Australia's Future Tax System Submission

October 2008

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The Victorian Farmers Federation

The Victorian Farmers Federation (VFF), Australia’s largest state farmer organisation and the only recognised, consistent voice on issues affecting rural Victoria. The Victorian Farmer’s Federation (VFF) welcomes the Australian Federal Government’s review into the current taxation system.

The VFF represents 19,000 farmer members across 15,000 farm enterprises. Victoria is home to 25 per cent of the nations’ farms. They attract neither government export subsidies nor tariff support.

Despite farming on only three percent of Australia’s available agricultural land, Victorian’s produce 30 per cent of the nation’s agricultural product. The VFF represents the interests of our State’s dairy, livestock, grains, horticulture, chicken meat, pigs and egg producers.

Introduction

The Victorian Farmers Federation (VFF) thanks the Federal government for the opportunity to provide input into the review of Australia's future Tax System. The VFF recognise that through taxation public services and infrastructure are provided for in the community. Further, through taxation, the government has a responsibility to ensure that the taxation delivers a system that is fair and equitable.

The VFF also realises that by way of taxation, behaviours can be changed. This could be a valuable tool for the government to use in these times of climate change awareness. Government must ensure that the Carbon Price Reduction Scheme (CPRS) design does not disproportionately affect sectors such as agriculture, or indeed, regional communities in general. This principle applies to sectors being either covered or uncovered by the CPRS.

The majority of the VFF submission relates to State based taxes and charges. The VFF's views on Federal matters are covered by input into the submission made by the National Farmers' Federation.

The VFF encourages the Government to adhere to the following principles when developing taxation policy:

- Taxation on business adjustment payments should be avoided;
- Taxation mechanisms should be fair and equitable; and
- Taxation mechanisms should not lead to distortions or be inflationary.

Fire Services Levy

The Fire Services Levy (FSL) needs to be re-evaluated. The FSL is a tax applied to insurance premiums to fund the operations of the Country Fire Authority (CFA) and the Metropolitan Fire Brigade (MFB). The current rate of the FSL in CFA regions is 58 per cent. By the time the FSL, GST and then the state stamp duty are applied, the taxes on $100 of insurance premium adds another $91 dollars.

The FSL approach is based on the historic model from England of insurance companies funding their own fire services. This model has long since passed its use by date and leads to poor outcomes. Taxing insurance at these levels leads to significant underinsurance or tax avoidance by insuring in overseas insurance markets.

The FSL penalises people and businesses that take responsibility for their own property risk by arranging insurance cover. This disincentivises risk management.

More than one in four households have no insurance cover, and therefore do not contribute to the cost of the community's fire services. Those who choose to under-insure contribute only partially to funding these services. Victoria has the highest tax levels on insurance in the world, because insurance policyholders are obliged to pay for the fire services on behalf of the whole community.

Rural Victorians are seriously disadvantaged by the current funding system because FSL rates in Country Fire Authority (CFA) areas are significantly higher than for the metropolitan area serviced by the MFB. The CFA receives 77.5 per cent of its funding from insurance contributions, while the MFB receives 75 per cent.

Below is a summary of reports and studies that have been conducted in the FSL.

Western Australia

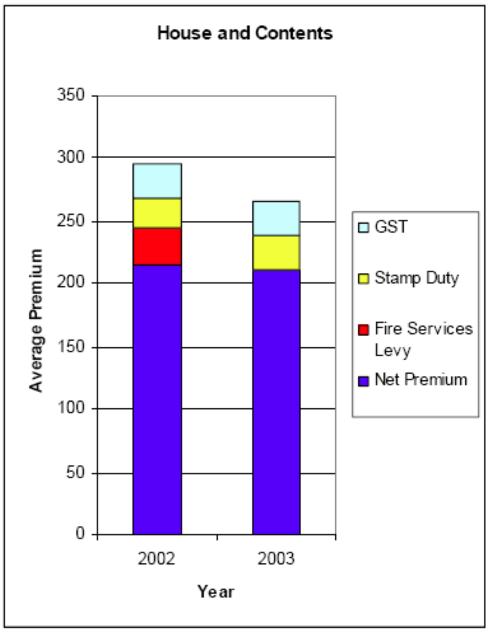
On 1st July 2003, Western Australia replaced its FSL with an Emergency Services Levy (ESL).

