Should There Be A National Review Of The Taxation Of General Insurance?

Commonwealth And State Government Taxation Treatment Of General Insurance: An Overview

Report commissioned by

Insurance Council of Australia

and prepared by

March 2003

Foreword

This report has been commissioned by the Insurance Council of Australia (ICA) and prepared by Access Economics.

There is a widespread lack of knowledge about general insurance, as well as some conceptual misapprehensions about the nature of insurance more generally. Nowhere is this more true than in relation to the taxation treatment of insurance, especially general insurance. Within the taxation area, there is a particularly profound misunderstanding, now reflected in taxation design both at Commonwealth and state government levels, about the nature of insurance claims and their appropriate national accounting and taxation treatment.

Taxation of general insurance has involved a series of historical revenue-raising decisions (at least in part self-defeating), initially mainly at the state government level, entailing individual inappropriate tax policies based on a misunderstanding about the nature of insurance claims. Because claims constitute a large proportion – in some cases or periods over 100% of the insurance premium pool – these errors effectively show up in the tax treatment of (gross) insurance premiums. Together, and especially in the larger states, these also involve a compounding of the policy errors because at least one layer of state taxes forms part of the base for another, generating 'tax on tax' problems.

The introduction of the GST has further compounded these problems in two ways. First, the design of the GST itself reflects a misunderstanding of how to treat insurance claims when introducing a value-added tax that ultimately is intended to target private consumption. Second, the GST has intensified the 'tax on tax' compounding problem by (i) being imposed on some state taxes, and (ii) forming part of the tax base for other state taxes. In some cases, general insurance faces at least four, compounding, layers of taxation or so-called levies.

Recent disasters, notably the Canberra bushfires on 18 January 2003, revealed yet more evidence of the pervasiveness and extent of no-insurance or under-insurance of property. They also served as a reminder that governments have to pick up a significant part of the bill in such cases. High taxation on insurance is a cost deterrent amenable to direct government control.

Access Economics considers that a thorough review of the tax treatment of insurance is both appropriate and timely. This brief report sets out a snapshot of our views on current problems and possible solutions in this area.

ICA has given Access Economics free rein in undertaking its analysis and reaching its conclusions. Access Economics acknowledges the assistance of ICA and others in relation to provision of relevant information sources, but accepts full responsibility for the approach taken and the conclusions reached.

Geoff Carmody

Director

Access Economics

March 2003

CONTENTS

EXECUTIVE SUMMARY i
Access Economics' Main Conclusions i
Policy Inferences ii
FULL REPORT 1
1. Introduction 1
1.1 Focus of Report 1
1.2 Structure of this Report 2
2. Conceptual Framework For Analysis Of Insurance Taxation 3
2.1 The Fundamental Nature Of Insurance 3
2.2 Key Components Of The Insurance 'Pool' 3
2.3 How Should Insurance Claims Be Classified? 4
2.4 Implications For Taxation Treatment Of Insurance 8
3. The Current Taxation Treatment Of General Insurance In Australia 10
3.1 Indirect Taxation: State Taxes & Charges 10
3.2 Indirect Taxation: The GST 10
3.3 Indirect Taxation Compounding Problems 11
3.4 An Interstate Comparison Of Indirect Taxation Of Insurance 12
3.5 Unfinished State Tax Reform Business From *The New Tax System* 18
3.6 Other Insurance-Related Taxes, Levies, Compulsory Premium Increases 18
3.7 Commonwealth Income Tax Treatment Of General Insurance 18
4. International Comparisons of Insurance Taxation 20
4.1 Indirect Taxation Of General Insurance 20
5. The Taxation Treatment Of Gambling Versus Insurance 22
5.1 Indirect Tax Treatment Of Gambling Versus Insurance 22
5.2 General Conclusions 22
6. Taxation Of Superannuation, Health Insurance Versus General Insurance 23
6.1 Superannuation 23
6.2 Health Insurance 23
6.3 Is General Insurance Different? 23
6.4 Policy Inferences: Commonwealth Taxation Treatment Of General Insurance 23
7. Insurance Demand Responses To Australian Tax Treatment 24
7.1 Possible Insurance Choices 24
7.2 Evidence Of Non-Insurance And Under-Insurance 24
7.3 Implications For Government Budgets 26
8. Access Economics' Conclusions And Policy Inferences 27
8.1 Conclusions 27
8.2 Policy Inferences 28

EXECUTIVE SUMMARY

The Insurance Council of Australia (ICA) has proposed a national review of the taxation of insurance products in Australia.

High taxation on insurance is a cost deterrent amenable to direct government control.

Most recently, ICA has proposed that any national review of the taxation of insurance products should consider the case for income tax deductibility for household insurance (property plus contents, plus other assets such as motor vehicles) as well.

This report has been commissioned by the Insurance Council of Australia (ICA) and prepared by Access Economics as a contribution to the proposed national review.

Access Economics' Main Conclusions

The conclusions reached by Access Economics from its review of the tax treatment of general insurance are as follows:

- There should indeed be a national review of the taxation of insurance products in Australia.
- Both at the Commonwealth and state government levels, the current tax treatment of general insurance:
  - Cannot be justified by reference to generally accepted definitions of income (for income tax), of consumption (for the GST), or of transactions (for stamp duties).
  - The fire levies, where applicable, are even more difficult to justify, and are a recipe for 'free rider' responses to the need to fund fire and emergency services, the adequacy of which is jeopardised by this funding mechanism.
  - In particular, the problem is caused by the failure to recognise that a large part of premium payments is effectively provisioning for, and the source of, settlement of claims against insurance policies. This portion – which typically accounts for about 80% of insurers' receipts in any year (more in poor years) – is neither income, nor consumption, nor involves an economic or financial transaction. Claims are transfer payments: compensation for lost assets funded from the insurance pool.
  - The correct treatment of general insurance claims has long been applied in the Australian Bureau of Statistics' *Australian National Accounts*. But it has been effectively ignored by successive Commonwealth and state governments in their tax systems.
- General insurance premiums are subject to high percentage rates of taxation, especially indirect taxation:
  - The overall indirect tax burden ranges from just under 20% of the basic premium (in Queensland) to almost 80% of the basic premium (in country Victoria). And this just covers fire levies, GST and stamp duty.
  - As a non-deductible expense, private general insurance is effectively taxed at up to 48.5% under the standard income tax scale alone. Much higher effective tax rates will apply to insureds who face application of benefit withdrawals under various means tests.
  - If we express these tax burdens as a percentage of that general insurance portion that is legitimately treated as income, consumption, or transactions – the insurers' margin – the real tax burden is at least *five times* as large in a 'good' year, and approaches an infinitely large burden in a 'bad' year.
  - From this perspective, with an insurers' margin of 20%, the overall indirect tax burden ranges from just under 100% of the margin (in Queensland) to almost 500% of the margin (in country Victoria). And as a non-deductible expense, private general insurance margins are effectively taxed at up to almost 250% under the standard income tax scale alone.

- This punitively high taxation of general insurance stands in contrast with the generally appropriate treatment of gambling, where the emphasis is more on that industry's margin. General insurance can be taxed more highly than tobacco and alcoholic beverages.
- Taking out general insurance to self-protect against economic loss is heavily penalised via taxation. Yet taking out insurance against other contingencies is encouraged by 'concessional' treatment (eg, health insurance, superannuation saving).

These problems can be corrected. For indirect tax, the correction should be made on a pooled basis – that is, by adjustments to the tax treatment of insurers. For income tax, the correction should apply to individual insureds.

Indirect Tax Corrections

Insurers should receive an *imputed input tax credit* (IITC) calculated as follows:

- For the fire levy, where applicable, the IITC = tax-exclusive claim value x fire levy rate = A.
- For GST, the IITC = A x GST rate = B.[1]
- For stamp duty, the IITC = B x stamp duty rate.

Income Tax Corrections

Insureds should be allowed to claim, say, 80% of premiums as a deductible expense for income tax purposes.

Policy Inferences

Access Economics considers that there is a very strong case, on efficiency grounds, for abolishing stamp duty on general insurance altogether. An equally strong case exists for abolishing the fire levy in those states still retaining it. Access Economics has developed those cases in earlier reports.

But if that action is not taken, basic tax design principles argue for the following reforms to the taxation of general insurance:

Indirect Taxation

- All indirect tax 'systems' applying to general insurance – fire levies, stamp duty, GST and others – should include an *imputed input tax credit* each year equal to the value of claims paid in that year (valued on the same tax base as applies for the tax in question) multiplied by the relevant tax rate on insurance premiums in that year. This will ensure that these taxes fall only on insurers' margins.
- For GST, these imputed input tax credits should be additional to any *actual* GST input tax credits and decreasing adjustments received.
- *All* GST actually paid on claim settlements – *whether in respect of private or business insurance* – should be refunded through input tax credits.

Income Taxation

- All private general insurance premium payments should be deductible expenses for personal income tax purposes to the extent of the claims portion.
- As a reasonable longer term approximation, this suggests that 80% of private general insurance premium purchases should be a deductible expense for the income year when they are purchased.

---

[1] Note that these adjustments greatly reduce the tax burden on general insurers associated with the fire levy (where applicable) and stamp duty. Operationally, these adjustments also imply insurers will generally be in a net GST *credit* situation. At first blush this may seem inappropriate. It is not. The insurers' net credit is a part-offset to GST paid elsewhere in the economy in settlement of claims. These payments may be made directly by the insurer (eg, buying a new car for a claimant), or occur when a claimant uses a cash payout on a claim to purchase/repair the lost/damaged products. The difference ends up being GST on the insurers' margin – albeit indirectly.

The effects of these reforms would be to reduce general insurance prices and after-income tax costs to insureds relative to what otherwise would apply. This, in turn, would generate a 'virtuous circle' of responses:

- Under- and no-insurance would be reduced.
- The insurance pool would be expanded, with industry competition inducing lower average prices than would otherwise apply.
- Governments would face lower demands to compensate those without adequate insurance cover following natural disasters, reducing the pressures on their budgets.

At the end of its review of the application of GST to general insurance, the Treasury commented as follows: [2]

> *… the initial GST approach to general insurance was input taxation. While this approach was not desirable from a tax design approach, most jurisdictions felt there was no alternative given the valuation difficulties associated with individual policies. New Zealand was able to avoid this difficulty by approaching the valuation on a pooled basis, an approach which has been adopted and refined by Australia. The New Zealand and Australian approaches are based on dividing supplies of general insurance into two components – the payment of a premium and the payout of a claim. This approach ensures that GST is collected only on the insurer's value added. It now remains to be seen whether other jurisdictions will adopt this approach and add further refinements.*

The European value-added tax (VAT) treatment of general insurance – input taxation – is truly laughable to the extent that claims are insurers' inputs! This approach reflects no deep understanding of the nature of insurance, and in particular claims.

The current Australia/New Zealand approach to general insurance under their GST systems is both better and worse than the European model:

- It is better in that it avoids tax 'cascading' effects.
- It is worse in that, directly or indirectly, it subjects the *entire* insurance premium – claims plus insurers' margins – to GST. The Australian GST applies both to the insurers' margin (via deductions of ITCs and decreasing adjustments from GST liabilities in respect of premium payments) *and* in effect downstream, to purchases of products by insurers in settlement of claims (when the insurers' ITC is simply an offset to GST already paid by the relevant supplier), or purchases by claimants of replacement products/repairs out of insurer cash payouts (when the decreasing adjustment is simply an offset to the GST effectively paid by the claimant).

Australia now has the opportunity – in Treasury's words – to 'add further refinements' to the tax treatment of general insurance:

- The adjustments to GST and income tax treatment recommended in this report would produce almost exactly the correct consumption tax and income tax treatment of general insurance.
- The adjustments to the fire levy (where applicable), stamp duty and other state taxes would greatly reduce the inappropriately high state tax burden on general insurance.

Whether or not other jurisdictions follow is their business. If they do not, that's their problem – and Australia's financial market competitive edge.

---

2 *GST and general insurance, Economic Roundup,* Spring 2000, the Treasury, page 57.

FULL REPORT

1. INTRODUCTION

The Insurance Council of Australia (ICA) has proposed a national review of the taxation of insurance products in Australia.

It has also drawn a connection between the current high levels of such taxation and the current extent of non-insurance and under-insurance, which is periodically highlighted after natural disasters such as the 18 January 2003 bushfires in Canberra. These disasters also serve as a reminder that governments have to pick up a significant part of the bill in such cases. High taxation on insurance is a cost deterrent amenable to direct government control.

Most recently, ICA has proposed that any national review of the taxation of insurance products should consider the case for income tax deductibility for private household insurance (property plus contents plus other assets such as motor vehicles) as well.

