expenses (\$'000's)



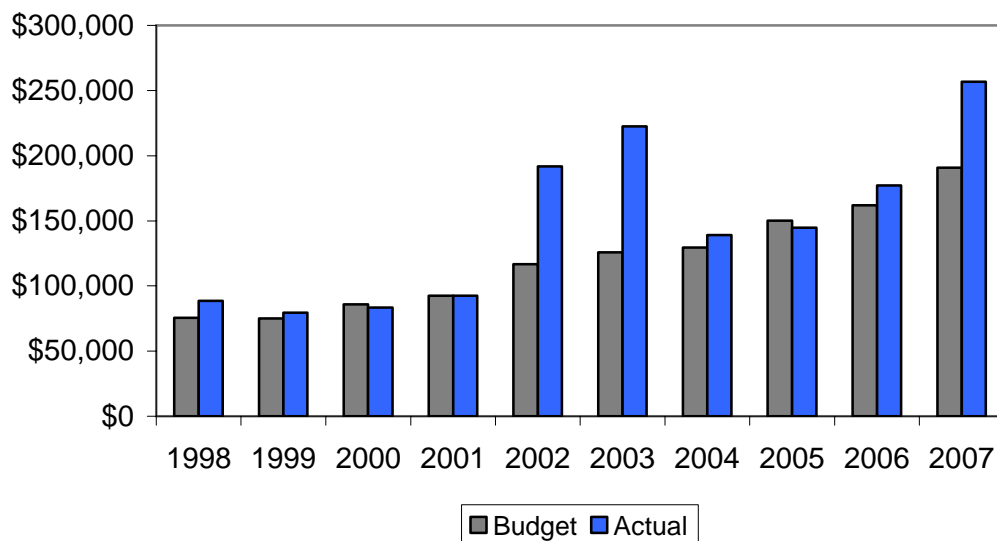
Source: NSW budget papers

NSW Rural Fire Service Employee costs



Source: NSW budget papers

NSW Rural Fire Services Operating Expenses



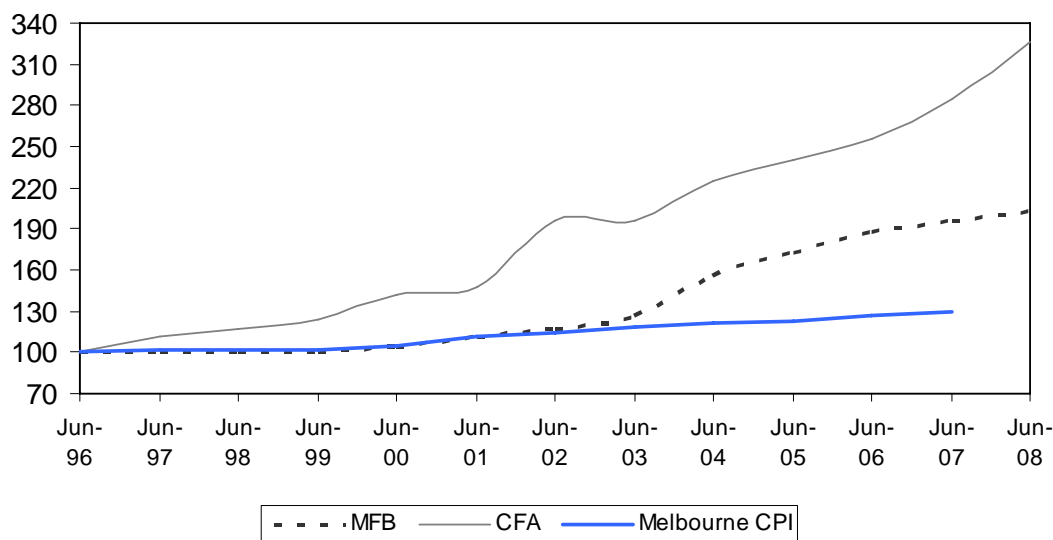
Source: NSW budget papers

As the charts demonstrate, operating expenses for the NSW Fire Brigades have risen on average by 7.5% pa over the nine years to June 2007 compared with growth in general government expenses of 6.0%. On average, the NSW Fire Brigades exceeded its budgeted operating costs by \$16.8m or 4.4% per annum due mostly to unconstrained growth in employee related expenses. The NSW Fire Brigade's EFT employee related operating expenses rose by 5.7% pa over the nine years to June 2007 compared with 4.2% growth in the public sector labour price index for NSW. The growth differential has added just under \$100m to the NSW Fire Brigades employee related operating expenses that would have occurred had these expenses increased in line with the broader public sector. As a consequence, the levies imposed on the general insurance sector to fund the NSW Fire Brigades have risen by 6.9% per annum while total taxation revenue in NSW has risen by only 3.6% pa.

Similarly, over the five years ending June 2007, the operating expenses of the Rural Fire Services have risen by 14.9% annually compared with 6.4% pa growth in general government expenses. In turn, the annual rural fire services levies imposed on the general insurance sector have risen by 8.4% annually while the government's taxation revenue has risen by 6.1% annually.⁶

A similar picture emerges for Victoria. In the case of Victoria, the growth in the expenditure of the fire services is demonstrated in the charts below.

Victorian Fire Brigade Contribution Budgets Indexed to Fiscal 1996



The Insurance Council supports the State Fire and Emergency Services bodies being well resourced and equipped to undertake their core fire services duties. However, the lack of transparency of the statutory contributions system results in a lack of appreciation and understanding of how service enhancements are paid for by the community encouraging service “creep” or cost shifting, whereby the fire services are tasked with responsibilities hitherto provided by other State agencies. The Insurance Council urges reform of the system as a path to not only improving transparency and accountability but also ensuring that the services are placed on a long term sustainable footing and are not tasked with responsibilities that may more properly rest with other agencies.

Reform of Fire Services Funding

The Insurance Council contends that there is considerable scope to reform the statutory contributions system and that alternative models of funding are available. In this regard, the Insurance Council sought Access Economics’ advice to cost the impact of reform of fire services contribution system in NSW and Victoria. The Access costings are estimated on the basis of two scenarios.

