INSURANCE COUNCIL OF AUSTRALIA

SUBMISSION TO THE SOUTH AUSTRALIAN STATE TAX REVIEW

April 2015

INTRODUCTION

The Insurance Council of Australia (ICA) welcomes the opportunity of providing a submission to the Inquiry into the South Australian taxation system (hereafter the Inquiry) being overseen by the Department of Treasury and Finance of the South Australian Government (hereafter the DTF).

The Insurance Council of Australia (ICA) is the representative body of the general insurance industry in Australia. ICA members represent more than 90 percent of total premium income written by private sector general insurers. ICA members, both insurers and reinsurers, are a significant part of the financial services system. December 2014 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $41.7 billion per annum and has total assets of $114.7 billion.

The industry employs approx 60,000 people and on average pays out about $107 million in claims each working day. Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance). At end December 2014 the sector insured over 85 million risks across Australia.

The ICA has been a major contributor to the State tax reform debate in the past [1] and is pleased to make further contributions to the State tax reform debate through the DTF process.

The DTF is undertaking this inquiry at a time when research and analysis on State taxation matters is relatively well developed and advanced. For example, the Review into Australia's Future Tax System (the AFTS) provides the fundamental platform on which to undertake a principle based appraisal of the efficiency of State taxes regardless of the State in which they are levied.

Similarly, jurisdictionally based reviews such as those undertaken in NSW, Tasmania, and the ACT reached recommendations consistent with those of the AFTS Review. The more recent Final Report of the GST Distribution Review[2] also reaffirmed the findings of the AFTS Review in its summation of the relative benefits and costs of a given set of State taxes.

These Federal and State reviews and inquiries all concluded that State taxes fall into two basic categories:

- taxes on transactions (such as stamp duties and levies on the purchase of insurance and on property sales) which have large dead weight costs, are a drag to prosperity and suffer from revenue volatility; and
- those State taxes, such as payroll and land taxes that, although they suffer from weaknesses in their bases through exemptions, offer the States a tax base that is potentially efficient and revenues that are stable and predictable.

The conclusion from these reviews is that the States would be materially better off if they reformed their tax bases on payroll and land to reduce exemptions at the same time as they reduced their reliance on transaction type taxes such as stamp duties.

The South Australian Government has the opportunity to take the initiative and by reforming its tax regime, not only boost the long term integrity of its own revenue base but also provide inspiration for the long foreshadowed Commonwealth-State tax reform process.

[1] See ICA submissions to the Australian Future Tax System Review, the NSW IPART Review, and the Tasmanian State Tax Review available at www.insurancecounicl.com.au

[2] See GST Distribution Review (October 2012) "Final Report"

DESIGNING A GOOD TAX SYSTEM

The ICA contends that a good tax policy should adhere to the principles of equity and fairness such that taxpayers with an equal ability to pay, pay the same amount of tax (horizontal equity) and taxpayers with greater ability to pay, pay more tax (vertical equity). Horizontal equity implies there should be no exemptions to a tax base while vertical equity requires that either taxpayers with a greater ability to pay should pay a higher rate of tax or a flat rate should be applied so those on higher incomes (or having greater wealth) will pay more tax in absolute terms.

