INSURANCE COUNCIL OF AUSTRALIA

SUBMISSION TO THE REVIEW OF AUSTRALIA'S FUTURE TAX SYSTEM

OCTOBER 2008

EXECUTIVE SUMMARY

The Insurance Council of Australia submits that reform of general insurance taxes should be a priority for the Review of Australia's Future Tax System (AFTS). As the Treasury report "*Architecture of Australia's tax and transfer system*" succinctly stated:

> *"The narrow base of many transaction taxes and their interaction with other taxes can have an impact on resource allocation in the economy. For example, insurance products are subject to GST, insurance taxes and, in some states, insurance companies can also be required to contribute directly to the funding of fire services. The interaction of these taxes increases the costs of premiums relative to other products, which may encourage people to take up less insurance than otherwise"* [1]

The Insurance Council supports the remarks in the Treasury paper and contends that the abolition of general insurance taxation will generate substantial gains to national economic welfare.

The Insurance Council submits that:

- Reform of general insurance taxes will yield gains to real household consumption of around 0.48% or a little under $2.6 billion ensuring that the gains to economic welfare from general insurance tax reform equate with those achieved from microeconomic reform efforts of the past.

- That the net cost of abolishing stamp duties on general insurance is $1.7 billion after allowing for second round effects and revenue claw backs to the States from efficiency gains. The net cost of such reform is comparable to the hitherto cost of previous State tax reform in financial services such as the removal of FID and Debits taxes.

- The gains from the removal of ***all*** State transaction taxes are extremely large, with gains to household consumption of between 1.1% and 1.8%.

- There is now an emerging consensus that reform of general insurance taxation is desirable and timely. For example, His Honour Justice Owen recommended reform of general insurance taxation in his Royal Commission into the collapse of HIH. More recently, the NSW Independent Pricing & Regulatory Tribunal (IPART) recommended reform of general insurance taxation and in particular, fire services levies and stamp duties. [2]

- Although the immediate emphasis of the Commonwealth State reform project rests with reform of service delivery, considerable gains can also be secured to national well being from reform of Commonwealth State taxation arrangements. Moreover, the model of the 2000 Intergovernmental Agreement between the Commonwealth and the States provides a proven platform under which future taxation reform efforts can be launched.

- The AFTS provides a rare and historic opportunity to correct the absence of general insurance tax reform from the 2000 IGA. The failure to include a program of insurance tax reform in the original 2000 IGA represents a significant anomaly in the history of national tax reform and in this regard, the AFTS Review provides a unique pathway to redress this situation.

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[1] See Australian Treasury (2008) "Architecture of Australia's tax and transfer system" at page 203.
[2] See Royal Commission into HIH (2003) "*Volume 1: A Corporate Collapse and its lessons*" and NSW Independent Pricing & Regulatory (June 2008) "*Review of State Taxation: Report to the Treasurer*"

INTRODUCTION

General insurance is vital to the health and well being of communities. After a natural disaster or major weather events, the presence of private insurance serves to manage the after effects of loss and to expedite recovery. The availability of general insurance compensates 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.

Together with these benefits to households and businesses, general insurance is integral to the functioning of an efficient and developed economy. Insurance "monetises" risk and allows risk to be efficiently transferred across the economy. In so doing, insurance intermediation is fundamental to efficient 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 for governments, general insurance provides financial security and stability, safe in the understanding that in the event of a major catastrophic event, the cost of assistance and recovery will not be met by governments alone, with the resultant straining of government capacities and resources.

Despite the widespread benefits that accrue to society from the availability of robust general insurance markets, the Australian general insurance industry remains unnecessarily burdened by inefficient policy settings. The Insurance Council contends in this submission to the Review of Australia's Future Tax System (AFTS) that reform of these policy settings is now timely and opportune. As decision makers begin to equip the Australian community for the challenges associated with climate change, the need to provide policy settings that regulate and provide for efficient risk pricing are fundamental to the task.

The Insurance Council submits that a known and practised pathway towards reform of general insurance taxes is available to the Commonwealth. The 2000 Intergovernmental Agreement (IGA) 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 most regrettable and a significant policy oversight. The Insurance Council believes that the absence of general insurance taxes in the original 2000 IGA should not preclude the adoption of a like process for general insurance tax reform today. Indeed, the absence of general insurance tax reform in 2000 *and* the availability of a practised and successful reform model should be sufficient to ensure that general insurance tax reform returns as a tax reform priority.

The gains to the national economy from transaction tax reform are large. Vis-a-vis other State taxes, stamp duties on general insurance result in large deadweight costs and represent a drag to economic well being. Reform of insurance taxes will 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 around 0.48% or a little under $ 2.6 billion. In other words, reform of stamp duties on GI would deliver a gain to living standards comparable to the successful micro economic reform programs of the last two decades. Seen in this light, a program of reform of insurance taxes represents another plank in a broader national project of microeconomic reform.

This submission provides decision makers with a costing of insurance tax reform, including second round effects. According to Access Economics, the net cost of abolishing all stamp duties on general insurance is $1.7 billion after allowing for revenue claw backs to the States from efficiency gains. Again, by way of comparison, reform of stamp duties on general insurance approximates the hitherto cost of previous State tax reform (ie FID taxes and Debits taxes) achieved in the framework of previous Commonwealth State agreements.

Lastly, the Insurance Council contends that future national programs of microeconomic reform will depend heavily on actions by the States. Although the immediate term emphasis on Commonwealth State relations may be securing reforms involving service delivery, the evidence suggests that significant economic gains can

be also be achieved from reform of Commonwealth State taxation arrangements. Insurance tax reform should be the priority for reform in this regard.

BACKGROUND TO THE INSURANCE COUNCIL

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.

2008 Australian Prudential Regulation Authority statistics show that the private sector insurance industry (both direct and reinsurers) generates gross premium revenue of $31.2 billion per annum and has assets of $91.0 billion. The industry employs approximately 43,000 nationally, and on average pays out about $87 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 risk profile. This profiling of risk enables economies to more flexibly and efficiently allocate resources, thereby encouraging stronger investment/growth and higher living standards.

