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Introduction

Insurance Australia Group (IAG) welcomes the Review of *Australia's Future Tax System*. IAG believes that it is timely for the Australian Government to undertake a comprehensive review of Australia's tax system to create a tax structure that positions Australia to deal with the demographic, social, economic and environmental challenges of the 21th century and enhance Australia's economic and social outcomes.

Who is Insurance Australia Group?

IAG is an international general insurance group, with operations in Australia, New Zealand, the United Kingdom and Asia. Its current businesses underwrite more than $7.5 billion of premium per annum. It employs more than 15,000 people of which around 10,500 are in Australia. It sells insurance under many leading brands including NRMA Insurance, CGU, SGIO and SGIC (Australia); NZI and State (NZ); Equity Red Star and Hastings Direct (UK); and NZI and Safety (Thailand).

IAG's core lines of business include:

- Home insurance
- Motor vehicle insurance
- Business insurance
- Consumer credit insurance
- Product liability insurance
- Compulsory third party (CTP) insurance
- Workers' compensation insurance
- Professional risk insurance

IAG has a crucial interest in the long-term viability of insurance as a product valued by the Australian community.

What is IAG's Interest in the Review?

IAG notes the Treasury's *Architecture of Australia's Tax and Transfer System* (August 2008) highlighted:

> *"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 transaction taxes and, in some states, insurance companies can also be required to contribute directly to the funding of fire*

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services. The interaction of these taxes increases the cost of premiums relative to other products, which may encourage people to take up less insurance than otherwise.

An additional efficiency cost arises where a taxable product is used as a business input, since the tax can encourage businesses to use a less efficient mix of inputs. In addition, such input taxes cascade through the production chain to affect the market price of the final product, reducing international competitiveness." (page 293)

IAG argues that there is a clear social and economic case for eliminating or at least reducing State insurance taxes and charges as a priority for any taxation reform agenda.

Governments should recognise the essential benefits of insurance to the economy and community generally and implement a taxation system which does not penalise insurance relative to other more discretionary purchases.

Please find attached IAG's submission to the current Review of Australia's Taxation System. The attached submission supplements the submission from the Insurance Council of Australia. IAG endorses the Insurance Council's submission.

IAG would be happy to discuss this submission and to assist 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 or myself on 9292 9291.

Yours sincerely,

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Insurance Australia Group's comments in relation to Australia's Future Taxation System

Introduction

IAG believes the current regimes for the taxation of insurance are an historical anachronism that is indefensible upon the generally accepted principles of taxation of simplicity, efficiency and equity. These tax regimes are inappropriate, regressive and based on historical circumstances rather than any concept of tax equity. These regimes contribute to under-insurance and non-insurance, with consequential negative fiscal impacts when the public purse is inevitably called upon in times of climate related disasters.

Taxation Burden on Australian Insurance Sector

Australian Bureau of Statistics (ABS) data indicate that nationally, taxes on insurance totalled $3,714 million in 2006-07 up $154 million or 4.3% on 2005-06 ($3,560 million) and accounted for 1.2% of total taxation revenue collected in Australia in 2006-2007.

	2001-2002 $m	2002-2003 $m	2003-2004 $m	2004-2005 $m	2005-2006 $m	2006-2007 $m	Change 2005-06 to 2006-07 %	Contribution to total taxes 2006-07 %
Taxes on Insurance	2 836	3 144	3 231	3 502	3 560	3 714	4.3	1.2

Source: ABS (2008), Taxation Revenue Australia 2006-07, Cat.No. 5506.0, April 2008.

Taxes on Insurance 2006-07

	NSW $m	VIC $m	QLD $m	SA $m	WA $m	TAS $m	NT $m	ACT $m	TOTAL $m
Insurance companies contributions to fire brigades	479	368	-	-	-	13	-	-	**860**
Third party insurance taxes	90	119	55	42	-	3	-	-	**309**
Taxes on insurance nec	875	608	366	259	335	35	23	43	**2 545**
TOTAL	1 443	1 095	421	301	335	51	23	43	**3 714**

nec not elsewhere classified
na not available

Source: ABS (2008), Taxation Revenue Australia 2006-07, Cat.No. 5506.0, April 2008.

Impact of Government Taxes and Charges on Insurance Premiums

By way of explanation, a hypothetical basic premium of $100 is used to demonstrate the taxation impost of insurance taxes on final premiums to businesses and households. Details are outlined in the following tables.