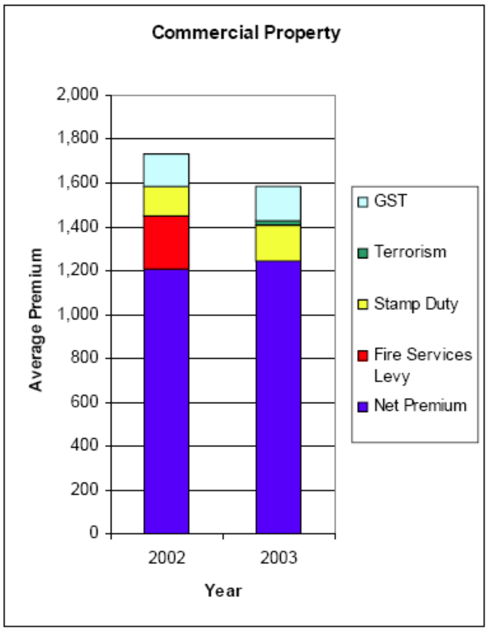
Sigma Plus Consulting's Emergency Services Levy Insurance Compliance Review: Final Report in relation to the effect of the phase-out of the Fire Services Levy (FSL) in Western Australia indicated the removal of FSL in Western Australia contributed to Western Australia having one of he most price competitive insurance markets in Australia in 2003, and consumers responded to cheaper insurance by increasing their insurance cover to more adequately protect themselves.

The report states:

'The evidence shows that the insurance industry **has passed on the FSL savings to consumers**. Gross premiums have dropped over the year – consumers are paying less for insurance. Net premiums (after removing government charges) have increased by amounts similar to other states. This is despite extra costs to insurers that are specific to WA, such as higher claim costs and the extra cost to insurers of complying with the new FSL regime.'

Savings in insurance premiums (constant sum insured)





South Australia

On 1st July 1999 South Australia abolished the FSL and replaced it with a broad based system. Referred to as the Emergency Services Levy (ESL), it is a charge on all property, registered motor vehicles and boats to fund emergency services across South Australia.

When South Australia phased out FSL, some consumers claimed that insurers were profiteering from its removal by increasing their premiums to offset the reduction in FSL. The South Australian Parliament was concerned to ensure that the full savings associated with the removal of the need to collect FSL was passed on to consumers, and was appropriately reflected in the total cost of insurance to policy holders.

To this end, the South Australian government commissioned an independent report which was prepared by the SA Centre for Economic Studies of the Adelaide and Flinders Universities in September 2000, and which was entitled 'Investigation into the Impact of the Enactment of the Emergency Services Funding Act 1998 on Insurance Premiums in South Australia'.

The overall finding of this investigation was that there was no evidence to suggest that any of the 48 insurance companies surveyed engaged in any inappropriate pricing behaviour during the transition period of the removal of the Fire Services Levy. On the contrary, there was strong evidence and strong reason to believe that, for the industry as a whole, all of the savings associated with the removal of the FSL were passed on to policy holders.

Victoria

Review of State Business Taxes

In 2000, the Victorian Treasurer established the State Tax Review Committee to conduct an independent review of the Victorian tax system. The Committee was established as an independent body, and was supported by a Working Party/Secretariat from within the Department of Treasury and Finance. The Review was the first comprehensive assessment of the State's tax system since 1983 and was a high priority in the 2001-02 State Budget.

This committee recognised the problems associated with stamp duties and also found that when removed the savings were ultimately passed on.

According to the final report,

"Some of Victoria's existing business taxes have a long heritage. Stamp duties, in particular, are a relic of a pre-industrial society. Taxes which were conceived many years ago for a completely different economy are now an obstacle to growing businesses, because they impose high marginal costs on expanding firms".