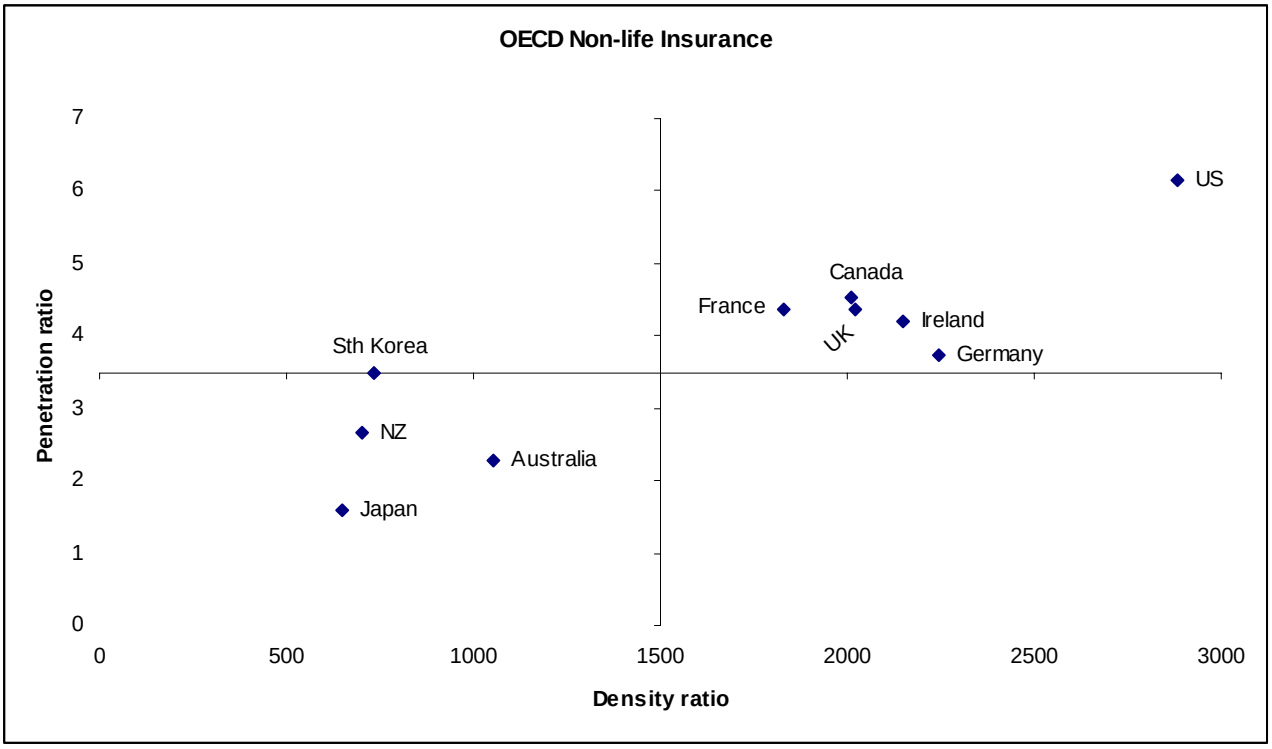
In other words, general insurance serves as an economic enabler, with its contribution to economic growth being:

- 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.

THE GENERAL INSURANCE INDUSTRY IN AUSTRALIA

According to the Australian Prudential Regulation Authority, direct insurers write in the order of $24.5 billion per year of gross premium revenue. The relative shares of insurance classes and the concomitant density ratios (ie premium per capita) vary between classes and across jurisdictions as a result of the overall penetration of the insurance class and the extent of private provision.



Notes: Density ratio is Gross Written Premium (Non Life) per Capita and the Penetration ratio is Gross Written Premium (Non Life) per GDP.

Source: OECD

According to APRA 130 private sector insurers accept general insurance business nationally (i.e. insurance other than life and health insurance). All licensed insurance companies are prudentially supervised under the Commonwealth *Insurance Act 1973.*

At a national level the general insurance industry contributes some $5.3 billion (0.51%) to GDP in value added terms.

As the figure above shows, Australia's insurance cover is less extensive than comparable advanced economies in Europe and North America. It is the Insurance Council's contention that policy settings, including the tax burden on general insurance, is a factor behind Australia's relatively low insurance density vis-a-vis other advanced nations.

AN OVERVIEW OF TAXATION ON GENERAL INSURANCE

Stamp Duties on the General Insurance Sector

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 are transaction based taxes levied 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, and the frequency of transactions.

The economic effect of a transaction tax is the same as a direct tax in that it affects consumption and production decisions. The result is increased prices for households and businesses together with reduced output, (thereby redirecting resources to less efficient uses). Economic welfare is reduced through the creation of dead weight losses and constrained consumer and producer surpluses. The overall effects depend on the elasticity of demand and supply, but the more inelastic is demand and or supply the smaller will be the production distorting and welfare effects of a transaction tax.

More specifically though, transaction taxes:

- Discourage the turnover of a good or service as taxpayers attempt to reduce or avoid paying the tax. Reduced turnover will make price discovery more difficult, reducing market efficiency. Where the taxable item is a productive input, businesses will be encouraged to use an alternative input to the preferred input, resulting in a less efficient input mix and higher costs that cascade through the production chain and add to output prices.

- Have a much narrower base compounding the misallocation of resources as the narrower a tax base the higher the tax rate must be to collect a given amount of tax revenue.

- Are regressive as lower income households and high frequency transactors pay a disproportionate amount of their income in tax. In addition, exemptions add to the inequities while unnecessarily adding to complexity.

According to the Australian Bureau of Statistics, stamp duties on insurance amounted to $2.9 billion in 2006/07. Since the introduction of the New Tax System in 2000, stamp duties on general insurance have increased by 78% compared with an increase in total State taxes of around 29%. The States now accrue approximately one in twelve tax dollars from taxes on insurance.

Statutory Contributions to the Fire Services

In the States of NSW, Victoria and Tasmania, the funding of fire services is undertaken through a contributions system, with the insurance industry being required to contribute funding according to a statutory formula. [3]

[3] See the Victorian *Metropolitan Fire Brigades Act 1958*, the *Victorian Country Fire Authority Act 1958*, the Tasmanian *Fire Service Act 1979*, the *NSW Rural Fires Act 1997* and the *NSW Fire Brigades Act 1989*.