Impact of Government Taxes/Charges on Business Insurance Premiums – Metropolitan

	Basic Premium $	Fire Levy $	GST $	Stamp Duty $	Total Cost $	Impact of Govt taxes %
NSW	100	34	13.40	13.26	160.66	60.7
VIC*	100	47	14.70	16.17	177.87	77.9
QLD	100	-	10.00	8.25	118.25	18.2
WA	100	-	10.00	11.00	121.00	21.0
SA	100	-	10.00	12.10	122.10	22.1
TAS	100	28	12.80	11.26	152.06	52.1
ACT	100	-	10.00	11.00	121.00	21.0
NT	100	-	10.00	11.00	121.00	21.0

** In non-metropolitan Victoria the fire services levy is 49%, with the total cost of a $100 premium $180.29 as a result of Federal and State Government taxes/charges.*

Impact of Government Taxes/Charges on Home Insurance Premiums - Metropolitan

	Basic Premium $	Fire Levy $	GST $	Stamp Duty $	Total Cost $	Impact of Govt taxes %
NSW	100	19	11.90	11.78	142.68	40.7
VIC*	100	19	11.90	13.09	143.99	44.0
QLD	100	-	10.00	8.25	118.25	18.2
WA	100	-	10.00	11.00	121.00	21.0
SA	100	-	10.00	12.10	122.10	22.1
TAS	100	-	10.00	8.80	118.80	18.8
ACT	100	-	10.00	11.00	121.00	21.0
NT	100	-	10.00	11.00	121.00	21.0

** In non-metropolitan Victoria the fire services levy is 20%, with the total cost of a $100 premium $145.20 as a result of Federal and State Government taxes/charges.*

Source: Derived from Insurance Council of Australia data (2007).

Insurance Taxation - International Comparison

A study by the Centre for International Economics, *The General Insurance Sector: Big Benefits But Overburdened* (2005) indicates by international standards, taxes on general insurance in Australia are high. Indeed, "taxes on property insurance in most Australian states and territories are higher than in the majority of the comparator countries. International taxes as a proportion of premiums are as low as 2 per cent in Ireland and Singapore and 2.4 per cent in the USA (California)".

The Report noted, "Australian taxes on property insurance are particularly high compared with international competitors in the area of business insurance… " (page 24). The Report is available at:
http://www.insurancecouncil.com.au/Portals/24/Submissions/International%20Economics%20Submission.pdf

Non-Insurance and Under-Insurance

- ***Business***

A national research report *Business Insurance: A National Survey of Small and Medium Size Businesses* (July 2001) commissioned by NRMA Insurance found that while the large majority of businesses have some form of insurance, close to half (47%) either do not have relevant cover or have cover which is judged inadequate. The survey of 1,253 small/medium businesses across Australia was undertaken to provide a better understanding of the business insurance market.

A business may be underinsured because its existing cover is inadequate or if it is not covered for a significant risk for which insurance is available.

Survey results indicate that:

- While the majority of businesses have some form of insurance (91%), 47% of businesses do not have a relevant cover or have a cover which is judged inadequate;
- Overall cover for damage to buildings, contents and stock due to fire or other events such as storm, explosive, vehicle impact or vandalism was the most common insurance held by businesses (85% covered);
- Cover for loss of profit due to damage from fire or other defined event was the least common (53%) (business interruption); and
- The most common reason why a business was not covered by an applicable insurance was the cost of premiums. 39% of businesses stated this as the main reason, while 11% stated they do not have enough time to arrange.

- ***Household***

Research commissioned by NRMA Insurance in relation to household non-insurance *Home and Motor Vehicle Insurance: A Survey of Australian Households* (October 2001), indicate that one in six Australian households do not have buildings and contents insurance. Applying the survey result to the total population, an estimated 1.2 million households are without building and contents insurance.

An estimated one in five passenger motor vehicles are not insured comprehensively.

The most common explanation householders give for why they do not have insurance relates to the cost of premiums. Similarly, the reason most frequently given by drivers for why their motor vehicles do not have comprehensive insurance or third party property damage insurance related to the cost of premiums.

Survey data suggest that a substantial reduction in the cost of contents insurance is likely to increase its incidence, particularly in rental households. Survey results also suggest that a reduction in the cost of motor vehicle insurance would increase its incidence.