- Removal of statutory contributions to the fire services from insurers and replacement funding through a lump sum tax similar to the Queensland Ambulance Charge
- Removal of the statutory contributions to the fire services from insurers and transferring the taxation base to a municipal/council taxation base.

The first simulation is modelled on the approach taken to funding the ambulance services in Queensland through the introduction of the Community Ambulance Charge. Under these arrangements, the ambulance

⁶ (The operating expenses for the Rural Fire Services were inflated by a transfer of staff from local council payrolls to the fire services in 2002).

services in Qld are funded through a fixed charge (ie lump sum tax) on the occupants of residential and non residential structures. Electricity retailers/suppliers are tasked with the compliance obligation to collect the levy through billing arrangements.

The second simulation looks at shifting the fire services funding away from insurance and replacing it with a charge on a landowners municipal rates notice. This is the broad approach used in Western Australia for the emergency services levy.

The Access Economics' costings for these reforms are as follows:

	Direct Revenue Effect (\$m)	Indirect Revenue Effect (\$m)	Net (Cost) to Government (\$m)
New South Wales			
Abolish insurance statutory contributions in the Fire Acts and replace with a lump sum tax similar to the Qld Ambulance Charge	\$0	\$66	\$66
Abolish insurance statutory contributions in the Fire Acts and transfer fire brigade funding to municipal tax base	\$0	\$38	\$38
Victoria			
Abolish insurance statutory contributions in the Fire Acts and replace with a lump sum tax similar to the Qld Ambulance Charge	\$0	\$63	\$63
Abolish insurance statutory contributions in the Fire Acts and transfer fire brigade funding to municipal tax base	\$0	\$40	\$40

Notes: All figures in 2005/06 dollars

Source: Access Economics 2007

As the above costings demonstrate, if reform of fire services funding was to take place in the form of a lump sum tax akin to the Qld Ambulance Charge or a shift to a municipal tax base, then the both the NSW and Victorian governments would be able to undertake such a reform in a modest revenue positive way. A shift in taxation along these lines would result in a revenue gain in the order of between \$40 to \$60 million depending on the taxation base nominated.

The Insurance Council submits that the Access Economics' costings clearly indicate the case for the States of NSW and Victoria to proceed with reform of the statutory contributions system. The Access Economics' modelling suggests that there is clear scope for the NSW and Victorian administrations to initiate actions to reform their fire funding systems. Further, the Insurance Council suggests that alternative efficient models are available for both the NSW and Victorian governments to draw from – including the Western Australian model of fire services funding.

Reforming the Fire Services Contributions System – the WA Model

The Western Australian Government reformed its fire services funding system in 2003 when it abandoned the previous statutory contributions funding model and replaced it with funding via a property levy. The Emergency Services Levy (ESL) funds all career and volunteer fire brigades, volunteer State Emergency Services (SES) units and volunteer emergency service units.

The WA levy charged for the ESL is based on four variables.

- The location of the property (the ESL rate is based on 5 categories which reflect service levels in the locality).
- The applicable ESL that reflects a given service category.
- The property's Gross Rental Value which is an independent Valuer General Determination and reflects the estimated rental return on a given property in any one year. These determinations are reviewed every three years.
- Minimum and maximum charges dependant on what a property is used for (example vacant land). The maximum and minimum charges also ensure equity is preserved by ensuring each property pays a minimum floor and no more than the maximum.

Exemptions are available for pensioners and seniors, with the ESL exempt from GST and stamp duty.

After their introduction, the implementation of the WA reforms were independently reviewed by an independent consulting company, Sigma Consulting. The review found that after the transition, the levels of insurance increased and insureds responded to the adjustment in price through the purchase of additional cover. The Insurance Council's "Non Insured" report also reviewed the WA experience, finding:

"Using the Roy Morgan Research data, the removal of FSL in Western Australia provides most scope for analysis ... The removal of FSL in Western Australia is more significant. ...

*The survey data appears to support the view that removal of FSL resulted in lower rates of non insurance. The apparent rates of non insurance for building and contents insurance in Western Australia in 2004 while the Australian average was increasing. That the fall in non-insurance is more significant for contents insurance than for buildings insurance is consistent with contents being more price sensitive"*⁷

STAMP DUTIES ON GENERAL INSURANCE PREMIUMS

Stamp Duties on Insurance are highly inefficient

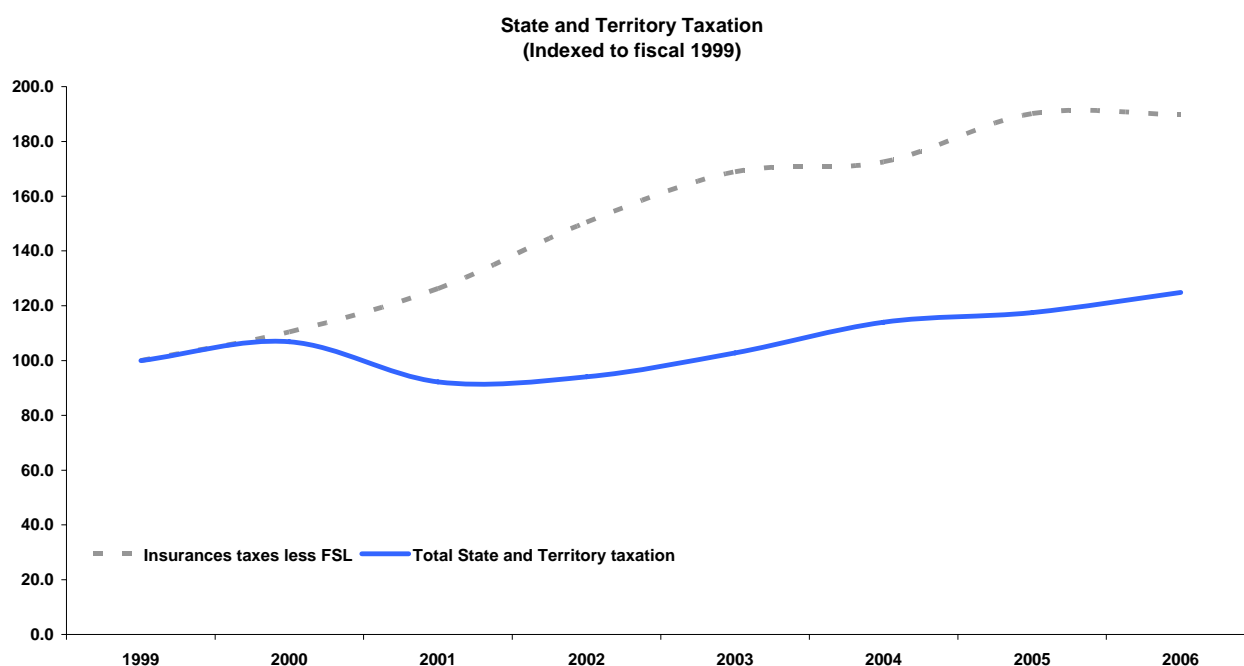
In all States and Territories, any person carrying on the business of general and/or life insurance is subject to insurance duty, otherwise known as stamp duties on insurance.

