INSURANCE COUNCIL OF AUSTRALIA

SUPPLEMENTARY SUBMISSION TO THE REVIEW OF AUSTRALIA'S FUTURE TAX SYSTEM

APRIL 2009

INTRODUCTION

Since the publication of the Insurance Council of Australia (Insurance Council) submission to the Review of Australia's Future Tax System (AFTS) in October 2008, the economic landscape has changed markedly, both domestically and internationally. In particular, a review of contemporary economic settings would include:

- A sharp deterioration in the world economy with world growth forecast revised sharply downwards. [1]
- A rapid slowing of the Australian economy with Treasury growth estimates revised downwards from 2.75% at the time of the 08/09 Budget to 1% in the Updated Economic & Fiscal Outlook statement. [2]
- A significant deterioration in the Federal Governments' budget position with Commonwealth Treasury estimating that the Federal Budget will move from an expected surplus of $21.7 b or 1.8% of GDP at the time of the Budget to an expected -$ 22.5 b or -1.5% of GDP in the Updated Economic & Fiscal Outlook.
- The announcement of two Federal government stimulus packages designed to stimulate domestic demand and with a total value of $52.4 billion.

Together these conditions may suggest that the capacity for considerable tax reform is likely to be constrained and that economic adversity serves as a bulwark against major change. To the contrary, the Insurance Council contends that the economic challenges presented by the current economic settings provide a unique opportunity to pursue major tax reform and improve the overall structure of the economy. To this extent, the Insurance Council agrees with Commonwealth Treasury when it observes:

".. finally, while economic theorists often think of fiscal stimulus in terms of a generic injection of government money to boost the economy, in the real world we might also want our fiscal measures to increase the long term productive capacity of the economy". [3]

Moreover, the deterioration in economic conditions highlights aspects of the fundamental inadequacies with current taxation settings, and especially those that apply to State governments. The volatility and unpredictability of State transaction taxes especially State stamp duties become more observable during times of economic adversity.

The Insurance Council also submits that since the release of the AFTS two consultation papers, the task of insurance and transaction tax reform has been regrettably slowed by specific State government's measures. For example, as part of its mini Budget in November 2008, the NSW Government announced its intention to fund the NSW State Emergency Service through the existing fire services statutory contributions framework and several States retreated on commitments to abolish specific transaction taxes hitherto scheduled for abolition under the 2000 Intergovernmental Agreement between the Commonwealth and the States (IGA). [4] Together, these announcements emphasise that State governments are reluctant to pursue tax reform unilaterally and moreover, that State governments are fundamentally constrained in their ability to eliminate inefficient taxes without either cutting outlays or risking their fiscal position.

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[1] For example, the World Bank has revised their world growth estimates from 0.9% in November 2008 to -1.7% in March 2009. See World Bank "*Global Economic Prospects 2009: Forecast Update; March 30, 2009*" The OECD also estimate growth in 2009 to contract by 4.3% in its member economies. See OECD Economic Outlook, Interim Report, March 2009.

[2] See 2008/09 Budget Statement No 1 & 2008/09 Updated Economic & Fiscal Outlook

[3] Nigel Ray (2009) "The role of fiscal policy in the current environment". Speech to the Financial Professionals Forum and available at http://www.treasury.gov.au/contentitem.asp?NavId=008&ContentID=1510

[4] See NSW Government 2008/09 Mini Budget . NSW deferred the abolition of mortgage duty on business loans, transfer duty on non land assets and duty on unquoted marketable securities until 1 July 2012. Queensland deferred the abolition of duty on the transfer of core business assets until 1 July 2012 and South Australia reset the abolition date for stamp duty on non quoted marketable securities and non real transfers until 1 July 2012.

At the same time however, while in some quarters the changed economic landscape may have caused the ambition to pursue insurance tax reform to slow, the need for change has been further highlighted by the devastating impact of the February 2009 Victorian bushfires, where large numbers of households were without general insurance. The financial impact on households of non insurance together with the impact on governments arising from the need to provide disaster relief highlights the key role that insurance plays in disaster recovery.