The Insurance Council commissioned study *"The Non-insured: Who, Why and Trends"* (2007) into non insurance by Dr Richard Tooth and Dr George Barker of the Centre for Law and Economics at the Australian National University also considered the effect of State Government based insurance taxes on non-insurance. The Report found:

> *"Rates of non-insurance are found to be closely correlated with insurance taxes when examined over time and across jurisdictions. Following the removal of the Fire Services Levy in Western Australia (which came into effect 1 January 2004), the level of non-insurance in both building and contents (as measured from the Roy Morgan Research data) declined while rates climbed elsewhere.*
>
> *The Roy Morgan Research data and the Australian Bureau of Statistics (ABS) Household Expenditure Survey (HES) data support the finding that states with higher tax rates on insurance premiums have higher rates of non-insurance for both building and contents insurance." (p.4)*

http://www.insurancecouncil.com.au/Portals/24/Issues/The%20Non%20Insured%20-%20Report.pdf

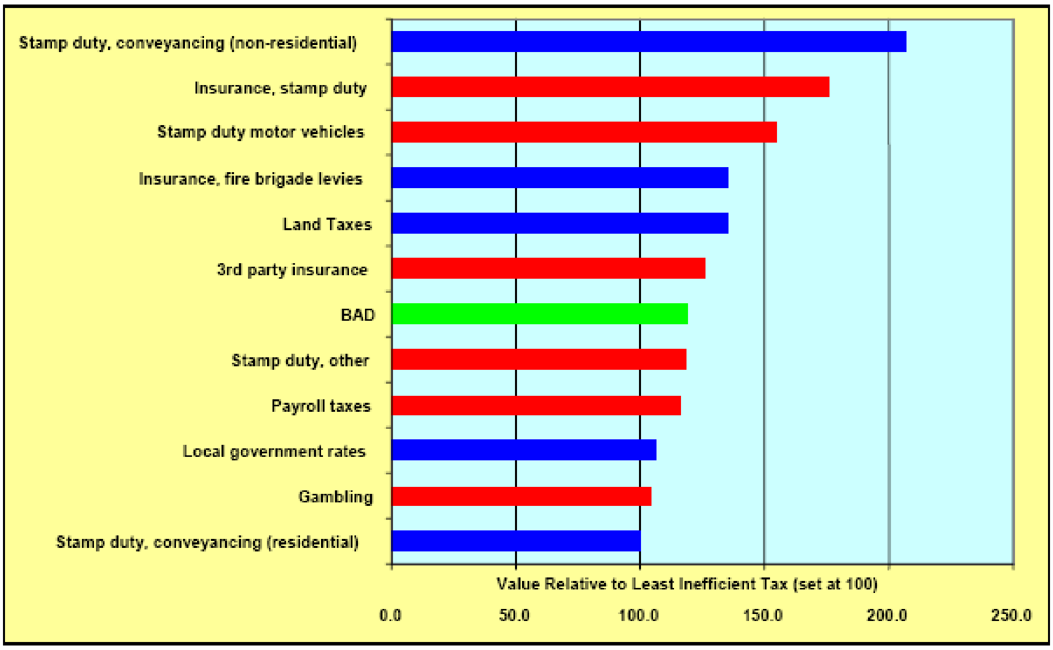
Taxation Reform – A Case for Insurance Taxes Reform

Access Economics' 2000 Review of the State taxes and charges on general insurance post GST (*The Overwhelming Case For Cutting State Taxes and Charges On General Insurance Post-GST, September 2000*) found a clear economic case for reducing State insurance taxes ahead of many other taxes, in particular payroll tax.

Using an economy wide approach, Access Economics took into account the interactions between consumers, producers and investors. They then used a highly sophisticated economic model called the computable General Equilibrium Model, which has been used to produce reports for Federal and State Governments. This model was used to estimate the economic impacts of reducing each State/Territory tax by $100 million (in total, for all States/Territories). The result from this modelling provides a clear economic case for reducing State/Territory insurance taxes ahead of many other taxes.

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.

Similarly, 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. The welfare efficiency results from the Access Economics modelling are summarised below.



Source: Access Economics (2004).

The Access Economics report 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/content/documents/AEconomics_State_Business_Tax_Reform_Nov_2004.pdf

Similarly, in its submission to the Independent Pricing and Regulatory Tribunal (IPART) New South Wales *State Taxation Review*, the Insurance Council highlighted the relative inefficiencies of State insurance taxes. These efficiency rankings, developed by Access Economics indicated the relative inefficiency of insurance taxes vis-à-vis other taxes. Importantly, IPART noted that" on economic efficiency grounds, there is a compelling case for abolishing stamp duty on insurance and making up the revenue foregone from consolidated revenue or other sources".*(IPART p.101)*

IPART's *State Taxation Review* also noted in relation to insurance taxes.