Stamp duties represent transaction based taxes on the purchase of various assets or services – such as the purchase of insurance cover. However, unlike the GST which is a tax on the value added component, stamp duties are more akin to selective turnover related taxes. In other words, stamp duties are:

- Selective to the extent that only some transactions – such as the transfers of property, shares and services such as insurance – are included in the taxation base. This contrasts sharply with broad based taxes like GST and payroll taxation which are broader in scope.
- Turnover related. In other words, the tax base is the total consideration in any transaction, not the value added component.

According to the Australian Bureau of Statistics, stamp duties on insurance amounted to \$2.6 billion in 2006/07. Since 2000, stamp duties on general insurance have increased by 76% compared with an increase in total State taxes of around 29%. The States now accrue approximately one in nineteen tax dollars from taxes on insurance.

⁷ Insurance Council of Australia (2007) "The Non-Insured: Who, Why and Trends" page 31



Source: Australian Bureau of Statistics, "Taxation Revenue" Cat No 5506.0

Following the introduction of the GST and the New Tax System, a program of reform of State taxation was undertaken including the abolition of stamp duties on most financial transactions. This program was undertaken in response to estimations that State stamp duties on financial transactions were highly inefficient and that overall economic welfare would be enhanced with their removal.

Most regrettably, insurance tax reform was not included as part of the 2000 Commonwealth State Intergovernmental Agreement. Given the relative inefficiencies of insurance taxes vis a vis other State taxes the absence of insurance taxes was a regrettable omission from the reform process. The Insurance Council contends that in a reinvigorated process of Commonwealth/State reform, the removal of insurance taxes should be given priority. Moreover, the economic gains from the abolition of insurance taxes places such reform on a comparable basis to the benefits achieved from other microeconomic reform initiatives.

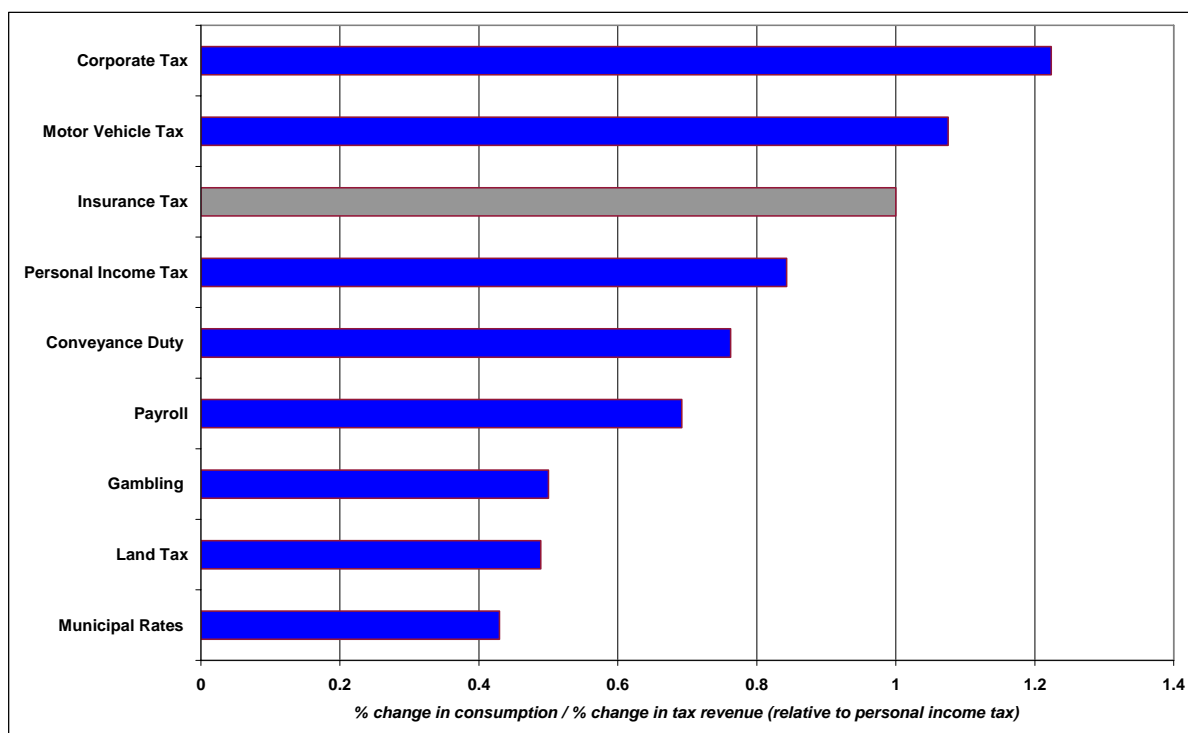
All taxes inevitably distort price signals, driving a wedge between the equilibrium market price and the price paid by consumers and those received by suppliers/producers. This price wedge serves to distort both demand and supply patterns resulting in a reduction in output below the market equilibrium, with resultant dead weight losses to society.

