



National Insurance Brokers Association.



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Response to Discussion Paper
2009 Victorian Bushfire Royal Commission
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The Fire Services Levy and Insurance Discussion Paper

Introduction

The National Insurance Brokers Association (NIBA) welcomes the opportunity to respond to the Royal Commission's discussion paper on *The Fire Services Levy and Insurance* and is pleased that the Royal Commission is focussing on this important issue.

NIBA's comments in this response supplement those that it made in its 11 May 2009 submission to the Royal Commission.

Insurance brokers represent the interests of the purchasers of insurance, the policy-holders, and not those of insurance companies. Consequently, comments made by NIBA and its members are made not on behalf of insurance companies but on behalf of the public that purchases insurance.

The Need for Change

Taxes and charges on property insurance in Victoria are extremely high. The rate of fire services levy for Victorian country commercial insurance is 84% of the basic insurance premium. When GST and stamp duty are applied the total taxes and charges are a staggering 123% of the basic premium.

These extreme rates of taxation drive normally prudent people away from insurance.

Clearly there is in Victoria a very large section of the public that do not protect their property by insurance. Not only do these people risk financial ruin and are a burden on the Government but they do not make an appropriate contribution towards the funding of fire services in Victoria.

Their fair share of the contribution to funding fire services is picked up by those that do insure their property.

According to standard taxation principles, a well-designed tax system is characterized by efficiency, equity, simplicity and transparency.

A number of public inquiries, including the HIH Royal Commission, have been critical of insurance taxes because they perform poorly against these basic principles of taxation.

The 2008 NSW IPART *Review of State Taxation* considered how insurance taxes fared against good taxation principles and concluded;

“Insurance duty and fire services funding contributions are the least efficient State taxes.”

2001: Victorian State Business Tax Review

The conclusion of studies (by groups including the Productivity Commission, The Heads of Treasuries State Taxes Working Group, comprising representatives of all state and territory Treasuries; and Access Economics) is that stamp duties and transaction taxes are among the most distortionary of all taxes available to the states. The Committee believes that abolishing them now would nurture business activity and growth.

The fact that the existing arrangements provide a steady stream of revenue for the Government to fund fire services without effective ongoing scrutiny is not sufficient justification to continue the current arrangement.

The personal tragedies that have resulted from non-insurance and under-insurance following the Black Saturday fires are becoming increasingly obvious to all. It is clearly time for change and NIBA would like to see the Royal Commission’s discussion paper act as a catalyst for such change.

Fire Risk

NIBA is pleased that the Royal Commission’s discussion paper questions the suggestion that a strength of the current insurance based funding model is that for those that are insured the fire services contribution reflects the fire risk. NIBA agrees with the comment in the discussion paper “that factors other than fire risk are important drivers of the insurance premium on which FSL contributions are based” and “FSL on residential property insurance cannot be said to reflect directly the risk of fire”.

Premium setting is a complex matter and involves far more than a consideration of the risk of fire. Individual premiums can go up or down without there having been any change in the perceived fire risk.

The premium (and hence the fire services levy) in relation to similar properties with the same fire risk can, and does, vary significantly.

When people insure their property they generally seek protection for a wide variety of risks and not simply fire. Other types of risks include, earthquake, explosion, accidental breakage, impact damage, lightning, oil – leaking or escaping, riots, civil commotion, terrorism, storm, water – leaking or escaping, flood and most importantly, theft or attempted theft.

In setting premiums insurers have regard to all the risks covered by the policy, and not simply the fire risk, together with a host of other factors. As a result the link between premium and fire risk is often very tenuous.

For example, an insurance company could increase a policyholder's premium following a recent burglary or series of burglaries. The increase in premium would automatically lead to an increase in fire services contribution even though there had been no change in the fire risk.

Conversely, a premium discount offered by an insurer to those who increased security arrangements for their property would, if accepted, result in the fire services contribution being reduced independently of the fire risk.

A completely different example of an individual's premium varying because of a change in a factor other than the fire risk would be where an insurer offered a discount for having more than one insurance policy with that insurer. In this situation household insurance and the fire services contribution could both be reduced simply because the policyholder took out car insurance.

It is an everyday occurrence for individual property premiums to vary as a result of factors other than the fire risk and in many situations fire risk is not the dominant risk covered by property insurance.

The case for the sometimes articulated propositions that premium for property insurance closely reflects fire risk and is a good basis for funding the fire services is not a very strong one, particularly in relation residential property. This has been recognised by those States that have rejected insurance based funding for fire services in favour of a property based system.

It would not be difficult to develop a risk based property system for funding fire services that had a wider more appropriate base and which more effectively reflected fire risk than the present insurance based system.

Transparency

One disadvantage of the current system in Victoria of funding fire services by a levy on insurance and not focussed on in the discussion paper, is a lack of transparency of the arrangements.

The fire services levy is almost a hidden tax and is generally poorly understood by the public. The complexity of the arrangements works against public understanding.

