

Deloitte Access Economics

Impact of removing stamp duties on insurance

Insurance Council of
Australia

October 2015

Contents

Executive Summary.....	i
1 Background.....	1
1.1 This report	2
2 Assessing the efficiency of taxes	2
3 Insurance-based stamp duties in Australia	4
4 Estimating the impact of removing insurance-based stamp duties	5
4.1 Impact on household consumption.....	6
4.2 Impact on government budgets.....	7
References.....	8
Limitation of our work	9

Charts

Chart 3.1 : Efficiency ranking of selected taxes	5
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Tables

Table 4.1 : Impact of selected reforms on real household consumption	6
Table 4.2 : Net revenue effect on government of selected reforms	7

Figures

Figure 2.1 : Illustrative impact of imposing a tax.....	3
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Executive Summary

Federal, local and state governments provide a range of services to Australians. The provision of these services is funded primarily through taxation. Taxes can take many different forms and be levied by different levels of government. Each tax has different designs and impacts. The effectiveness of a tax in achieving its purpose can be assessed against a number of criteria, including efficiency, equity and simplicity.

The Insurance Council of Australia has engaged Deloitte Access Economics to prepare a note on the economic efficiency impact of:

- removing the Emergency Services Levy (ESL) in NSW, and replacing it with commensurate increases in land taxes; and
- removing all insurance-based stamp duties across Australia, including the ESL in NSW, and replacing them with commensurate increases in land taxes.

Taxes are, generally, distortionary. This erodes economic efficiency. The less distortionary a tax is, the less it will lower economic welfare. One measure of the efficiency of a tax is its marginal excess burden - the reduction in welfare associated with collecting one extra dollar of tax revenue from a given tax. The marginal excess burden of a tax tends to be lower where its economic incidence falls on goods and services demand for/supply of which is relatively less responsive to changes in price, and goods that are subject to lower overall rates of tax.

Insurance-based taxes are a form of transaction tax. In Australia, state governments generally levy them on insurers, who pass them on to businesses and individuals as they purchase various insurance policies.

In addition to these insurance taxes, general insurance companies in NSW impose an Emergency Services Levy (ESL) on premiums.¹ The emergency services determine the funding required, and charge a proportion of this to insurance companies. The contribution required of each individual insurer reflects its market share. Insurers seek to recover this cost by passing it on to policy holders in the form of a percentage levy, the ESL, on the value of insurance premiums.

This note finds that such taxes are relatively inefficient compared with other taxes levied by Australia's state governments – especially taxes on land. This finding is supported by other papers, including Cao et al (2015) and Access Economics (2008).

Using computable general equilibrium modelling, this report finds that significant economic benefits could arise from removing insurance-based stamp duties and raising the revenue forgone through alternative, more efficient means – namely, municipal rates (i.e. a broad-based tax on land). Specifically:

- Removing the Emergency Services Levy (ESL) in NSW, and replacing it with commensurate increases in municipal land rates would lead to an increase in real

¹ Tasmania also charges an Insurance Fire Levy, which is a contribution received from insurance companies in respect of premium income on prescribed classes of insurance.

private household consumption in NSW of \$799 million, and a net increase in NSW tax revenue of 0.30%.

- Removing all insurance-based stamp duties across Australia, including the ESL in NSW, and replacing them with commensurate increases in municipal land rates, would lead to a net increase in real private consumption across Australia of \$5.52 billion, and a net increase in tax revenue collected by state and local governments of 0.69%.

Deloitte Access Economics

1 Background

Federal, local and state governments provide a range of services to Australians. The provision of these services is funded primarily through taxation.

Taxes can take many different forms and be levied by different levels of government. The Henry Tax Review (Commonwealth of Australia, 2011) noted that

“Australians pay at least 125 different taxes each year. Of these, 99 are levied by the Australian government (including 67 agricultural levies), 25 by the States and 1 (council rates) by local government.”