The size of dead weight losses depends fundamentally on the underlying elasticity of demand and supply. The more elastic is demand and supply the greater the demand and supply responses to tax distorted price signals and the consequent dead weight loss. Alternatively, the less elastic is demand and supply, the smaller the demand and supply responses to price distorting taxes and the subsequent dead weight loss.

An efficient tax is a tax that has a minimum effect on consumers and producers demand and supply decisions. That is, an efficient tax will have a minimal effect on the behaviour of economic units. Consequently, an efficient tax would ideally be levied on goods and services characterised by small demand and supply elasticities.

Stamp duties on general insurance are amongst the least economically efficient taxes in Australia. Accordingly, the scope to enhance economic welfare from reform of insurance taxation is large.

According to Access Economics, the efficiency rankings of State and Federal taxes are outlined in the chart below.



Source: Access Economics, 2007

It is important to note that the Access Economics' efficiency rankings do not reflect *absolute* changes in real consumption. Rather, the rankings reflect a comparison *between* taxes measured as the *percentage* change in real consumption divided by the *percentage* change in tax revenue. Maximising absolute efficiency or welfare gains by maximising absolute improvements in real consumption will depend upon the absolute budget available for tax reductions, or the absolute scale of the tax-expenditure/tax mix shift contemplated.

Using these efficiency rankings, Access Economics have been able to estimate that the percentage increase in real household consumption from reforming stamp duties on general insurance to be 0.48% or the equivalent of an increase in real household consumption of a little under \$2.6 billion. According to Access Economics, this translates into a boost to living standards comparable to the gains achieved from the micro economic reforms of the past.

The Insurance Council submits that the considerable welfare gains arising from the removal of insurance stamp duties is sufficient to warrant the attention of policy makers to place insurance tax reform as the centrepiece of any future discussions on Commonwealth State Financial Relations. Although the emphasis on Commonwealth State Relations has to date tended to focus on reforms on outlays and expenditure, the evidence indicates that significant gains in economic welfare can also be made from State taxation reform. At a net cost of \$1.7 billion to the States (ie a direct cost of \$2.2 billion and a "claw back" of \$540 m) insurance tax reform remains an affordable measure. Moreover, the Insurance Council notes that the States are set to enjoy GST revenues greater than their Guaranteed Minimum Amount, with these gains estimated to increase to \$4.6 billion by 2010-11 from \$3.4 billion in 2007-08.

The Access Economics costings of the reform of stamp duties on general insurance are outlined in the table below.

	Direct Revenue Effect (\$m)	Indirect Revenue Effect (\$m)	GST Gain (\$m)	Net Cost (\$m)
Abandonment of all stamp duties on GI products	(2,239)	431	108	(1,700)
A reduction in stamp duty rates to 7.5%	(441)	76	21	(344)
A reduction in stamp duty rates to 7.5% with the abandonment of the current exemption regime on all classes.	656	(112)	(32)	513

Note: All figures in 2005/06 dollars

Source: Access Economics 2007

The above table demonstrates abandoning stamp duties on general insurance products would have a net cost to the States of around \$1.7 billion per annum after taking in the indirect revenue effects including gains from GST flows. A “harmonisation” policy whereby the stamp duties on general insurance are reduced to 7.5% as a first step would have a cost in the order of \$344 million. Reducing stamp duties to 7.5% whilst simultaneously removing the exemptions that currently apply to certain classes of insurance (for example, workers compensation, CTP) would see the State accruing an extra half a billion dollars in revenue.

The Access Economics’ costings clearly indicate that reform of stamp duties on the general insurance sector would approximate the hitherto cost of reforming other financial services taxes such as Financial Institution Duties (FID) and the Debits Tax at \$1.6 billion and \$1.3 billion respectively. Moreover, reform of stamp duties on general insurance services would be considerably less costly than the current estimated \$2.8 billion cost associated with reform of conveyancing duties on non residential property.

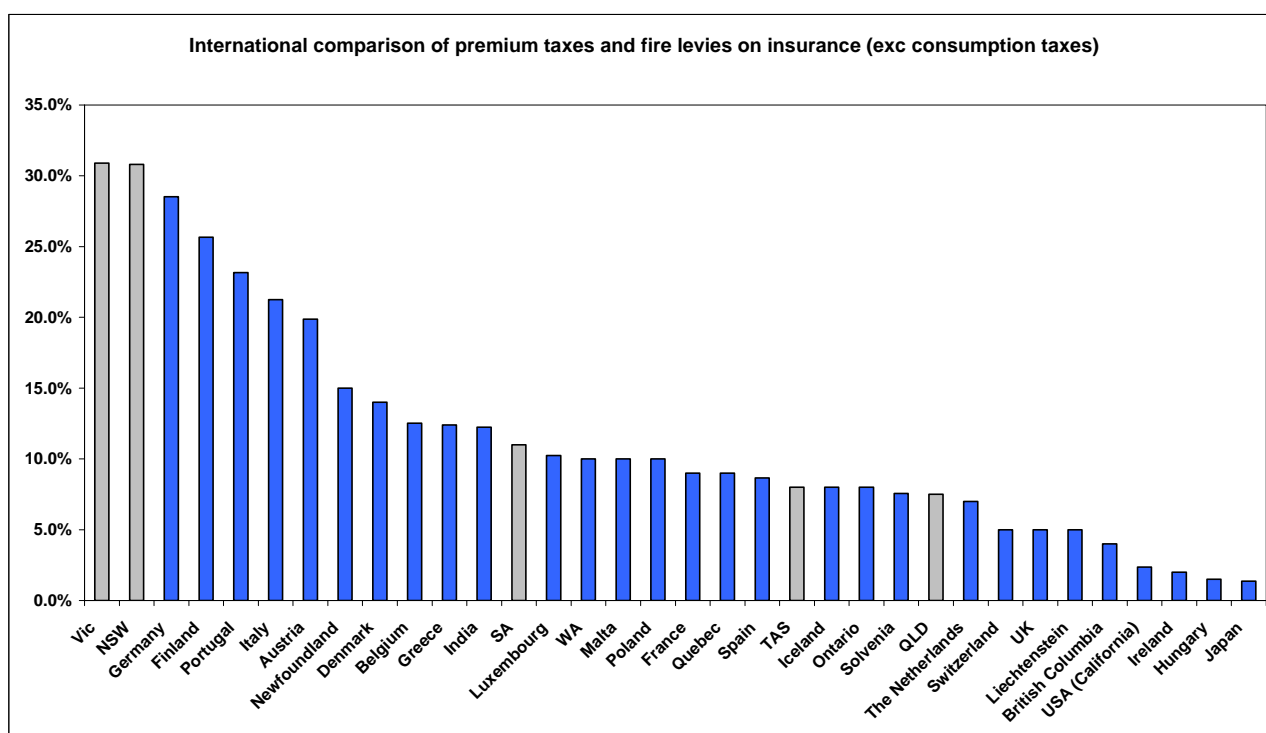
The Insurance Council submits that insurance tax reform should be included as a priority in future Commonwealth State reform processes. In particular, renewed attention needs to be given to establishing a clear framework for future financial agreements between the States and the Commonwealth that will incorporate insurance tax reform. At a time when concern over climate change includes a need to respond to more erratic weather events through adaptive behaviour, policy frameworks that support and encourage general insurance will be fundamental. The Insurance Council contends that a renewed Commonwealth State Financial Agreement that builds in insurance tax reform is not only consistent with such a policy framework but will also deliver considerable gains in economic welfare.