Under the respective State Fire Acts, insurers are required to report to the fire authorities actual gross written premiums from specific property classes in the financial year immediately preceding. These gross premiums are then "weighted" according to a formula to determine a "deemed" premium pool for the year. Each insurer is then allocated their funding contribution according to their market share of the overall deemed premium pool.

Insurers recover the fire services contributions they make to the fire services through imposing a levy – otherwise known as the Fire Service Levy - on their insurance policy holders.

The actual process of determining the appropriate recovery charge for fire contributions is complex and difficult for insurers. Given that contributions are sought 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 mix (ie across classes of business) and the premium levels (ie hardening or softening markets) results in insurance companies bearing all collection risk for the fire services. Under or over collection is an inevitable feature and failure of the current system.

NSW, Victoria and Tasmania retain statutory contribution funding systems for the funding of fire services. In recent times, most 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. 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. [4] 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. Furthermore, the Royal Commission into the collapse of HIH Insurance recommended the reform of fire service contributions systems for those States that retain that approach to fire funding. [5]

NSW Insurance Protection Tax

The *NSW Insurance Protection Tax Act 2001* was introduced as part of the 2001 NSW Budget and followed the collapse of HIH insurance. The Insurance Protection Tax (IPT) imposes a charge on the NSW insurance industry of $69 million to be apportioned according to the relative market shares of premium. The proceeds of the IPT are set aside for a Policyholders Protection Fund.

A key feature of the NSW IPT Act is Section 21 that prohibits the recovery of the IPT tax. The IPT Act prohibits any insurer required to pay tax under the IPT from charging an insured person for the amount attributable to the tax and is therefore a tax on company shareholders.

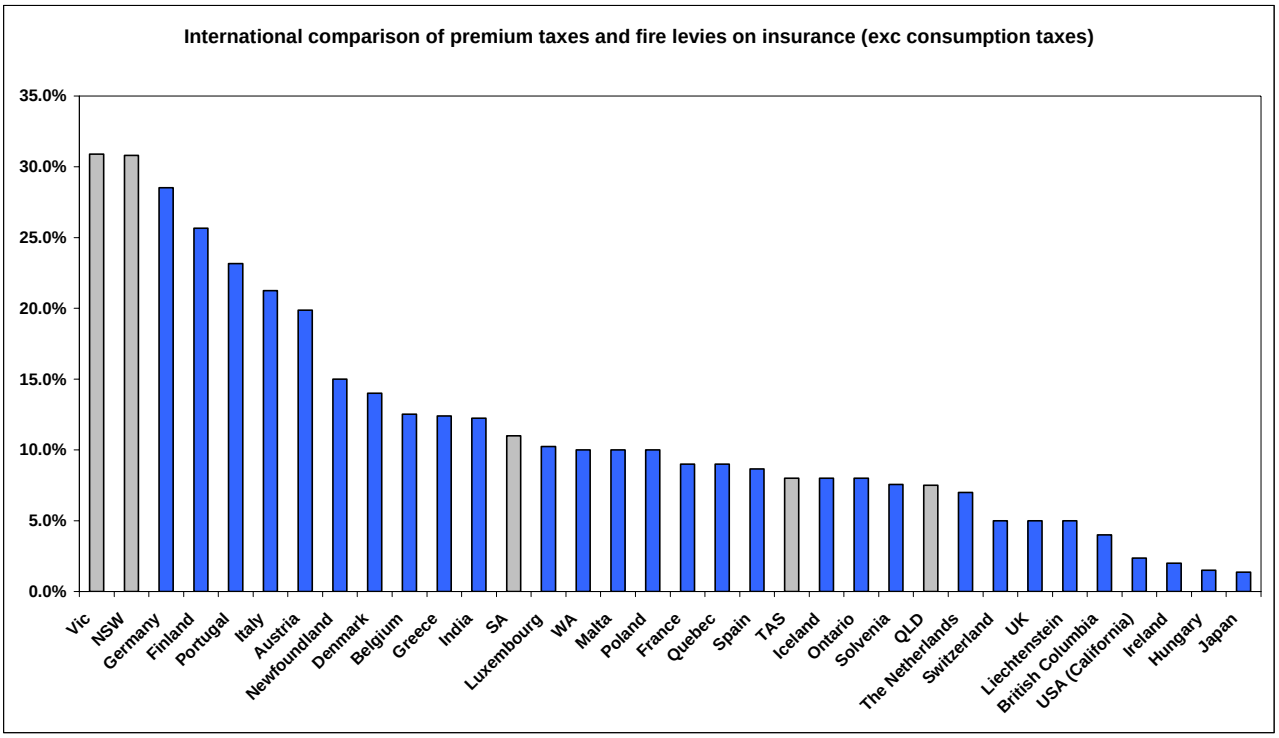
INTERNATIONAL COMPARISONS OF INSURANCE TAXES

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.

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

[5] HIH Royal Commission (2003) "*Volume 1: A Corporate collapse and its lessons*" page 306



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.

ARE INSURANCE TAXES EFFICIENT & EQUITABLE?

Insurance Taxes Distort Behaviour

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. As Access Economics argue:

> *"An efficient tax system raises revenue for the government without distorting the allocation of resources in the economy… In reality, all tax systems distort the allocation of resources, thereby imposing a cost on society. This occurs because the imposition of a tax distorts the private cost (the price that consumers must pay for a good), so that it is higher than the social cost (the cost to society) of producing it. This causes the level of consumption to be below what it would otherwise have been without the tax. Since the social value (benefit to society) exceeds the social cost of the foregone consumption, the tax causes a loss in economic welfare, which is typically referred to as a "deadweight" loss".* [6]

As highlighted previously, transaction taxes 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 the resultant dead weight costs to the economy.

The extent of a given taxes 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

[6] Access Economics (2008) "*Analysis of State Tax Reform including taxes on General Insurance*"

loss. Consequently, an efficient tax would ideally be levied on goods and services characterised by small demand and supply elasticities.