Throughout the consultation process, Victorian business argued that the State tax system needs major changes. Businesses are critical of the number of taxes, the way they are levied, their relative importance as a source of revenue and the array of thresholds, exemptions, multiple rates and administrative arrangements for each tax. These arguments were raised regardless of the size or location of the business.

Most businesses which considered broader business trends in their submissions to the Review believed that taxes on transactions were not sustainable, especially financial taxes and stamp duties.

Stamp duties were the Committee's key priority for early abolition because they are most clearly inequitable, involve the largest compliance costs, and act as impediments to business investment and location in the State. The Committee regarded stamp duties as an impediment to capital formation and corporate re-structuring and therefore a disincentive to investment, and stated '*These taxes have little intrinsic merit or economic justification'.*

The report continued:

'"Many of these taxes do not exist in other countries. To persist with them in Victoria poses a threat to the competitiveness of Victorian and Australian firms that seek to compete in world markets.

Abolition of stamp duties also removes the suggestion of double taxation or an aggregate windfall revenue gain to the State. This was a frequent criticism levelled at Government in many public forums as well as in written submissions. With the advent of the GST, the revenue from which is passed to the States, it is anachronistic to be raising additional revenue by more than one State tax on the same transaction. For example, as noted, both stamp duty on general insurance and the fire services levy currently apply on general insurance premiums"

The Committee concluded that:

'stamp duties and transaction taxes are among the most distortionary of all taxes available to the states. The Committee believes such duties are therefore ripe for abolition, and that abolishing them now would nurture business activity and growth'.

"The Committee expects that, beginning in 2001, a total of around $1 billion of stamp duties and $600 million of financial taxes will be abolished under the package. This will effectively reduce costs when businesses set their prices.

Under the Committee's proposal, stamp duty abolition would be funded by the proposed reformed land tax regime. ***However, in the longer run, the savings from the abolition of stamp duties will be passed onto households***. For example, the initial effect of abolition of stamp duty on general insurance is lower costs for insurance companies. In turn, businesses buying general insurance should gain from lower premiums, resulting in lower costs. A useful analogy is the introduction of GST and the abolition of wholesale sales tax, where price responses showed up almost immediately. This process continues over the longer term and all along the product chain. Ultimately, prices of food, medical treatment and so forth paid by households fall"

General Discussion of taxation on insurance

Insurance Australia Group (IAG) has stated that 'taxation of insurance is 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 schemes contribute to under-insurance and non-insurance, with consequential negative fiscal impacts as the public purse is inevitably called upon in times of climate related disasters'.

The Royal Commission report on the failure of the HIH Insurance Group was tabled in Federal Parliament by the Honourable Mr Justice Owen on 16 April 2003. Recommendation 56 by the Commissioner stated:

‘I recommend that the states that have not already done so abolish fire service levies on insurers’.

A study by the Centre for International Economics, The General Insurance Sector: Big Benefits But Overburdened (August 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.’

The Report noted, ‘Australian taxes on property insurance are particularly high compared with international competitors in the area of business insurance’.

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.

Access Economics concluded that reducing stamp duties on insurance would result in gains to economic welfare, Gross Domestic Product and investment that are many times greater than the gains that would arise if payroll taxes were reduced by the same amount.

The Business Coalition for Tax Reform (2004) commissioned Access Economics report on the efficiency of State and Territory taxes noted that for insurance taxes there is a strong efficiency case for further state tax reform.

The Access Economics report noted, ‘FSL and stamp duty on general insurance are inefficient 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’.

In its submission to the New South Wales Public Accounts Committee Inquiry into Fire Services Funding (2003), the New South Wales Treasury 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 involved, but overall economic efficiency and growth would be affected by the changed resource allocation’ (NSW Treasury submission, page 14)

The submission continued, ‘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’.

The NSW Treasury 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 the 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 to lead to under-insurance with adverse consequences for resource allocation and economic growth' (NSW Treasury submission page 20).

Alternative

The disincentive to insure caused by taxing these products at such a high rate, leads to increased community disruption and hardship following disasters such as fires and storms. The predictions of climate change are for increased occurrences of severe fires and increased frequency and severity of storms. Without encouraging increased coverage and adoption of risk management tools such as insurance, the level of community hardship due to climate change will be magnified.