WHAT IS THE SCOPE FOR TRANSACTION TAX/STAMP DUTY REFORM?

The AFTS Consultation paper poses a number of challenges to stakeholders insisting on the need to reform State taxation. In particular, the Consultation paper remarks:

"*In considering alternatives to the current mix of state taxes, a number of factors need to be taken into account. The ability to reform state taxes will depend upon:*

- *the revenue raised by broadening the base of efficient taxes and any revenue forgone of tax rates are lowered as part of these reforms;*
- *the revenue lost due to the abolition (or reduction) of inefficient taxes;*
- *any changes to other revenue sources of state governments;*
- *the constitutional restrictions on the states levying some taxes; and*
- *the scope to raise additional revenue from user charging.*"

The Insurance Council considers it appropriate that the AFTS review consider the funding *capacity* for reform and tax reform *packages* that would enhance overall economic welfare.

The initial Insurance Council submission to the AFTS Review used Access Economics modelling to estimate the net cost (i.e. after second round effects) of general insurance tax reform at $1.7 billion. The Insurance Council also drew attention to research from the Finance Industry Council of Australia (FICA) which costed the removal of all State stamp duties at a net $10.5 billion. [5] The Insurance Council suggested that funding of State tax reform should be considered as part of a revamped Commonwealth/State Financial reform process and pointed to the 2000 Intergovernmental Agreement between the Commonwealth and the States (IGA) as an appropriate policy model.

A greater role for Payroll Taxation

In this submission, the Insurance Council examines alternative funding sources for the removal of State transaction taxes that are within the terms of reference of the AFTS Review. In particular, the Insurance Council examines the scope for payroll taxes to play a greater role in revenue collection including the potential to improve economic welfare by placing a greater reliance on payroll taxes and moving away from inefficient transaction type taxes.

This approach is in accordance with the broad findings of the NSW Independent Pricing & Regulatory Tribunal which found:

[5] See Insurance Council of Australia (2008) "*Submission to the Review of Australia's Future Tax System*" page 57

"*Payroll tax is one of the most efficient of the State taxes in its current form, and there is significant scope to improve its efficiency and equity by reducing the tax –free threshold and the number of exemptions. It also performs well against the robustness, simplicity and transparency criteria*". [6]

Further, IPART remarked:

"*In theory, payroll tax is one of the more efficient taxes available to State governments, due to its relatively broad base (which is a function of the businesses liable to the tax and the wages upon which the tax is assessed)*".[7]

To the extent that the NSW IPART recommend a greater role for payroll tax in revenue collections, IPART are applying orthodox economic principles in distinguishing between the *legal* and *economic* incidence of the tax . As the NSW Treasury argue, payroll tax has been one of the most maligned taxes operating in Australia since Federation and this has undermined its potential as an efficient source of taxation. [8]

Nevertheless, there exist numerous problems with current State payroll tax arrangements. These include:

- The existence of exemptions and thresholds which reduce the broadness of the payroll tax base.
- The lack of uniformity and harmonisation in the payroll tax rates.
- The temptation by State governments to offer payroll tax concessions and exemptions for the purposes of industry development policy.

To address these issues, the Insurance Council contends that there exists significant merit in the AFTS Review examining the potential for payroll tax to be transferred to the Commonwealth and with this transfer, to apply a uniform rate and remove exemptions. As highlighted in the AFTS Consultation Paper, the best manner in which this could be achieved would be for the Australian Taxation Office (ATO) to collect payroll tax on behalf of the States for redistribution back to the States.[9]