Insurance Duty

> *"Insurance duty is a highly inefficient tax that creates disincentives for appropriate insurance. This suggests that the State should seek to reduce its reliance on this duty over the long term."(p.61)*

> *"Insurance duty is a highly inefficient tax. By adding to the price of insurance, it encourages underinsurance and non-insurance in a market that already exhibits significant market failures. The effect on consumer and business behaviour is amplified because the duty is applied on top of the embedded fire services funding contributions and the GST. The Royal Commission into the collapse of HIH recommended governments throughout Australia review their taxes on insurance."(p.61)*

> *"The ad valorem nature of insurance duty means that individuals with more assets to protect pay higher premiums, to the extent that the risk related to those assets is the same. However, risk plays a significant role in determining insurance premiums so the link is very weak. Furthermore the equity impacts are confused by the incentive to underinsure."(p.61)*

> *"In principle the insurance duty should be a reasonably stable source of revenue – the changes in the revenue collected would largely reflect changes in the condition of insurance markets. However, in practice, it may be less robust due to the incentive to underinsure. Furthermore, tax rates have been subject to significant changes."(p.62)*

Fire Services Funding Contributions

> *"The Fire Services Contribution by insurers is effectively a levy on insurance and creates disincentives for taking out appropriate insurance. On this basis, its removal should be a priority."(p.65)*

> *"Fire services funding contributions by insurers (known as the 'fire services levy' – FSL – by policy holders) is a relatively inefficient tax. The extent to which insurers pass through the cost of their contributions to policy holders acts as a disincentive to insure. This may lead to underinsurance and non-insurance in a market that already exhibits market failures. The effect on consumer and business behaviour is amplified because the FSL becomes part of the base premium to which the GST and insurance duty are applied." (p.66)(*

> *"The FSL may be seen to be neutral or progressive because it is based on property values (albeit indirectly through house values). However, the opportunities for avoidance and minimisation through underinsurance means its horizontal equity is poor. Those who underinsure or don't insure avoid contributing via insurance policies to the cost of operating the fire services while they still receive the benefit of these services in the event of fire affecting their property." (p.66)*

While IAG notes and supports the above IPART findings we would reinforce that the fire services levy is a poorly targeted mechanism for distributing the cost of fire services and not considered equitable. Indeed, data shows there is no correlation between the average levy collected and the incidence of fire callouts. This reflects the fact that the levy is imposed on the total premium - which includes the full range of perils including storm and theft - and not just that proportion associated with fire.

As IAG highlighted in its submissions to IPART the proportion of premium attributable to each kind of risk varies considerably from post code to post code based on local factors and claims experience. At an individual household level the premium level, and thus the levy paid, is ultimately determined by the insured value of the home and/or its contents as well as factors such as loyalty and no claim discounts. This means that areas with very low fire risk can contribute substantially more on a per household basis to total levy collections that the more bushfire prone areas of the State.

IAG notes the views of the Australian Consumers' Association that the fire services levy is "an illogical rule that deters consumers from taking out home building insurance (due to higher price)" and this "should be replaced with a levy by all building owners rather than only those who prudently insure" (*p.21, ACA submission to Taskforce on Reducing the Regulatory Burden on Business, December 2005*).

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 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).*

The Treasury (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.*
>
> *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 a 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.*
>
> *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).*

Put at its simplest, the current fire services levy regime imposes a tax on people who protect their property, businesses and personal possessions by insuring them. It is their taxes that pay for the fire fighting and protection services provided to the entire community. A fairer and more rational system would see property owners pay for these services, spreading the burden equitably.

State Government Reforms

A number of State and Territory Governments have taken steps to remove fire services levies and replace these levies on insurance with a broader tax base – in most cases, property.

Western Australia

The Western Australian Government replaced Fire Service Levies with a property based funding system in 2003-04.

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/internet/upload/93510369/docs/insurance_Compliance_Rprt_April_2004.pdf

IAG agrees with the Western Australian Government statement 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.*
>
> *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*

Australian Capital Territory

The Australian Capital Territory introduced a fire and emergency services levy on all residential, rural and commercial properties from 1 July 2006. Residential and rural properties are charged a fixed levy of $84 per annum per property. For rateable commercial properties, the levy is imposed as a percentage (0.4875%) of the average unimproved land value of the property that exceeds the threshold of $22,000. The amount of the levy is billed and shown as part of the annual rates assessment notice issued to all property owners.