The VFF suggest that instead of a levy on insurance-holders, fire services be funded through consolidated revenue. This is the most equitable method of funding a service that benefits all members of the community. Other States have changed their fire service funding systems and these should also be examined.

Stamp Duty

Victoria's current taxation system on insurance makes Victoria a very unattractive place to invest and establish a farm business. Victorian businesses are suffering from a huge added tax cost on their insurance premiums, and personal and business transactions under the current system. Furthermore, the promise by the States that when GST was introduced other taxes such as stamp duty would be abolished has not been honoured.

CPI Indexation

It is State Government policy that a number of State Government taxes and charges are automatically indexed to the Consumer Price Index (CPI). The VFF urge the state Government to change this policy and suggest that a system whereby the taxpayer could scrutinise these increases ensuring government accountability. Further, the VFF wish to highlight that previous federal governments have reversed their policies on some automatic CPI increases. The VFF argues that indexation of taxes and charges do not provide any incentives for improving productivity or efficiency of service delivery.

Competitive pressures force private enterprise to increase productivity and reduce the costs of production as they cannot automatically apply a CPI rise to their prices. It is reasonable to expect the Government sector to subject to the same drivers for productivity.

Taxes and charges applied on an *ad valorem* basis increase over time as the price of goods or incomes rise. These rises should not be magnified by any increase in the rate of the tax or charge.

If taxes and charges are to be linked to CPI it should be on the basis of CPI minus a percentage, in order to drive increases in productivity.

The current budget processes applied at levels of Government, particularly establishing local government municipal rates, works from a premise of establishing an expenditure level and then allocating this across the rate base. In Victoria these rises have been on a CPI plus basis for some years.

The alternative and more appropriate process for using CPI in these calculations would be to index the previous budget to CPI minus X. In this manner incentive for productivity gains in service delivery is ingrained in the process.

Allowing Governments to increase taxes and charges in line with CPI is not conducive to obtaining a more efficient Government sector. The private sector has reduced costs, increased productivity and improved service without the privilege of being able to automatically increase price. The Government sector should be under the same pressures.

Fuel Tax Credit

The Fuel Tax Credit scheme is an important tool in ensuring export industries and rural areas are not disadvantaged. The current rebates for heavy vehicles and in agriculture are essential in maintaining viable production systems.

Fuel and energy costs are a vital input for farm businesses, comprising a significant portion of the total farm cost of production. Since the start of 2008, the international diesel cost has risen substantially. Recent escalation in these prices, particularly for fuel, has placed increasing pressure on farm operating margins. Australian farmers' fuel costs increased substantially in the past year.

Maintaining the Fuel Tax Credit scheme is a key component in maintaining the costs competitiveness of Australian agriculture and the viability of rural communities. There should be a further rebate for those in agricultural communities, due to the distances that families must travel and the burden of increased costs to engage in social and community activities. A tax off-set for costs of sending rural children to attend tertiary education should also be available, as there are no universities in the areas, and therefore no option for these children but to move away from home. This in turn places more financial stress on rural families.

Fuel Excise

The VFF has used *Department of Environment, Water, Heritage and the Arts* analysis on the carbon emissions from fuel combustion to derive potential flow-through impacts of higher fuel prices arising from a CPRS. This analysis notes that combustion of a litre of petrol produces 2.4 kilograms of CO_2, and a litre of diesel produces 2.7 kilograms of CO_2.[1] This equates to a potential emission cost of between 2.4c and 2.7c per litre per $10 of greenhouse emission cost and demonstrates the direct impact that a CPRS can have on this resource use.

Because of the escalation in the price of oil in recently and the significant shock that this is having on all sectors of the Australian economy, including agriculture, the VFF supports the CPRS Green Paper's recommendation that that fuel price impacts be offset. The offset recommendation is particularly welcomed by the VFF considering that the majority of our members are located in regional areas so have less access to public transport, and are therefore more exposed to the cost of fuel. Fuel taxes as part of the up and coming CPRS

[1] Department of Environment, Water, Heritage and the Arts, http://www.environment.gov.au, sourced on 26 August 2008

should be a permanent offset in the fuel tax price equivalent to the impact on fuel of the CPRS.