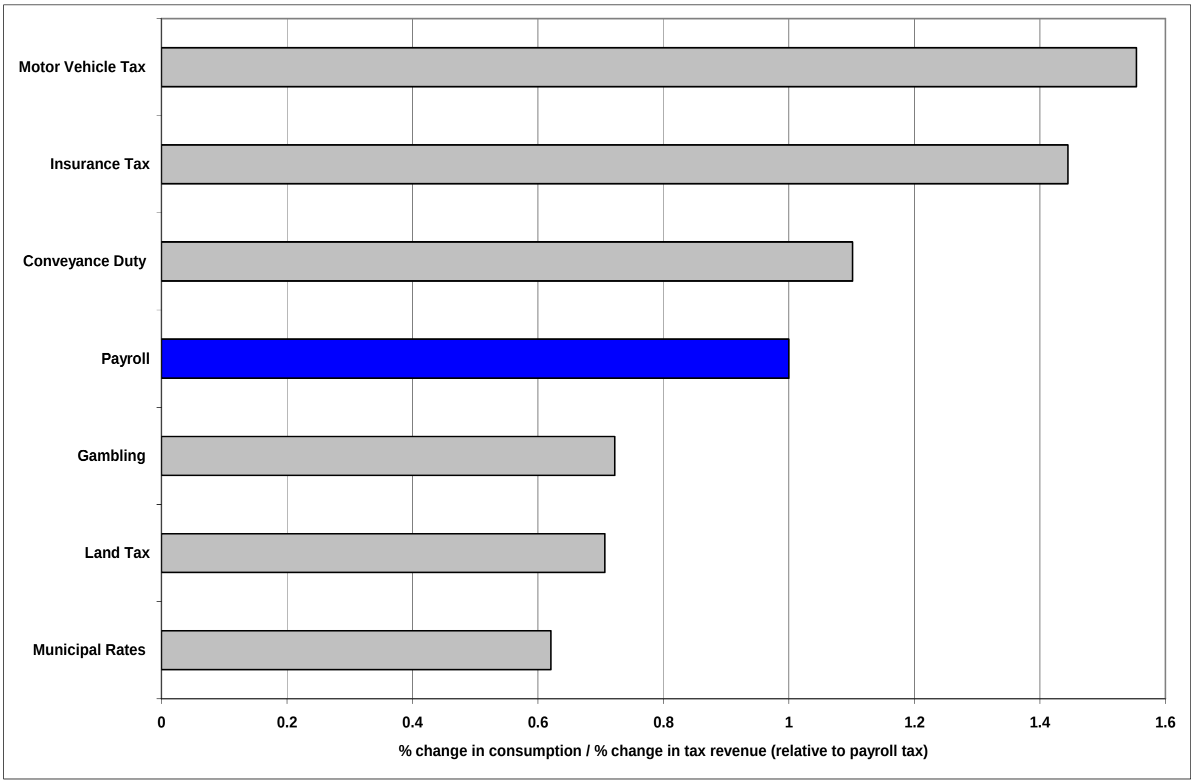
Costing Payroll Tax Reform and the implications for State transaction taxes

The Insurance Council submits that overall economic efficiency would be improved if State transaction tax reform was funded by the more efficient payroll tax. This is demonstrated in the following charts which set out the relative efficiencies of State taxes.[10]

In the charts, taxes are ranked from least to most efficient with the most efficient tax being a tax on land – municipal rates. In the charts, efficiency is reported relative to the efficiency of payroll taxes, with taxes less efficient than payroll scoring an index number of greater than one and those taxes more efficient than payroll scoring an efficiency index of less than one.