The Assistant Treasurer, Senator the Hon. Helen Coonan, has indicated her intention[3] to raise the ICA proposal for consideration at the next Ministerial Forum scheduled for 4 April 2003:

> *States and territories can make a positive and immediate impact on premiums and I will seek to put this issue on the agenda at the next Ministerial meeting in April.*

To assist that discussion, ICA has undertaken to provide the Assistant Treasurer with more information and a discussion paper.

This report has been commissioned by the Insurance Council of Australia (ICA) and prepared by Access Economics as a contribution to the proposed national review.

1.1 FOCUS OF REPORT

There is a widespread lack of knowledge about general insurance, as well as some conceptual misapprehensions about the nature of insurance more generally. Nowhere is this more true than in relation to the taxation treatment of insurance, especially general insurance. Within the taxation area, there is a particularly profound misunderstanding, now reflected in taxation design both at Commonwealth and state government levels, about the nature of insurance claims and their appropriate taxation treatment.

Taxation of general insurance has involved a series of historical revenue-raising decisions (at least in part self-defeating), initially mainly at the state government level, entailing individual inappropriate tax policies based on a misunderstanding about the nature of insurance claims. Because claims constitute a large proportion – in some cases or periods over 100% of the insurance premium pool – these errors effectively show up in the tax treatment of (gross) insurance premiums. Together, and especially in the larger states, these also involve a compounding of the policy errors because at least one layer of state taxes forms part of the tax base for another, generating 'tax on tax' problems.

The introduction of the GST has further compounded these problems in two ways. First, the design of the GST itself reflects a misunderstanding of how to treat insurance claims when introducing a value-added tax that ultimately is intended to target private consumption. Second, the GST has intensified the 'tax on tax' compounding problem by (i) being imposed on some state taxes/levies, and (ii) forming part of the tax base for other state taxes (notably stamp duties). In some cases, general insurance faces at least four, compounding, layers of taxation or so-called levies.

Access Economics agrees that a thorough review of the tax treatment of insurance is both appropriate and timely. This brief Report sets out a snapshot of our views on current problems and possible solutions in this area.

---

[3] See Press Release CO11/03, *States And Territories Are Key To Reducing Household Insurance Costs,* Senator the Hon. Helen Coonan, Minister for Revenue and the Assistant Treasurer, 24 February 2003.

1.2 Structure of this Report

The remainder of this report is organised as follows:

- Section 2 sets out a basic conceptual framework for any analysis of general insurance, on the basis of which much of the criticism of the current taxation treatment in the remainder of the Report rests.
- Section 3 summarises the current and prospective taxation treatment of insurance in Australia, both at the Commonwealth and state government levels, including the impact of the GST and the *New Tax System*.
- Section 4 presents a brief international comparison with the taxation status quo in Australia.
- Section 5 contrasts the current indirect taxation treatment accorded gambling with that applicable to general insurance.
- Section 6 contrasts the current Commonwealth (income) taxation treatment accorded superannuation and health insurance with that applicable to general insurance.
- Section 7 presents a summary of the evidence of demand responses associated with high taxation of general insurance, and the implications (both revenue- and outlays-sides) for government budgets.
- Section 8 draws together Access Economics' conclusions and policy inferences.

2. CONCEPTUAL FRAMEWORK FOR ANALYSIS OF INSURANCE TAXATION

It is important to be clear about the nature of insurance in developing a conceptual framework within which the taxation treatment of insurance can be examined. This section of the Report addresses this need.

2.1 The Fundamental Nature Of Insurance

At its most basic, insurance offers buyers (the insured) products supplied by sellers (the insurers) in the form of contracts providing *compensation* if a specified adverse event occurs in future.

The basic idea of insurance is to spread the risk of adverse events over a sufficiently broad group of the insured to achieve balance between the need to:

- reduce the cost to insurers of compensating that (usually relatively small) proportion of the insured that suffers from the specified adverse events in any period
- to a total amount well within the total financial assets of the insurers in the relevant period
- at a per-insured price (premium) sufficiently low to induce a sufficiently large take-up of the relevant insurance products.

Getting the balance 'right' is often easier said than done, as recent history in Australia underscores. For example:

- adequate provisioning for the relevant risks is an inexact science at best;
- competitive forces between insurers may generate pricing/provisioning tensions as individual insurers seek to maximise the premium pool for their own specific products;
- getting pricing 'right' – especially in Australia – is complicated by:
  - large taxation imposts;
  - the evident price-sensitivity of demand; itself the product of
  - the range of choices open to the potential insureds (no- or self-insurance, under-insurance, and, in some cases, possibly 'market shopping' to reduce premium costs); and
  - to some extent, market failure (short-sightedness, or 'it won't happen to me') phenomena.

2.2 Key Components Of The Insurance 'Pool'

Insurance involves *risk pooling.* Risk pooling involves, for any period:

- Financial contributions by the insured into a pool held by the insurers (premium income).[4]
- Withdrawals from the pool to settle valid claims on insurance policies.
- Expenses plus profit for the insurers (the gross margin).

In competitive markets, downwards pressure on premiums typically means that the insurers' gross margins (defined as the difference between premium and investment income, and payments for claims) are low.

Gross margins in good years may be as much as 20% of premium income. In bad years (eg, due to unexpectedly high claims and/or poor investment returns and premium receipts) gross margins may be negative.

As a good approximation, for any period premium income and claim payments can be thought of as two sides of the same coin.

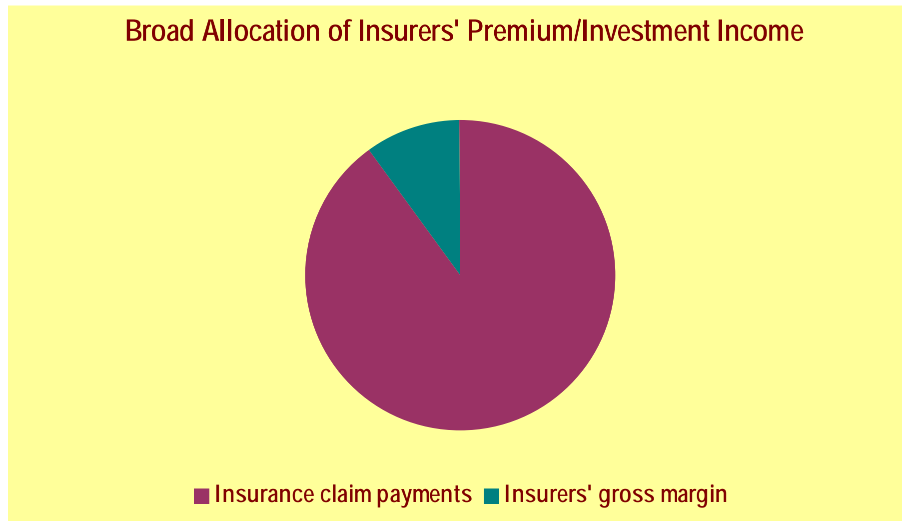
That coin is the insurance funds pool, into which premium and investment income flows and out of which claim payments are withdrawn. The former finances the latter. That is its primary function.

---

[4] Investment income from deployment of pool funds can also be a significant contributor to the pool over time. However, in poor investment income years it may also be a net drain on the pool.

In aggregate, therefore, insurance claims are pretty much the flip side of insurance premium payments and investment income (minus, in a viable market, a gross margin to cover overheads and 'normal' profit for the insurers). See diagram 2.2.1 below.

Diagram 2.2.1 Premium Income & Insurance Claims In Any Period:
Two Sides Of The Same Insurance Coin



For the purposes of the following analysis, this point is fundamental.

Viewing insurance from the perspective of the insurance pool *as a whole* (ie, from an Australia-wide, or a state/territory-wide, perspective):

- Insurers' premium income today is largely, if not wholly, insureds' insurance claim settlements tomorrow.
- *In this critical sense, the taxation treatment of premium payments, timing aside, is essentially the taxation treatment of insurance claim settlements.*

This puts the spotlight on the appropriate way to think about insurance claims. That provides guidance about the appropriateness of the current taxation treatment of insurance claims (primarily through the taxation of premiums). The next sub-section deals with this issue.

2.3 How Should Insurance Claims Be Classified?

For general insurance, claims are *compensation*:

- They may take the form of a cash payment.
- They may take the form of repairs to, or replacement of, assets such as a motor vehicle, household contents, or the house itself.

Either way, general insurance claims are intended to replace or restore previously-existing assets, not to add to the stock of such assets in the insureds' hands.

As explained in sub-section 2.2 above, in aggregate (ie, looking at the insurance pool as a whole) insurance premiums are effectively an advance on settlement of later insurance claims. They are largely advance payments for – and provisioning against – future compensation payments to policyholders.

This compensation feature is crucial.

In general, the currently operational tax bases in Australia can be classified as follows:

- Income (flows) – eg, Commonwealth personal and company income tax.

- Consumption (flows) – eg, the GST. (Payroll tax can be thought of as having both income and consumption tax base justifications, especially the latter.)
- Expenditure or transactions (flows) – eg, stamp duties.
- Wealth, in practice notably real estate (stocks) – eg, land tax.

If taxation of general insurance claims (via taxation of insurance premiums) is to be justified on the basis of sound tax design principles, then insurance claims (compensation) must be classifiable under one or more of these operational tax bases.

In fact, general insurance *claims*:

- are not classified as income to the household sector;
- are not classified as consumption expenditure either – see below;
- are not expenditure, or transactions, in the sense of an exchange of money for an increment to the purchasers' enjoyment of services, consumer goods (including consumer durables), or other net assets, including financial assets;
- and they are not an increment to wealth; at best they involve restoring wealth losses.

This logic leads straight to the conclusion that, under these tax bases, only the insurers' *margin* is a sensible potential candidate for taxation if a principled approach to the matter is to guide tax policy.

This treatment of general insurance claims is already recognised officially, for example in Australia's system of national accounts (ANA) as published by the Australian Bureau of Statistics (ABS).[5]

Private Final Consumption Expenditure (Household Consumption)

- Private final consumption expenditure in any period – the ideal tax base for the GST – is defined to include gross premium payments in that period by households (whether for health, life insurance, or the relevant parts of general insurance) *less* total claims against the relevant policies in the same period.
- This difference (the insurers' margin) is conceptually treated as the purchase of a consumer service – insurance cover – by the household sector (see for example ABS Cat. No. 5216.0, sections 6.20, 6.64, 6.66, 6.73, 6.104) and included in household consumption expenditure. The claims portion is – properly – netted off as the provision of compensation for assets lost, rather than being part of household consumption.

Intermediate Consumption (Ownership Of Dwellings)

- The business entitled 'dwellings owned by persons' includes allowances for operating expenses including rates, repairs and maintenance, and insurance, as well as receiving rental income. In the case of owner-occupiers, the rental income corresponds with the private consumption item 'imputed rent of owner occupied dwellings' which, in consumption, values the accommodation services enjoyed by owner-occupiers.
- In this context, insurance is effectively a business input cost (for the owners under the 'ownership of dwellings' business) rather than final consumption expenditure.
- But the insurance treatment is exactly the same. The relevant cost item is building insurance premiums *less* claims in any period (see for example ABS Cat. No. 5216.0, sections 11.28 and 11.30).

Definitions Of Income

- The ABS defines wages, salaries and supplements to include (as part of supplements) claims made under workers' compensation policies and received by employees. Because workers compensation premiums are compulsory in Australia, these are treated as part of the insurance service charge paid by employers (see for example ABS Cat. No. 5216.0, section 10.4). The claims included in income are in the nature of income substitutes. These do not include general insurance claims.

---

[5] See for example, *Australian National Accounts: Concepts, Sources and Methods* ABS Cat. No. 5216.0, various issues, sections 3, 6, 10, 11 and 13.

- The ABS defines gross operating surplus (GOS) to include, amongst other things, taxable income which measures gross income less costs incurred in generating income. Taxable income includes (for insurers) business insurance premiums *less* claims and other insurers' costs. In addition to taxable income, GOS also includes adjustments, amongst other things, for prepaid insurance premiums and third party insurance transfers and insurance claims on property damage. These last two items, by definition:
  - are not part of business taxable income;
  - represent the counterpart transaction in the calculation of the insurance service charge (insurance premiums are an allowable deduction for income tax purposes). (See for example ABS Cat. No. 5216.0, section 11.6).
- In short, general insurance claims are not part of taxable income.