INTERNATIONAL COMPARISON OF INSURANCE TAXES

How does Australia compare?

As the graph below demonstrates, Australia compares quite poorly vis a vis international comparisons on insurance premium taxation for households. The graph presents the ad valorem rate of insurance taxation on premiums, including fire services levies.

The graph highlights that the premium based taxes (excluding value added/consumption taxes) is just under three times as large as the comparable international average rate.



Source: CEA Indirect taxation on insurance contracts in Europe. PWC international comparison of insurance taxes (March 2007). Governor's Budget California 2005-06 PW Guides Canada other indirect taxes.

RECOMMENDATIONS OF THE HIH ROYAL COMMISSION

What did the HIH Royal Commission recommend?

Following the collapse of HIH Insurance, in 2001 the Commonwealth Government established a Royal Commission into the collapse, appointing the Honourable Justice Owen to conduct the Royal Commission. Item (e) in the terms of reference for the Commission was set out as:

- e) the adequacy of appropriateness of arrangements for the regulation and prudential supervision of general insurance at Commonwealth, State and Territory levels, taking into account your findings in relation to the matters referred to in the preceding paragraphs and other relevant matters, including:*
- (i.) Commonwealth arrangements before and after the Financial System Inquiry reforms; and*
 - (ii.) Different State and Territory statutory insurance and tax regimes⁸*

His Honour considered the role of State taxation in Volume 1, Chapter 10 of his report. In this regard, his Honour made four recommendations in relation to State taxes. They were:

- That State and Territory Governments abolish stamp duty on general insurance products with the process to be coordinated through the proposed Ministerial Council with responsibility for general insurance.
- That those States that have not already done so, abolish fire services levies on insurers.
- That the State and Territory Governments exclude the cost of the GST for the purposes of calculating stamp duties or any other State or Territory levies that are imposed on insurance premiums.
- That Governments avoid imposing on insurers levies and other taxes that cannot be passed on to policyholders.

⁸ The HIH Royal Commission (2003) "Volume 1: A Corporate collapse and its lessons" page 306

At present, these recommendations of the Royal Commission remain outstanding. The Insurance Council contends that the time is ripe for these recommendations of the HIH Royal Commission to be revisited and implemented.

NON INSURANCE IN THE AUSTRALIAN COMMUNITY

What is the relationship between insurance taxes and non insurance?

Good tax design requires that similarly situated taxpayers face similar tax burdens and that any tax, as far as possible, not distort economic decision making and resource allocation. The consequence of non insurance and its direct bearing to insurance taxation highlights the distortionary effects of insurance premium taxation.

Research conducted on behalf of the Insurance Council by the Australian National University (ANU) Centre for Law and Economics⁹, has highlighted the relationship between levels of insurance taxation and non insurance in the house and contents insurance classes.

The study, "*The Non Insured: Who, Why and Trends*" examined the demand for domestic building and contents insurance and confirmed the imposition of stamp duties and the Fire Services Levy on insurance products materially affected consumer's decisions regarding the purchase of insurance.

The "*Non Insured*" report found that, prima facie, the demand for house and contents insurance was negatively correlated to the price of insurance products. State based taxes on general insurance premiums result in a smaller number of households purchasing insurance and reduces the amount of cover purchased as well.

The table below, drawn from the study, shows the levels of non insurance on a household basis in absolute terms and as a proportion of the potential market. The potential market for contents is the number of occupied households while the potential market for house insurance is owner occupied households not paying body corporate fees.