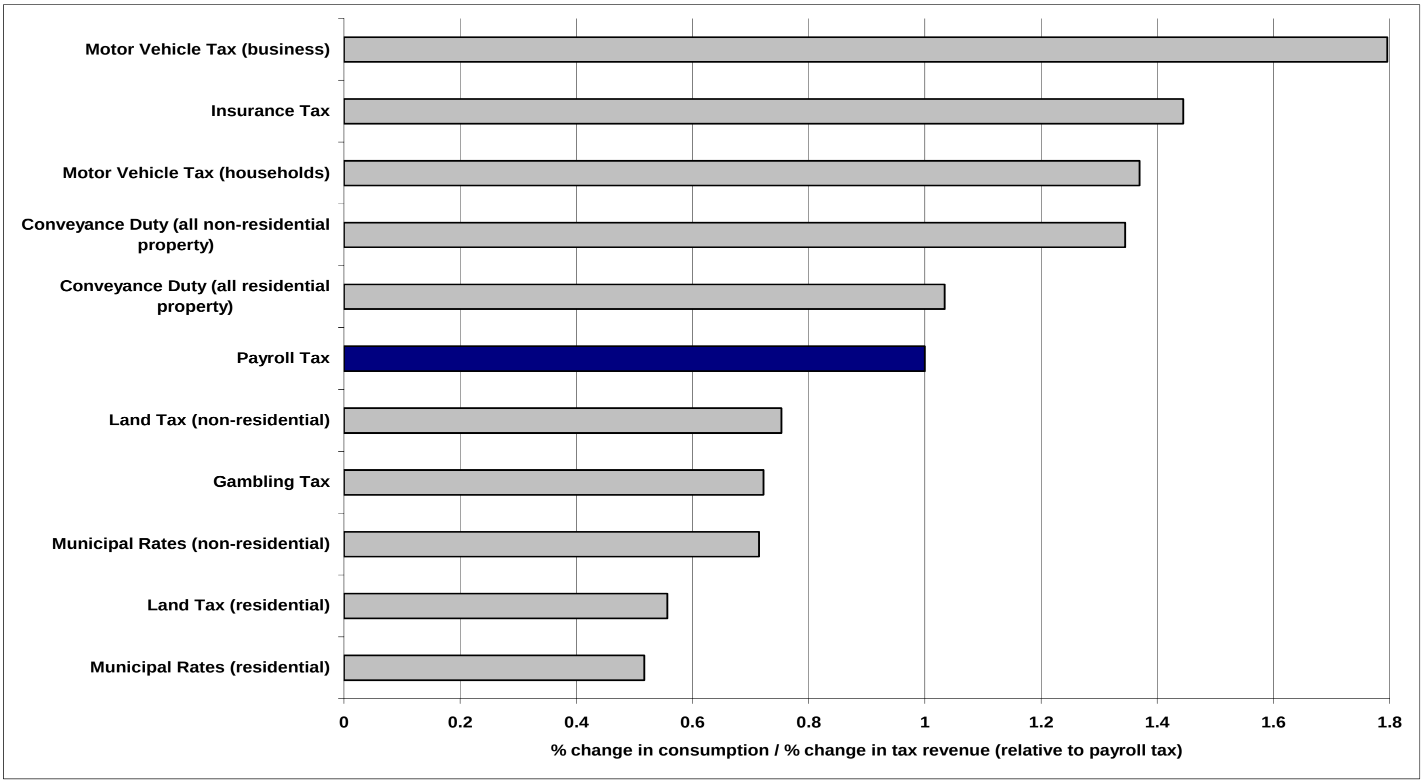
[6] See NSW Independent Pricing & Regulatory Tribunal (2008) "*Review of State Taxation: Report to the Treasurer*"
[7] See IPART (2008) "ibid" page 57
[8] See NSW Treasury (1999) "*The Case for Payroll Tax*" Research and Information Paper, TRP 99-3.
[9] See AFTS (2008) "Consultation Paper" page190.
[10] Access Economics (2009) "*Alternative Funding for Stamp Duty Reform: An Examination of Payroll Taxes*"

Figure 1: Australia Wide Efficiency Rankings



Source: Access Economics (2009)

Figure 2 Detailed Australian-Wide Efficiency Rankings of State taxes



Source: Access Economics (2009)

To accompany the efficiency rankings, the Insurance Council instructed Access Economics to cost the option of funding the abolition of State stamp duties through adjustments to payroll taxes. Access Economics modelled the following effects:

1. The revenue impact of removing existing payroll tax exemptions and harmonising the payroll tax rate at 4.75% - the lowest rate amongst the States and applicable in Queensland.

2. The revenue impact of removing all State stamp duties.

3. The revenue impact of removing stamp duties on insurance

4. The additional payroll tax revenue required to ensure the cost of State stamp duty reform combined with payroll tax reform (option 1 above) is revenue neutral.

The following table summarises the net revenue effects to all jurisdictions of the reform options 1-3 above.