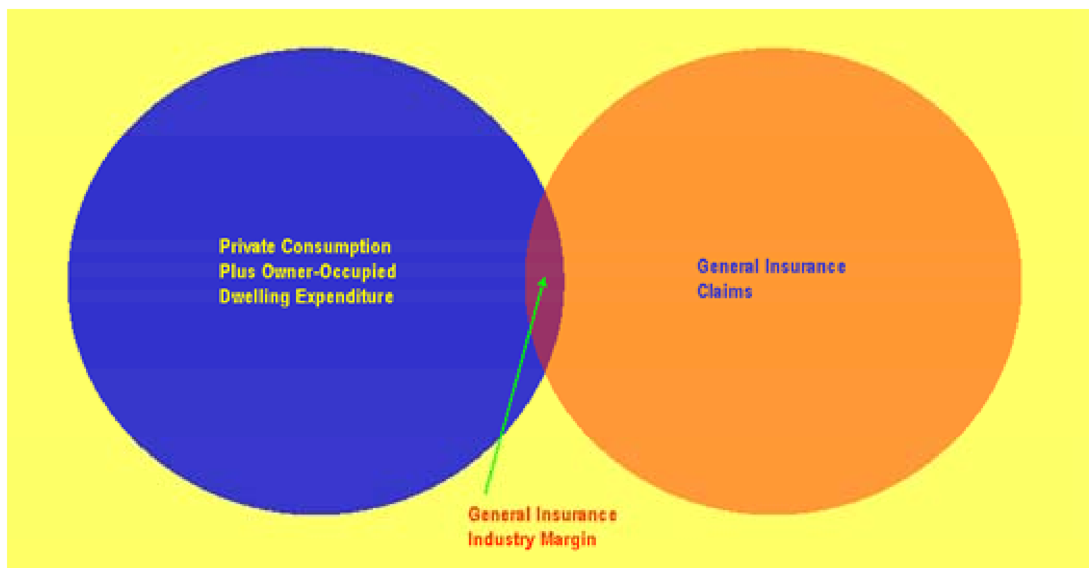
Transactions Versus Transfers

- As noted by the ABS, in the national accounts 'a major distinction is made between transactions relating to the supply and disposition of goods and services on the one hand, and transfer payments and financial transactions on the other. Only the former payments are concerned with the production of goods and services and therefore affect the level of GDP. Transfer payments represent a transfer of income from one sector to another. Financial transactions are concerned with the acquisition of financial assets and liabilities and are the mechanism whereby surplus saving of one sector can be transferred into the productive investment of another sector.' (ABS Cat. No. 5216.0, section 3.15).
- General insurance claims are transfer payments – compensation for lost or damaged assets. They are not transactions relating to the supply and disposition of goods and services, or of financial transactions.

Diagrammatically, the extent to which insurance can be regarded as part of the main operational tax bases in Australia, based on standard ABS national accounts definitions, is illustrated below.

A Consumption/Ownership Of Dwellings Tax Base For Any Accounting Period

Diagram 2.3.1 The Overlap Between General Insurance And Consumption (Plus Ownership Of Dwellings)



In 'normal' (or 'good') insurance years – where claims and income are more or less in line with expectations – the overlap between general insurance and consumption (plus expenditure by dwelling owners) is confined to the insurance industry margin, as shown above. In poor years, there may be no overlap at all, because insurance industry margins are zero or negative.

Note that general insurance purchased by businesses is:

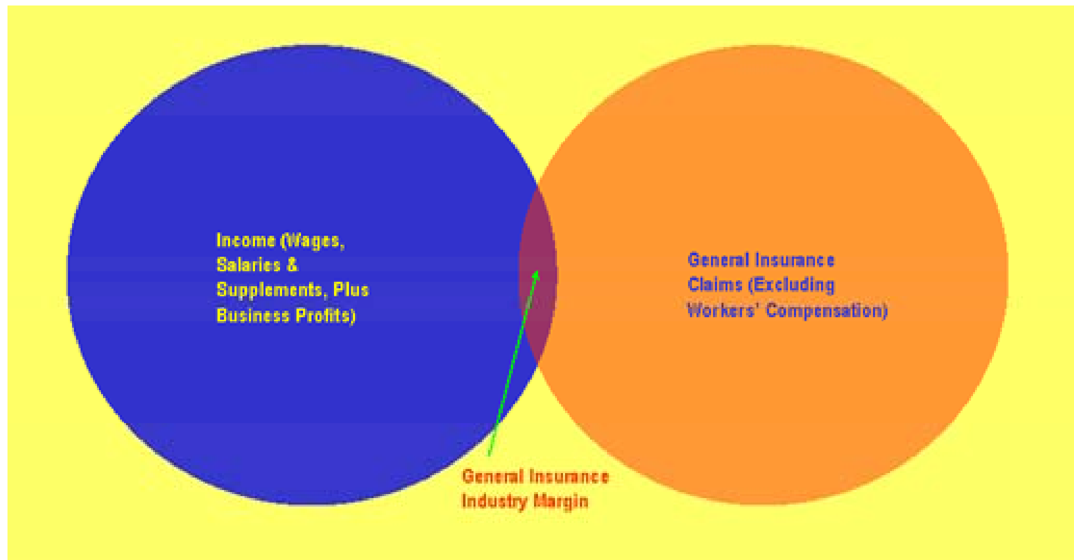
- by definition, not part of private consumption at all;

- so claims thereon do not form part of the private consumption tax base;
- and any insurers' margin thereon is an (income) tax-deductible expense;
- and any such margin forms part of the value-adding process that ends up in private consumption.

In short, a properly-specified consumption tax base does not include, at least in any direct sense, general insurance purchased by businesses, let alone claims thereon.

An Income Tax Base For Any Accounting Period

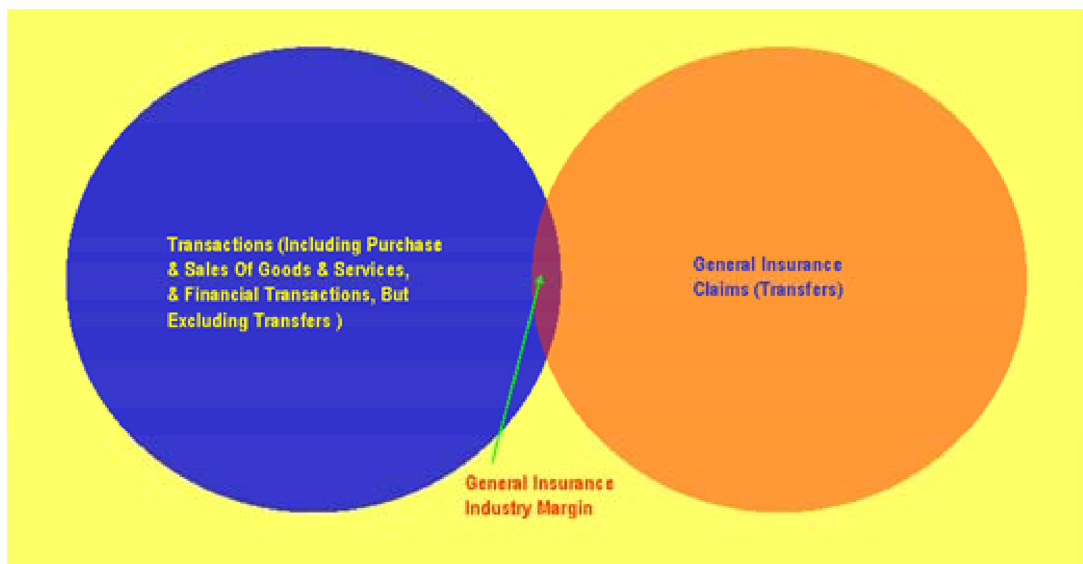
Diagram 2.3.2 The Overlap Between General Insurance And Income



There *is* an overlap between workers' compensation (and some health insurance) claims and income, because these are, in some cases, income substitutes. But that conclusion does not apply to general insurance. There is no overlap between general insurance claims and income. Again, the only overlap is between the margin earned by insurers (the basis for insurers' taxable income) and other income. General insurance claims are out of scope for this definition of income.

A Transactions Tax Base For Any Accounting Period

Diagram 2.3.3 The Overlap Between General Insurance And Economic & Financial Transactions

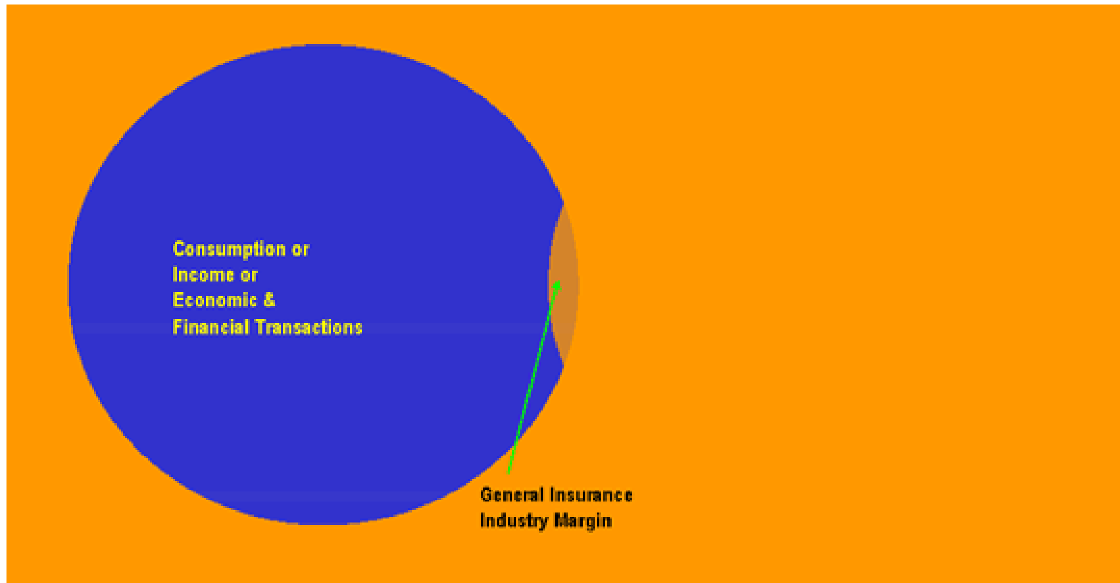


Again, there is no overlap between general insurance *claims* and economic or financial transactions. The only overlap applies to the purchase of insurance *cover*. From an insurance pool perspective, the purchase of this financial asset involves, as noted above, the gross premium *less* claims – the insurers' margin. The same conclusion applies in relation to any definition of wealth: general insurance claims are out of scope.

2.4 Implications For Taxation Treatment Of Insurance

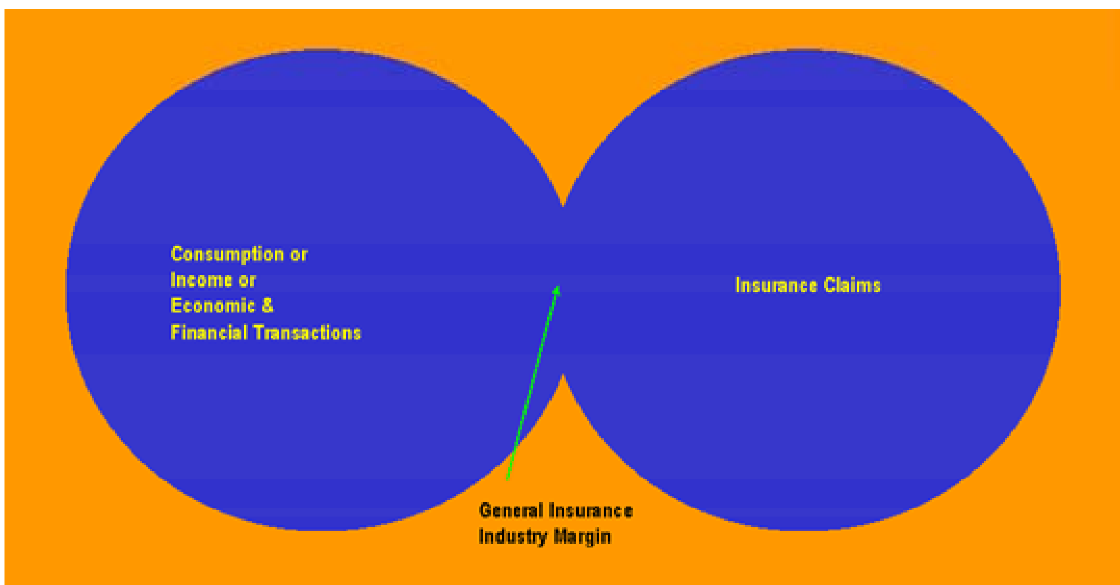
General insurance *claims* should not be taxed at all, under any of the currently operational tax bases in Australia, because they are not defined as part of any of the currently operational or recognised tax bases for tax systems.

