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State Tax Review
Department of Treasury and Finance
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STATE TAX REVIEW – Interim Report

Introduction

Insurance Australia Group (IAG) welcomes the State Tax Review - *Interim Report* released on 1 June 2006 and the invitation from the Treasurer for comments on the preliminary findings.

IAG supports a consultative approach to regulatory review and an approach that engages with industry at all stages of the review process. IAG commends the Government for its consultative approach to date and the opportunity to make a submission to the Review.

Preliminary Findings

Stamp Duty on Insurance Premiums

"Levying stamp duty on a GST-exclusive basis would appear to pose few administrative or compliance issues".

Additional Issues

"In addition to any comments on the preliminary findings, feedback is invited on whether removing stamp duty on GST should be more of a priority for stamp duties (e.g. insurance) than others (e.g. motor vehicles or commercial property)".

Reducing the Insurance Duty Burden

"Abolition or phasing out of insurance duty would be difficult to afford, particularly if this only occurred in Western Australia such that there was little offsetting GST gain, and would compromise the State's budget flexibility.

However, a reduction in the insurance duty rate would be a relatively high priority on economic efficiency grounds, although not currently on interstate competitiveness or administrative efficiency grounds.

Further research should be undertaken in Stage 2 of the Review on equity aspects of insurance duty, and its impact on the take-up of insurance cover by the community".

As IAG highlighted in its initial submission to the State Tax Review, Governments should recognise the essential benefits of insurance to the economy and community generally and implement a taxation system, which encourages insurance.

IAG argues that there is a clear economic case for reducing State Government insurance taxes and charges ahead of many other taxes in order to reduce the taxation impost on insurance premiums to businesses, households and the community.

The Business Coalition for Tax Reform (2004) commissioned Access Economics report on the efficiency of State and Territory taxes (*Axing the Alcabala: A Program for a 21st Century State Tax System*) noted that for insurance taxes there is a strong efficiency case for further state tax reform. Access Economics modelling results undertaken for both the Property Council of Australia (2003) and the Insurance Council of Australia (2000) also highlighted the efficiency case for insurance tax reform.

Indeed, Access Economics concluded that reducing stamp duties on insurance would result in gains to economic welfare, GDP and investment that are many times greater than the gains that would arise if payroll taxes were reduced by the same amount. Access Economics noted that in broad terms, the results indicate that taxes that fall on investment (such as stamp duties on non-residential conveyancing and insurance) lead to the greatest economic costs, and would therefore provide the greatest economic benefits if they were to be reduced.

Access Economics note that "reductions in payroll taxes provide relatively small economic gains due to the assumption that in the very long run, labour supply and employment are relatively unresponsive to real wages. (p.12)

The Centre for International Economics (2005) notes the Access Economics' modelling indicates " cutting stamp duty taxes on insurance would provide almost double the welfare benefit that results from cutting the lowest cost benchmark tax"…The modelling can also be viewed as a means of ranking taxes. Were the government considering a tax cut, it could determine which ones would deliver the best outcomes for economic welfare. Taxes on insurance, particularly stamp duty, would rank highly in any such consideration" (p.31).
http://www.ica.com.au/general/issueslist.nsf/17e2e1f61d0819b9ca256e38001b8277/947bb702dddc7fdcca257059007e43fe/$FILE/CIE%20Final%20report%20ICA_15.pdf

The Access Economics Report further noted, "FSL and stamp duty on general insurance are inefficient enough in isolation. In combination – and even if the tax base for insurance was properly specified - the taxation of general insurance products subject to all three taxes is the most inefficient taxation treatment existing at the state level".
http://www.bctr.org/upload/AEconomics_State_Business_Tax_Reform_Nov_2004.pdf
Moreover, the New South Wales Treasury in its submission to the New South Wales Public Accounts Committee Inquiry into Fire Services Funding (2003) stated, "…It would be undesirable if consumers and businesses were choosing not to insure, or underinsuring, because of higher prices caused by taxes on insurance.

Not only could this affect the persons or businesses concerned, but overall economic efficiency and growth would be affected by the changes resource allocation" *(NSW Treasury submission, page 14).*
http://www.parliament.nsw.gov.au/prod/parlment/committee.nsf/0/e5fea4093a03babeca256dec001570b5/$FILE/Treasury%20submission.pdf
The New South Wales Treasury (2003) noted, "It seems reasonable to expect that high tax rates would contribute to non-insurance and under-insurance – price increases generally lead to a reduction in demand for goods and services." *(NSW Treasury submission, page 14).*

Indeed, the Insurance Council of Australia's initial submission to the State Tax Review highlighted the extent of under-insurance and non-insurance in the community. The ICA noted "Research by the ICA has found that up to one in four households in Australia carries no insurance at all, with this percentage being influenced by non-insurance in the tenancy and housing commission sectors. Preliminary investigations by the Insurance Disaster Response Organisation following the ACT firestorm has found (based on well over 100 households affected by the fires) significant underinsurance of contents, with underinsurance ranging between 30 and 50 percent below realistic replacement costs. House structures were found to be underinsured, on average, by 40 percent of the replacement cost" (ICA, p.11). The issue of building under-insurance is particularly relevant in Western Australia in light of the State's resources and housing market activity putting pressure on building supplies and trades which have pushed up construction costs in recent years.

The HIH Royal Commission also stated "another reason why high rates and sales and turnover taxes on insurance products should be discouraged concerns the inherent benefits to individuals, third party claimants and the community more broadly that arise from taking out of appropriate insurance cover" (HIH Royal Commission Report p.277).

IAG contends that it is in the best interests of Governments and the community if people are encouraged to protect their property by insurance. IAG agrees a reduction in the insurance duty rate should be a relatively high priority on economic efficiency grounds.