As rural residents have limited access to public transport they are disadvantaged in the capacity to avoid the use of private vehicles for necessary day to day activities. As fuel prices increase due to supply and demand factors, this will become an increasing problem. For these reasons a reduction in all on-road fuels' excise for rural residents should also be applied in addition to the CPRS offset.

Insurance

The tax on tax effect of stamp duty being added on top of the fire service levy and GST on insurance premiums has resulted in a gross under insurance problem across Victoria. Under insurance has been exacerbated due to the high price sensitivity associated with insurance payments – as the taxes and prices go up, fewer people insure.

Stamp duties on insurance distort business operational decisions in the sense that every time a business chooses to insure, it becomes liable to a state tax. Victoria has a much higher rate of taxation on insurance premiums than other Australian states.

Lowering the stamp duty rate on insurance in Victoria will lower costs to businesses and make Victoria a more competitive state for business investment in Australia. It will also allow Victorian businesses to better manage risk.

Asset Transactions

The VFF sees no logic in taxing the transfer of assets used for business reasons. The movement of assets between businesses or individuals facilitates growth in the economy. Assets pass to people who value them the most and who believe they can leverage or utilise the assets to make profits.

Taxing movement of assets impacts on purchasing decisions results in deferred or avoided purchases. This in turn defers or prevents the assets being transferred to the most valuable uses. The removal of stamp duty on the transfer of factors of production is an impediment to the efficient allocation of resources and would provide beneficial economic outcomes. There should be a free movement of capital (as in the European model) rather than a cost to doing so as per Article 3. EEC: free movement of goods, persons, services and capital and Articles 106 and 67(2) - free movement of payments.

Municipal Funding

Municipal funding is a concern to agricultural enterprises. The VFF maintain that the municipal funding system is a regressive tax as the capital base rating systems does not capture accurately capacity to pay nor benefit received.

In attempting to respond to increasingly demanding community expectations, local government now provides an increasing range of community services and infrastructure to support local communities, but lacks appropriate funding, as it ranks lowest on the tier of the federal system.

Local councils in Australia have, in some cases reluctantly, moved beyond their traditional role of being responsible for 'roads, rates and rubbish'. More functions are expected of local government but little or no funding is provided to undertake them.

Land, labour and capital are the factors of production. Land is the farmer's major income producing asset. Land, however, in the non-farm sector is where the enterprise and income producing assets are located. The income producing assets of the of the non-farm sector are not subjected to an annual *ad valorem* tax; whereas, the major income producing asset of the farm sector (land) is so subjected to this tax. This imposes a distorting burden on agriculture.

The Farm rate differential was introduced in 1949 (in Victoria) to reflect the lower rate of return on monies invested in the farm sector vis-a-vis the non-farm sector.

Net Annual Value in Victoria is deemed to be 5 per cent of "market" valuation. The Johnson Report demonstrated 5 per cent was almost three times actual return on farm land, whereas commercial property traditionally (not the Johnson Report) earned about 7.5 per cent. Now that vegetation management overlays affect farm land, notional rental values would be fairer than the present system, but de-rating would be better. The current system is counterproductive for agriculture.

This lower rate of return was confirmed by the Jones Report (Municipal Association of Victoria and VFF join commission) and by the Johnson Report commissioned by the VFF.

The rating system is founded on the Poor Relief Act of 1601 in England, which introduced local taxation for Poor Relief. Liability to be rated (taxed) was imposed on every inhabitant, person, vicar, every occupant, land or houses, etc. In the course of time, other rates were levied, e.g. borough, general district, highway (for military purposes).

By 1925, The Rating and Valuation Act 1925 (England), abolished overseers and transferred their rating functions to borough, urban and rural district councils. Uniformity was entirely absent and incidence and distribution were inequitable. In the same way in 2007, valuations fluctuate significantly and incidence and distribution vary widely between different parts of the State.