Diagram 2.4.1 Properly Defined Tax Bases Covering General Insurance



And yet, as summarised in section 3 below, insurance claims are *heavily* taxed in Australia *through the tax treatment of insurance premiums*. In short, there is no principled rationale for the status quo as regards taxation of general insurance, as the remainder of this Report emphasises, and the tax base – which includes claims – is far too large.

Diagram 2.4.2 Actual Australian Tax Bases Covering General Insurance



The problem illustrated in diagram 2.4.2 above can be expressed in two ways:

- Either – as shown above – the tax base applied to general insurance (whether we are looking at consumption, income or transactions tax bases) is grossly overstated.
- Or, if we define the taxes currently in operation as being applicable only to the correctly-specified tax base – the insurers' margin – then the effective rate of tax is grossly understated. For example, if the rate of stamp duty on general insurance premiums is formally set at 10% of the premium, and insurers' margins (in a good year) average 20% of premium receipts, then the properly-specified effective rate of stamp duty is 50%, not 10%. Of course that tax rate rises rapidly as insurers' margins fall to zero (being 200% at a 5% margin, for example).
- Significantly, this analysis points the spotlight not only on indirect taxation (such as the GST, fire services levies and stamp duties), but also on income taxation, where it raises the case for substantial, if not 100%, tax deductibility for household insurance. This case is developed in section 6 below.

The correct expression of existing tax rates at the present time means that general insurance in Australia is actually subject to triple-digit effective rates of taxation.

This point is developed further in section 3 below.

We note at this point that the inappropriate taxation treatment of compensation may not be confined to insurance, but also extend to court-ordered compensation payments in response to theft or injury:

- To the extent that these compensation payments cover the same types of claims as general (and at least some health) insurance claims, the justification of their taxation on good tax design grounds is equally flawed.
- Moreover, the inappropriate tax treatment of such compensation payments may be reflected in court judgements (ie, they may be boosted to cover the tax-inclusive cost of restoring stolen property, or purchasing various goods and services). If so, the fundamental tax policy flaw may further increase the cost of insurance policies intended to protect against such claims.

This matter is pursued no further in this Report, but it seems to be an issue worthy of further examination.

3. THE CURRENT TAXATION TREATMENT OF GENERAL INSURANCE IN AUSTRALIA

3.1 INDIRECT TAXATION: STATE TAXES & CHARGES

As set out in more detail in sub-section 3.4 below, there is a range of state-level taxes and levies, varying widely across the states and territories, applicable to general insurance.

These typically have the following features:

- Tax or levy rates are expressed as a percentage of the premium payment.
- There is no input tax credit in respect of the value of claims that can be used as an offset to the gross tax paid.
- In effect, and despite its very different nature, the claims portion of insurance is taxed exactly the same way as the margins portion.
- Tax 'cascading' is a feature of these revenue raising instruments.

3.2 INDIRECT TAXATION: THE GST

While the way in which it is achieved is somewhat more complex, the GST in Australia effectively treats general insurance premiums and claims exactly the same way as other GST-taxable supplies. The sale of a new car, and the provision of a car to a claimant in settlement of an insurance claim, end up being treated the same.

This ignores the nature of general insurance claims as set out in section 2 above. The GST treatment of general insurance is inconsistent with properly-designed value added tax systems, whose ultimate tax base is private consumption.

It is true that, *from an insurer's perspective*, the GST operates to catch (net) only the insurer's value added. That is no different from the GST treatment of most other goods and services, and properly so.[6]

It is in the effective treatment of claims under the Australian GST that the problems arise:

- Where insurers receive input tax credits (ITCs) for GST paid in settlement of claims, these simply offset GST paid elsewhere in the economy. In total, (net) GST is paid both on the insurer's value added (by the insurer), and (elsewhere) on the settlement of the claim via what otherwise are taxable supplies for GST purposes.
- Where insurers pay out cash to non-registered insureds, the 'decreasing adjustment' provision ensures the insurer's margin is taxed, but this adjustment simply shifts the effective GST treatment to the registered insured case, with the 'decreasing adjustment' offsetting GST paid by the insured in purchasing the replacement goods and services.[7]
- Under the amended Division 78 of the GST Act, where a registered insured no longer has a GST liability when it receives a payout under an insurance policy, the insurer is not entitled to an ITC at the time it makes a payout under the policy.[8] This is inappropriate. At issue here are general insurance claims. Swapping a GST liability (on the insured) for an ITC (for the insurer), in respect of a claim makes no sense at all. It implies that the claim

---

[6] See, for example, *GST and general insurance, Economic Roundup,* Spring 2000, the Treasury, pages 49-57. This is a useful, clearly expressed, exposition of the GST treatment of general insurance from the perspective of the insurer. It is also a useful summary of how Australia and New Zealand have, in one respect, improved on the VAT treatment of general insurance that is typical in Europe. It clearly states the principle that GST should only apply to the insurer's margin or value added (eg, page 50). But it does not really explore in detail the Australian GST treatment from an economy-wide perspective. In particular, the economy-wide treatment of general insurance claims is not covered.

[7] See *Economic Roundup,* Spring 2000, the Treasury, pages 55-57.

[8] *Economic Roundup,* Spring 2000, the Treasury, page 55.

itself is a taxable supply. At law, it may be so defined in Australia under the GST Act. Economically, however, it is a transfer payment, not final private consumption.

In one respect, however, the GST is superior to state taxes currently applying to general insurance. By itself, it does not give rise to the 'cascading' or 'tax-on-tax' effects associated with state taxes such as the fire levy and stamp duty.

That said, as set out in sub-section 3.3 below, the *interaction* between the GST and state taxes and levies on general insurance causes its own 'tax-on-tax' problems.

3.3 Indirect Taxation Compounding Problems

Broadly defined, taxation compounding, or 'tax-on-tax' effects would include:

- For any *particular* tax, 'cascading' effects where the same tax is imposed more than once, and the first and subsequent impositions are included in the tax base when the tax is imposed again. (For example, FID was a cascading, or turnover-based, tax.)
- Across *different* taxes, there are many types of tax interactions, or tax-on-tax effects. These can cover direct and indirect taxes, and involve taxes at all levels of government. (For example Commonwealth excise on petroleum products is a pervasive part of the tax base for many state taxes.)
- And the introduction of the GST generates another layer of tax sitting *between* some state/local government taxes (which are included in the GST base) and other state/local taxes (which are excluded from the GST base, but for which, in many cases, the GST-inclusive price forms their tax base). GST *itself* can involve tax-on-tax effects in cases where transactions are GST-exempt (or input-taxed) and there is no access to input tax credits (ITCs)

'Cascading' tax-on-tax effects are of interest from efficiency/equity/simplicity perspectives. In general 'cascading' or turnover taxes score poorly, at least on the first two criteria, if not all three.

Tax-on-tax effects across different tax instruments are also of interest, but, where different levels of government are involved, there are limits on the powers of any particular government to respond.

Of course, tax-on-tax effects associated with the GST are also of interest, but, because the tax base and tax rate in this case are locked-in as part of the *Intergovernmental Agreement on the Reform of Commonwealth-State Relations* (IGA), there are even more substantial limits on the powers of any particular government to respond – at least in terms of varying the GST details.

Under the IGA, it was agreed that:

- State stamp duties would not form part of the tax base for GST.
- But it was *not* agreed that GST would not form part of the tax base for stamp duties.
- In fact, state stamp duties are levied on the GST-inclusive value of the relevant transaction.
- In practice, this is *worse* than having the tax order reversed, that is, having GST apply to the stamp duty-inclusive value of the transaction, in the case of business transactions including those involving commercial insurance.

Because, in general, GST on business inputs is refundable via input tax credits (ITCs), can it be argued that there is no ultimate 'tax on tax' problem for business insurance? The answer is 'no':

- The GST-inflated value of the transaction subject to stamp duty boosts the value of stamp duty by 10%.
- But there is no ITC for stamp duty.
- As a result, and net of GST ITCs, the tax burden on dutiable transactions including those involving commercial insurance is increased by 10% directly as a result of the interaction between GST and stamp duty.
- And the states – who collectively receive the GST revenue anyway – also receive an effective 10% revenue gain from GST-inflated stamp duty revenues.

- This outcome is largely a result of the amendments to the original IGA, under which most if not all stamp duties would have been abolished as part of the *New Tax System*. However, the problem would have remained for business insurance.
- If the states had in fact agreed to reverse the order – including stamp duty in the tax base for GST – then they would have ensured that business transactions subject only to stamp duty and GST in general would not have suffered from 'tax on tax' effects. GST would have been inflated by the stamp duty-inclusive value of the GST tax base, but this would have been offset by larger ITCs.
- For non-business transactions, of course, 'tax on tax effects' are larger and independent of the order of taxation: there are no ITCs in such cases.

The scope for the states to do something about any problems that arise from 'tax on tax' effects is straightforward:

- For business transactions, reverse the current taxation order: that is make stamp duty part of the GST base, rather than vice-versa.
- For all transactions, including business transactions, revert to the original IGA package, and abolish stamp duties now that the GST is in place.
- As a more limited reform, for existing state taxes where other state taxes, or the GST, form part of the tax base, the options open to the state governments are:
  - To abolish the state taxes concerned.
  - To reduce the tax rate by at least enough to offset the 'compounding' effect of introduction of the GST as part of the base for the state tax (this requires a sizeable reduction in the ad valorem equivalent rate of the state tax concerned, which varies with the rate of that tax).
  - To redefine the tax base to exclude GST.

Significant changes to the GST itself (tax base or tax rate) will be difficult, in practice, for any one state to secure.

3.4 An Interstate Comparison Of Indirect Taxation Of Insurance

The following four charts illustrate current indirect taxation burdens on (i) home insurance premiums for both metropolitan and country areas, and (ii) business insurance premiums for both metropolitan and country areas, for each State and Territory.

The charts:

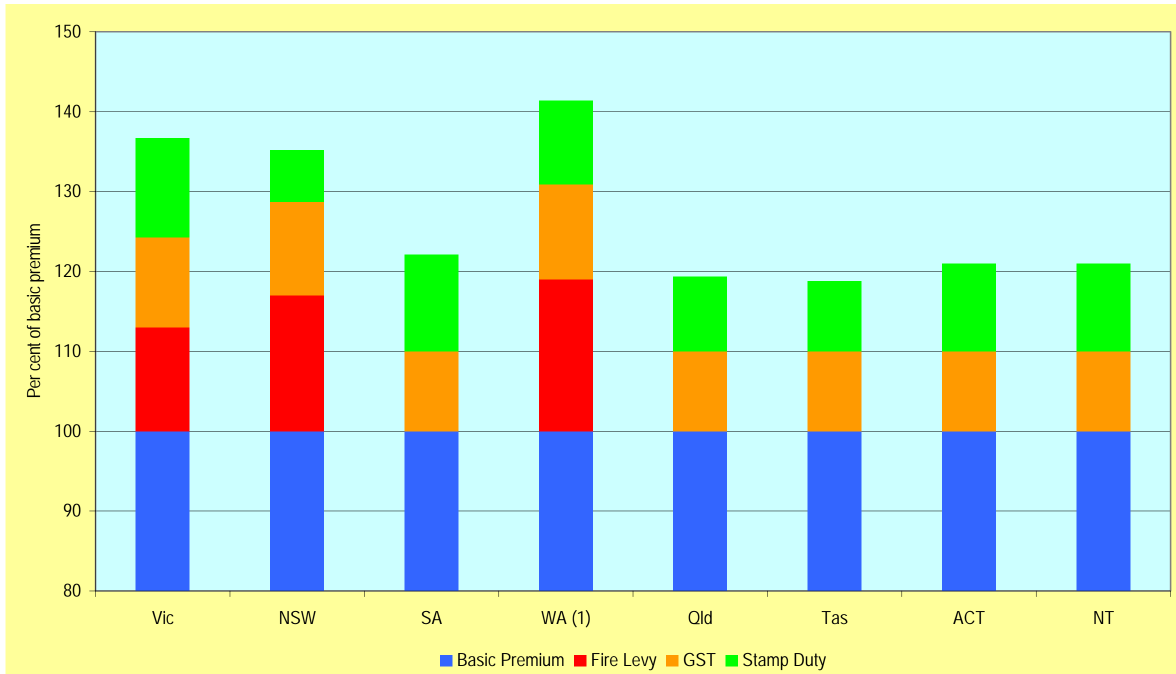
- only cover fire levies (where applicable), GST and stamp duty;
- express ad valorem tax rates as a percentage of the basic premium, which is part of the relevant formal tax base;
- the presentation builds in the 'tax-on-tax-on-tax' features arising from the compounding problems mentioned in sub-section 3.3 above.

Chart 3.4.1 shows the tax burdens for home insurance in metropolitan areas across Australia.