Foreign Insurance and Discretionary Mutual Funds

"Consideration of broadening the insurance duty tax base to DMFs and DOFIs should await the outcome of the Commonwealth Government's response to the Potts Review.

In the meantime, there may be value in State governments approaching the Commonwealth to support APRA taking on a data collection role in relation to DOFIs and sharing this data with the States, so that stamp duty implications can be assessed."

While IAG argues that there is a clear economic case for reducing insurance taxes ahead of other taxes in order to reduce the taxation impost on insurance premiums, it is also important to ensure the effective application of insurance taxes to DMFs and DOFIs in order to provide greater fairness in the application of the tax.

IAG believes that one of the key requirements for an efficient general insurance market is a “level regulatory playing-field” for the various market participants. While technically insurance policies offered by DOFI are subject to stamp duty, there is little if any enforcement mechanisms to ensure that these taxes are paid. Since the products of DMFs are not considered to be insurance, they are also able to avoid these taxes. This ultimately results in higher tax payments for Australian insureds who source their insurance through APRA authorised general insurers and are subject to stamp duty.
IAG believes that regulation has an important role to play within the Australian insurance market. IAG contends that the rationale for prudential regulation of general insurance is one of consumer protection. It also has a role in ensuring that an even “playing field” is maintained with respect to competition when implementing prudential regulation. Within the general insurance sector, IAG considers that a substantial information “asymmetry” exists, in that policyholders may not be equipped with sufficient information on which to base a decision to insure. The consequences of this are adverse for policyholders if it results in insurance claims not being met. It is unreasonable to expect retail consumers to conduct a detailed review of the financial security of their insurance contract or its provider. They should be entitled to assume a base level of security from all providers of retail insurance operating in the local market.

While discretionary mutual funds and direct offshore foreign insurers are permitted to continue to operate without either obligations to provide “true” insurance (i.e. an enforceable contract to pay claims for specified losses rather than a right to request a fund to exercise its discretion in favour of the claimant) or meet capital adequacy requirements, consumers remain inappropriately exposed. Accordingly, regulatory reform must ensure that consumers are adequately protected and that market failures are alleviated, but also that competitive forces are sustained. In fact, we believe that Australian consumers believe that they are protected by regulation from the impact of insurance company failure.

IAG believes it is necessary to provide the same level of protection to consumers (and third parties) of products supplied by discretionary mutual funds and direct offshore foreign insurers as is provided to consumers of products supplied by insurers subject to prudential regulation under the provisions of the Insurance Act 1973.

IAG agrees there would be value in State Governments approaching the Australian Government to support APRA taking on a data collection role in relation offshore insurers and sharing this data with the States, so that stamp duty implications can be assessed.

Emergency Services Levy

“The new levy is considered fairer than the previous funding arrangements. Abolition of the levy, and funding emergency services from general revenue, would be costly and require a stronger case in terms of the State Tax Review principles than has so far been made. However, further submissions should be accepted as part of Stage 2 of the Review.”

IAG agrees the emergency services levy is considered fairer than the previous funding arrangements.

As the Government is aware, the Sigma Plus Consulting's *Emergency Services Levy Insurance Compliance Review: Final Report* in relation to the effect of the phase-out of the Fire Services Levy (FSL) in Western Australia indicated the removal of FSL in Western Australia contributed to Western Australia having one of the most price competitive insurance markets in Australia in 2003 and consumers responded to cheaper insurance by increasing their insurance cover to more adequately protect themselves.
http://www.fesa.wa.gov.au/upload/1514878857/docs/insurance_Compliance_Rprt_April_2004.pdf

IAG notes the Government states in the *State Tax Review Interim Report*

> *"The former FSL on insurance premiums suffered from the drawback that some property owners avoided the levy through non-insurance, underinsurance or offshore insurance (receiving a 'free ride'). By contrast, the ESL is levied on all property that may require fire and emergency services, making it broader-based and fairer. Previous funding arrangements through insurance premiums and local government/community-based funding arrangements also suffered from lack of transparency.*
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> *It is not valid to make a simple comparison between the amounts paid under the old FSL and new ESL, as the former covered only 75% of the costs of providing emergency services. The increase in levies reported by survey respondents might be due in part to avoidance of the former levy as described above." p.284-285*

Moreover, the New South Wales Treasury in its submission to the New South Wales Public Accounts Committee Inquiry into Fire Services Funding (2003) also noted:

> "*The principle underpinning the Fire Services Levy is to ensure beneficiaries of the fire services contribute to funding the service. However, the presence of non-insurance and under-insurance indicates that a significant proportion of beneficiaries are either not contributing to funding the fire services or are under contributing.*
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> *As a means of matching contributions to fire risk, the levy performs poorly particularly for householders. Fire risk is only one element of insurance policies, and it is evident that there is not s strong correlation between fire risk and fire services levy contributions.*
>
> *A weakness of the current arrangements is that the government is not able to ensure the extent of recovery from each type of insurance policy category is appropriate. However, even if this were addressed, the fact remains that insurance policies are much broader in scope than fire so that the premiums will substantially reflect risks other than fire risk.*
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> *It is also apparent that insurance is relatively highly taxed – with the fire services levy the highest impost. High tax levels are likely to discourage insurance and lead to under-insurance with adverse consequences for resource allocation and economic growth." (NSW Treasury submission, page 20).*

Again, IAG agrees the emergency services levy is considered fairer than the previous fire services funding arrangements and should be retained.

We at IAG are happy to discuss this submission and assist the Review in any way we can. If you wish to discuss this matter or make further inquiries please contact David Wellfare, Senior Adviser, Economics & Policy on (02) 9292 8593.

Yours sincerely
Nola Watson
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