

ICA submission to the Productivity Commission Inquiry into National Competition Policy Arrangements

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1 Executive Summary

1.1 Introduction

ICA is the representative body of the general insurance industry in Australia and its members account for over 90 per cent of total premium income written by private sector general insurers. ICA is pleased to present this submission to the Productivity Commission Inquiry into National Competition Policy Arrangements on behalf of its members and looks forward to working with the Commission to increase competition within the Australian general insurance industry.

1.2 Terms of Reference

The Productivity Commission has been asked to inquire into the impact of competition policy reforms undertaken by Australian governments to date and to suggest possible future reforms. From ICA's perspective the primary National Competition Policy (NCP) issues are the removal of restrictions on competition and the promotion of competitive neutrality in the Compulsory Third Party (CTP) and Workers Compensation classes of insurance. These issues are addressed in section 4 of this submission.

ICA is of the view that points 4 b and 5 b of the Terms of Reference give the Commission the mandate to go beyond "competition policy" and extend into the domain of general microeconomic reform related to market efficiency. From ICA's perspective the most important issues in this area are economic inefficiencies that arise from regulatory duplication and the taxation of insurance policies, be it by Fire Services Levy (FSL) or Stamp Duty in affecting the decisions of economic agents. ICA also makes note of the need to alter the Horizontal Fiscal Equalization (HFE) methodology applied by the Commonwealth Grants Commission (CGC) as it is a disincentive to the reform of state taxes. These issues are discussed in section 5 of this submission.

1.3 Conclusion/Recommendations

The application of NCP to general insurance in Australia has been disappointing and there is a significant divide between what may have occurred in terms of better outcomes for the consumers and taxpayers and what actually has been achieved.

With this Inquiry, and the coming review of the NCP process, there exists an opportunity to critically review the benefits of applying NCP obligations to the general insurance industry in Australia. ICA proposes that NCP reforms focus on the pursuit of competitive neutrality and the removal of unjustified restrictions on competition.

In addition, ICA sees the opportunity to greatly improve the efficiency of the general insurance market in Australia through the elimination of inefficient taxes, such as stamp duty and fire service levies, and the consolidation and simplification of prudential regulation. ICA is also of the view that the current system used to calculate States and Territories' respective shares of GST be altered as it is a material disincentive to the effective taxation reform.

2 Introduction

ICA is the representative body of the general insurance industry in Australia and its members account for over 90 per cent of total premium income written by private sector general insurers.

ICA members, both insurance and reinsurance companies, also form a significant part of the overall financial services system. Recently published statistics from the Australian Prudential Regulation Authority (APRA) show that the private sector insurance industry generates over \$34.9 billion per annum in gross premium revenue and has assets of \$61.0 billion¹. The industry employs about 30,000 people.

3 ICA's interpretation of the Terms of Reference²

The Productivity Commission have been asked to inquire into the impact of competition policy reforms undertaken by Australian governments to date and to suggest possible future reforms. From ICA's perspective the primary NCP issues are the removal of restrictions on competition and the promotion of competitive neutrality in the Compulsory Third Party (CTP) and Workers Compensation classes of insurance and these are discussed in Section 4 of this submission.

ICA is of the view that the Commission also has the mandate to consider broader, non-competition policy related, microeconomic reforms. ICA notes that point 4 b of the Terms of Reference request that the Commission report on:

*"at the Australian, State and Territory level, areas offering opportunities for significant gains to the Australian economy from **removing impediments to efficiency** and enhancing competition, including through a possible further legislation review and reform programme, together with the scope and expected impact of these competition related reforms." [emphasis added]*

Terms of Reference 5 b – the Commission should also:

*"focus new review and reform activity on areas where there is clear evidence of significant potential gains, in particular where clear gains are possible in Australia's international competitiveness, **in the efficiency of domestic markets or for Australian consumers**; to ensure possible reform activity considers appropriately the adjustment and distributional implications and its contribution to achieving other policy goals." [emphasis added]*

ICA's view is that the Terms of Reference clearly go beyond "competition policy" and extend into the domain of general microeconomic reform related to market efficiency. From ICA's perspective the most important issues in this area economic inefficiencies that arise from regulatory duplication and the taxation of insurance policies, be it by Fire Services Levy (FSL) or Stamp Duty in affecting the decisions of economic agents. ICA also makes note of the need to alter the Horizontal Fiscal Equalization (HFE) methodology applied by the Commonwealth Grants Commission (CGC) as it is a disincentive to the reform of state taxes. These issues are addressed in Section 5 of this submission.