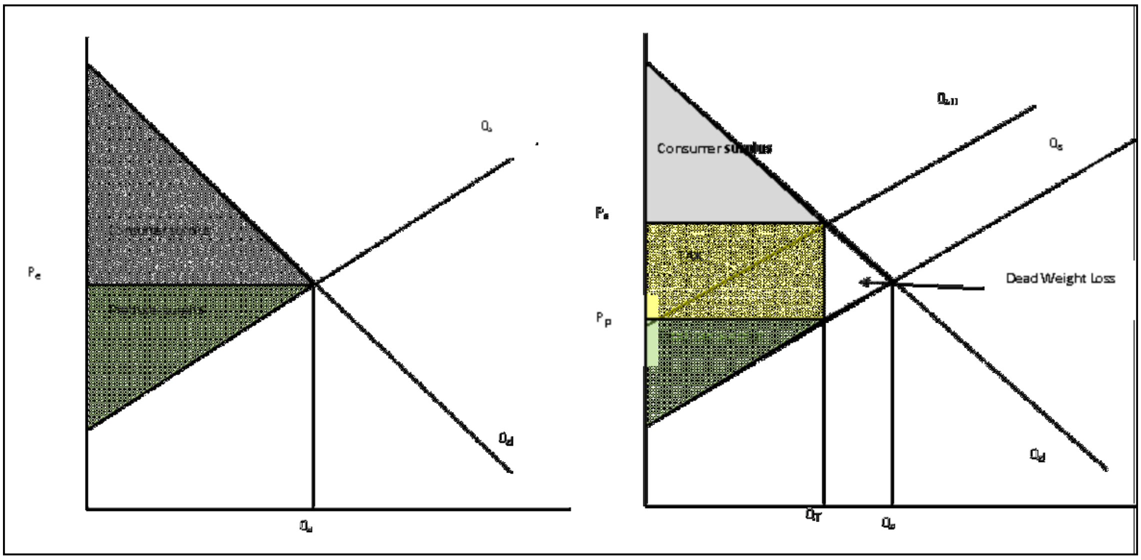
Furthermore, the taxation system should incorporate certainty about the amount of tax payable, the timing and method of payment, convenience of payment and be simple to understand. In addition, a tax should be transparent, be structured to minimise noncompliance and ensure sufficient funds are available to the government to enable it to adequately provide services expected by the community. It's important therefore that a tax stream should be easily predictable.

A tax should also be efficient, in that its imposition has a minimal affect on investment and consumption decisions, thereby minimally distorting resource allocation and ultimately the pace of economic growth and community wellbeing.

All taxes drive a wedge between the price consumers pay and producers receive causing a decrease in output and resource use in a particular industry. The resultant misallocation of resources depends on the relative elacticities of demand and supply. The welfare cost to society is measured by the dead weight loss which is that part of consumer and producer surplus that is not transferred to government as tax revenue and is directly related to the lost output. For a given demand/supply elasticity, the more inelastic is supply/demand the smaller will be the negative welfare effect of a tax

Efficient taxes are therefore those with relatively inelastic demand and supply. The lower the tax rate the smaller will be the tax wedge and the subsequent welfare cost. For a given targeted tax revenue, the tax rate will therefore be inversely proportional to the size of the tax base. Hence the larger the tax base the more efficient and less welfare destroying will be a tax. Figure 1 demonstrates the concept of dead weight loss as a measure of the loss of community welfare arising from the imposition of a tax.

Figure 1



The ICA’s assessment of South Australia’s tax structure relies on the principles outlined above. The ICA recognises however that in the context of Australia’s federal system of government comprehensive tax reform will not occur at the individual State level but rather will require a coordinated reform effort across all Commonwealth, State and Territory jurisdictions. This is particularly pertinent given the Commonwealth Government has announced it will undertake a comprehensive review of the Australian taxation system.

SOUTH AUSTRALIA’S TAX MIX RELATIVE TO THE OTHER STATES

Table 1 compares the reliance of South Australia and the remaining States and Territories on selected taxes, measured in terms of individual tax revenue as a proportion of total tax revenue for fiscal 2013 and the average of the ten years ending fiscal 2013.

Relative to the other jurisdictions, South Australia is less dependent on payroll taxes, marginally less dependent on conveyance taxes, significantly more reliant on taxes on immovable property, similarly dependent on motor vehicle taxes, more reliant on insurance taxes and marginally less reliant on gambling taxes

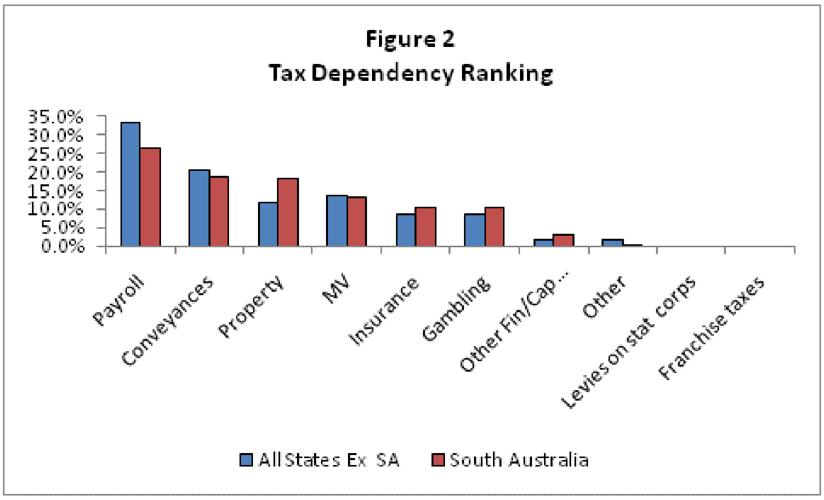
Table 1
Comparison of proportion of selected Taxes to Total State Taxes.