The 2003 *Review of Victorian Fire Services Funding Arrangements* by the Department of Treasury and Finance stated in its report;

“The Current funding system lacks transparency at an individual and aggregate level. Individual policyholders may not be aware of the extent to which they are funding the Fire Services. Further the amount collected by insurance companies as the FSL may not equate to actual statutory contributions made, in part, because of the unpredictable nature of the insurance market.”

Dr Ken Henry, the Chair of the Commonwealth’s Review of Australia’s Future Tax System (AFTS) and head of the Commonwealth Treasury in a speech on 15 October 2009 referred to insurance taxes as “bad taxes” and indicated that a tax on a broader base would be more efficient, equitable and transparent. He stated:

“Some of the existing State taxes provide a clue. Many of these taxes – such as those on insurance policies and the transfer of property and motor vehicles – are generally recognised as being highly inefficient, sometimes even by the States themselves.

Yet in the absence of less distorting, more broadly-based taxes, the States have continued to use them to finance spending on critical services such as hospitals, schools and police. These taxes may not be noticed by people as much as other taxes, perhaps because they are only paid irregularly, possibly at times when people are thinking about the benefits they might receive from buying the house, or car or insurance. But what should we make of the fact that the burden of these taxes actually falls quite heavily on people who are more disenfranchised — such as those needing to adjust their housing circumstances due to relationship breakdown; or people in the lowest income quintile who spend a higher proportion of their income on motor vehicle purchases than the highest quintile; or those who bear risk where they would prefer to be insured but aren't, because of tax.

Taxes levied on broader bases would be more efficient policy tools, probably more equitable and certainly more transparent ways of raising revenue.

Without such tools, governments will continue to rely on bad taxes to achieve their spending objectives.”

While the Victorian Government recently made some attempt to increase the transparency of the current scheme, the general public understanding of it is still very limited.

There are significant advantages in moving from the current arrangements to a more open and transparent funding model such as those adopted by Western Australia or South Australia where the basis for calculating the payment is readily understood and the property owner receives an invoice that clearly shows their contribution.

GST and Stamp Duty

Any realistic assessment of the funding arrangements for fire services cannot ignore the effects of taxes on contributions. The current insurance based arrangements involve taxes on taxes on taxes. This would not be the situation with a property based system. Under a property based system GST and stamp duty would **not** be levied on basic contributions.

Not all money paid by Victorians as a result of the fire services levy goes towards funding fire services. A significant amount is “funnelled off”.

The Victorian Government’s Green Paper *Fire services and non-insured* indicated that the fire services levy is expected to raise \$510 million for the Victorian Government in 2009/10. The total financial implications of the levy for individuals and businesses are, however, far greater than that figure. Policyholders have to pay GST and Victorian stamp duty on top of their fire services contribution, something that would not be necessary if a move was made to property based fire services funding.

Under current arrangements insurance policyholders will be required to pay \$617 million in 2009/10, made up of \$510 million fire services levy, \$51 million GST and \$56 million in Victorian stamp duty. A 21% increase on the figure used in the Government’s Green Paper.

In other words, in 2009/10, Victorians will be required to pay in total \$617 million as a result of the existence of the fire services levy but only \$510 million of the \$617 million will go directly to funding the fire services.

If Victoria was to move to a property based system there would be no “syphoning off” of contributions paid by property owners for fire services.

Under Insurance

Under-insurance is generally regarded as occurring when the sum insured is insufficient to enable full replacement of the damaged or destroyed property and the reestablishment of the business where a commercial enterprise is involved. “Replacement value” is

different from the concepts of “Capital Improved Value” or “the value of the building structures” used in the Government’s Green Paper. It is also different from “market value”. “Market value” is the monetary amount that the property would fetch from an orderly sale. While it is often used for insurance purposes it is usually less, and in some cases significantly so, than the “replacement value”.

“Replacement value” is the dollar amount required to completely rebuild and re-establish, following the destruction of a property, and includes all costs associated with rebuilding.

People who had their homes destroyed by the Black Saturday bushfires would usually like to hold insurance that covered the completed restoration (replacement) of their home and contents.

“Replacement value” can change because of inflation, new building requirements or particular circumstances existing at the time e.g. building and other costs often rise sharply as a result of a national catastrophe. Insurance based on “market value”, realistic at the time it was given, could well fall short of what is needed for restoration.

While it is often difficult to establish the replacement cost for buildings it is far more difficult to calculate the replacement cost of property other than buildings e.g. the contents of a domestic house or the stock and equipment used by a business. FSL paid in relation to property insurance for other than buildings is very significant.

Commercial property insurance can include coverage for business interruption risk which is relevant for FSL purposes. A number of businesses have gone out of businesses after the Black Saturday bushfires because they did not have sufficient business interruption insurance. In any consideration of under-insurance business interruption insurance should not be ignored.

Often under-insurance only becomes obvious after a disaster and when the insurance payout is insufficient for complete restoration. As a result under-insurance is very difficult to quantify. Similarly, it is not always easy to establish what the right amount of insurance is at the time a policy is taken out; a judgement may be necessary. Notwithstanding the difficulties involved in quantifying the extent of under-insurance in Victoria, all available evidence, including that from oral and written submissions to the Royal Commission, indicates that it is a very significant problem.