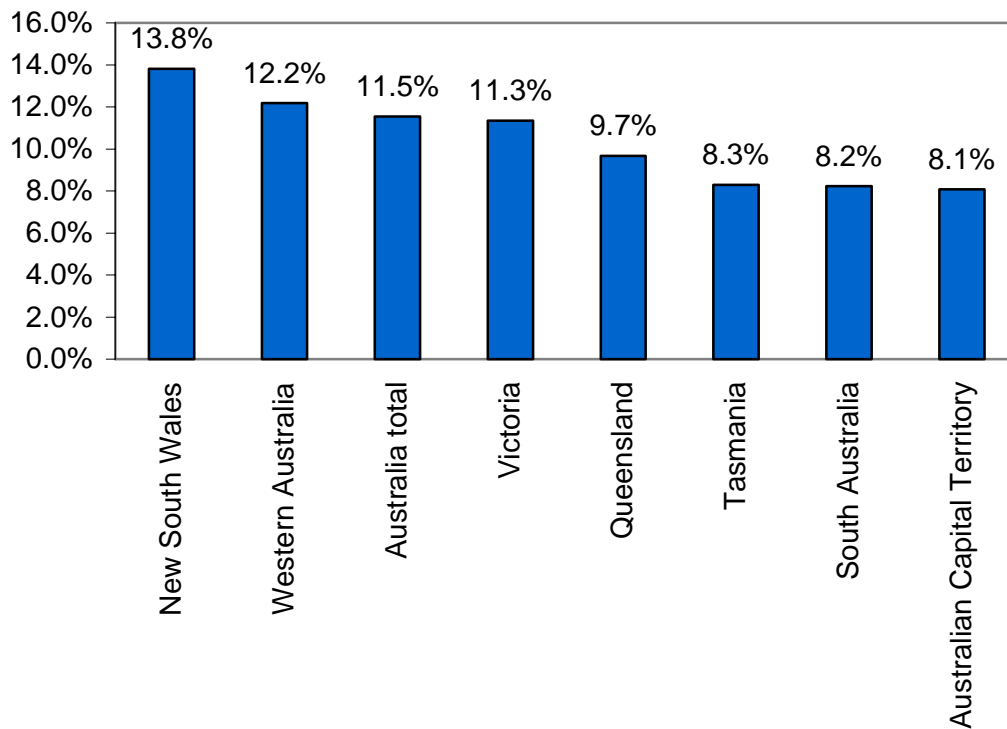
	Class of insurance	Households with no insurance (000's)	Potential market (000's)	% of Households
Australia	Contents	2170	7,736	28.1
	House	203	4,996	4.1

Source: ABS Household Expenditure Survey 2003-04

The following graphs, again drawn from the study, compare the rate of non insurance for contents insurance across jurisdictions on a tenure basis.

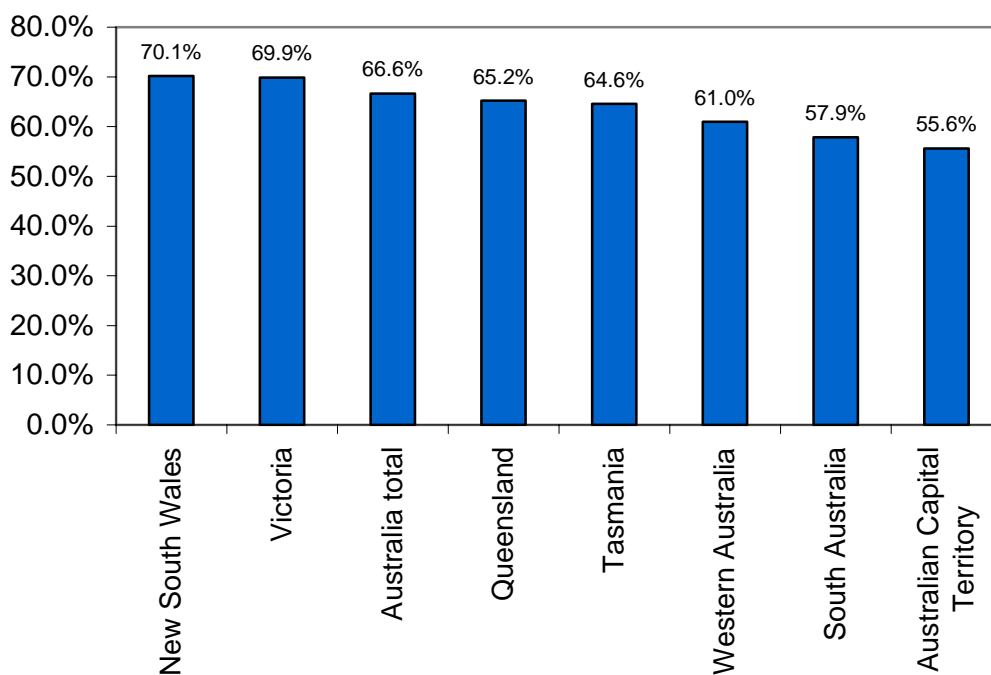
⁹ Insurance Council of Australia (2007) "*The Non Insured: Who, Why and Trends*" prepared by Dr Richard Tooth and Dr George Barker from the Australian National University, Centre for Law and Economics.

Proportion of owner occupier households that have no contents insurance



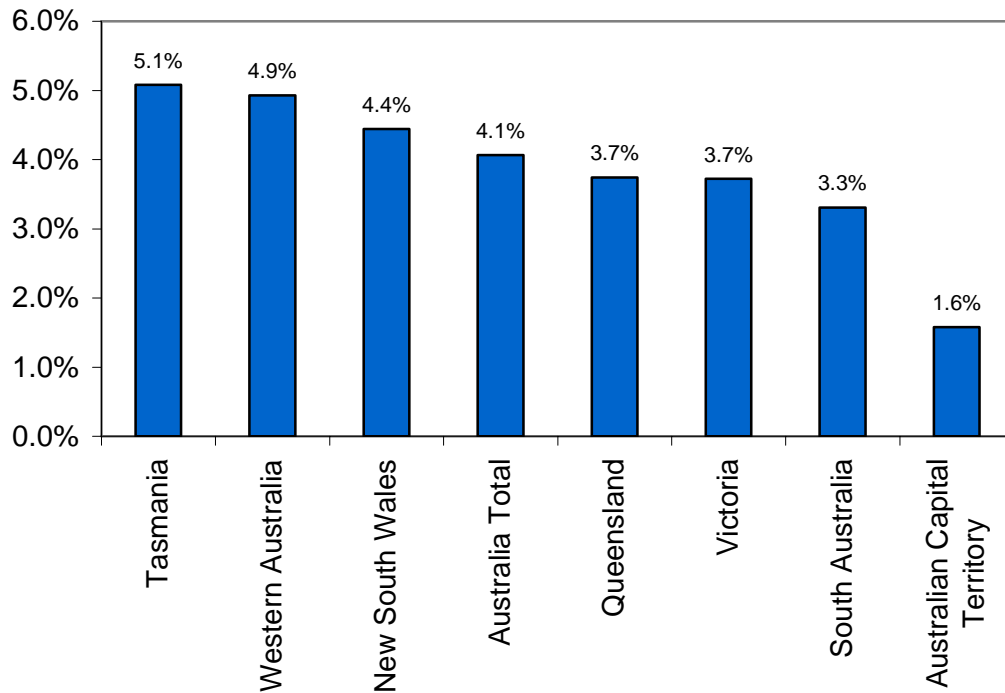
Source: ABS Household Expenditure Survey 2003-04