	All states ex SA	South Australia	All states ex SA	South Australia
	Average % of total 2003-04 to 2012-13		% of total 2012-13	
Employers' payroll taxes	30.8	25.5	33.2	26.2
Conveyances	23.0	20.6	20.3	18.8
Taxes on immovable property	11.2	16.1	11.8	17.9
Motor vehicle taxes	12.7	12.8	13.5	13.2
Insurance	8.3	9.5	8.6	10.4
Taxes on gambling	9.3	11.9	8.5	10.2
Total			95.9%	96.7%

Source: ABS Taxation Revenue Australia 2012-13 catalogue No 5060DO001-201213

A notable feature of the tax mix comparison is that while the dependence on individual taxes varies across the jurisdictions there is a similar ranking of the relative dependency.

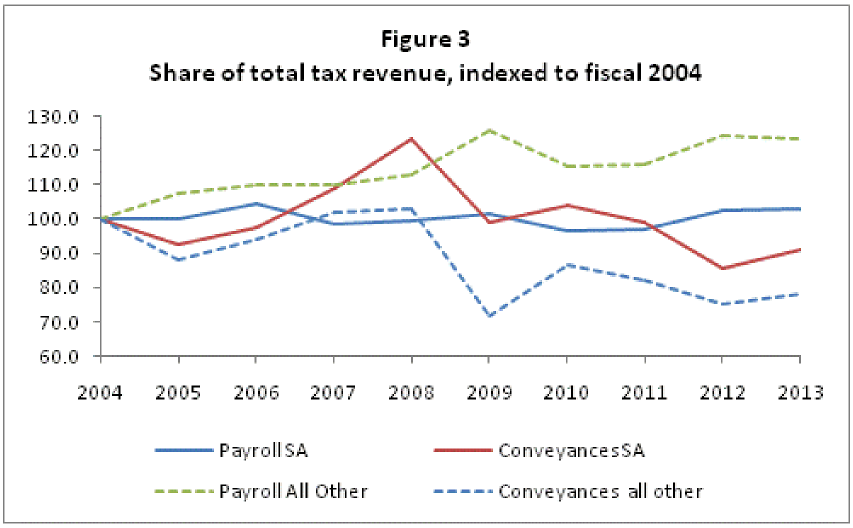
This is shown in figure 2 below where the selected taxes are listed in the declining order of dependency for South Australia. The only different ranking is that for motor vehicle taxes and property taxes. The obvious implication of the similar ranking is that the challenges facing South Australia in shifting to a more efficient and sustainable tax mix are the same as those for all jurisdictions.



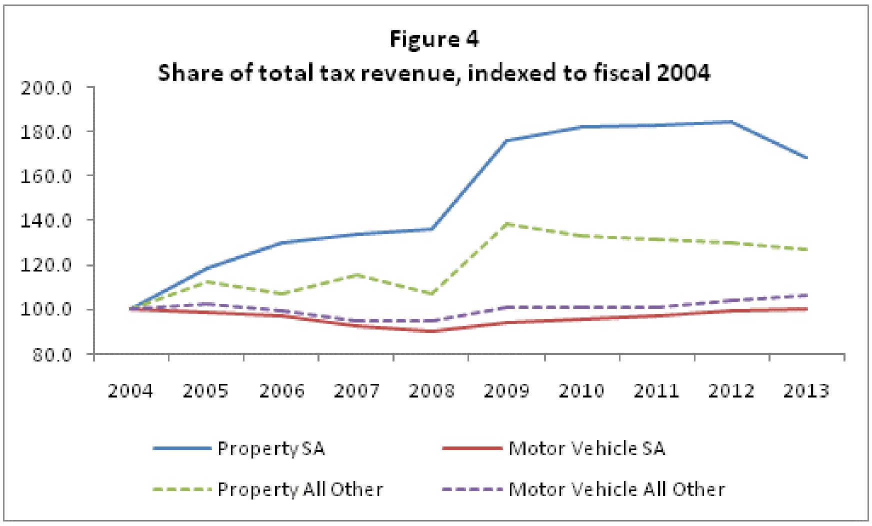
Source: ABS Taxation Revenue Australia 2012-13 catalogue No 5060DO001-201213