The 2003 Treasury and Finance Study

The Government’s Green Paper relies heavily on the 2003 Review by the Department of Treasury and Finance for the Government’s view that the current insurance based funding system for fire services should be continued. This view appears to be largely based on the Government’s desire to protect a strong income stream rather than on equity or sound taxation principles.

The Green Paper states that the 2003 review found “the current model was the best way to fund Victoria’s fire services.” This statement appears to NIBA to misrepresent the 2003 review’s report.

The Department of Treasury and Finance Report drew no firm conclusions as to a preferred model nor did it make any recommendations.

The report was also deficient in that its terms of reference did not extend to the effect of GST and stamp duty on the various funding models considered.

NIBA whose strong view that the existing fire services funding model fails many of the basic principles of taxation and should be replaced, is shared by a number of recent public inquires and reviews that were well-resourced and highly qualified.

Widening the Base for the Fire Services Levy and the Introduction of a Substitute Levy on the Non-insured and Under-insured

The sought after increase in equity for the current insurance based system (if it can be achieved and there must be considerable doubt about that) can only come about by a dramatic increase in the complexity of the scheme.

The difficulties for charging the non-insured and under-insured a substitute levy in relation to buildings were outlined in the discussion paper and in the section above relating on Under-Insurance. These difficulties, however, pale into insignificance when considering how the substitute levy might be applied to non-insured or under-insured property other than buildings such as home contents or the stock, machinery, equipment and fixtures and fittings of businesses and business interruption insurance. FSL coverage is far wider than simply buildings. If only buildings are included, NIBA questions whether the improvement in equity flowing from a substitute levy could ever be sufficient to justify a change.

In addition to the practical administrative issues involved with the introduction of a substitute levy there are also significant administrative cost issues to overcome.

Even more importantly, however, than the administrative difficulties and the cost issues with the introduction of a substitute levy, is the fact that such arrangements would do nothing to improve the other failings of the current arrangements including those relating to taxation, clearly articulated in the Royal Commission’s discussion paper and by other public reviews.

Compulsory Insurance

While compulsory insurance may help to reduce under-insurance and non-insurance NIBA does not support the approach.

There are very significant practical issues involved. NIBA agrees with the statements in the discussion paper about the difficulties of enforcing compulsory insurance.

There are also issues around what would constitute acceptable compulsory insurance.

Would it apply to all insurance subject to FSL or only to buildings? Would it simply relate to the minimum insured value or would it include insurance coverage and terms and conditions? Would it be based on replacement value or some less effective alternative? What would be the position in relation to deductibles? Would it apply to commercial property including farms or would it simply apply to housing? If it applied only to housing what would be the position in relation to housing used for commercial purposes? Would there be some exceptions for social or other reasons? The more exclusions from the compulsory requirement the less effective the arrangement would be in forcing people into paying their fair share of the fire services.

Setting minimum compulsory insurance standards is likely to see some people reducing their current cover to that of the Government's acceptable minimum standard and work against the concept of individuals taking responsibility for protecting their own property.

There is also the question of what responsibility the Government would assume if the compulsory insurance proved inadequate for complete restoration of the insured property.

Making insurance compulsory could work against risk management techniques often employed by insurance policyholders, particularly those engaged in commercial activities.

It is interesting to note that following the 2003 Department of Treasury and Finance Report the Victorian Government decided that it would apply FSL to insurance deductibles. However, the Government decided against such an approach after a detailed study and consideration all of the implications.

In addition, making insurance compulsory would only focus on one of the deficiencies of the current insurance based funding model. Others relating to other aspects of equity, efficiency and transparency would remain.

As mentioned in the discussion paper, FSL on residential property insurance does not directly reflect the fire risk and there is a poor correlation between the insurance premium for home contents insurance and fire risk.

Those who derive the greater benefit from the fire services are not necessarily the ones currently with the greater funding burden and those who generate similar fire risk are not always treated the same. In other words, even with compulsory insurance there would still remain a significant question mark over the equity, efficiency and transparency of the arrangements.

A Property Based Model

NIBA strongly favours a move to a property based model for funding fire services, the contributions for which incorporate an adjustment factor for risk.

Such an arrangement would overcome the major deficiencies of the current insurance based funding mode.

The only areas of concern with a property based model are that the administrative costs would be borne by property owners rather than insurance policyholders and new administrative arrangements, including a property data base and collection procedures, would need to be developed. These are hardly insurmountable hurdles and minor compared to improvements in equity, efficiency, simplicity and transparency.

Victoria should use the property based models for funding fire services employed in Queensland, Western Australia, South Australia and the ACT as possible examples for new arrangements.

NIBA agrees that the design questions listed on page 7 of the Royal Commission's discussion paper would need to be resolved prior to Victoria moving to such a property based funding model. These questions are best answered by others.

Conclusion

NIBA strongly supports a move to funding fire services by way of a property levy. Such a move would increase efficiency, effectiveness, simplicity and transparency. It would eliminate the situation, under the current arrangement, whereby a tax is applied to a tax which is applied to a tax and it would not discourage individuals and businesses from protecting their property by way of insurance.

If I can be of any further assistance please do not hesitate to contact me.

Yours sincerely



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