This inequitable system needs to be re-thought. The VFF suggested plan of action is that Local Government rate funding needs to be based on the value of a ratepayer's house and curtilage. Rates on farm land should be abolished as in the UK because farmland is a means to production, and its value bears little relationship to the farmers' wealth or his capacity to pay.

The Rating and Valuation (Apportionment) Act 1928 (England) in conjunction with the Local Government Act 1929 (England) gave complete relief from rates to agricultural land and buildings, other than farm houses and cottages. This relief is commonly known as de-rating and it was designed to assist productive industry and agriculture, which were experiencing financial difficulties at the time. Rating authorities lost considerable rateable value as a result of this and were compensated by the government.

In Australia, the Federal Government would gain from GST and Income Tax if farm land were de-rated. This would support the Productivity Commission's findings and fair and equitable taxation and justify appropriations to municipalities in general and necessitous areas in particular. Farmers faced with harsh climatic conditions do not need further financial inequitable rating burden place upon them.

To demonstrate this inequitable system, in Gannawarra, the urban majority was lightly taxed and the farmers charged significantly more.

Below is an excerpt from the Productivity Commission Research Report into the Revenue Raising Capacity of Local Government.

Although there is likely to be a link between property values and incomes, property values are an imperfect and incomplete indicator of the incomes of residents and hence of their ability to pay rates.

A number of participants to this study support the view that the principal determinant of a council's revenue-raising capacity is the income of its community.

The Local Government Association of Queensland (sub. 11, p. 3) stated:
It is important that the Productivity Commission recognises that growth in the overall value of property does not determine revenue-raising capacity. It is the recurrent resources available to each sector of the economy to meet the rate impost that has a significant bearing on revenue capacity.

Similarly, the Launceston Municipal Ratepayers and Residents Association
(sub. 10, p. 6) commented:
This association submits that in examining the capacity of different types of councils to raise revenue, the income of the community should be a central indicator of such capacity.

All things considered, the Commission considers that the appropriate indicator of fiscal capacity for each council in the context of this study is the aggregate income of its local community. Ultimately, it is the incomes of individuals in local communities that constrain the choices they face between consuming public or private sector goods and services.

The most appropriate indicator is based on a comprehensive measure of income. This includes income from all sources, such as wages, salaries, interest, dividends, imputed income from housing ownership, and capital gains on assets (whether realised or not). It also includes all business income (such as retained earnings) that has not been paid to residents in the form of dividends (Barro 2002; Musgrave and Musgrave 1989).

People and businesses in local government areas pay taxes and charges to other spheres of government and receive income from outside the local area (including welfare and other transfer payments from the Australian and State Governments). In principle, the indicator of a community's ability to pay for local government services should be based on disposable income, net of other taxes and charges.

These statements support the VFF contention that a capital based rating system is no longer an appropriate mechanism to tax residents for Local Government services. The problems identified by the Productivity Commission report are most relevant for rural shires and for farmers.

The VFF suggests a new approach to funding local government. Funding Local Government through consolidated revenue would achieve the suggestion of the Productivity Commission that income is a better indicator of capacity to pay.

Simplified Tax System

The Simplified Tax System has excluded 90 to 95 per cent of Australian agriculture. As per the Australian Tax Office, the simplified tax system (STS) no longer operates for the 2007–08 and later income years, and has been replaced by the small business entity provisions. A farmer can continue to use the concessions that were in the STS if you are a small business entity.

The VFF believe compliance costs continue to increase, yet by changing systems, this adds to the compliance burden by having to re-think processes. A simplified tax system for all would be an easy to comply with and administer system.

Conclusion

The VFF again wish to applaud the Federal government for undertaking an extensive review of the current taxation system. Furthermore, the VFF wish to reiterate that the farming and agricultural community are to go through significant change in the short to medium term.

Systems will need to be developed for climate change, drought preparedness and environmental stewardship. The taxation system can play a significant part in the change of behaviours, but the Australian government need to ensure that changes put in place are fair and equitable. We encourage the Federal government to ensure distortions and inflationary outcomes are avoided.