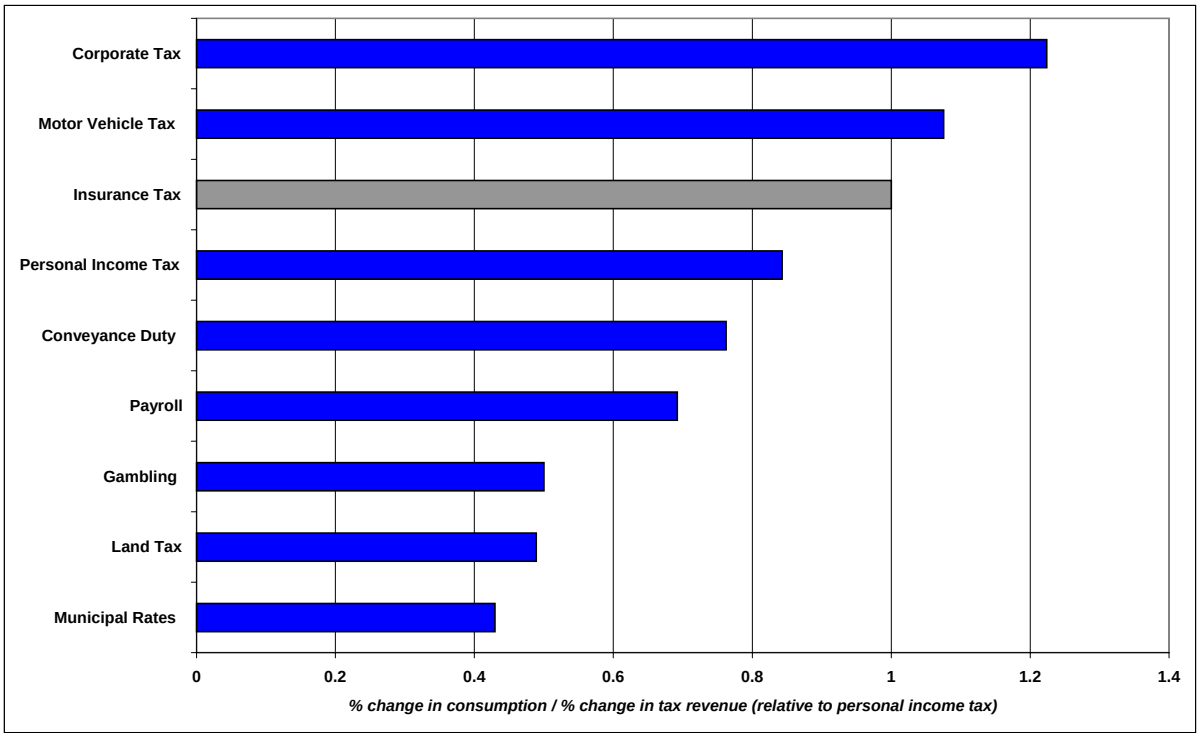
The imposition of the Fire Services Levy and Stamp Duties on General Insurance Premiums significantly increases the premium paid by the insured. The overall increase is exacerbated by the layering of different levels of taxation where:

- Fire Service Levies are imposed on the base premium;
- Commonwealth GST is then added on to the FSL inclusive premium and finally;
- State Government stamp duties is then imposed on the GST plus FSL inclusive premium.

The issue of tax on tax effects or "cascading taxes" was raised in the course of the HIH Royal Commission, wherein his Honour, Justice Owen commented:[7]

> *" What has been described as the 'cascading" application of taxes on general insurance gives rise to further anomalies. This is because the GST is levied on the basic premium, including the cost of fire services levies, and stamp duties are levied on the whole premium, including both fire services in those states that have them and the GST. Stamp duties could therefore be described as a 'tax on a tax on a tax' in NSW, Victoria and Tasmania. This treatment lacks transparency, is inequitable, and is contrary to good tax policy"* .

To assist the Insurance Council in determining the efficiency of a given array of taxes, Access Economics was commissioned to measure and model [8] the relative efficiencies of general insurance taxes vis-a-vis a basket of other common taxes, including *average* corporate and personal income tax. [9] These rankings are reproduced below.



[7] Royal Commission into HIH (2003) " *Volume 1: A Corporate Collapse and its lessons*" page 279.

[8] It is important to note the limitations of the Access modelling and in particular the treatment of conveyancing duties. The Access model does not capture the effects of reduced turnover of assets or the impact of leaving assets in the ownership of economic agents who may not be best placed to make effective use of the assets. The effect of these would be to lower the efficiency ranking of the conveyancing duties.

[9] Note, Access Economics have not modelled the precise intricacies of the corporate and personal income tax regimes. The model assumes the corporate and personal tax regimes adjust to alter average tax rates without change to the structure of arrangements.

Source: *Access Economics (2008), "Analysis of State Tax Reform including Taxes on General Insurance"*

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.

As the chart demonstrates, stamp duties on general insurance are amongst the least economically efficient taxes in Australia. Access Economics estimate that the percentage increase in real household consumption from reforming stamp duties on GI 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 NSW Independent Pricing and Regulatory Tribunal (IPART) considered the efficiency of State stamp duties on general insurance (and transaction taxes more broadly) in its review of NSW State Taxation. The NSW IPART commented that: [10]

> "*Stamp duties on insurance and asset transactions are among the State's most inefficient taxes. IPART considers that, in the short-term, NSW should seek to reduce existing exemptions to help fund reductions in the standard rate of these taxes. In the longer term, it should aim to either reduce its reliance on revenue from these taxes, or eliminate these taxes by placing more weight on other more efficient taxes*".

The NSW IPART also remarked:

> *"Insurance duty and fire services funding contributions are arguably the least efficient State taxes. Both these revenue sources penalise those who are prudent enough to take out insurance, and so encourage underinsurance and non-insurance. In addition, significant free-rider problems are associated with the fire services funding arrangements, where non-contributors benefit from the provision of fire services without contributing to the cost through insurance policies".*

The Insurance Council agrees with these assessments and also notes that the HIH Royal Commission report also recommended the removal of stamp duties on general insurance products. [11]

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.

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.

[10] NSW Independent Pricing & Regulatory Tribunal (June, 2008) "*Review of State Taxation: Report to the Treasurer*".(Pages 7 and 44)
[11] See HIH Royal Commission (2003), Op Cit.