	Direct Revenue Effect ($m)	**Second Round Revenue Effect ($m)**	**Net Effect to all Jurisdictions ($m)**
Remove current payroll tax exemptions and harmonise rate to 4.75%	$7,060	$(2,269)	$4,791
Abolition of all State stamp duties	(15,160)	5,665	(9,495)
Abolish Insurance Stamp Duty	(2,239)	1,190	(1,049)

Notes: All figures in 2005/06 dollars

Source: Access Economics 2009

As the above summary suggests, harmonising State payroll tax at 4.75% and removal of existing exemptions returns an extra $4.8 billion in revenue. Given the impacts of the payroll tax adjustment on wider economic activity, the revenue distribution of this gain is split between a gain of $6.5 billion to the States and a loss of $1.7 billion to the Federal government.

The Access Economics modelling indicates that, after taking into account second round effects, the cost of abolishing State stamp duties altogether is $9.5 billion with the cost of removing general insurance stamp duties $1.1 billion.

Access Economics were also instructed to provide the needed revenue boost to payroll tax to ensure that funding of State stamp duty reform was "revenue neutral". [11] Access Economics estimated that payroll tax would need to be augmented by an additional $7.5 billion to ensure that the abolition of State stamp duty was revenue neutral. This additional revenue would be secured by adjusting the payroll tax rate from 4.75% to around 6.6%.

On the other hand, to ensure that insurance stamp duty reform was payed for by an adjustment to payroll tax in a revenue neutral fashion, some $5.8 billion in payroll tax could be returned to fund the transition. That is, abolition of insurance stamp duties could be funded by removing current payroll tax exemptions and shifting to a harmonised marginal rate of 3.3%.

[11] After taking into second round effects. See Access Economics (2009) "*Alternative Funding for Stamp Duty Reform: An Examination of Payroll Taxes*"

The final change effects to all jurisdictions revenue from funding stamp duty reform through harmonised payroll taxes is set out below.

	Abolish all stamp duty and replace with a harmonised payroll tax rate of 6.6%	Abolish insurance stamp duty and replace with harmonised payroll tax rate of 3.3%
NSW	(400)	(815)
Vic	(477)	(339)
Qld	334	292
SA	237	41
WA	(876)	72
Tas	78	21
NT	(5)	11
ACT	80	30
Total all States	(1,028)	(659)
of which due to		
- property	(10,967)	169
- insurance	(2,168)	(2170)
- gambling	56	26
- payroll	13,993	1296
- motor vehicles	(1,941)	20
Total Federal	1,028	659
of which due to		
- GST	434	99
- Personal income	(542)	441
- Corporate	1,136	118
Total Impact	0	0

Source: Access Economics (2009)

The economic and welfare benefits of removing state transaction taxes for payroll taxes.

In addition to costing the reform of state stamp duties and payroll taxes, Access Economics were also instructed by the Insurance Council to estimate the welfare benefits of such a reform package. Access Economics estimated that the welfare benefits of removing State stamp duties and replacing them with a common State payroll tax could increase Australian household consumption by 1% - the equivalent of $5.7 billion in 2005/06 prices.

The economic welfare benefits of removing State transaction taxes and replacing them with a concomitant adjustment to payroll taxes is outlined below:

	Percentage change in real household consumption	$ Millions change in real household consumption
Abolish all stamp duty and replace with harmonised payroll taxes	1.05	5,771
Abolish insurance stamp duty and replace with harmonised payroll taxes	0.39	2,161
Notes: $ Millions in 2005/06 prices		
Source: Access Economics (2009)		

The welfare benefits of a reform "package" of this type should not be surprising given the relative efficiencies of State transaction taxes vis-à-vis payroll taxes. Nevertheless, there remains an insistence by some commentators that payroll tax is a poor tax and that it should be abolished. The insistence that payroll tax should be abolished stands contrary to the prevailing orthodoxy that the long term impact of a comprehensive payroll tax is akin to other broad based taxes such as a value added tax in so far as the economic incidence of the tax falls on labour either as lower after tax wages or indirectly through higher prices for goods and services. [12] To the extent that payroll tax remains broad based and comprehensive, payroll tax is one of the more efficient taxes available to State jurisdictions.