Figures 3 – 5 below show the trend in the proportion of tax revenue collected for selected taxes in South Australia and the total of the other jurisdictions over the ten years ended June 2013.

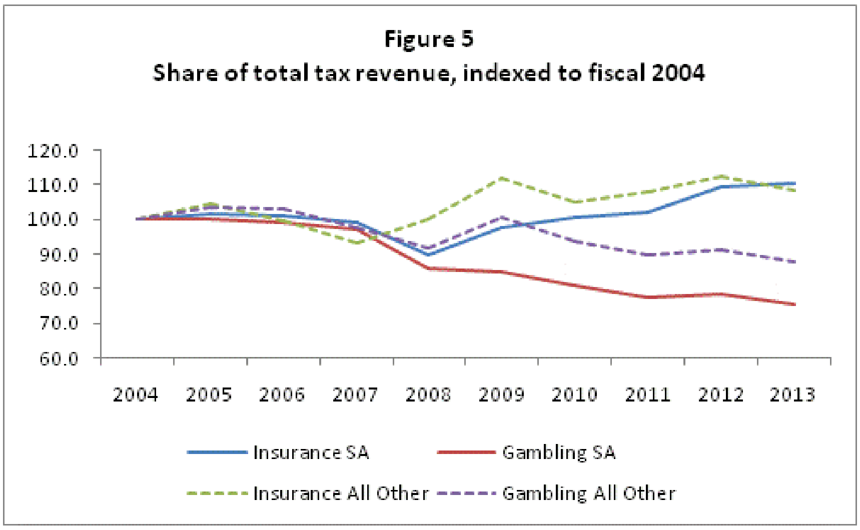
The main observation is that South Australia's reliance on payroll taxes has changed little over the decade while the other jurisdictions have increased their dependency by around a quarter. While all jurisdictions have reduced their dependency on conveyance taxes, South Australia has been less successful, reducing its dependency by around 9.0% compared with 20% for the remaining jurisdictions. While all jurisdictions have increased their dependency on taxes on immovable property, South Australia has been relatively more successful increasing its dependency by nearly 70% compared with a little over a quarter for the total of the remaining jurisdictions. South Australia's reliance on motor vehicle taxes has increased somewhat over recent years but is virtually unchanged over the decade, while the remaining jurisdictions have recorded a small net increase in dependency. All jurisdictions have increased their dependency on insurance taxes and while they have reduced their dependency on gambling taxes, South Australia has become less reliant than the remaining jurisdictions.



Source: ABS Taxation Revenue Australia 2012-13 catalogue No 5060DO001-201213



Source: ABS Taxation Revenue Australia 2012-13 catalogue No 5060DO001-201213



Source: ABS Taxation Revenue Australia 2012-13 catalogue No 5060DO001-201213

Overall, the States and Territories combined have increased their reliance on efficient taxes somewhat over the past decade but there has not been a broad based shift away from inefficient taxes to efficient taxes. As a result all the States and Terriroties remain over reliant on inefficient taxes that impose a brake on economic growth while simultaneously diminishing community welfare. The South Australian tax mix is examined from this perspective in more detail below.