Insurance Taxes Encourage Non Insurance

Research conducted on behalf of the Insurance Council by the Australian National University (ANU) Centre for Law and Economics[12], 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.

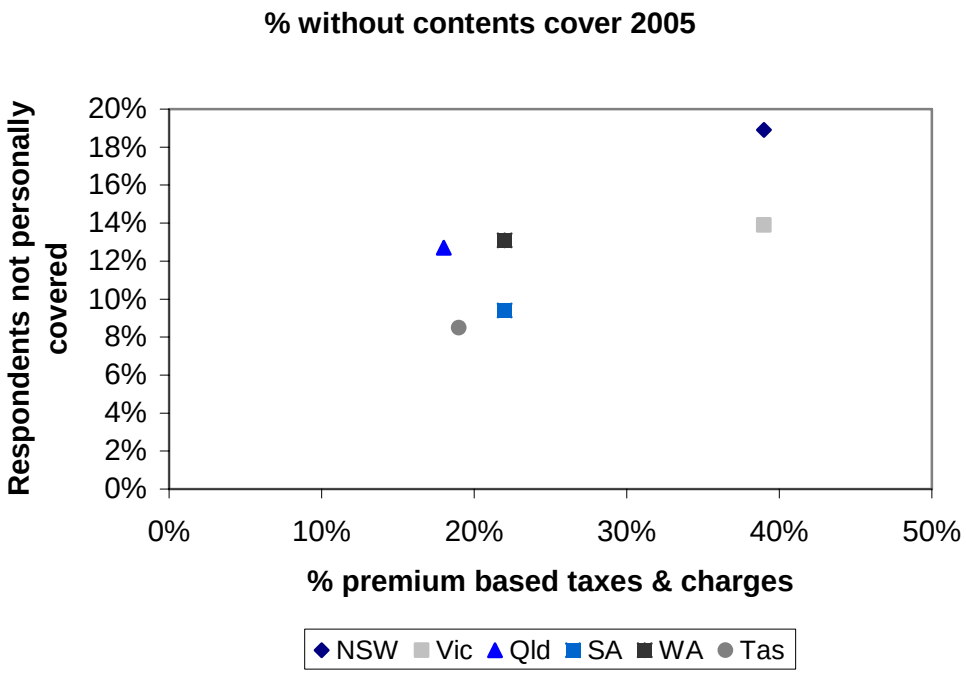
	Class of insurance	Households with no insurance (000's)	Potential market (000's)	% of Households
Australia	Contents	2170	7,736	28.1
	House	203	4,996	4.1

Source: *ABS Household Expenditure Survey 2003-04*

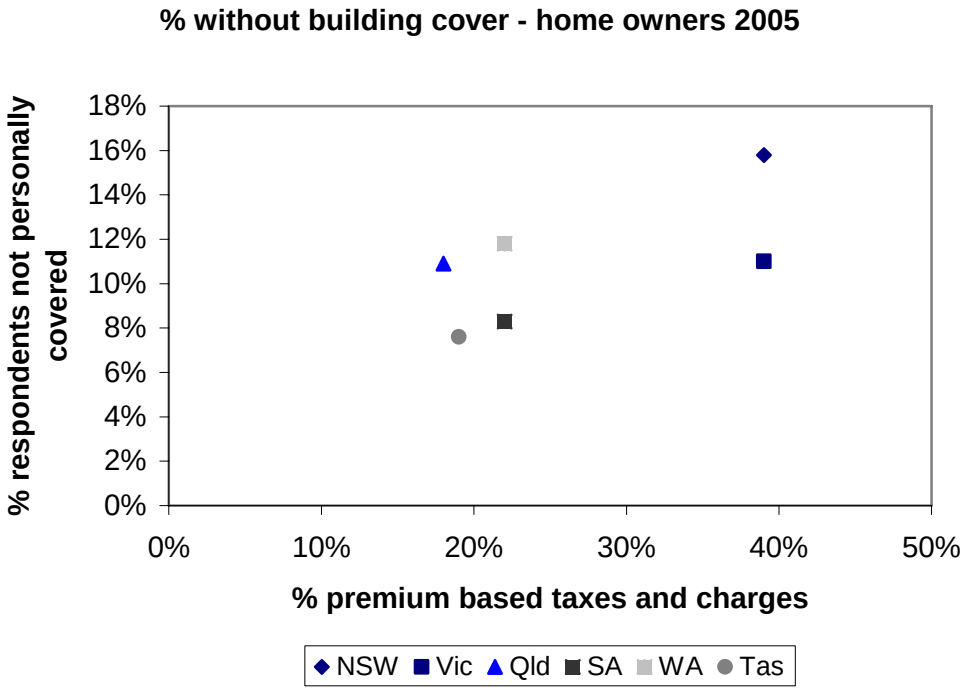
Together with the 2003/04 ABS Household Expenditure Survey (ABS HES) the ANU study also reviewed non insurance using data from the Roy Morgan Single Source Survey (RMSS). The RMSS is a large continuously updated information source examining a broad range of items and matters, including the purchase of 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.

[12] 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.



Source: Insurance Council 2007



Source: Insurance Council 2007

Following on from the initial "*Non Insured*" report , 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. [13] 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:

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

- The effect of a change in government policies toward state taxes on insurance;
- An estimate of price elasticity of demand[14] 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.

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 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".*

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

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.

Income effects

Policy makers[15] (without the benefit of a study on price elasticity) have previously argued that a revenue neutral change in the tax base away from insurance premiums will have no net impact on aggregate incomes and therefore no effect on the quantity of insurance products demanded. The findings of the elasticity study challenge this assertion.

The estimates of price elasticities are based on differences in taxation of insurance across jurisdictions and over time and thus incorporate alternative methods of raising revenue. Thus the study provides direct evidence that demand is responsive to revenue neutral changes involving insurance taxes.

This result is not surprising. Insurance expenditure as a percentage of household income is small. As noted in the study, on average households only spend around 1% of household income on insurance. A change in household income is therefore spread across a range of goods and services.

The study also looked at the income elasticity of demand for contents and building insurance. Income is closely related to the value of a household's portfolio of contents and assets it needs or desires to insure. To focus on the role of income as a determinant of demand, the value of contents and assets were controlled for by holding their values constant across a range of incomes.