¹ <http://www.apra.gov.au/Insight/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=7098> , last accessed 10 June 2004.

² <http://www.pc.gov.au/inquiry/ncp/tor.html> , last accessed 10 June 2004

4 National Competition Policy Issues

4.1 NCP Progress to date

In spite of a decade of NCP, there has been little progress in regards to general insurance markets in Australia. As noted by a recent National Competition Council (NCC) report, public sector intervention in the premium setting process is commonplace and serves only to distort the incentives that risk-based pricing creates. Indeed, in NSW and Victorian Workers' Compensation there has been an entrenchment of public monopoly rather than movement towards a competitively neutral outcome.

Despite the lack of reform, there have been few formal findings, and even where blatant breaches have occurred, such as when the planned privatisation of NSW Workers Compensation was first deferred and then later cancelled without a formal NCP review, there have been no negative consequences.

In short, the process has failed Australian consumers, insurers and taxpayers.

A summary of the current state of CTP and Workers Compensation insurance in the States and Territories is at Appendix 1.

4.2 Future Directions for NCP

ICA proposes that for general insurance, NCP should have two objectives:

1. The removal of anti-competitive restrictions; and
2. Competitive neutrality for Government Business Enterprises (GBEs).

State and Territory Governments have previously undertaken to move towards these but, to date, have failed to move in the direction they agreed.

4.2.1 The removal of anti-competitive restrictions

In its most recent assessment of CTP and workers compensation insurance, the NCC noted that:

Governments tend to set CTP premiums in Australia according to community rating approaches. Workers compensation premiums reflect industry ratings and experience, but also a degree of centralised premium setting and a blunted approach to relating individual employer risk to price. Such premium controls reduce the role of price in influencing safety behaviour and increase premium costs for those employers and drivers who have good safety records. In this way, insurance holders are not rewarded for good historical performance. The Council believes that the benefits of risk-related premiums are potentially important and worthy of further consideration by jurisdictions.³

ICA supports the view of the NCC, but notes that in CTP the arguments for community rating are stronger than for Workers Compensation. However, the use of community rating in CTP need not be at the expense of the competitive dynamic and NSW is a good example of how the two approaches can be applied simultaneously.

³ National Competition Council, 2002, "2002 Assessment of governments' progress in implementing the National Competition Policy and related reforms - Volume One: Assessment", p. 9.11., available at: <http://www.ncc.gov.au/pdf/AST4As-010.pdf>, last accessed 9 June 2004.

4.2.2 The promotion of competitive neutrality

In addition to the removal of anti-competitive restrictions, ICA would like to see all the existing public systems move towards competitive neutrality as described by the Australian Government Competitive Neutrality Complaints Office (AGCNCO). The AGCNCO defines competitive neutrality as a situation where GBEs:

- Charge prices that fully reflect costs;
- Pay, or include an allowance for, government taxes and charges such as Goods and Services tax, payroll tax, stamp duties and local government rates;
- Pay commercial rates of interest on borrowings;
- Generate commercially acceptable profits; and
- Comply with the same regulations that apply to private businesses⁴.

ICA expects that the State and Territory governments will argue that the impact of moving to competitive neutrality is higher prices for consumers. This, in itself, is no reason to resist reform and in any event is not necessarily an outcome of such reform.

However, the effects of continued public operation with no regard for appropriate pricing are known and include:

- Massive unfunded liabilities (eg NSW, South Australia and Victoria Workers Compensation)
- The costs of past and current injuries being transferred to future employers and new businesses, and
- The incentives of the "free market" being blurred, if not removed completely.

ICA sees the achievement of competitive neutrality an outcome in itself, but also an important and necessary step on the path to a privately underwritten market. Competitive neutrality is one of 7 steps on the path to privatisation that ICA has identified. If you start with the **status quo** and then have **effective reform**, you will eventually achieve **competitive neutrality**. Over time, this should lead to **stability** and then some indication of **profitability** which will give the providers of **capital** enough confidence to enter these markets and thus achieve **privatisation**.

ICA cannot emphasise enough the importance to be placed on achieving true competitive neutrality and an environment that, to the extent possible, is devoid of anti-competitive restrictions and operates with a competitive dynamic. Where this to be achieved it would be of significant benefit to consumers and a major achievement for NCP.

⁴ <http://www.pc.gov.au/agcnco/competitiveneutrality.html> , last accessed 9 June 2004.