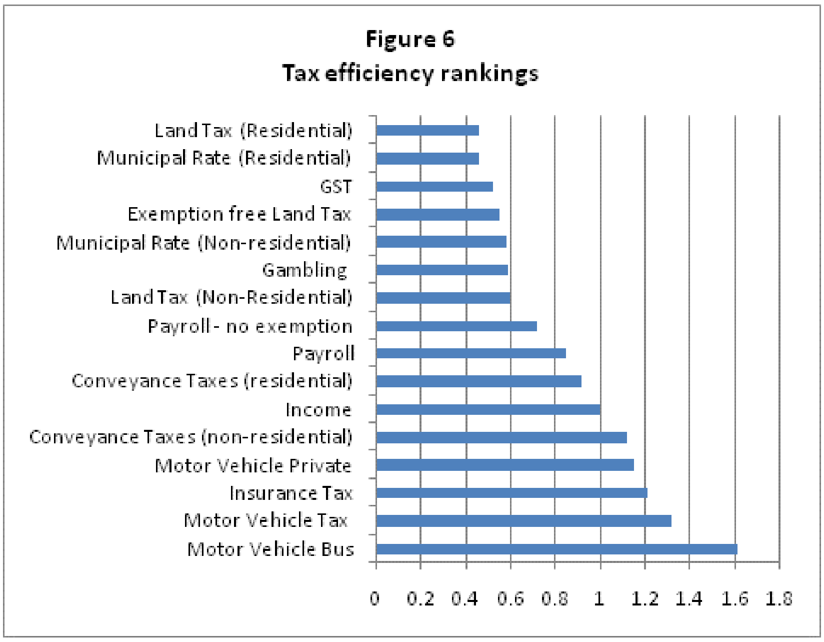
TAX EFFICIENCY RANKINGS

As part of the ICA's submission to the Economic & Finance Committee's 2013 inquiry into the South Australian taxation system, the ICA commissioned Deloitte Access Economics to rank South Australia's taxes along with selected Commonwealth taxes according to their efficiency, relative to income tax. Accordingly income tax was assigned a ranking score equal to one. More efficient taxes have a lower ranking score while less efficient taxes have a higher ranking score.

These rankings are reproduced in figure 6.

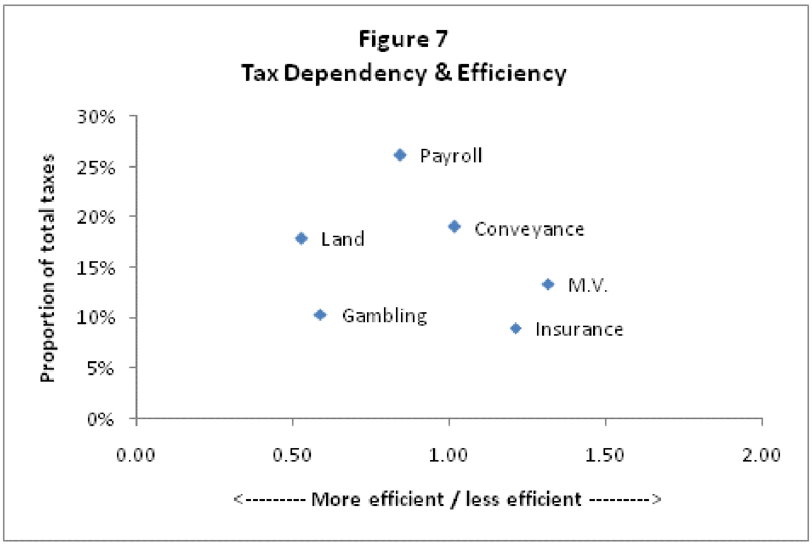
Using income tax as the benchmark, the more efficient taxes are land taxes, gambling, payroll and residential conveyance taxes while the less efficient taxes are non-residential conveyance, motor vehicle and insurance taxes.

The efficiency rankings also indicate that the GST is a relatively efficient tax; the efficiency of a payroll tax is increased with the removal of exemptions; while an exemption free land tax is also a relatively efficient tax.



Source Deloittes Access Economics

When looked at from the perspective of an efficiency and dependency trade off, South Australia clearly relies too much on inefficient taxes. As shown in figure 7 below, South Australia is as reliant on conveyance taxes as it is on land taxes and around twice as much as on gambling taxes despite it being the least efficient of these three taxes. Furthermore, motor vehicles and insurance taxes generate around the same level of revenue as gambling taxes and not much less than land taxes but are the least efficient of all State Government taxes.