The income elasticity of demand for contents insurance was estimated to be low (<0.2) and, in some models, not statistically significant while there was little evidence that demand for building insurance is income elastic.

The findings on income elasticity support the conclusion that shifting the tax base for both general insurance stamp duties and the FSL from insurance premiums to an alternative tax base will result in a net increase in the demand for both contents and buildings insurance.

[15] See for example, Victorian Department of Treasury and Finance (2003) "A *Review of Victorian Fire Services Funding Arrangements*".

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

The models 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		Forecast reduction today if FSL, stamp duties, and IPT [16] 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		Forecast reduction today if FSL, stamp duties, and IPT were removed	
	Estimate	Estimate	% Decline	Estimate	% Decline
Australia	203	49	24.1	69	33.9

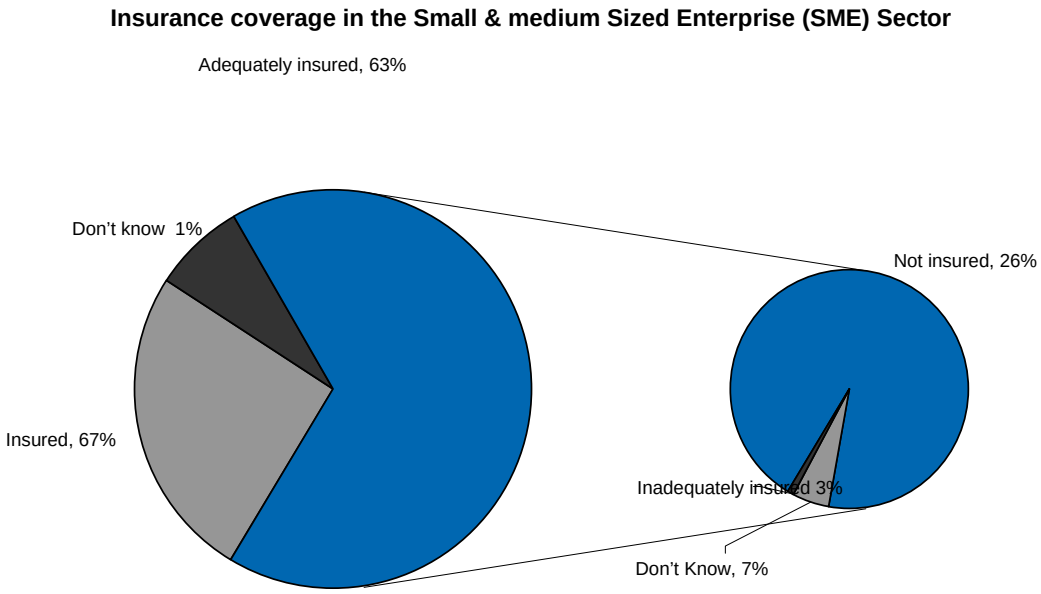
Source: Tooth, Richard (2007) "An analysis of the Demand for House and Contents Insurance in Australia: A report for the Insurance Council of Australia".

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.

Non Insurance in the Small to Medium Sized Business Sector

The Insurance Council commissioned Woolcott Research in September 2008 to survey 1,000 small to medium sized enterprises on their respective general insurance coverage. [17] The research indicated that some 26% of SME's surveyed did not purchase general insurance for their business and of the 67% who indicated that they had purchased insurance for their business, some 5% of this population indicated that they believed their general insurance coverage was inadequate. Overall, only 63% of SME's surveyed believed they had adequate insurance. Premium cost was sighted by almost 80% of SME's that were inadequately insured as their reason for not purchasing adequate insurance. For sole traders, the extent of non insurance was significantly greater, with some 40% of sole traders indicating that they did not purchase general insurance for their business. [18]

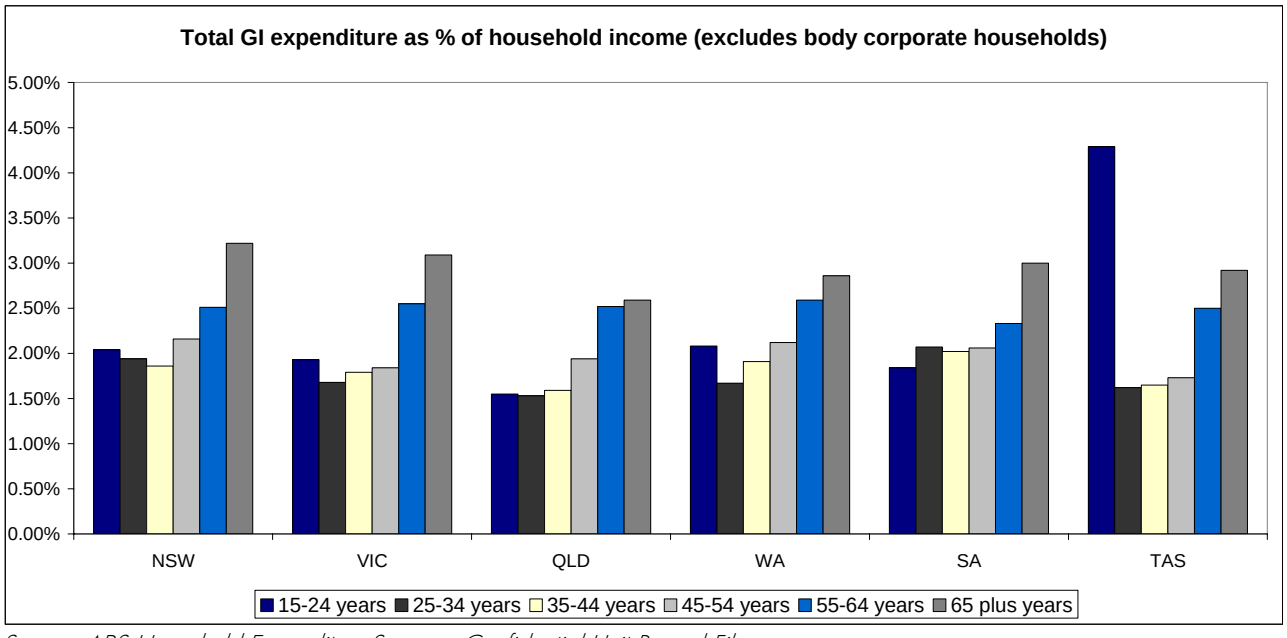
[16] IPT is the NSW Income Protection Tax introduced in 2001 in the wake of the collapse of HIH.
[17] Woolcott Research (September 2008) "*Report for the Insurance Council*". The survey was conducted between 1 – 12 September, 2008 with a sample size of 1,000 small to medium sized businesses nationally. SME defined as businesses with less than 20 employees. Of the 1,000 SME's surveyed, 255 were sole traders, 420 had employee numbers of between 1 - 4, 221 had 5 – 10 employees and 104 had between 11 and 19 employees.
[18] Note, the sample size for sole traders was 255.