Each tax has different designs and impacts. The effectiveness of a tax in achieving its purpose can be assessed against a number of criteria. The most common of these are:

- **efficiency** – the extent to which a tax distorts price signals and thereby behaviour in a market;
- **equity** – the extent to which a tax is ‘fair’, for example horizontal equity (treating taxpayers who are similar in all relevant respects in a similar way), vertical equity (taxpayers who have a higher capacity to pay taxes should pay more relative to those with less capacity) and administrative equity (enforcing the tax law fairly); and
- **simplicity** – the extent to which a tax is easy to understand and administer.

Formal economic analysis is best placed to answer questions about efficiency. In recent years, several papers have used economic modelling to analyse the relative efficiency of various taxes at state and federal levels in Australia:

- Access Economics (2008) considered the impact of various state taxes on economic efficiency, using a multi-sector/multi-region general equilibrium model of the Australian economy to model these impacts for the first time. It found that taxes levied on immovable property (land-based taxes) are more efficient than taxes levied on movable property (equipment and motor vehicles), and that taxes on business are less efficient than comparable taxes levied on households;
- KPMG (2010) used computable general equilibrium modelling to analyse the tax system broadly. It found that some Australian taxes are much more inefficient than others, and that the excess burden of a tax rises with the mobility of its tax base (i.e. the more moveable it is) and the narrowness of its tax base;
- Access Economics (2011) updated previous modelling on the impact of state taxes on economic efficiency;
- Rimmer, Smith and Wende (2014) assessed the incidence of company tax in Australia. They found larger welfare gains from cutting the company tax rate than reducing other major revenue sources, with the majority of these gains being passed on to other economic agents rather than being accrued by capital owners; and
- Most recently, Cao et al (2015) used a static representative household general equilibrium model to assess the additional welfare cost of major Australian taxes, and the economic incidence of marginal changes. They found that stamp duty on

conveyances and the company income tax are Australia's least efficient taxes, while the most efficient tax is a hypothetical broad-based land tax.

1.1 This report

Previous work undertaken by (Deloitte) Access Economics has consistently identified stamp duties – including motor vehicle tax and insurance taxes – as among the least efficient taxes in Australia.

Several States and Territories are currently considering changes to stamp duties. For example, the Australian Capital Territory has cut insurance taxes successively, with insurance tax to be fully abolished from 1 July 2016 (ACT Government, 2015). South Australia has committed to phasing out stamp duties on non-residential property transfers over the next three years. (SA Government, n.d.).

The Insurance Council of Australia has engaged Deloitte Access Economics to prepare a note on the economic impact of:

- removing the Emergency Services Levy (ESL) in NSW, and replacing it with commensurate increases in municipal land rates; and
- removing the all insurance based stamp duties in Australia, including the ESL in NSW, and replacing them with commensurate increases in municipal land rates.

2 Assessing the efficiency of taxes

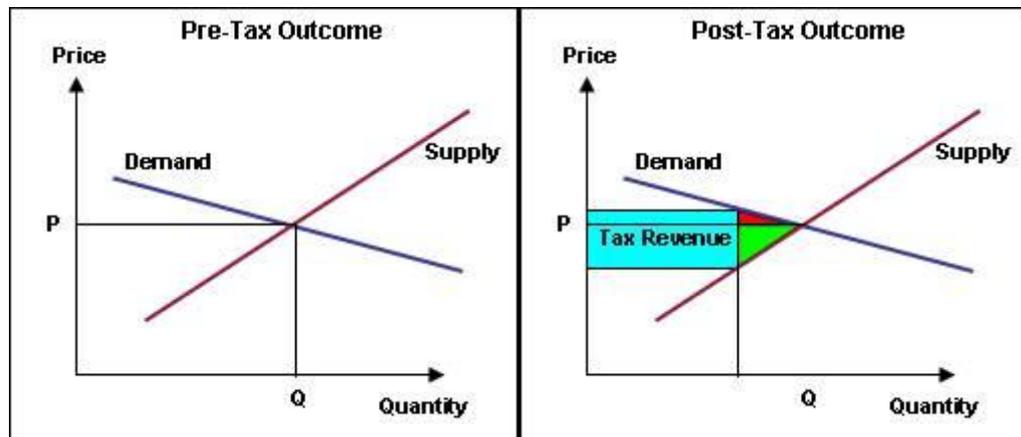
An efficient tax system would raise revenue without distorting the allocation of resources in the economy. For example, this would mean that individuals make decisions about how many hours to work irrespective of tax considerations and that tax wedges do not stop the flow of goods and services to those who value them most.