5 Microeconomic reform issues

ICA strongly supports the package of reforms recommended by the HIH Royal Commission as creating a solid platform for major regulatory reform and the following key areas of reform would achieve this:

- 1) Extending the benefits of prudential regulation to all areas of insurance and insurance like products, with potential changes to the definition of insurance business in the *Insurance Act*.⁵
- 2) A rationalisation of regulation with APRA being the sole prudential regulator and States and Territories removing overlapping or duplicate requirements in statutory and other classes of insurance.
- 3) The potential for greater affordability of insurance products through removal of insurance taxes and levies and overcoming the tax on tax effect of having GST included in the calculation of stamp duties and FSL. Appendix 2 provides an overview by state of the impact of government taxes on insurance premiums.
- 4) A safety net for policyholders in the unlikely event of a future collapse of an authorised general insurer.⁶

These reforms, many of which are currently being considered by the government, are viewed by ICA as a package as each builds on the other to strengthen the industry, remove impediments to efficiency and enhance the confidence and protection of consumers.

The primary microeconomic reforms that relate to NCP are:

- The confirmation of APRA as the sole prudential regulator of general insurance in Australia, thus removing the unnecessary regulatory duplication that currently exists; and
- The reduction and, ideally, abolition of taxes on general insurance such as State and Territory Stamp Duties and, where applicable, Fire Services Levies (FSL). In this regard, ICA draws the Commission's attention to the HFE methodology employed by the CGC and argues that in its current form it retards any meaningful reform of insurance taxes at the State and Territory level. Combined rates of tax on tax operate effectively at the level of penalty rates for what is essentially a community good.

The positions put forth by ICA in this submission are consistent with many of the recommendations of the HIH Royal Commission and specific details can be found at Appendix 3.

5.1 APRA as the sole prudential regulator

The HIH Royal Commission found that duplicative prudential regulation in Australia is unnecessary and only imposes additional compliance costs on insurance and hence consumers. ICA and the HIH Royal Commission recommend that:

⁵ Further information on this element of the package, if required, can be obtained from ICA.

⁶ Further information on this element of the package, if required, can be obtained from ICA.

- State and Territory governments should remove nominal defendant and nominal insurer schemes relating to the failure of a general insurer in statutory classes of insurance;
- The capacity for State and Territory governments to legislate in any way which impacts on the capital, profit or solvency of authorised insurers should be removed, and;
- APRA should be the strong, central and sole regulator of capital and solvency for general insurers in Australia. This would remove regulatory overlap and confusion, jurisdictional discrepancies and improve insurers' confidence as they price and write policies.

5.2 The reform of insurance taxation

Economists often talk of the features of a "good tax". Professor Joseph Stiglitz, acknowledged expert on the economics of the public sector and Nobel Laureate for Economic Sciences⁷, has identified a good tax as having five characteristics, namely economic efficiency, administrative simplicity, flexibility, transparency or political responsibility and fairness.⁸

Table 1 (overleaf) evaluates State and Territory Stamp Duties and the Fire Services Levy (where it exists) on insurance.

5.2.1 Stamp duties on insurance

ICA notes that in 2003/04 the State and Territory Government's in Australia are collectively anticipating the receipt of over \$2 billion in stamp duties on insurance policies alone.⁹

For reasons summarised in Table 1, ICA proposes that stamp duties on general insurance be abolished.

5.2.2 The Fire Services Levy

FSL affects the operation of competitive insurance markets in Australia because sophisticated purchasers of insurance are able to access risk cover through Discretionary Mutual Funds (DMFs), Direct Offshore Foreign Insurers (DOFIs) and others and thus avoid the payment of levies as FSL, which are otherwise payable in the general insurance markets.

While FSL is a tax to fund fire services, the deterrent value of the high tax component on insurance (of which FSL is the most significant) can lead to the Government losing revenue by having to provide relief to uninsured or underinsured persons affected by natural disasters.

For the reasons above and in Table 1, ICA has proposed in the recent reviews of FSL in NSW and Victoria that, as an alternative to FSL, fire services be funded through a system based on property values and collected in coordination with municipal rates.¹⁰

⁷ Joseph Stiglitz is currently Professor of Economics and Finance at Columbia University. Professor Stiglitz was awarded the 2001 Nobel Prize for Economic Sciences, see: <http://www.nobel.se/economics/>, last accessed 19 September 2003.

⁸ Stiglitz, J.E., 1988, *Economics of the Public Sector*, 2nd Edition, WW Norton and Co., New York.

⁹ Source: ICA calculation based on a review of the 2003/04 Budgets for each State and Territory in Australia.

¹⁰ Further information on this proposed change, if required, can be obtained from ICA.