A PROPOSED POLICY PATHWAY

The Insurance Council contends that the AFTS should review the policy settings surrounding payroll tax and in particular, evaluate the feasibility of reverting collection of payroll to the Australian Taxation Office. [13] In turn, a harmonised payroll tax regime could be used to fund reform of the more inefficient State transaction taxes.

The benefits of this approach would include:

- The seamless administration and collection of payroll tax by the Commonwealth, including harmonisation.
- The collection of payroll tax by the Commonwealth with remittance back to the States according to payroll may avoid some of the challenges relating to the operation of the Commonwealth Grants Commission and the distribution of GST proceeds.
- A uniform and harmonised payroll tax regime could be used to fund relief of more inefficient State taxes, such as State transaction taxes.
- The States would see a return to more predictable and less volatile sources of revenue, allowing them to better plan service delivery.
- A uniform approach across the Commonwealth would alter the incentive to provide exemptions and relief of payroll tax for the purposes of industry policy.
- The policy is flexible enough to allow for transition paths to be adopted including the staged removal of specific transaction taxes in the first instance, leading to the eventual abolition of all State transaction taxes at a given time.

The original Insurance Council submission urged a renewed Commonwealth/State Financial Agreement to support general insurance tax reform. [14] This Insurance Council submission goes further by suggesting to the AFTS a more robust and efficient source of revenue to fund transaction tax reform by the States. Nevertheless, for this policy to be implemented, the requirement for a Commonwealth/State Financial Agreement still exists. The Insurance Council contends that for stamp duty/transaction tax reform to succeed, the importance of Commonwealth/State agreements is fundamental.

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[12] See NSW Treasury (1999) "*The Case for Payroll Tax*" Research & Information Paper; Australia's Future Tax System (2008) "*Consultation Paper*" and NSW Independent Pricing & Regulatory Tribunal (2008) "*Review of State Taxation: Report to the Treasurer*"

[13] This option is mentioned in the AFTS Consultation Paper. Prior to 1971 payroll tax was a Commonwealth tax. See S Reinhardt & L Steel (2006) "*A brief history of Australia's Tax System*" Paper presented to the 22nd APEC Finance Ministers' Technical Work Group Meeting available at http://www.treasury.gov.au/documents/1156/PDF/01_Brief_History.pdf

[14] The FICA submission argued in similar terms.

OTHER INSURANCE TAXES – FIRE & EMERGENCY SERVICES LEVIES

Both the AFTS Consultation paper and the AFTS Architecture paper pointed to the impact that insurance taxes have on non insurance and under insurance by increasing the cost of insurance products. The AFTS Consultation paper also drew attention to how sub optimal insurance levels may also lead to an increase in government outlays if assistance is provided to uninsureds post a disaster. The Insurance Council strongly supports these remarks and notes that the comments are largely consistent with Insurance Council previous submissions.[15]

Nevertheless, since the release of the AFTS Consultation Paper the task of insurance tax reform has suffered a significant setback with the NSW government Mini Budget measure to fund the NSW State Emergency Services (SES) through the statutory contributions formula. [16] The NSW SES measure is expected to add approximately $10 to the cost of the average house and contents policy in NSW. [17]

The Insurance Council supports the need for a well equipped and resourced fire and emergency services capability within the States. However, the challenge for policy makers (Federal and State) is to ensure that the funding of such services is undertaken on an efficient and sustainable basis.

The Insurance Council contends that the Federal Government has a role to play in leveraging State administrations to place fire and emergency service funding on a better footing. This need has been further highlighted by the Victorian bushfire event in February 2009.