In practice, however, all tax systems distort the allocation of resources in some way. This imposes a welfare cost on society, because the imposition of a tax makes the price that consumers pay for a good higher than the cost of producing it.²

Figure 2.1 shows that this creates an efficiency loss, represented by the red and green areas. These areas show the value lost on mutually beneficial transactions that do not take place as a result of the tax.

² In some cases, taxes can correct an inefficiency. This can happen when the true social cost of consumption is not reflected in the price, because a good imposes 'negative externalities', or costs on individuals other than those who are purchasing the good.

Figure 2.1: Illustrative impact of imposing a tax



Source: Access Economics, 2008

Ultimately, the goal is to raise revenue as efficiently as possible, without unduly compromising other design considerations, in particular equity (noting the role of the transfer system).

This is done by minimizing the 'excess burden' - a common measure of the total welfare cost of a tax - for a given revenue target. Minimizing the excess burden is a means of maximising the efficiency with which revenue is raised.

A related measure is 'marginal excess burden', which calculates the loss of welfare associated with collecting one extra dollar of tax revenue from a given tax. This provides a basis for understanding how changes can be made to the tax mix to improve efficiency.

There are three main drivers of marginal excess burden:

- **elasticity** – the responsiveness of supply and demand to changes in price;
- the **overall tax rate** which applies to a good or service; and
- **general equilibrium effects**, including the interaction of a tax with existing taxes and the impact on the cost of capital and hence on investment.

Goods and/or services where quantities traded are more responsive to price have a higher marginal excess burden. The more sensitive demand and supply are to prices, the more likely are there to be large behavioural changes (distortions) to behaviour as a result of imposing taxes.

3 Insurance-based stamp duties in Australia

Insurance-based taxes are a form of transaction tax levied by state governments on both businesses and individuals on certain insurance transactions. They are calculated either as a percentage or fixed dollar amount of total premium paid.

These taxes apply to a wide range of insurance products. For example, in NSW, insurance duties are payable by any general insurer or life insurer on products including (NSW Office of State Revenue, 2015):

- motor vehicle insurance;
- home and contents insurance;
- life insurance;
- disability income insurance; and
- hospital and ancillary benefits health insurance.

In Tasmania the government imposes a fixed levy on selected commercial insurance products, whereas in NSW the fire and emergency services are funded by statutory contributions from the General Insurance industry and local and state governments. The insurance industry's contribution funds 73.7% of the emergency services budget while local and state government contributions fund 11.7% and 14.6%, respectively. Insurance companies attempt to recover their contribution by imposing an emergency services levy (ESL) on premiums.