Table 1: An analysis of Stamp Duty and the Fire Services Levy

Five Features of a "Good Tax"	Stamp Duties on General Insurance	Fire Services Levies
Economic efficiency: the tax should not prevent efficient allocation of resources, that is, it should not, to the extent possible, distort behaviour	Distorts economic efficiency by being a significant additional cost (a deterrent) on the purchase of appropriate insurance	Distorts economic efficiency by being a <i>significant</i> additional cost (a deterrent) on the purchase of appropriate insurance.
Administrative simplicity: the tax should be easy and inexpensive to administer	Administratively simple to administer. However, once the rate is set, the insurance industry becomes the tax collector	Administratively cumbersome for insurers to calculate as it is done so a year in advance.
Flexibility: The tax system should respond easily to changes in economic conditions	Are rarely amended. ¹¹ As stamp duty is an ad-valorem tax Governments have been quite content to simply apply it and forget it, save for the significant revenue generated	Is inflexible and has not been amended for years to take account of the changing nature of fire services nor of the persons who benefit from or demand those services
Transparency or political responsibility: individuals should be able to ascertain their tax burdens so that burdens can be politically tailored to what society considers desirable	Are only transparent to the extent that it appears as a line on insurance contracts. Those who insure and pay stamp duty are never given any justification for the precise amount levied upon them other than it represents a fixed percentage of their base premium	Is only transparent to the extent that it appears as a line on insurance contracts. As a result of the mechanism that has been put in place those who pay the FSL are never given any justification for the precise amount levied upon them nor how it relates to either the fire risk that they represent or the fire services available to them
Fairness: the tax system should be fair in its treatment of different individuals. Horizontal equity deems that individuals who are the same in all relevant aspects should be treated equally, whilst vertical equity holds that individuals who are better able to pay higher taxes should bear a higher share of total taxes. ¹²	Are unfair and inequitable as they are based on insurance premiums which are discretionary expenditure and thus can easily be avoided	It is unfair and inequitable as it is based on insurance premiums which are discretionary expenditure and thus FSL can easily be avoided

¹¹ In August 2002 NSW reduced its stamp duty rate from 10% to 5%. Unfortunately this lead has not been followed by the other jurisdictions and NSW remains the leader in the reform of stamp duties on insurance. Indeed, in 2003 WA increased its stamp duty on general insurance from 8% to 10%. Queensland has announced a reduction from 8.5% to 7.5% as of 1 August 2004.

¹² Stiglitz, J.E., 1988, Economics of the Public Sector, 2nd Edition, WW Norton and Co., New York., pp. 390-408.

5.2.3 The CGC's HFE Methodology as a disincentive to state taxation reform

HFE is a process through which the CGC purports to provide the States¹³ with equal *capacity* to provide services. States with below average revenue-raising capacity or above average spending needs may receive a larger share of GST. HFE redistributes resources from the states that the CGC deems as having above-average capacity to provide services, to those it deems with below-average capacity to provide services.

In determining how much capacity there is and what is "above" and "below" average revenue raising capacity the CGC looks at a weighted average of revenues on a per capita basis by State.

It is essential to note that HFE looks only at capacity to raise revenue – not what actually occurs. HFE is supposed to be "policy neutral" in a revenue sense.

The problem with this is that it discourages the reform of state taxes

Looking at stamp duty on insurance specifically, it is easy to see how the use of a national weighted average discriminates against a state with low levels of stamp duty. Despite being the largest single "market" in Australia, NSW stamp duty revenue is invariably below the national average (when expressed on a per-capita percentage basis).

As such, when the CGC applies HFE it does so on the basis that NSW is collecting more stamp duty on insurance than it actually is. That is, the CGC focuses on the capacity it has identified and ignores what actually happens.

The current system creates a clear disincentive on all States for reducing stamp duty on insurance unilaterally as any reduction would only either bring them towards the national weighted average, or (in the case of a jurisdiction like NSW which is already below average) move them further away from the national average.

The disincentive exists because under the current HFE methodology, any State that is below average is deemed to be collecting more revenue than they actually do and, other things being equal, therefore have a reduced need for GST.

Similarly, states with above-average levels of stamp duty are better off.

¹³ States meaning "States and Territories"

6 Concluding Comments/Recommendations

ICA sees the greatest benefits from NCP coming from the removal of restrictions that distort the competitive dynamic and therefore asks that the following NCP related reforms be recommended by the Commission:

- The removal of unjustified restrictions on competition; and
- The achievement of competitive neutrality, as defined by the AGCNCO, for the currently publicly underwritten statutory classes of insurance in the States and Territories.