Proportion of rental households without contents insurance



Source: ABS Household Expenditure Survey 2003-04

Proportion of owner occupied households not paying body corporate fees and with no contents insurance

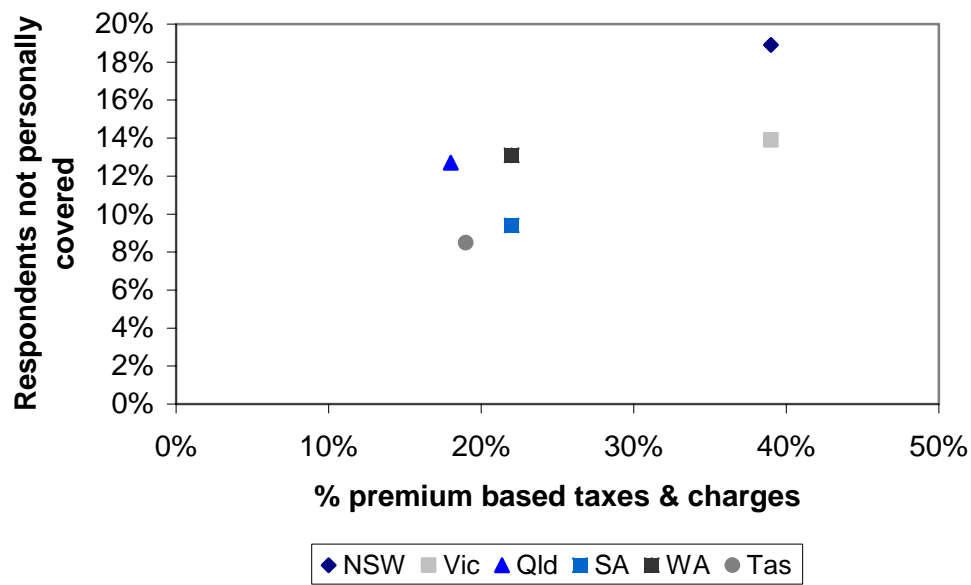


Source: ABS Household Expenditure Survey 2003-04

Together with the 2003/04 ABS Household Expenditure Survey (ABS HES) the ANU study also reviewed non insurance using data from the Roy Morgan Single Source Survey (RMSS). The RMSS is a large continuously updated information source examining a broad range of items and matters, including the purchase of particular goods and services, service provider preferences, financial information etc. The RMSS is based on a very large base survey sample size of more than 50,000. The database is updated on average by an additional 1000 samples per week. Accordingly, the RMSS provides a significant and reliable source of data for examining non insurance.

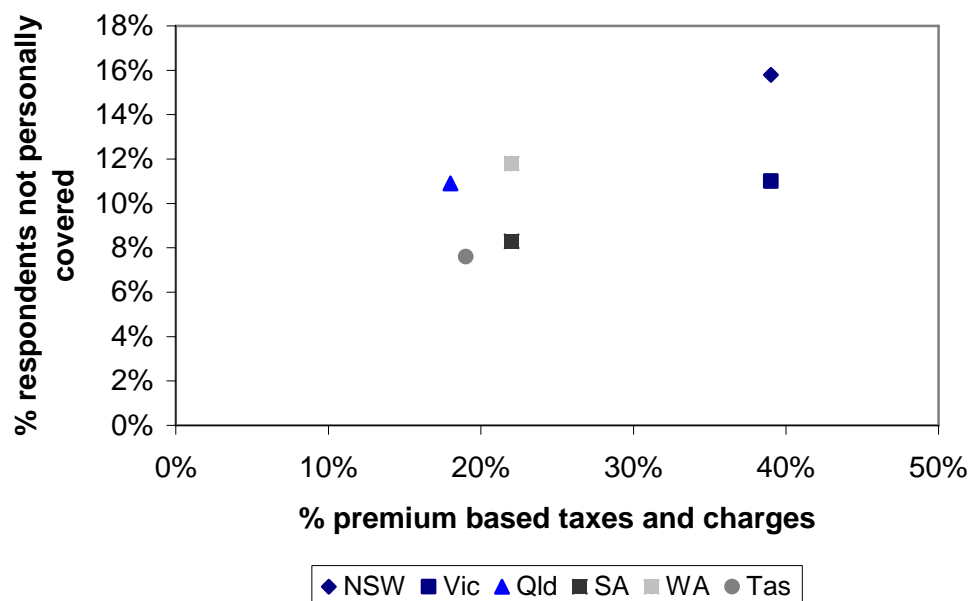
Using both the ABS HES and the RMSS data, and after controlling for relevant variables that may impact on non insurance (such as tenure) the *"Non Insured"* report concluded that State taxes directly impact the take up of insurance. The charts below, drawn from the *"Non Insured"* report show the positive correlation between premium taxes paid and the percentage of respondents who indicate they do not have home or contents insurance.

% without contents cover 2005



Source: Insurance Council 2007

% without building cover - home owners 2005



Source: Insurance Council 2007

The Insurance Council's "Non Insured" report concluded as follows:

"State taxes on building and contents insurance in Australia are significant, varying between 18% and the 45% on top of the pre tax premiums.

The analysis in this section suggest that these state taxes have impacted the take-up of insurance and in doing so, caused deadweight losses to society. The analysis supports the view that demand for contents insurance is more price sensitive than for building insurance.

These findings are supported by analysis of both variation in taxes between jurisdictions and across time and analysis of both the Roy Morgan Single Source and ABS HES data sets.

Only NSW and Victoria still impose a fire service levy on insurance premiums. The data presented supports the view that this approach to funding the fire services is costly to society. Other jurisdictions have successfully migrated to other more efficient and equitable funding methods. These should be explored by NSW and Victoria. All states should also consider alternatives to stamp duties on insurance. ¹⁰

What is the elasticity of demand for household insurance?