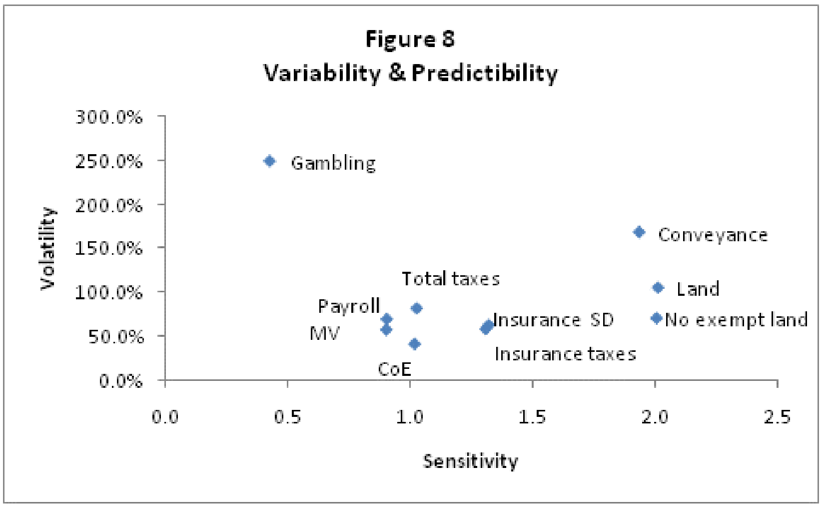


Source Deloittes Access Economics and ABS Taxation Revenue Australia 2012-13 catalogue No 5060DO001-201213

The characteristics of a stable tax were broadly defined in the State Tax Review Discussion Paper as including its revenue sensitivity to movements in the broader economy and the volatility of revenues from year to year. The trade off between these two characteristics, “volatility” and “sensitivity” [3]is shown in figure 8.

On this basis, an ideal tax is one with a sensitivity ratio equal to one and a volatility measure close to zero. Payroll and motor vehicle taxes are closest to this ideal while insurance duty/taxes have a comparable volatility but an average growth rate larger than state output. Land and conveyance taxes are disadvantaged by greater volatility but grow on average around twice the rate of state output. Gambling taxes rate the lowest on these criteria, being extremely volatile and growing at less than half the rate of state output.

A no-exemptions payroll tax[4] ranks significantly better than the current payroll tax regime exhibiting a lower volatility and an average growth rate equal to GSP. Similarly the removal of exemptions on land tax[5] reduces volatility to a level comparable with Motor Vehicle and Insurances taxes albeit having little affect on sensitivity.



Source ABS Taxation Revenue Australia 2012-13 catalogue No 5060DO001-201213 and State Based National Accounts

INSURANCE TAXES VIOLATE EQUITY PRINCIPLE

The imposition of stamp duty on insurance premiums after the application of GST adds $12.10 to the cost of purchasing insurance for each $100 base premium. Including the GST, the aggregate compound effect on the cost of purchasing insurance per $100 base premium increases the cost to the household by $22.10.

The increased cost of insurance acts as a disincentive to purchase insurance, increasing the incidence of non-insurance and/or a reduction in the amount of coverage purchased which results in households and businesses being underinsured.

The imposition of stamp duties on household behaviour has a greater proportional impact on households at the lower end of the income scale.

The ICA used members’ data on average premium, average sum insured and the number of policies for 311 post code areas across South Australia and Australian Taxation Office

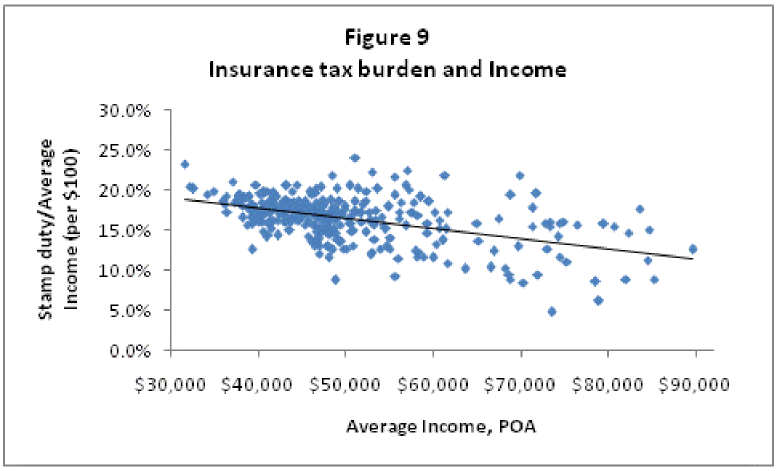
[3] Defined as the ratio of the standard deviation of annual percentage change in revenue to the average annual change in revenue (the Coefficient of Variation) and the ratio of the average annual percentage change in revenue to the average annual percentage change in Gross State Product.