Insurance Protection Tax – A Case for Reform

The collapse of HIH Insurance resulted in liabilities estimated in 2002 at $600 million being incurred by New South Wales mainly through the operation of State guarantees to claimants, mainly under the compulsory motor vehicle insurance scheme with some liabilities also due to the home warranty scheme. To assist in funding these liabilities, New South Wales imposed an insurance protection tax which, unlike any other jurisdiction faced with similar liabilities, effectively levied insurance company shareholders rather than policyholders through a prohibition on passing on the tax as a cost of business.

It is of note the HIH Royal Commission recommended, *"Governments avoid imposing on insurers levies and other taxes that cannot be passed on to policyholders".* The HIH Royal Commission Report noted in relation to the New South Wales insurance protection tax *"….to the extent that this tax has to be met by insurers and cannot be passed on, it might have the effect of reducing the size of the capital base, which might in turn reduce the financial strength of the affected insurers – a potentially undesirable outcome".*

IAG believes suggestions that the insurance industry be responsible for funding the failure of another industry participant should be cognisant of extra cost already borne by companies that have a relatively lower risk profile (through greater capital requirements), and the security this affords customers, employees, suppliers and shareholders. Transacting with a low risk insurer thus rewards the community. If the Government forces all other companies to subsidise the loss of a high-risk company then the stakeholders of other companies are all penalised for being risk averse. This creates a perverse result, as it is in the interest of the community to reward prudence and penalise excesses.

As the Commonwealth highlighted in its submission to the HIH Royal Commission *"…Risk is an important element of market development, and risk also means that institutions may fail".* The failure of a financial institution may reflect a range of factors, including poor or inappropriate management, exogenous shocks, strong competition or adverse economic conditions. The Commonwealth stated that *"…as sound management is encouraged through an appropriate regulatory framework and cannot be legislated, it follows that regulation cannot guarantee absolutely against institutional failure. Ultimate responsibility for the management of a business rests with the board of directors and senior management, not with the regulator or the Government. This is consistent with the Wallis Inquiry view on the extent of regulatory assurances…".* Competitive markets experience failures.

IAG believes the concept of taxing viable insurance businesses to cover the costs of the failure of a competitor is inconsistent with a market competing for the delivery of a product to consumers. IAG is not, and should not be, responsible for the financial promises of its competitors.

Importantly, the recent announcement by the Federal Government (June 2008) that it will introduce legislation to establish a Financial Claims Scheme (FCS) renders the need for the New South Wales insurance protection tax unnecessary. The Federal Treasurer stated "To avoid the need for ad hoc arrangements of the sort established in the wake of the HIH failure, the FCS will also provide compensation to policyholders who have valid claims with a failed general insurer".

The Federal Treasurer also noted:

> *"The FCS will be administered by APRA and will make early payments to eligible depositors or general insurance policyholders using Government funds in the first instance. APRA would then take the place of the depositors/policyholders in the liquidation of the failed institution. If APRA was unable to recover the full costs of the scheme in the liquidation, relevant financial institutions could be levied to recover the costs of the FCS."*

The insurance protection tax was justified at the time as a temporary measure to meet a specific and unanticipated need. The 2008- 09 NSW Budget Statement notes:

> *"Outstanding HIH liabilities are expected to reduce to $95 million by 30 June 2008 with payments made to policyholders and those entitled to third party compensation estimated to be approximately $48 million for 2007-08.*
>
> *During 2007-08, HIH liquidators paid the Government $67 million. A further $10 million is expected in 2008-09."*

This raises the obvious question as to why the $69 million annual revenue from the Insurance Protection Tax remains in the forward estimates.

Federal – State Financial Relations

When the Federal Government announced that it would fundamentally reform the Australian taxation system by introducing a Goods and Services Tax (GST) it also announced that the revenue would go to the States and Territories. The stated intention was that the GST, as a growth tax, would build revenue for State Governments and as a result an opportunity should be created to reduce certain State Government taxes. Under the *Intergovernmental Agreement,* all GST revenue collected by the Australian Taxation Office is provided to the States.

IAG acknowledges that each State Government will make the decisions it believes are in the best interests of the community and that are based on sound financial management principles. IAG believes it is appropriate for the Federal and State Governments to examine a new set of undertakings beyond the current *Intergovernmental Agreement* to assist further reform of State taxation. A strong case can be made that reform of insurance taxes should have a high priority in both scenarios.

Conclusion

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

Governments should recognise the essential benefits of insurance to the economy and community generally and implement a taxation system which does not penalise insurance relative to other more discretionary purchases.