Source: Woolcott Research 2008

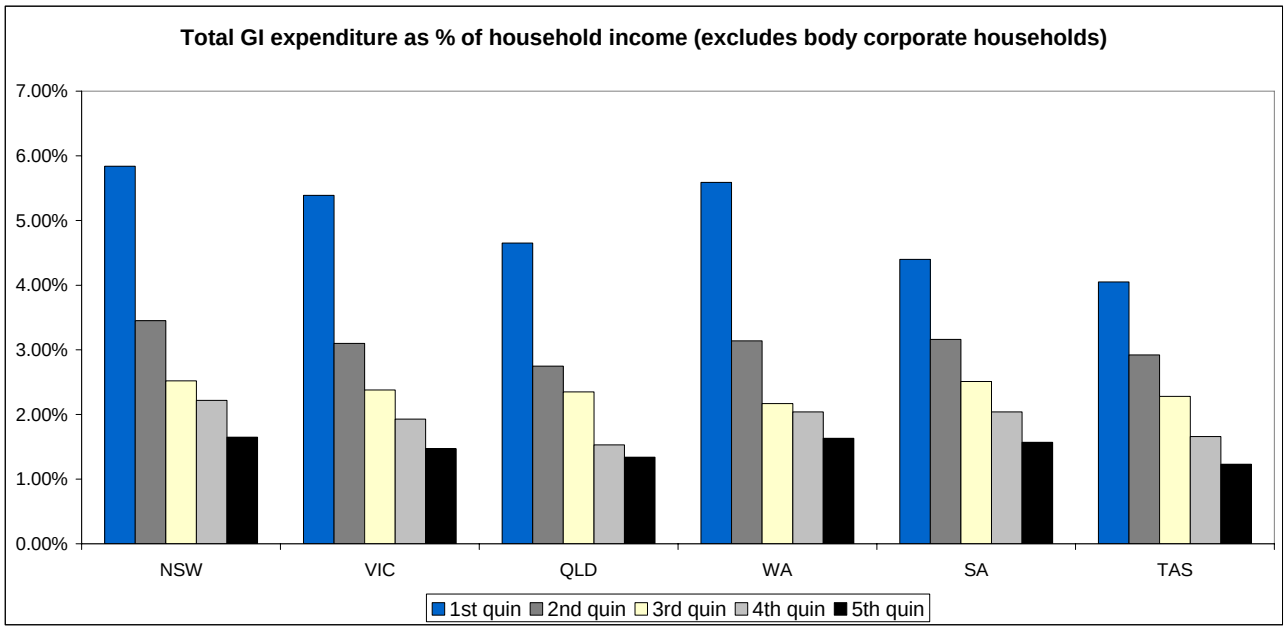
The Household Distribution of General Insurance Expenditures

Utilising the Australian Bureau of Statistics Household Expenditure Survey Confidential Unit Record Files, the Insurance Council has been able to estimate the average household expenditure on general insurance services [19]across income quintiles and age cohorts. These are reproduced in the charts below.



Source: ABS Household Expenditure Survey – Confidential Unit Record Files

[19] General insurance expenditure includes all GI products for household who have purchased general insurance but does not include compulsory insurances (for example, compulsory CTP) or body corporate fees.



Source: ABS Household Expenditure Survey – Confidential Unit Record Files

The charts highlight that as a proportion of weekly household income, those in the lower income quintiles and the aged expend a disproportionately larger share of their household income on general insurance. For example, those on the bottom two income quintiles spend between 3.5% to 6.0% of their average household income on general insurance while the those households at the top two income quintiles outlay around 2% of their weekly household income on general insurance.

A similar pattern emerges when one examines general insurance expenditure across income cohorts. As a share of household weekly income, those aged 65 plus outlay the greatest amount on general insurance.

This distributional analysis provides additional confirmation of the inequities associated with general insurance taxation. Insurance stamp duties suffer from equity implications to the extent that the tax is only imposed when the transaction takes place – leaving those that refrain from taking out insurance the ability to avoid taxation. Moreover, as the graphs above indicate, notwithstanding their low incomes, some households are subject to higher rates of tax despite engaging in the same activity.

ESTIMATING THE COST OF GENERAL INSURANCE TAX REFORM IN AUSTRALIA

To assist the Review of the Australia's Future Tax System, the Insurance Council instructed Access Economics to undertake analysis of the net cost of general insurance tax reform proposals. Access Economics were commissioned by the Insurance Council due to their application of a general equilibrium framework/model in undertaking costings of tax reform proposals.

The Access Economics approach is to use a suitably modified version of the Monash Multi Regional Forecasting model to undertake the efficiency ranking of various State taxes, as well as considering any specific taxation reform proposals. The Access Economics model has been used previously to support the Productivity Commissions National Reform Agenda. The base data for the model is derived from Australian input/output tables produced by the Australian Bureau of Statistics.

Reform of General Insurance Stamp Duties

The Insurance Council requested Access Economics to undertake costings of several options for reform of stamp duties on general insurance across Australia, taking into account both first and second round effects. Access Economics modelled three scenarios/options for the costing of stamp duty insurance tax reform. They included:

- The abandonment of all stamp duties on general insurance products.
- A reduction in stamp duty rates to 7.5% on existing general insurance products with the retention of the current exemption regime on certain classes.
- A reduction in stamp duty rates to 7.5% on existing general insurance products with the abandonment of the current exemption regime on certain classes.

The latter two options were considered as a possible short term pathway to a reform which would see the eventual abandonment of all State stamp duties on general insurance.