As chart 3.4.1 shows:

- the overall metropolitan home insurance tax burden varies widely across states/territories
- the tax burden is under 20% in Queensland and Tasmania, up to 35% or more in NSW and Victoria, and, (before 1 January 2003) was over 40% in Western Australia.

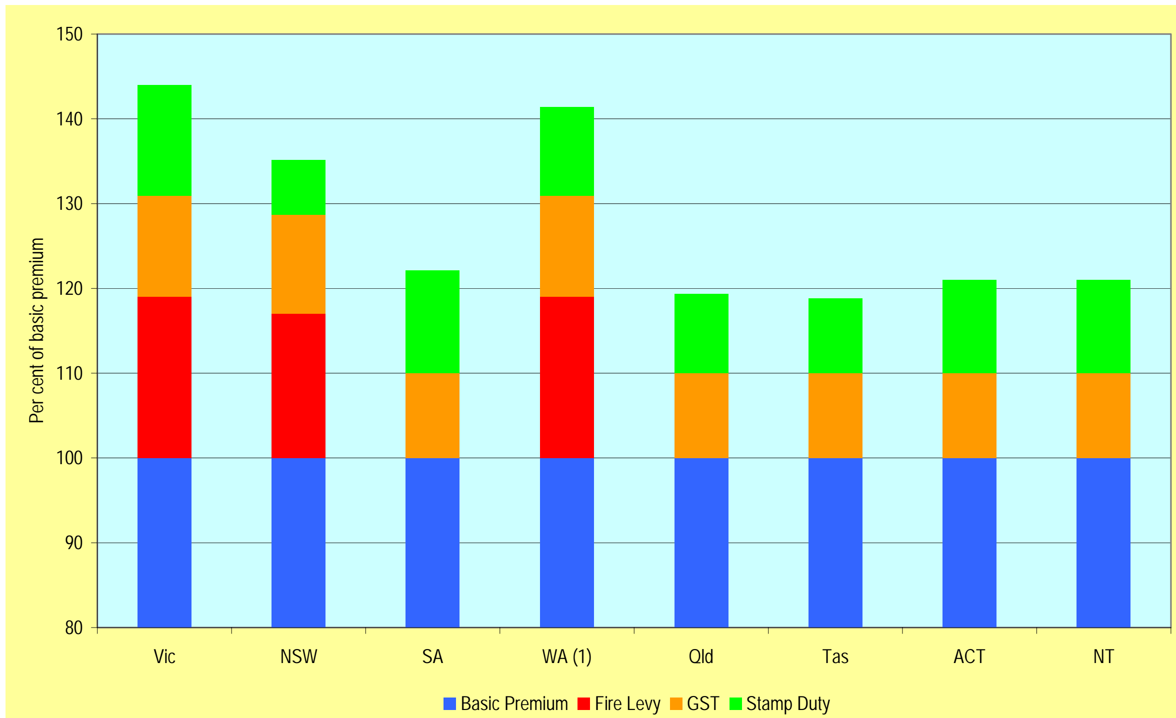
Chart 3.4.1 Indirect Taxes & Charges On Metropolitan Area Home Insurance Premiums



(1) WA fire services levy phasing out from 1 January 2003.

Chart 3.4.2 shows the corresponding tax burdens for home insurance in country areas across Australia.

Chart 3.4.2 Indirect Taxes & Charges On Country Area Home Insurance Premiums



(1) WA fire services levy phasing out from 1 January 2003.

As chart 3.4.2 shows:

- the overall country area home insurance tax burden varies widely across states/territories
- for most states and territories, the burden is about the same as for metropolitan areas
- but for country Victoria, the much higher rate of the Fire Levy pushes the total tax burden to an Australia-wide high of nearly 45%.

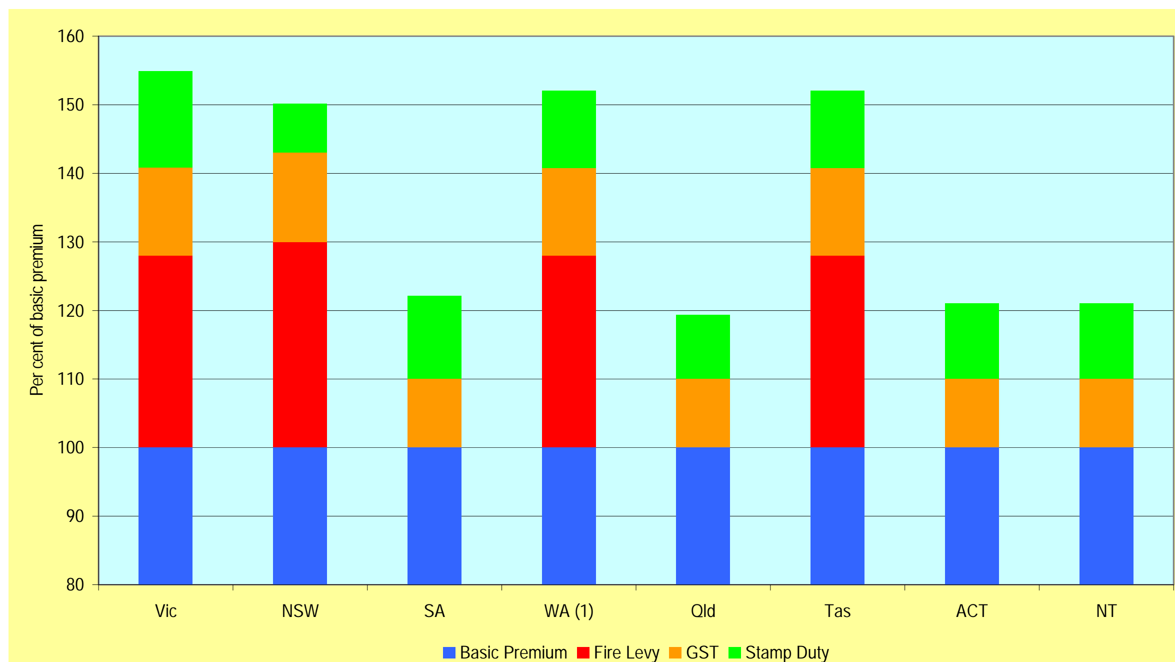
For business insurance, gross indirect tax burdens on premiums tend to be higher than for home insurance in four states: NSW, Victoria, Western Australia and Tasmania.

Chart 3.4.3 shows the corresponding tax burdens for business insurance in metropolitan areas across Australia.

As chart 3.4.3 shows:

- the overall metropolitan area business insurance tax burden varies widely across states/territories
- for four states and territories; South Australia, Queensland, the ACT and NT, the burden is about the same as for home insurance
- but for NSW, Victoria, Western Australia and Tasmania, the much higher rate of the Fire Levy (for the first three), and the existence of a 28% fire levy for business insurance in Tasmania pushes the total tax burden in those states to Australia-wide highs of over 50% – nearly 55% in the case of Victoria
- while, in some circumstances, GST is refundable as an input tax credit for business insurance, it still lifts the overall tax burden through the 'tax-on-tax' compounding process (because GST forms part of the tax base for stamp duty.

Chart 3.4.3 Indirect Taxes & Charges On Metropolitan Area Business Insurance Premiums



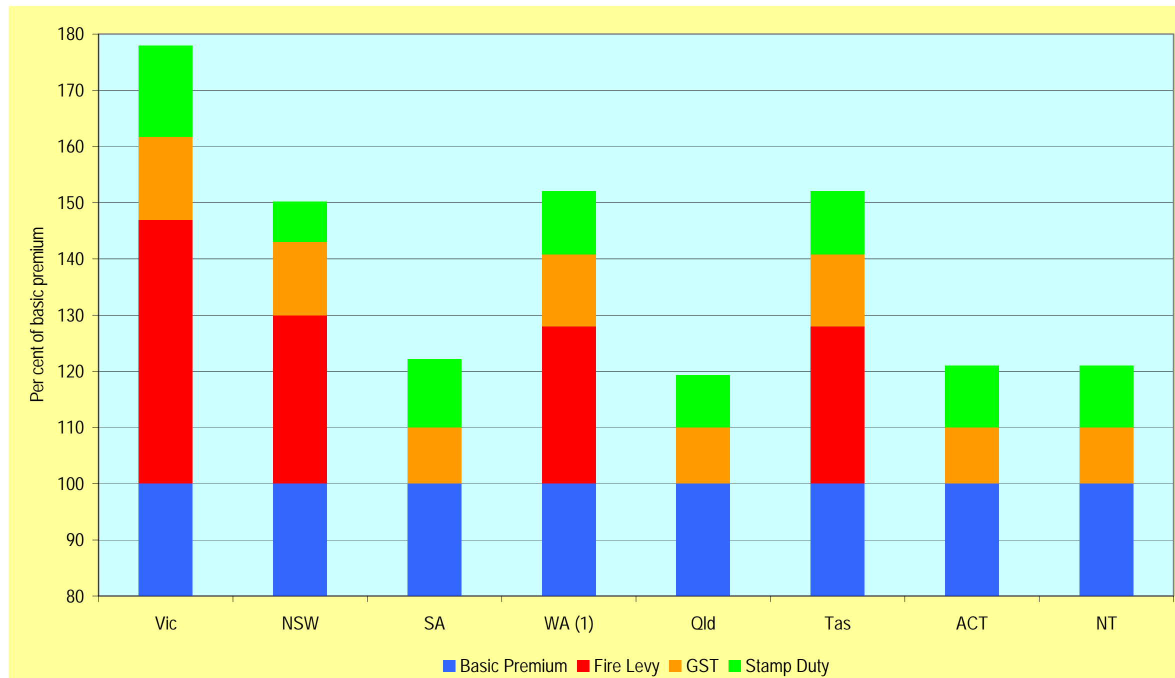
(1) WA fire services levy phasing out from 1 January 2003.

Chart 3.4.4 shows the corresponding tax burdens for business insurance in country areas across Australia.

Chart 3.4.4 shows that, in country Victoria, the gross indirect tax burden rises even higher – to nearly 78% – because of the imposition of a 47% fire levy in that State:

- Victoria's gross indirect tax burden on business insurance premiums in country areas is over four times as high as that in the lowest-taxing state (Queensland).

Chart 3.4.4 Indirect Taxes & Charges On Country Area Business Insurance Premiums



(1) WA fire services levy phasing out from 1 January 2003.

In the following four charts, current indirect tax burdens are re-expressed relative to the insurers' margin, which is assumed to be 20% of premium income.

The charts:

- only cover fire levies (where applicable), GST and stamp duty;
- the presentation builds in the 'tax-on-tax-on-tax' features arising from the compounding problems mentioned in sub-section 3.3 above.

Chart 3.4.5 shows the tax burdens for home insurance in metropolitan areas across Australia.

Chart 3.4.5 shows that

- even in the lowest-taxing states, the effective ad valorem tax burden is near, or over 100%
- in Victoria and NSW, the overall tax burden is over 275%
- and, before 1 January 2003, in Western Australia, the overall tax burden exceeded 300%.

These are absurdly high tax burdens.

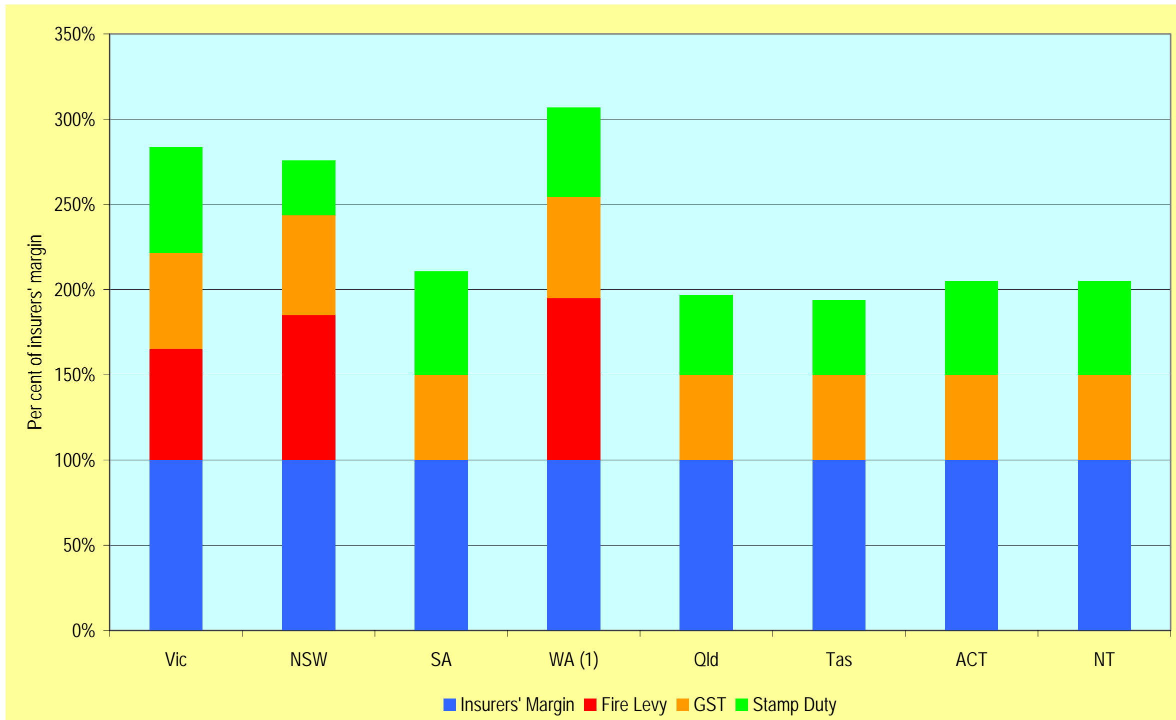
Chart 3.4.6 shows the tax burdens for home insurance in country areas across Australia.