[4] Based on SA Compensation of Employees in the ABS Australian National Accounts: State Accounts, 2016-14 catalogue No 5220.0

[5] Derived from the State Valuation Office, Site and Capital Value Statistics

postcode level income data to estimate the average stamp duty paid on insurance premiums as a proportion of income for each individual postcode.

The trade off between the tax burden and income is shown in figure 9 below, where the negatively sloped fitted line indicates that as incomes increase/decrease the burden[6] of insurance stamp duty decreases/increases.



Source: ICA Member & Australian Taxation Office data

Table 2 summarises the stamp duty burden on an income quartile basis. The ratio (per $100 of income) falls from 17.9% for the lowest 25% of incomes to 14.6% for the highest 25% of households. This represents nearly a 20% reduction in the tax burden for high income earners relative to low income earners.

Table 2
Insurance stamp duty burden by income quartile

Income quartile	Stamp duty/Income (00s)
Q1	17.9%
Q2	17.1%
Q3	16.3%
Q4	14.6%

Source: ICA Member & Australian Taxation Office data

Table 3 shows the number of owner occupied dwellings that do not pay Body Corporate fees that have house/building insurance by income quartile. The non-insurance rate for the lowest 25% of South Australian households is 5.0% and falls to 1.7% for the second quartile. Overall, the rate of non-insurance for households in the bottom half of the income scale is 3.2% compared with 0.3% for households in the top half.

[6] Ratio of stamp duty to income

Table 3 Rate of House/Building non-insurance Households that do not pay Body Corporate fees by income quartile.				
		Insured Households (000's)		
Income quartile		No	Yes	Total
1st quartile	Number of households	4.2	79.7	83.8
	% of households	5.0%	95.0%	100.0%
2nd quartile	Number of households	1.8	102.6	104.4
	% of households	1.7%	98.3%	100.0%
3rd quartile	Number of households	0.1	115.2	115.3
	% of households	0.1%	99.9%	100.0%
4th quartile	Number of households	0.7	135.4	136.1
	% of households	0.5%	99.5%	100.0%
Total	Number of households	6.8	432.9	439.7
	% of households	1.5%	98.5%	100.0%

Source: ABS 2009/10 Survey of Income and Housing and Household Expenditure Survey.

Table 4 shows the rate of non-insurance for contents insurance falls from 33.2% for households in the lowest income quartile to 7.5% for households in the top income quartile.

Table 4 Rate of Contents non-insurance All occupied households by income quartile.				
		Insured Households (000's)		
		No	Yes	Total
1st quartile	Number of households	54.9	110.3	165.3
	% of households	33.2%	66.8%	100.0%
2nd quartile	Number of households	40.5	125.1	165.7
	% of households	24.5%	75.5%	100.0%
3rd quartile	Number of households	21.9	144.1	166.0
	% of households	13.2%	86.8%	100.0%
4th quartile	Number of households	12.5	152.1	164.5
	% of households	7.5%	92.5%	100.0%
Total	Number of households	129.8	531.6	661.4
	% of households	19.6%	80.4%	100.0%

Source: ABS 2009/10 Survey of Income and Housing and Household Expenditure Survey.

The results of research conducted by Dr Richard Tooth (then of the Centre for Law and Economics) to estimate the elasticity of demand for insurance on behalf of the ICA in 2007 implies the removal of stamp duty on insurance premiums in South Australia would lead to a fall in the number of households without contents insurance by around 13,000 while the number of households without house/building insurance would fall by around 1,500.

Importantly, the elasticity of demand for the $ amount of insurance purchased was estimated to be considerably larger than for the decision to purchase insurance. The impact of the removal of stamp duties would therefore have a proportionally larger effect on the rate of underinsurance than it would on the rate of non-insurance.