ICA is also of the view that broader microeconomic reform is justified under the Terms of Reference and that two reforms in particular be pursued, as a part of a broader package, as a matter of priority:

- The recognition of APRA as being the sole prudential regulator of general insurance in Australia with the States and Territories absenting themselves from this area of regulation; and
- The abolition and/or minimisation of State and Territory Stamp Duties on general insurance contracts and, where applicable, the removal of the FSL. The current system used by the CGC to calculate States' and Territories' respective shares of GST is a material disincentive to effective taxation reform and supports moves to restructure the process such that innovation in taxation is not punished.

Appendix 1 – The status of statutory classes in the States and Territories

Queensland	Workers Compensation	<ul style="list-style-type: none"> ▪ Government monopoly ▪ Regulatory functions removed from WorkCover to Q-Comp ▪ No direct private sector involvement ▪ No private sector involvement
	CTP	<ul style="list-style-type: none"> ▪ Private underwriters ▪ Regulatory and structural barriers to competition ▪ Very minor change after NCP review
NSW	Workers Compensation	<ul style="list-style-type: none"> ▪ Public underwriting ▪ Privatisation in 1999 deferred, then cancelled ▪ McKinsey Review further entrenches role of WorkCover Authority ▪ Insurers will become contracted service providers to WorkCover
	CTP	<ul style="list-style-type: none"> ▪ Private underwriters ▪ Some capacity for competition ▪ Satisfied NCP tests
Victoria	Workers Compensation	<ul style="list-style-type: none"> ▪ Public underwriting ▪ Privatisation from "appointed day" removed from legislation ▪ Insurers operate as contracted claims managers
	CTP	<ul style="list-style-type: none"> ▪ Public underwriting ▪ TAC is pure monopoly ▪ No effective change following NCP review
Tasmania	Workers Compensation	<ul style="list-style-type: none"> ▪ Private underwriting and competitive ▪ Little restriction on competition
	CTP	<ul style="list-style-type: none"> ▪ Public underwriting ▪ MAIB is pure monopoly ▪ No effective change following NCP Review ▪ Pricing subject to review by GPOC
South Australia	Workers Compensation	<ul style="list-style-type: none"> ▪ Public underwriting ▪ Insurers appointed as claims agents only ▪ No effective change following NCP review
	CTP	<ul style="list-style-type: none"> ▪ Public underwriting ▪ One insurer appointed as claims manager ▪ No effective change following NCP review
Western Australia	Workers Compensation	<ul style="list-style-type: none"> ▪ Private underwriting ▪ Competitive market
	CTP	<ul style="list-style-type: none"> ▪ Public underwriting ▪ ICWA is pure monopoly ▪ No effective change following NCP review
ACT	Workers Compensation	<ul style="list-style-type: none"> ▪ Private underwriting ▪ Competitive market
	CTP	<ul style="list-style-type: none"> ▪ Private underwriting ▪ One insurer only, others can apply to participate
Northern Territory	Workers Compensation	<ul style="list-style-type: none"> ▪ Private underwriting ▪ Competitive market
	CTP	<ul style="list-style-type: none"> ▪ Public underwriting via TIO ▪ No private sector participation ▪ No change following NCP review

Source: ICA

Appendix 2 - Impact of Government Taxes on Insurance Premiums

Appendix 3 – ICA consistency with HIH Royal Commission Recommendations

The policy positions promoted by ICA in this submission are entirely consistent with the following HIH Royal Commission recommendations:

Recommendation 42 – that the Commonwealth Government amend the *Insurance Act 1973* to extend prudential regulation to insurance-like products, to the extent possible within constitutional limits.

Recommendation 49 – that APRA be the sole prudential regulator of general insurance

Recommendations 51 and 52 – propose that the States and Territories reduce inconsistencies in their statutory schemes, and apply relevant prudential requirements to government insurers and statutory fund schemes

Recommendation 53 – propose that the States and Territories consider allowing greater price flexibility in their statutory schemes, and progress this through the proposed Ministerial Council or like arrangement

Recommendation 55 – propose that the States and Territories abolish stamp duty on general insurance products

Recommendation 56 – that those States and Territories that have yet to do so, abolish FSL

Recommendation 57 – that GST be excluded for the purposes of calculating stamp duties or any other state and territory levies that are imposed on insurance premiums

Recommendation 61 – that the Commonwealth Government introduce a policyholder protection scheme where insurance companies fail