The Access costings are reproduced below.

	Direct Revenue Effect ($m)	**Indirect Revenue Effect ($m)**	**Net (Cost) to Government ($m)**
Abandonment of all stamp duties on GI products	$(2,239)	$539	$(1,700)
A reduction in stamp duty rates to 7.5% with the retention of the current exemptions on certain classes	$(441)	$17	$(344)
A reduction in stamp duty rates to 7.5% with the removal of the current exemption regime on all classes.	$656	$(143)	$513

Notes: All figures in 2005/06 dollars

Source: Access Economics 2008

The estimated welfare benefits of the reform proposal is presented below.

	Percentage Change in real household consumption from reform of stamp duties on general insurance.
Abandonment of all stamp duties on GI products	0.48
A reduction in stamp duty rates to 7.5% with the retention of the current exemptions on certain classes	0.10
A reduction in stamp duty rates to 7.5% with the removal of the current exemption regime on all classes.	- 0.14

Source: Access Economics 2008

The above table demonstrates, abandoning stamp duties on general insurance products would have a net cost to revenue of around $1.7 billion after taking account of the indirect revenue effects. However, the estimated welfare effects from the removal of general insurance stamp duties would be large. For the option where the

States remove stamp duties on general insurance, the estimated increase in real household consumption are of the order of 0.48%. [20]

Reform of Fire Services Funding

The Insurance Council also requested Access Economics to estimate the cost of reform of the fire service contribution system. In particular, the Insurance Council requested an estimation of the impacts on government revenue and the welfare benefits that would accrue from removal of the statutory contributions system for funding the fire services in the States of NSW and Victoria and transferring the fire service funding base to a municipal/local government taxation base.

The Access costings for these reforms are as follows:

	Direct Revenue Effect ($m)	**Indirect Revenue Effect ($m)**	**Net (Cost) to Government ($m)**
Abolish insurance statutory contributions in the NSW Fire Acts and transfer fire brigade funding to municipal tax base	$0	$29	$29
Abolish insurance statutory contributions in the Victorian 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

The Access Economics modelling of fire funding reform suggests that the welfare effects of this reform would be positive – with the change in real household consumption increasing between 0.17% and 0.19%, with the benefits accruing largely to the States enacting the reforms (ie NSW and Victoria). Notwithstanding this observation, it is clear that the overall Australian economy would be improved when individual States adopt measures that improve the efficiency of their tax bases.

Reform of all State Stamp Duties/Transaction Taxes

In 2008, the Finance Industry Council of Australia (FICA)[21] (of which the Insurance Council is a member) commissioned Access Economics to model and cost the impact to government revenues (both first round and second round effects) and the welfare benefits of the abolition of State stamp duties/transaction taxes. [22]

The FICA report highlights the following:

- The potential gains from reform of State stamp duties are extremely large, with the abolition of State transaction taxes yielding gains to household consumption of between 1.1% and 1.8% - the equivalent of between $ 6.1 billion and $ 9.9 billion in 2005/06 prices. The magnitude of these gains suggests State transaction tax reform has the scope to rival the gains secured from the major microeconomic reforms of the past two decades.

[20] Access Economics (2008) "*Analysis of State Tax Reform including Taxes on General Insurance*"
[21] The Finance Industry Council of Australia comprises the Association of Building Societies and Credit Unions, the Australian Bankers' Association, the Australian Finance Conference, the Australian Financial Markets Association, the Financial Planning Association of Australia, the Insurance Council of Australia and the Investment and Financial Services Association.
22 Access Economics (2008) "*Analysis of State Tax Reform: A Report for the Finance Industry Council of Australia*"

- The cost to State revenues of removing all State stamp duty is $10.5 billion after taking into account second round effects. Removing business State stamp duties would have a more modest cost of $2.6 billion - suggesting that a pathway approach that reforms State stamp duties over time (and similar to the approach adopted in the 2000 Intergovernmental Agreement between the Commonwealth and the States) may be a feasible approach.

- The Commonwealth stands to be a major beneficiary from reform of State stamp duties. In the Access modelling, the Commonwealth will accrue substantial gains to its revenue base from the economic efficiency gains arising from reform of State stamp duties. Of the estimated $5.6 billion in revenue gains through second round "efficiency dividends", Federal revenue is estimated to account for around $4.5 billion, with gains to personal and corporate taxation being the major recipients. The estimated gains to the Commonwealth provides a further rationale as to why the Commonwealth should be actively engaged in the process of State transaction tax reform.

- Nevertheless, the FICA report also emphasises that the States can accrue gains from the unilateral reform of their tax bases and in particular, shifting their tax bases from narrow transaction taxes to taxes of a more efficient structure. This observation has been subsequently endorsed by the NSW Independent Pricing & Regulatory Tribunal that argued along similar lines. [23]

CONCLUSION

The Insurance Council contends that reform of general insurance taxation should be a priority for the AFTS review, particularly given the large deadweight costs that are associated with taxation of insurance premiums. The Insurance Council submits that the absence of insurance tax reform in the 2000 Intergovernmental Agreement between the Commonwealth and the States was a major anomaly and that the current AFTS represents the next available opportunity to redress this anomaly. Moreover, since the 2000 IGA, subsequent independent reports have also recommended for reform of insurance taxation– namely the HIH Royal Commission and the NSW IPART Report into State Taxation – leaving the AFTS review as the key vehicle to respond to these recommendations.

The Insurance Council submits that reform of general insurance taxation can be readily accommodated within the realm of Commonwealth State Financial Relations. At a net cost of $1.7 billion, the Insurance Council suggests that the magnitude of the reform task equates to the hitherto costs of previous State tax reform in financial services - that is, FID and Debits taxes – which together formed the bedrock of the previous Commonwealth State IGA. Moreover, the gains to economic efficiency are large, as the Access Economics modelling highlights. At a gain to real household consumption of 0.48% or a little under $2.6 billion, reform of general insurance stamp duties represents a gain to living standards comparable to the successful micro reform programs of the last two decades.

[23] See in particular, NSW Independent Pricing & Regulatory Tribunal NSW (June, 2008) "*Review of State Taxation: Report to the Treasurer*" at page 7.