As the AFTS Consultation has noted non insurance and under insurance can place strains on government funding at times of natural disaster. [18] Accordingly, the key role the Commonwealth plays in supporting disaster recovery and in funding emergency disaster assistance to the States could potentially be used to leverage change in State emergency service funding arrangements and to have these arrangements made more sustainable. As the State tax efficiency charts highlight, there is considerable scope to improve the efficiency of State fire funding arrangements by shifting from an insurance base to a land/municipal tax base. As Access Economics observe:

> *"In NSW (and Victoria and Tasmania) fire services are funded in part through taxes applied to insurance premiums. The efficiency rankings reported above show that insurance taxes are relatively inefficient when compared with most other current State taxes. This means that the provision of fire services causes a relatively large deadweight loss in NSW (and Victoria and Tasmania). This deadweight loss could be reduced by shifting the FSL from insurance to more efficient taxes on immoveable property, such as the municipal rates base".* [19]

The Insurance Council submits that the Commonwealth Government has the critical ability to drive essential change in State emergency services funding through its support arrangements with the States on emergency funding. Moreover, the AFTS provides the opportunity for the Commonwealth to ensure that State based emergency services funding is efficient and sustainable by recommending that such funding be supported through the most efficient tax base.

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[15] See Insurance Council (2007) "*Federal Budget Submission*"; Insurance Council (2008) "*Federal Budget Submission*"; Insurance Council (2008) "*Submission to the NSW Independent Pricing & Regulatory Tribunal Inquiry into State Taxation*"; Insurance Council (2008) "*Submission to the Review of Australia's Future Tax System*" and Insurance Council (2009) "*Federal Budget Submission*"

[16] Under Division 6 of the *NSW State Emergency Service Act 1989*, insurance companies are required to contribute 73.7% of the cost of running the NSW State Emergency Service .

[17] See Insurance Council Media Release "NSW Mini Budget = More Tax Pain for General Insurance Policyholders" (11 November, 2008) available at http://www.insurancecouncil.com.au/Default.aspx?tabid=1604

[18] AFTS Consultation Paper at page 191

[19] See Access Economics (2008) "Analysis of State Tax Reform including Taxes on General Insurance" at page 17.