Chart 3.4.6 shows that

- in Victoria, the effective ad valorem tax burden is over 320%.

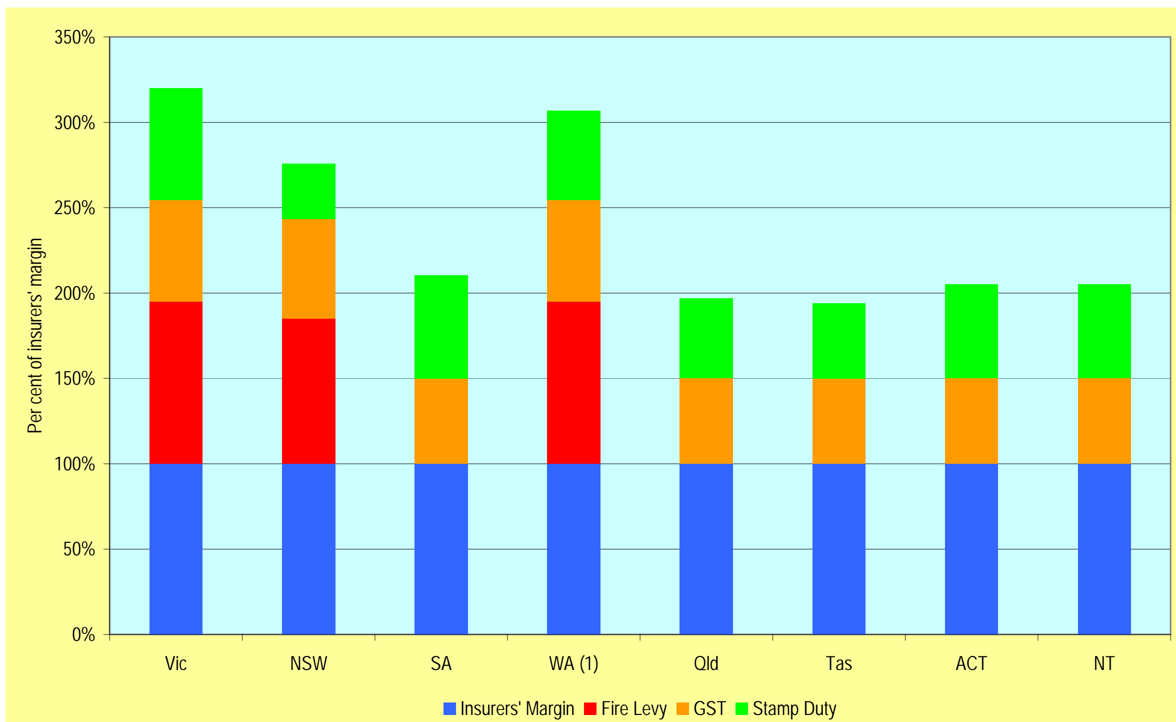
Again, these are absurdly high tax burdens.

Chart 3.4.5 Indirect Taxes & Charges On Metropolitan Area Home Insurance Premiums



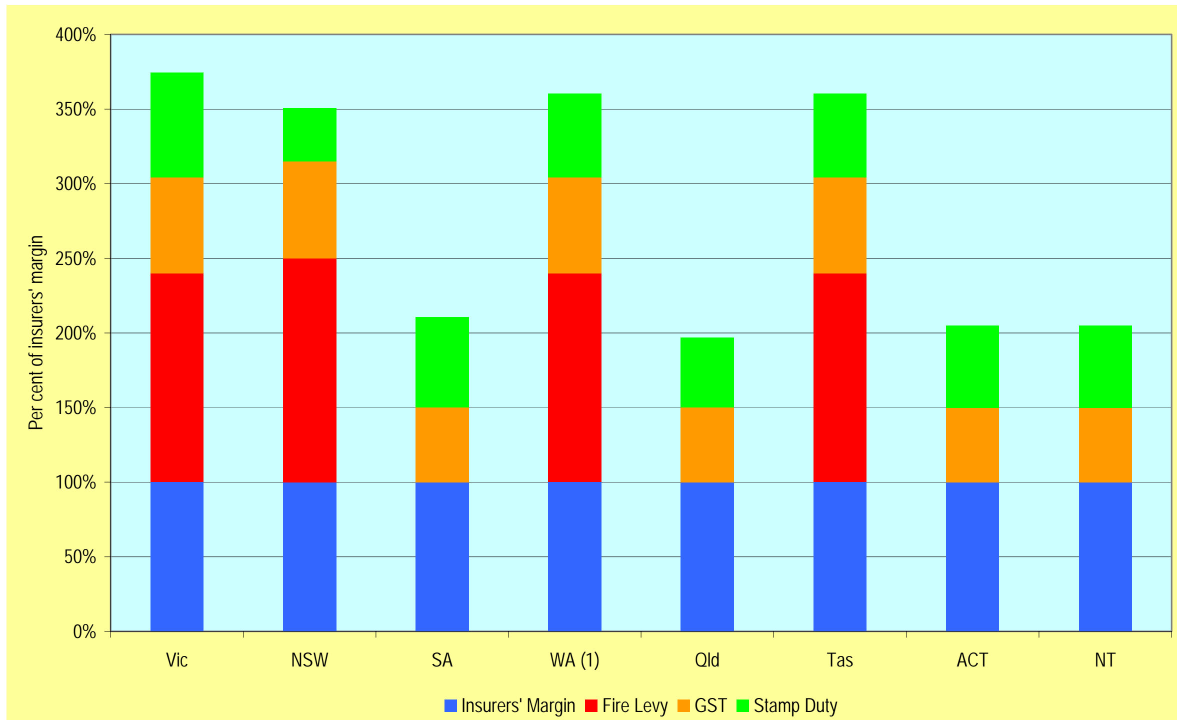
(1) WA fire services levy phasing out from 1 January 2003.

Chart 3.4.6 Indirect Taxes & Charges On Country Area Home Insurance Premiums



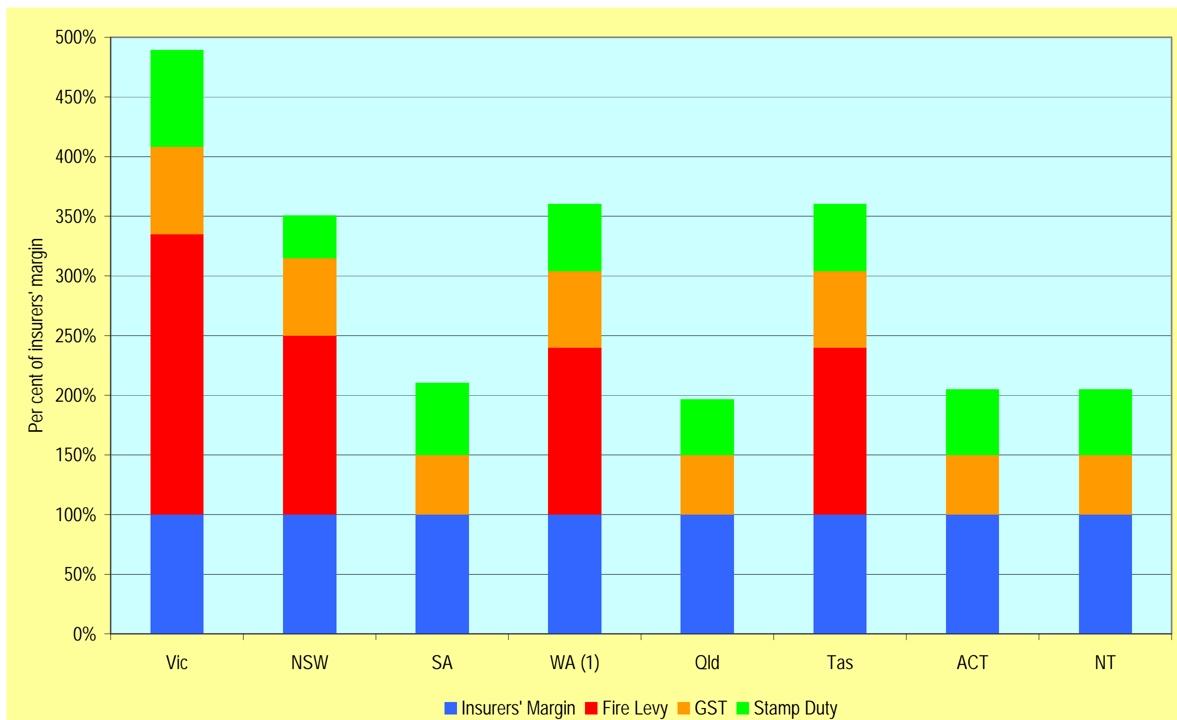
(1) WA fire services levy phasing out from 1 January 2003.

Chart 3.4.7 Indirect Taxes & Charges On Metropolitan Area Business Insurance Premiums



(1) WA fire services levy phasing out from 1 January 2003.

Chart 3.4.8 Indirect Taxes & Charges On Country Area Business Insurance Premiums



(1) WA fire services levy phasing out from 1 January 2003.

Gross business insurance tax burdens are even higher, as the charts above show.

Chart 3.4.7 above shows the tax burdens for business insurance in metropolitan areas across Australia.

Chart 3.4.7 shows that

- even in the lowest-taxing states, the effective ad valorem tax burden is near, or over 100%
- but in Victoria and NSW, the overall tax burden is about 375% and 350%, respectively
- in Tasmania and, before 1 January 2003, in Western Australia, the overall tax burden exceeded 350%.

Chart 3.4.8 below shows the tax burdens for business insurance in country areas across Australia.

Chart 3.4.8 shows that:

- in Victoria, the effective ad valorem tax burden is approaching 500%!

These rates assume an insurers' margin of 20% of the gross premium/investment income received in any year. As that margin – in a bad year – approaches zero, the abovementioned tax burdens rise towards infinite percentages.

3.5 Unfinished State Tax Reform Business From *The New Tax System*

Under the current *Intergovernmental Agreement* between the Commonwealth and the states, there is an agreed timetable for abolition of BAD (from 1 July 2005 at the latest, although New South Wales has already implemented this reform).

For conveyancing duties on business property; stamp duties on credit arrangements, instalment purchase arrangements and rental (hiring) agreements; stamp duties on leases; stamp duties on mortgages, bonds, debentures and other loan securities; and stamp duties on cheques, bills of exchange and promissory notes, there is only a commitment to review these taxes (by 2005) in the light of States' budget circumstances.

State taxes and levies on general insurance are not even mentioned as candidates for review, despite the very large aggregate indirect tax burden they bear, especially in Victoria, NSW, WA and Tasmania.

3.6 Other Insurance-Related Taxes, Levies, Compulsory Premium Increases

In addition to these tax imposts, the Commonwealth Government has announced that from 1 July 2003 terrorism cover will be compulsory for all commercial property insurance contracts. An initial premium of 2% of the underlying base premium will be charged, and surcharges of 10% and 2% will apply to capital city CBDs and urban areas, respectively.

A variety of other levies (eg, the so-called Insurance Protection Tax in NSW which by law cannot be passed on to the insured via premium price adjustments) also apply.

3.7 Commonwealth Income Tax Treatment Of General Insurance

Commonwealth income tax treatment of general insurance has good and bad elements:

- In general, business insurance premiums are a deductible business expense, so both the insurers' margin and the claim component are effectively income tax free in the hands of the insureds, and only the margin is taxed (eg, partly as insurers' profit, partly as input suppliers' profit and partly through income tax on employee wages). In effect, the income tax treatment of business insurance, to this extent, is appropriate, *provided* that general insurance claims are not themselves subject to income tax.
- Private general insurance is non-deductible for income tax purposes. In effect, the claim portion of general insurance premiums is taxed at the relevant personal marginal rate on purchase of the insurance policy.
- An alternative specification of the problem (using the insurers' margin of 20% as an illustration) is that private general insurance *margins* are subject to discriminatory personal income taxation at *five times* the relevant marginal income tax rate.