The Insurance Council commissioned Dr Richard Tooth of the Centre for Law and Economics at the Australian National University to undertake further and more detailed analysis into the elasticity of demand for house and contents insurance. ¹¹ The study commissioned by the Insurance Council used econometric analysis to more closely examine the factors that affect demand for house and contents insurance. The report sought to determine:

- The effect of a change in government policies toward state taxes on insurance;
- An estimate of price elasticity of demand¹² for house and contents insurance;
- Other factors that may influence the demand for insurance.

The study by Dr Tooth provides a significant advance in the understanding of the factors that drive insurance demand. Prior studies on the demand for insurance have largely focussed on non-property insurances and/or have been limited in analysing the importance of price. Further, prior to Dr Tooth's analysis there appeared to be no Australian based study examining the elasticity of demand for insurance. The study serves to bridge this gap in understanding.

Dr Tooth's report makes use of the ABS Household Expenditure Survey (HES) for the survey years 2003/04, 1998/99 and 1993/94. The ABS HES record detailed information on household characteristics and household expenditure on a range of items including house and contents insurance. The ABS HES data is supplemented with information on state based taxes on insurance premiums collected by the Insurance Council. These taxes are used as an effective proxy for the price of insurance and are used to calculate the pre-tax insurance premiums so that inter-state comparisons can be made.

What is the elasticity of Contents Insurance?

The results of the analysis showed households are sensitive to price signals. The demand elasticity for the decision of whether to purchase contents insurance was estimated to be around -0.5, which is consistent with estimated demand elasticities for other broad product categories of goods and services.

The report found evidence that households who have purchased insurance will respond to higher taxes by reducing their premiums by either reducing their level of cover or increasing their deductibles. The price elasticity of demand for expenditure on insurance (ie incorporating both the decision to insure and the amount of cover purchased) was estimated to be around -0.75.

Furthermore the price elasticity of demand was found to be even greater for those households that do not have a need to purchase house insurance. For this group of households the price elasticity of demand (in terms of expenditure on insurance) was estimated to be between -1.1 and -1.6.

The price elasticity of demand for contents insurance for all households and those households without potential for house insurance is summarised in the following table. Elasticities for both groups of households are reported

¹⁰ Insurance Council of Australia (2007) : "The Non Insured: Who, Why and Trends" page 37

¹¹ Tooth, Richard (2007) "An Analysis of the Demand for House and Contents Insurance in Australia" (A report for the Insurance Council of Australia).

¹² Given the nature of insurance provision, the elasticity estimated is that of the combined effect of supply and demand.

in terms of the decision as to whether to take up contents insurance and the total expenditure on insurance cover.

Price Elasticity of Demand for Contents insurance

	Decision to purchase	Expenditure on insurance
All Householders	-0.5	-0.75
Households without potential for house insurance	-0.9	-1.0

Source: Tooth, Richard (2007) *"An analysis of the Demand for House and Contents Insurance in Australia: A report for the Insurance Council of Australia"*.

What is the elasticity of Building Insurance?

The study also found that although the determinants of building insurance were in general similar to that of contents insurance there are some marked differences. In particular, the demand for building insurance was found to be less sensitive to price.

The results in the study are consistent with expectations and the observation that there is greater take-up of building insurance by households that have a need for house insurance, i.e. owner occupiers not paying body corporate fees.

Factors that would contribute to the greater take up and thus lower price elasticity of demand for building insurance include:

- The larger potential loss from damage to a house relative to contents;
- The absence of practical choice as to the level of replacement; and
- The requirement, in many cases, by mortgage lenders for mortgagees to take out building insurance.

Although less elastic, the analysis showed households are sensitive to price changes and thus high taxes on insurance will lead to households being uninsured or underinsured. Estimates of the price elasticity of demand for the decision to purchase house insurance were between - .06 and - .13. There was no evidence that households were price sensitive in terms of the level of cover that they purchased.

What is the estimated effect of removing premium based taxes on the take-up of contents insurance?

The models and elasticity used to estimate elasticities for house and contents insurance were also used to estimate the additional take up of general insurance upon reform of general insurance taxes. The additional take up of insurance following reform of insurance taxes is outlined below.

Households (000s) without contents insurance

	From 2003/04 survey	Forecast reduction today if			
		FSL were removed		FSL, stamp duties, and IPT ¹³ were removed	
	Estimate	Estimate	% Decline	Estimate	% Decline
Australia	2,170	182	8.4	300	13.8

Estimated effect of removing premium based taxes on the take-up of building insurance

Households (000s) without building insurance (owner occupiers not in body corporate)

	From 2003/04 survey	Forecast reduction today if			
		FSL were removed		FSL, stamp duties, and IPT were removed	
	Estimate	Estimate	% Decline	Estimate	% Decline
Australia	203	49	24.1	69	33.9

Source: Tooth, Richard (2007) "An analysis of the Demand for House and Contents Insurance in Australia: A report for the Insurance Council of Australia".

As the above tables demonstrate, removing premium based insurance taxes is estimated to lead to an additional 300,000 households having contents insurance and an additional 69,000 having building insurance. Although the projected effect on the building insurance market is less than that for contents insurance, taken as a share of the non insured, the effect on building insurance is quite marked.

CONCLUSION

The Insurance Council's Senate Select submission argues that the economic gains from insurance tax reform are significant enough to be worthy of the attention of State governments. Moreover, the Insurance Council contends that given insurance tax reform was not included as part of the 2000 Intergovernmental Agreement between the Commonwealth and the States, a sense of urgency needs to be applied to the insurance tax reform task.

Moreover, given the potential for economic benefits that will accrue from change, insurance tax reform is affordable at a net cost to the States of \$1.7 billion. This places insurance tax reform in the same cost bracket as comparable State tax reform measures introduced as part of the 2000 IGA. Given a gain to real household consumption of 0.48% or the equivalent of \$2.6 billion, insurance tax reform will deliver economic gains closely resembling the gains secured as part of previous microeconomic reform processes. This should make insurance tax reform a prime candidate for State action.

¹³ IPT is the NSW Income Protection Tax introduced in 2001 in the wake of the collapse of HIH.