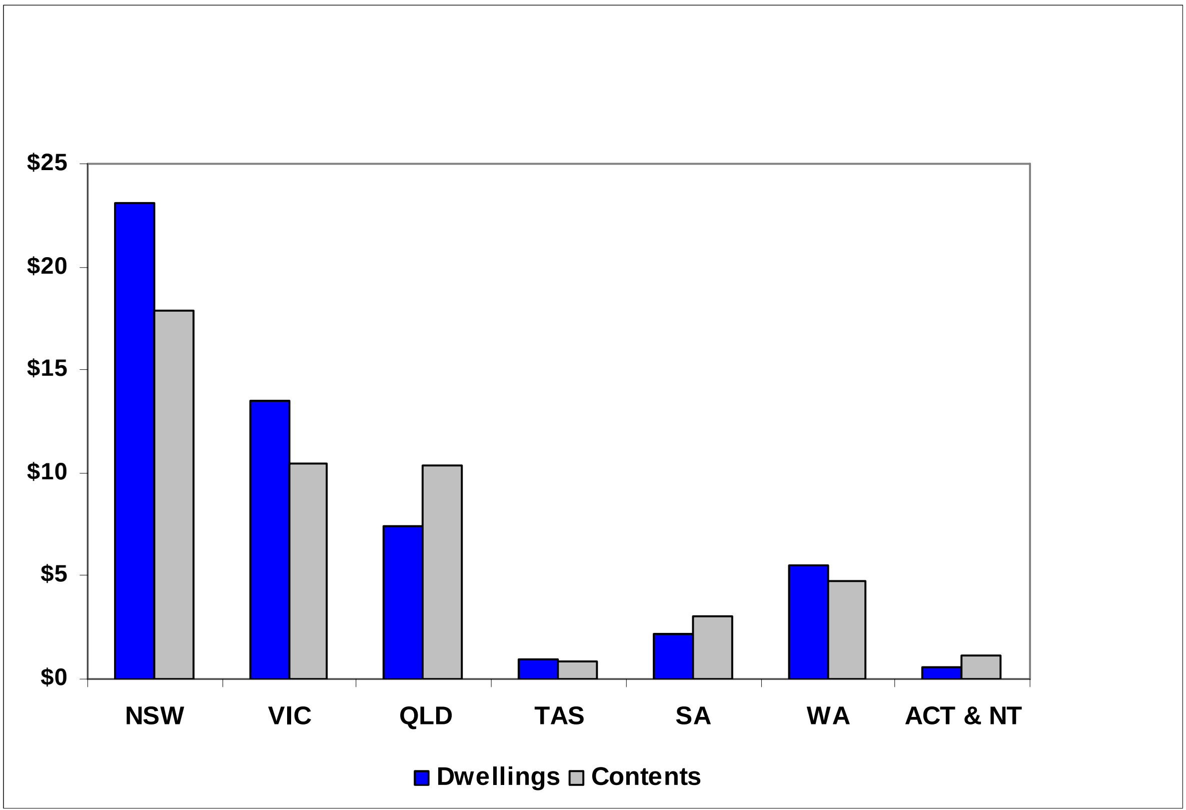
NON INSURANCE – VALUE OF ASSETS AT RISK

The original Insurance Council submission to the AFTS provided evidence on the extent of non insurance in the Australian community using material from the Australian Bureau of Statistics Household Expenditure Survey (ABS HES). This submission will build on these observations by introducing the AFTS review to an understanding of non insurance in terms of the value of household assets at risk in the Australian community. [20]

Using ABS HES Confidential Unit Record Files, the Insurance Council has estimated that for dwelling owners not paying body corporate fees, the value of dwelling assets not insured nationally is estimated to be $53.3 billion.[21] The value of household contents insurance at risk from non insurance is estimated to be around $48.4 billion.

The value of assets at risk from non insurance by State is represented in the chart below.

Figure 3: Value of Household Assets Not Insured ($ billions)



(Source: Australian Bureau of Statistics, Household Expenditure Survey)

[20] The Victorian Department of Treasury & Finance review into Victorian Fire Service Funding Arrangements considered this matter and provided an estimate. See Victorian Department of Treasury & Finance (2003) "*A Review of Victorian Fire Services Funding Arrangements*" at page 30.
[21] Owner occupiers not paying body corporate fees provides the best reference for the market for building insurance. See Insurance Council of Australia (2007) "*The Non Insured: Who, Why and Trends*" available at
http://www.insurancecouncil.com.au/Portals/24/Issues/The%20Non%20Insured%20-%20Report.pdf

CONCLUSION

The Insurance Council acknowledges and appreciates that economic conditions have changed markedly since the announcement of the AFTS Review and the release of the AFTS Architecture and Consultation papers. In this respect, the constrained economic and budgetary environment places additional obligations on the AFTS in arriving at tax reform options that both enhance economic capacity and are sustainable in the longer term. As Treasury has recently argued:

"*It is also important that we continue to expand our productive capacity over time – it would not make much sense to close the output gap by just reducing our productive potential*" [22]

Consistent with the approach taken in the Insurance Council's original submission to the AFTS, the Insurance Council confirms that reform of transaction taxes and general insurance more particularly, should be a main priority for the AFTS review. The evidence that economic welfare would be significantly enhanced with the removal of transaction taxes is now available to the AFTS.

Moreover, in this supplementary submission, the Insurance Council has gone further in providing advice to the AFTS as to an appropriate tax mix package that would allow the goal of removing inefficient transaction taxes. The tax mix package would see a switch away from inefficient State based transaction taxes to be replaced by a considerably more efficient and harmonised and centralised payroll tax regime. This tax package accrues significant economic welfare gains adding some 1% to real household consumption. A package of this type is best delivered in a new round of Commonwealth/State Financial reform.

The Insurance Council continues to submit that the absence of insurance tax reform in the 2000 Intergovernmental Agreement between the Commonwealth and the States was a major anomaly and that the current AFTS represents the next available opportunity to redress this anomaly. Moreover, since the 2000 IGA, subsequent independent reports have also recommended for reform of insurance taxation– namely the HIH Royal Commission and the NSW IPART Report into State Taxation. What these reports have in common is the conclusion that taxation on general insurance is inefficient and that reform of general insurance is needed.

[22] See Nigel Ray (2009) "*The Role of Fiscal Policy in the Current Environment*" Speech to the Finance Professionals Forum. Available at http://www.treasury.gov.au/contentitem.asp?NavId=008&ContentID=1510