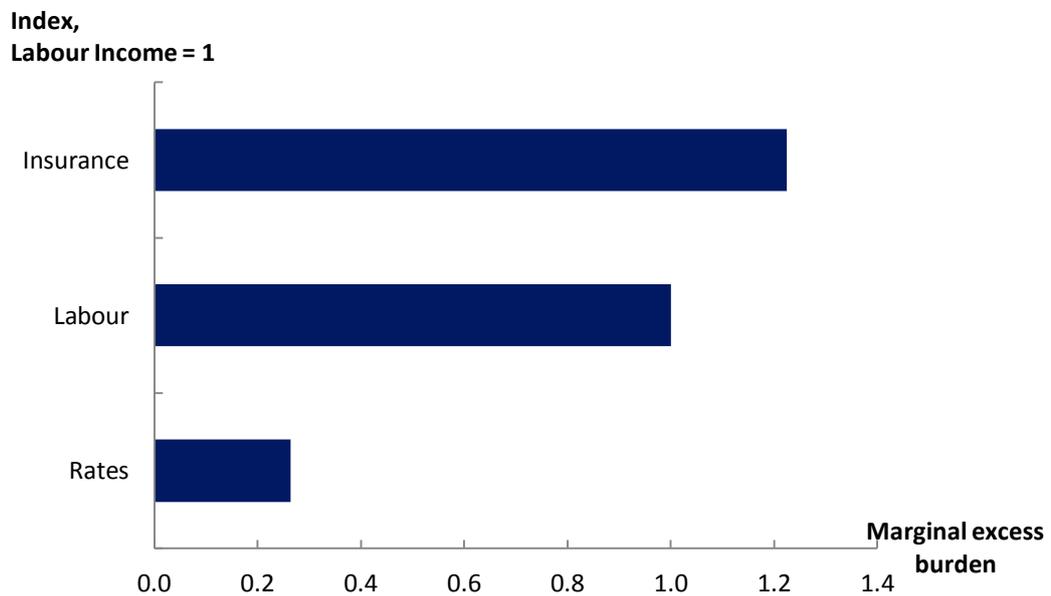
The Henry Review noted that insurance-based taxes, including the Emergency Services Levy, could have a higher distortionary effect than other taxes (Commonwealth of Australia, 2001):

“The narrow base of many transaction taxes and their interaction with other taxes can have an impact on resource allocation in the economy. For example, insurance products are subject to GST, insurance transaction taxes and, in some States, insurance companies can also be required to contribute directly to the funding of fire services. The interaction of these taxes increases the cost of premiums relative to other products, which may encourage people to take up less insurance than otherwise.

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

Chart 3.1 depicts the efficiency ranking of selected taxes. It shows that insurance taxes are less efficient than taxes on labour and land (i.e. through municipal rates). This is consistent with both economic theory and previous estimates (for example, KPMG (2015)).

Chart 3.1: Efficiency ranking of selected taxes



Source: Deloitte Access Economics, 2015

4 Estimating the impact of removing insurance-based stamp duties

Chapter 1 discussed several methodologies that have been used to model the impact of various taxes in Australia, both at a state and federal level. However, recent best practice for modelling the impact of taxes in Australia focuses on computable general equilibrium modelling (for example, Cao et al., 2015)

This report models two scenarios:

- **Scenario 1** – the ESL in NSW is removed, and replaced with a commensurate increase in municipal land rates; and
- **Scenario 2** – all insurance-based stamp duties in Australia, including the ESL in NSW, are removed, and replaced with a commensurate increase in municipal rates.

This report uses a comparative static computable general equilibrium model of the Australian economy with a representative household to model the impact of these changes on private consumption (as a proxy for welfare) and government budgets.

The model assumes a one-off shock to the economy. However, the economy will take some time to adjust to changes. As a result, the impacts are modelled as a total long-run impact – that is, the impact in the long term (5+ year horizon) once the economy has settled at a new equilibrium.

4.1 Impact on household consumption

Stamp duties on insurance are a particularly inefficient tax, as discussed in Chapter 2. This means that raising an extra dollar of revenue through stamp duty is more costly, in welfare terms, than raising it through other taxes (such as municipal land rates).

Table 4.1 shows the impact of moving to a more efficient tax base on real household consumption, as a proxy for economic welfare.