In short, private general insurance premiums are non-deductible expenses, and thus either the claim portion of the premium is subject to income tax or the margin is punitively taxed.

For the reasons set out in section 2 above, this is inconsistent with income tax design principles and underlying Haig-Simons definitions of income (as accretions to personal net worth):

- The claim (or non-margin) portion of a general insurance premium is effectively an advance transfer payment into the insurance pool to fund future claims settlements. It does not constitute income in the period when the policy is purchased, and is not treated as such in the national accounts.
- The correct treatment is:
  - To make the claims portion of the premium (say around 80%) a deductible expense for income tax purposes.
  - Ensure that claim settlements (excluding workers' compensation income maintenance settlements) are themselves not subject to income tax.

4. INTERNATIONAL COMPARISONS OF INSURANCE TAXATION

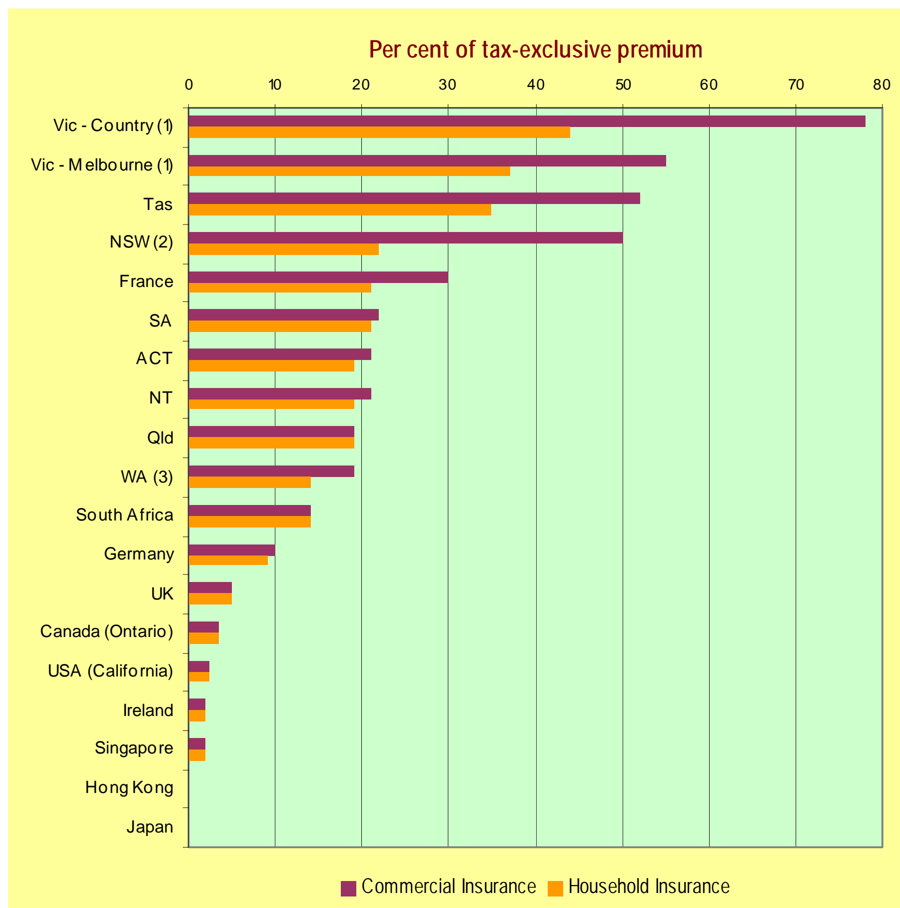
As section 3 shows, Australia taxes general insurance heavily. There are also wide inter-state differences in the level of state taxation as well.

In addition, Australia appears to tax general insurance very heavily by international standards. This section of the Report summarises the current situation.

4.1 INDIRECT TAXATION OF GENERAL INSURANCE

Chart 4.1.1 provides a current snapshot of Australian (state plus GST) and international tax treatments of general insurance for property.

Chart 4.1.1. Taxes On Property Insurance Premiums: An International Comparison*



Source: Deloitte Touche Tohmatsu, 1 March 2003.

* Taxes include GST (and equivalents), stamp duty, and fire brigade funding levies. Taxes have been expressed as a percentage of premium before taxes.

(1) These adjusted taxes began applying progressively to renewals in Victoria, largely from January 2003. The commercial insurance rates are currently 88% for Victoria ex-Melbourne and 62% Melbourne. The current corresponding rates for household insurance are 50% ex-Melbourne and 40% Melbourne.

(2) NSW stamp duty was reduced from 10% to 5% from 1 August 2002. Following changes to the Fire Services Levy newly adjusted taxes began applying progressively to renewals, largely from April 2003. The commercial and household rates were 55% and 36% respectively.

(3) The WA fire services levy is being removed progressively from renewal premiums from 1 January 2003. (The figures have been adjusted to the new basis.)

Note that:

- all of the tax imposts (Hong Kong and Japan excluded where taxes are zero) are expressed as a percentage of the pre-tax premium, not the relevant insurance margin. In large measure, therefore, these burdens effectively fall on property insurance claims as well; and
- the new terrorism cover – which, like taxation, is compulsory – has the effect of exacerbating the overall tax burden, (i) by adding to the tax base for all add-on taxes, and (ii) thereby compounding the existing 'tax on tax' problems as well.

5. THE TAXATION TREATMENT OF GAMBLING VERSUS INSURANCE

In a conceptual sense, there are strong similarities between insurance and gambling:

- The wager 'pool' is fed by gamblers placing bets, like the insurance 'pool' is fed by premium and other income.
- The wager 'pool' is used to pay out winning bets, like the insurance 'pool' is used to settle valid claims.
- Economically, the gambling industry's margin is properly regarded as:
  - Income.
  - Consumption.
  - The result of economic transactions.
- The winning bets, like insurance claims, are simply transfer payments.

This conceptual similarity is reflected in the Australian Bureau of Statistics' Australian National Accounts, where, for example, it is the gambling industry's margin, not the total value of bets, that appears as part of private consumption.

However, if one applies broadly-held social value judgements, there would be widespread support for the view that there are important differences between insurance and gambling. There would be general support for the following four propositions:

- Own-provision of general insurance cover for future economic contingencies is both prudent and desirable.
- If anything, the tax system should be neutral, or even encourage such behaviour.
- Gambling is generally accepted within limits, but abuse does lead to severe individual and social problems.
- If anything, the tax system might be used to discourage excessive gambling (via 'sin' taxation).

5.1 Indirect Tax Treatment Of Gambling Versus Insurance

In practice, the indirect tax treatment of insurance and gambling effectively reverses each of the four propositions set out above:

- Own-provision of cover for future economic contingencies is apparently less desirable than gambling.
- If anything, the tax system discourages such behaviour.
- Gambling should be encouraged relative to insurance.
- In general, (albeit with some design flaws in the case of the GST) the indirect tax system only taxes the insurers' margin, and encourages gambling relative to general insurance.

These conclusions follow because, in general, indirect tax systems in Australia are designed only to apply to the gambling industry margin.

There are some exceptions. Notable amongst them is the case of the GST, in situations where successful bets are settled with non-cash prizes deemed to constitute taxable supplies for GST purposes

5.2 General Conclusions

Governments at all levels would profess to subscribe to the four value judgments set out just before sub-section 5.1 above.

However, in practice, Commonwealth and state government indirect tax systems give implicit, but powerful, support for precisely the opposite value judgments.

Ironically, this reality has led governments to apply heavy, but very inefficient, taxes to general insurance, and lighter, but very efficient, taxes to gambling.

Switching the emphasis would deliver both more revenue and more efficiency.

6. TAXATION OF SUPERANNUATION, HEALTH INSURANCE VERSUS GENERAL INSURANCE

In the context of own-provision for future contingencies, the tax treatment of general insurance is the odd person out.

6.1 Superannuation

Own-provision for retirement income rather than reliance on the age pension is encouraged in Australia:

- By compulsion, through the Superannuation Guarantee.
- Through – relative to an income tax base – income tax 'concessions', notably in the form of lower income tax rates on superannuation contributions, and through lower income and capital gains tax rates on super fund earnings.

These incentives do not apply to general insurance.

6.2 Health Insurance

Own-provision for future health contingencies via health insurance is encouraged through the health insurance rebate.

No such incentive applies to general insurance.

6.3 Is General Insurance Different?

Superannuation, health insurance, and general insurance all constitute own-provision for future contingencies, the benefits of which include less pressure on future government budgets.

They are similar products from this perspective.

In principle, there would be widespread support for the view that such own-provision activity is desirable and should even be encouraged (although there is a community debate about the health insurance rebate at present).

Successive Commonwealth governments generally would support these views.

6.4 Policy Inferences: Commonwealth Taxation Treatment Of General Insurance

In the case of general insurance, actions speak louder than words.

The income tax system discourages general insurance, notably via its inappropriate treatment of claims.

Effectively the Commonwealth government is signalling to insurers that superannuation saving and health insurance are desirable and worthy of 'concessions', but this does not apply to general insurance.

7. INSURANCE DEMAND RESPONSES TO AUSTRALIAN TAX TREATMENT

There is some evidence that demand for general insurance is sensitive to the costs of taking out such cover. This section of the Report reviews some of the issues and evidence that supports this proposition.

7.1 Possible Insurance Choices

Australian households and businesses face a variety of options when considering whether or not to purchase insurance products:

- Depending on their financial circumstances they may opt for 'self-insurance' – that is, accepting all the risks that they potentially face and internally provisioning to cover their potential costs.
- They may opt for no insurance – an option similar to the preceding choice but without provisioning for adverse events. In part this may reflect short-sightedness or the 'it won't happen to me' syndrome
- They may opt for under-insurance – really a blend of the no-insurance and full externally-provided insurance options.
- For Australians, there may be opportunities to avoid the worst of the existing tax burdens by purchasing policies in the lowest-taxed states, or even overseas.

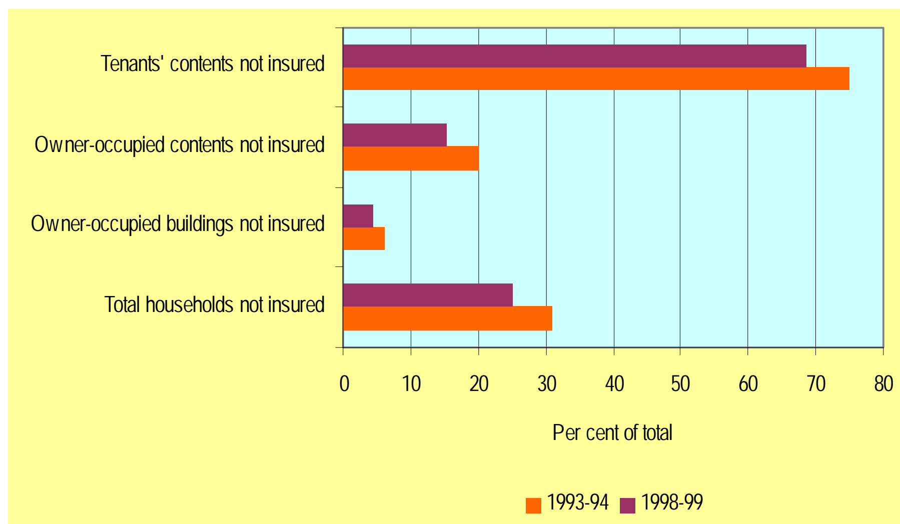
In short, there is a wide range of choices available to those potentially insured within Australia.

7.2 Evidence Of Non-Insurance And Under-Insurance

Given the wide range of choices, it should not be surprising that evidence of non-insurance and under-insurance is widespread, at least where purchasing insurance is optional (as is the case with most property insurance, if not for workers' compensation and CTP insurance).

The ICA, which represents over 90% of all insurance business in Australia, has monitored the evidence of non-insurance and under-insurance via the Non-Insurance and Under-Insurance Survey. The results for 1993-94 and 1998-99 are summarised in the following charts.

