

10 July 2008

Review of State Taxation
Independent Pricing and Regulatory Tribunal
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Introduction

Insurance Australia Group (IAG) is pleased to comment on the Draft Report - *Review of State Taxation* by the Independent Pricing and Regulatory Tribunal (IPART).

IAG welcomes IPART's findings that "IPART considers that its assessment of NSW taxes indicates that there is scope to improve the design and mix of NSW taxes, and to improve the efficiency of some of the most important taxes."

Indeed, in relation to insurance taxes IAG welcomes IPART's findings:

"Insurance duty and fire services funding contributions are 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."

IAG also welcomes the Government's in principle decision in relation to fire services funding to consider IPART's recommendations subject to the IPART Review of the Revenue Framework for Local Government.

IAG is however extremely disappointed that IPART has made no recommendations in relation to the insurance protection tax. While the insurance protection tax may have been justified at the time as a temporary measure to meet a specific and unanticipated need, the Insurance Protection Tax is no longer necessary. The rescinding of the Insurance Protection Tax should be a high priority, particularly in light of the recent Federal Government decision to establish a Financial Claims Scheme which will make the tax unnecessary.

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

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- 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 of State Taxation?

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 reform of Australia's taxation system.

This case is based on recognition of the essential benefits of insurance to the economy and community generally and of the role of the tax system in encouraging insurance coverage.

Please find attached IAG's submission to the Draft Report - *Review of State Taxation*. These comments supplement 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 me on 9292 1511.

Yours sincerely

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Insurance Australia Group's comments in relation to IPART Review of State Taxation – Draft Report

Taxation Reform – A Case for Insurance Taxes Reform

IAG notes and supports the following IPART findings:

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)

Recommendation 6

“In the short term, the stamp duty exemption for third party motor vehicle personal injury insurance should be abolished and that the standard rate of stamp duty for general insurance (Type A) be reduced from 9 per cent to 6 per cent.” (p.102)

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

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.

IAG however supports no change to the CTP exemption regime. Noting the NSW Government's lack of support for the current IPART recommendation in relation to general insurance, IAG encourages IPART to consider the Insurance Council's submission to the Draft Report which outlines an alternative proposal which is not dependent on adjusting exemption regimes.

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 original submission 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 than the more bushfire prone areas of the State.

Recommendation 7

"In the short term, the statutory contributions by insurance companies to fund fire services should be replaced by a corresponding increase in the contributions by local councils, with a phased implementation and accommodating increases in the municipal rate cap." (p.104)

Agree. IAG contends that New South Wales is well placed to build on the experience of other States in relation to insurance taxation reform. In particular, IAG believes a fire services

funding system, which encourages full value insurance, would result in economic and community benefits, especially as regards under-insurance. A system that is fair, consistent and more understandable to taxpayers and the community at large is needed. IAG believes that the most effective way of achieving this end is to implement a system that sees all property owners sharing the responsibility for funding fire services.

IAG notes the Local Government and Shires Association of NSW submission to the IPART Review:

“The Associations have long advocated a change to the current fire services funding model. We maintain that the current system is lacking in transparency, accountability and equity.”...“The Associations are advocating a property valuation based levy model to replace the existing fire services levies on local government and the fire services levy on insurance policy holders.” (Local Government and Shires Associations of NSW submission to IPART Review of State Taxation, November 2007).

Similarly, IAG notes the views of the Australian Consumers' Association's 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*).

Insurance Protection Tax – A Case for Reform

IAG is extremely disappointed that IPART made no recommendations in relation to the insurance protection tax. IAG continues to believe the concept of taxing viable insurance businesses to cover the costs to the State arising from the failure of a competitor is wrong in principle. It further undermines the credibility of the tax system to continue to levy such a tax beyond the point when its stated purpose has been achieved.

As IAG outlined in its submission to the IPART Review, 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 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.

IAG believes the NSW Insurance Protection Tax should be abolished this financial year.

Conclusion

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.

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.