Table 4.1: Impact of selected reforms on real household consumption

	Removing ESL in NSW		Removing ESL and all insurance-based stamp duties across Australia	
	Consumption change (%)	Consumption change (\$m)	Consumption change (%)	Consumption change (\$m)
NSW	0.38	1,085	1.07	3,056
VIC	-0.06	- 127	0.51	1,080
QLD	-0.06	- 100	0.35	582
SA	-0.01	- 6	0.53	298
WA	-0.05	- 47	0.28	263
TAS	-0.09	- 15	0.35	57
NT	-0.10	- 9	0.58	55
ACT	0.11	17	0.81	123
Total	0.10	799	0.66	5,515

Source: Deloitte Access Economics, 2015.

Changes made to insurance taxes in one jurisdiction can affect consumption and government budgets in other jurisdictions in one of two ways.

- **competition effect** – if a change in one jurisdiction makes it more competitive, then it may attract resources, such as capital and labour, away from other jurisdictions, exerting a negative impact on other jurisdictions; and
- **trade effect** – a jurisdiction that becomes more prosperous may demand more goods and services from other jurisdictions, causing their economies to expand.

In the first scenario, households in NSW gain the most significant benefits, with an increase in real consumption of 0.38% or \$1.09 billion. Impacts on consumption in other jurisdictions are comparatively minor. This is to be expected as the consequences of removing stamp duties on general insurance are predominantly realised in the State removing the duty.

As described above, the first scenario also affects other states. The size and nature of this impact (i.e. whether it is positive or negative) depend on the relative strengths of the competition and trade effects. For example, Table 4.1 shows that, under scenario 1, the ACT is the only jurisdiction other than NSW to benefit from the change. This is because of the strong trade linkages between the ACT and NSW.

The benefits of removing all insurance-based stamp duties across Australia, including the NSW ESL, are also shown in Table 4.1. The most significant benefits accrue in NSW, where there is a modelled increase in real household consumption of 1.07%. The total increase in consumption is estimated to be \$5.52 billion across Australia.

4.2 Impact on government budgets

By design, the direct impact of both scenarios on state government budgets is neutral. This is because it is assumed that the loss of revenue from insurance-based stamp duties is compensated by a commensurate increase in municipal land rates.

However, as discussed in Section 4.1, moving towards a more efficient tax base will increase economic activity generally. Given that increased economic activity results in higher tax receipts for government, an increase in overall government tax revenue can be expected.

Table 4.2 details the indirect impacts on government revenue that arise from moving towards a more efficient tax base.

Table 4.2: Net revenue effect on government of selected reforms

	Removing ESL in NSW		Removing ESL and all insurance-based stamp duties across Australia	
	Revenue change (%)	Revenue change (\$m)	Revenue change (%)	Revenue change (\$m)
NSW	0.30	84	1.42	400
VIC	-0.06	-12	0.47	98
QLD	-0.03	-4	0.14	21
SA	0.04	2	0.55	30
WA	-0.01	-1	0.22	23
TAS	-0.08	-1	-0.08	-1
NT	-0.15	-1	0.75	5
ACT	0.23	3	2.24	29
Commonwealth*		26		185
Total	0.08	68	0.69	575

*Commonwealth revenue refers to increases in GST revenue as a result of the change.

Note: Revenue changes in \$m are in 2014-15 Australian Dollars. These are calculated by applying the revenue change calculated to total local and state taxation income for 2013-14, using ABS 5506.0

Source: Deloitte Access Economics, 2015.

As expected, in the first scenario where only the NSW ESL is removed and replaced with a commensurate increase in rates, the largest impact is on NSW state and local government revenues. Table 4.2 shows an increase in net revenue of 0.30% or approximately \$84 million for NSW.

The second scenario has broader implications for government budgets through indirect impacts. The impact on revenue ranges from 2.24% in the ACT to -0.08% in Tasmania. In total, the scenario results in a net increase in state and territory government revenues of \$575 million.

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Contact us

Deloitte Access Economics
ACN: 149 633 116

Level 7
225 George St
Sydney NSW 2000
PO Box N250
Sydney NSW 1220 Australia

Tel: +61 2 9322 7000
Fax: +61 2 9322 7001

www.deloitteaccesseconomics.com.au

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