Chart 7.2.1. The Incidence Of Uninsured Households

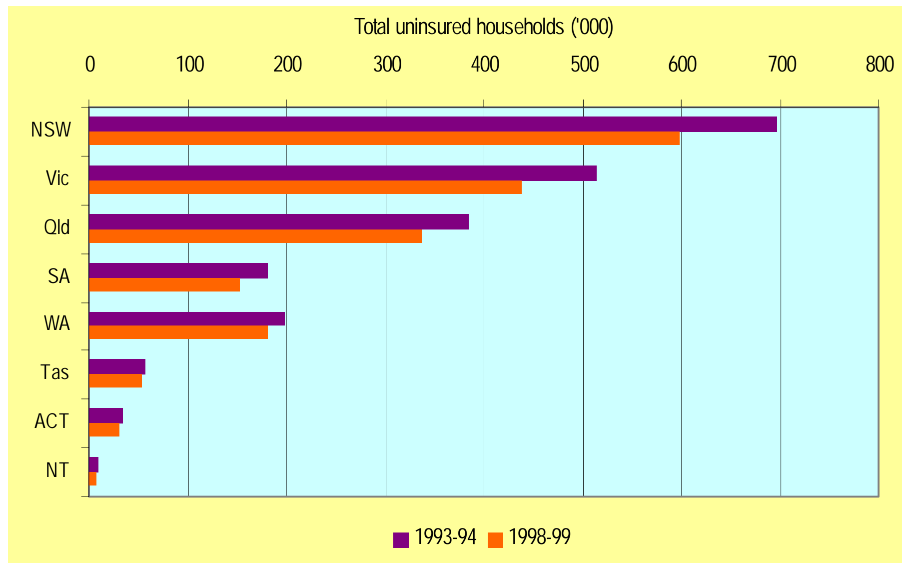


Source: ICA Non-Insurance and Under-Insurance Survey.

While there has been some improvement between 1993-94 and 1998-99, there is evidence of substantial non-insurance by household, especially for tenants' contents:

- Between 1993-94 and 1998-99 there has been a modest reduction in the proportion of household s uninsured.
- About one-quarter of households in Australia are still without home or contents insurance.
- Almost 70% of tenants still do not protect their property.
- The problem is exacerbated by those who are under-insured.

Chart 7.2.2. Uninsured Households By State/Territory



Source: ICA Non-Insurance and Under-Insurance Survey.

Again, while there has been some improvement between 1993-94 and 1998-99, there is evidence of substantial non-insurance by households across all states and territories:

- In 1998-99, over 27% of households in NSW were uninsured.
- Over 21% of households in Victoria were uninsured.
- Over 26% of households in Queensland were uninsured.
- Over 26.8% of households in South Australia were uninsured.
- Over 23% of households in Western Australia were uninsured.
- Over 23% of households in Tasmania were uninsured.
- Over 25.5% of households in the ACT were uninsured.
- Over 30% of households in the Northern Territory were uninsured.

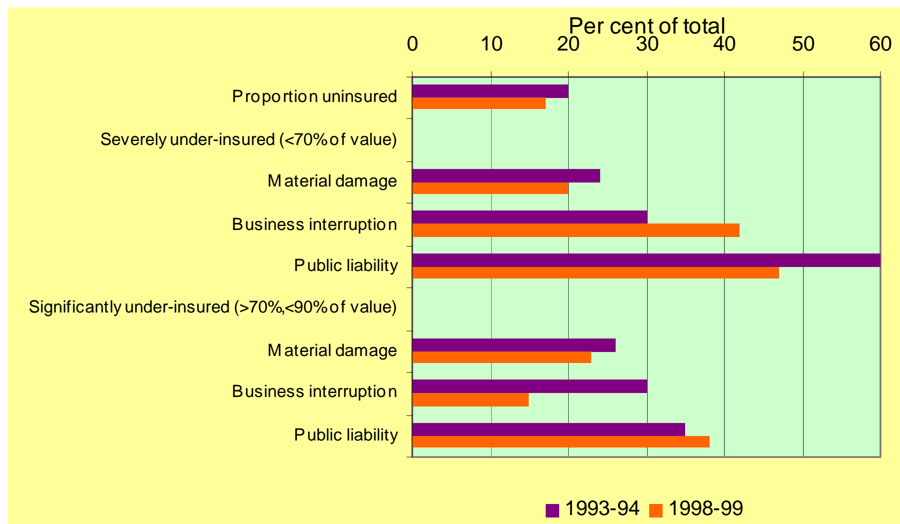
Adding under-insurance exacerbates the story. According to ICA estimates:

- About 7.5% of home buildings are insured for less than 70% of their replacement value.
- About 20% of home buildings are insured for between 70% and 90% of their replacement value.
- Up to 35% of all household contents are markedly under-insured.

For small to medium enterprises (SMEs), the non-insurance and under-insurance story is broadly similar to even worse.

The following table shows the situation as estimated in 1993-94 and 1998-99, again as recorded in the ICA Non-Insurance and Under-Insurance Survey.

Chart 7.2.3. Uninsured/Underinsured Small To Medium Enterprises (SMEs)



Source: ICA Non-Insurance and Under-Insurance Survey.

7.3 Implications For Government Budgets

The extent of under-insurance and no-insurance indicated above suggests that state government budgets are adversely affected in two ways:

- In an ongoing sense, they receive less revenue from state taxes and levies on insurance, and this is at least in part the insureds' response to those taxes and levies: where insurance is voluntary, people are electing not to pay any or as much in taxation to the states' coffers.
- In the aftermath of disasters like the 18 January 2003 bushfires in Canberra, governments are having to provide income and other support to the less well off who either have no, or inadequate, insurance cover, to a much greater extent than would otherwise be necessary.
- In short, state government budget bottom lines are hit by less revenue, and greater outlays, than would otherwise be necessary.

8. ACCESS ECONOMICS' CONCLUSIONS AND POLICY INFERENCES

8.1 CONCLUSIONS

The conclusions reached by Access Economics from the foregoing review are as follows:

- There should indeed be a national review of the taxation of insurance products in Australia.
- Both at the Commonwealth and state government levels, the current tax treatment of general insurance:
  - Cannot be justified by reference to generally accepted definitions of income (for income tax), of consumption (for the GST), or of transactions (for stamp duties).
  - The fire levies, where applicable, are even more difficult to justify, and are a recipe for 'free rider' responses to the need to fund fire and emergency services, the adequacy of which is jeopardised by this funding mechanism.
  - In particular, the problem is caused by the failure to recognise that a large part of premium payments is effectively provisioning for, and the source of, settlement of claims against insurance policies.
  - This portion – which typically accounts for about 80% of insurers' receipts in any year (more in poor years) – is neither income, nor consumption, nor involves an economic or financial transaction.
  - Claims are transfer payments: compensation for lost assets funded from the insurance pool.
  - The correct treatment of general insurance claims has long been applied in the Australian Bureau of Statistics' *Australian National Accounts*.
  - But it has been effectively ignored by both the Commonwealth and state governments in their tax systems.
- General insurance premiums are subject to high percentage rates of taxation, especially indirect taxation:
  - The overall indirect tax burden ranges from just under 20% of the basic premium (in Queensland) to almost 80% of the basic premium (in country Victoria).
  - As a non-deductible expense, private general insurance is effectively taxed at up to 48.5% under the standard income tax scale alone. Much higher effective tax rates will apply to insureds who face application of benefit withdrawals under various means tests.
  - If we express these tax burdens as a percentage of that general insurance portion that is legitimately treated as income, consumption, or transactions – the insurers' margin – the real tax burden is at least *five times* as large in a 'good' year, and approaches an infinitely large burden in a 'bad' year.
  - From this perspective, with a 20% insurers' margin, the overall indirect tax burden ranges from just under 100% of the margin (in Queensland) to almost 500% of the margin (in country Victoria). And as a non-deductible expense, private general insurance margins are effectively taxed at up to almost 250% under the standard income tax scale alone.
- This punitively high taxation of general insurance stands in contrast with the generally appropriate treatment of gambling, where the emphasis is more on that industry's margin. General insurance can be taxed more highly than tobacco and alcoholic beverages.
- Taking out general insurance to self-protect against economic loss is heavily penalised via taxation. Yet taking out insurance against other contingencies is encouraged by 'concessional' treatment (eg, health insurance, superannuation saving).

These problems can be corrected. For indirect taxation, the correction should be made on a pooled basis – that is, by adjustments to the tax treatment of insurers. For income taxation, the correction should apply to individual insureds.

INDIRECT TAX CORRECTIONS

Insurers should receive an *imputed input tax credit* (IITC) calculated as follows:

- For the fire levy, where applicable, the IITC = tax-exclusive claim value x fire levy rate = A.
- For GST, the IITC = A x GST rate = B.[9]
- For stamp duty, the IITC = B x stamp duty rate.

Income Tax Corrections

Insureds should be allowed to claim, say, 80% of premiums as a deductible expense for income tax purposes.

8.2 Policy Inferences

Access Economics considers that there is a very strong case, on efficiency grounds, for abolishing stamp duty on general insurance altogether. An equally strong case exists for abolishing the fire levy in those states still retaining it. Access Economics has developed those cases in earlier Reports.

But if that action is not taken, basic tax design principles argue for the following reforms to the taxation of general insurance in Australia:

Indirect Taxation

- All indirect tax 'systems' applying to general insurance – fire levies, stamp duty, GST and others – should include an *imputed input tax credit* each year equal to the value of claims paid in that year (valued on the same tax base as applies for the tax in question) multiplied by the relevant tax rate on insurance premiums in that year. This will ensure that these taxes fall only on insurers' margins.
- For GST, these imputed input tax credits should be additional to any *actual* GST input tax credits and decreasing adjustments received.
- *All* GST actually paid on claim settlements – *whether in respect of private or business insurance* – should be refunded through input tax credits.

Income Taxation

- All private general insurance premium payments should be deductible expenses for personal income tax purposes to the extent of the claims portion.
- As a reasonable longer term approximation, this suggests that 80% of private general insurance premium purchases should be a deductible expense for the income year when they are purchased.

The effects of these reforms would be to reduce general insurance prices and after-income tax costs to insureds relative to what otherwise would apply. This, in turn, would generate a 'virtuous circle' of responses:

- Under- and no-insurance would be reduced.
- The insurance pool would be expanded, with industry competition inducing lower average prices than would otherwise apply.
- Governments would face lower demands to compensate those without adequate insurance cover following natural disasters, reducing the pressures on their budgets.

At the end of its review of the application of GST to general insurance, the Treasury commented as follows: [10]

---

9 Note that these adjustments greatly reduce the tax burden on general insurers associated with the fire levy (where applicable) and stamp duty. Operationally, these adjustments also imply insurers will generally be in a net GST *credit* situation. At first blush this may seem inappropriate. It is not. The insurers' net credit is a part-offset to GST paid elsewhere in the economy in settlement of claims. These payments may be made directly by the insurer (eg, buying a new car for a claimant), or occur when a claimant uses a cash payout on a claim to purchase/repair the lost/damaged products. The difference ends up being GST on the insurers' margin – albeit indirectly.

10 *Economic Roundup,* Spring 2000, the Treasury, page 57.

> *… the initial GST approach to general insurance was input taxation. While this approach was not desirable from a tax design approach, most jurisdictions felt there was no alternative given the valuation difficulties associated with individual policies. New Zealand was able to avoid this difficulty by approaching the valuation on a pooled basis, an approach which has been adopted and refined by Australia. The New Zealand and Australian approaches are based on dividing supplies of general insurance into two components – the payment of a premium and the payout of a claim. This approach ensures that GST is collected only on the insurer's value added. It now remains to be seen whether other jurisdictions will adopt this approach and add further refinements.*

The European VAT treatment of general insurance – input taxation – is truly laughable to the extent that claims are insurers' inputs! This approach reflects no deep understanding of the nature of insurance, and in particular claims.

The current Australia/New Zealand approach to general insurance under their GST systems is both better and worse than the European model:

- It is better in that it avoids tax 'cascading' effects.
- It is worse in that, directly or indirectly, it subjects the *entire* insurance premium – claims plus insurers' margins – to GST. As has been pointed out earlier, the Australian GST applies to the insurers' margin (via deductions of ITCs and decreasing adjustments from GST liabilities in respect of premium payments) *and* in effect downstream, to purchases of products by insurers in settlement of claims (when the insurers' ITC is simply an offset to GST already paid by the relevant supplier), or purchases by claimants of replacement products/repairs out of insurer cash payouts (when the decreasing adjustment is simply an offset to the GST effectively paid by the claimant).

Australia now has the opportunity – in Treasury's words – to 'add further refinements' to the tax treatment of general insurance:

- The adjustments to GST and income tax treatment recommended in this report would produce almost exactly the correct consumption tax and income tax treatment of general insurance.
- The adjustments to the fire levy (where applicable), stamp duty and other state taxes would greatly reduce the inappropriately high state tax burden on general insurance.

Whether or not other jurisdictions follow is their business.

If they do not, that's their problem – and Australia's financial market competitive edge.[11]

---

[11] There are important implications of the analysis of general insurance in this report for other transfer payments. These will be the subject of separate reports.