The distorting role of insurance taxes and levies on the purchasing decisions of insureds has been acknowledged in a number of reviews both at the state and federal levels. This was most recently acknowledged by the Productivity Commission in its draft report into Natural Disaster Funding where in Draft Recommendation 4.8 it stated:

> "State and Territory taxes and levies on general insurance should be phased out and replaced with less distortionary taxes[7]".

This was echoed in Recommendation 79 of the AFTS:

> "All specific taxes on Insurance products, including the fire services levy, should be abolished. Insurance products should be treated like most other services consumed within Australia and be subject to only one broad-based tax on consumption[8]"

RECOMMENDATIONS

Primary recommendation

The ICA respectfully submits that the South Australian Government should implement a tax reform strategy designed to shift the State's reliance from inefficient, narrow-based transaction taxes to broad-based, more efficient taxes.

The ICA therefore specifically recommends the South Australian Government remove stamp duty on general insurance premiums and proposes that the revenue cost ($309m 2013-14) be recouped by a broad based property tax imposed on the site value of land only or a combination of a broad based property tax and an exemption free payroll tax.

The ICA considers a flat rate on individual *site values* to be the best option. As pointed out in the AFTS, a flat tax is the simplest approach, overcomes issues of aggregation, avoids bracket creep and with no exemptions removes the potential to transfer part of the tax burden to second entities such as renters. The ICA acknowledges a flat rate tax could be considered inequitable as it provides windfall gains to high value land owners and increases the burden on low value or previously exempted land holdings. The equity issue can in theory be addressed by a *stepped tax rate based on the per square meter value of a property* as it provides a mechanism for fixing a specified progressivity into the tax structure. However, the ICA cautions against a zero rating for low land values as this appears to conflict with the efficiency principle.

The ICA also considers a non-exempt payroll tax an option worth exploring because a tax with threshold exemptions not only does not prevent the tax burden falling on employees in tax exempt entities but at the same time distorts relative wage outcomes leading to a misallocation of labour.

Table 5 summarises indicative land tax rates for three alternative reform scenarios combined with three alternative land tax bases; the current land tax regime, the current regime with the threshold exemption removed and a broad based property tax. Scenario A is revenue neutral, raising the $345m land tax collected in fiscal 2014. Scenario B funds the removal of General Insurance duties ($309m) and scenario C funds the removal of General Insurance stamp duties but with the additional revenue from a non-exempt payroll tax. The indicative

[7] Productivity Commission Draft Report into Natural Disaster Funding Arrangements, Volume 1 p 179
[8] Australia's future tax system Repor t to the Treasurer Part two Detailed Analysis Volume 2 of 2, P 474

tax rates highlight the principle that the broader a tax base the smaller the tax rate required to raise a given revenue amount.

Table 5
Indicative Land Tax Rates

Land Tax base	Site value (Tax Base) $b	(A) Revenue neutral	(B) GI stamp duty	(C) GI duty ex Payroll exemption
Current Land Tax Base	34.0	1.02	1.93	0.60
Current base ex exemption	59.4	0.58	1.10	0.35
All private property	187.8	0.18	0.35	0.11

Source: ICA analysis.

Recommendations conditional on a multi jurisdictional reform process

As mentioned above, the ICA is cognisant of the fact that meaningful and far reaching State tax reform is more likely if it occurs within a broader process involving all levels of Government. The Commonwealth Government's recently announced review of taxation provides the mechanism for a multi jurisdictional reform of taxation regimes.

Within this broader context, the ICA would recommend the removal of the remaining inefficient state taxes such as conveyance tax and taxes on motor vehicles and replace these foregone revenues by the removal of tax expenditures at both the state and federal levels.

SUMMARY/CONCLUSION

The ICA contends that the unique economic and demographic challenges faced by South Australia, and in particular, the rapid ageing of the South Australian community vis-vis-the rest of the Australian community presents a set of circumstances that create a pressing need for structural taxation reform.

The need for a long term, secure, and efficient tax bases to support infrastructure spending and social objectives arising from an ageing society necessitates that South Australia commence a path away from taxes on transactions such as stamp duties and towards those taxes that provide more secure sources of income and also are less distortionary and welfare destroying.