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#### Acknowledgements

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**LIST OF ACRONYMS USED**

CFA	Country Fire Authority of Victoria
FSL	Fire Services Levy scheme for funding the fire services
GST	Goods and Services Tax
ICA	Insurance Council of Australia
MFB or MFESB	Metropolitan Fire Brigade, officially known as the Metropolitan Fire and Emergency Services Board
SES	State Emergency Service

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**LIST OF CONTENTS**

	Page
WHY IS THE VICTORIAN GOVERNMENT SO COMMITTED TO RETAINING FSL?	
• Background	4
• Possible reasons for resistance to change	4
LIMITATIONS OF FSL	
• Is FSL good public policy?	6
• Does FSL meet standard criteria for assessing tax systems?	6-10
• The “tax on a tax on a tax” feature of FSL	11
• FSL generates the world’s highest tax rates on insurance	12
• What an “off-budget” source of revenue means for the Government	12
• Why FSL is ultimately unsustainable	13
• Explaining under- and over-collections of contributions	13
• Would further assessment of non-insurance help?	
SCRUTINISING GOVERNMENT ARGUMENTS IN SUPPORT OF FSL	
• “FSL is not a tax imposed by government”	15
• “Insurance should pay because insurance benefits”	15
• “Other (non-FSL) schemes offer less incentive for fire risk management”	16
• “Many would pay more under a property-based scheme”	16
• “Other funding schemes have higher administration costs”	16
ASSESSING THE 2002/03 REVIEW OF FIRE SERVICES FUNDING IN VICTORIA	
• The absence of detailed quantitative modelling	18
• Unnecessary link with fire risk	18
• Summary of the biases favouring FSL	19-29
• Seeking an explanation for the inadequacies of the Treasury review	29
• The Government’s 2009 Green Paper	30
EVALUATING OTHER FUNDING OPTIONS	
• Principles of assessment	31
• Queensland model	31
• South Australian model	31
• West Australian model	32
• General assessment	32
FINDINGS, CONCLUSIONS AND RECOMMENDATIONS	33
ATTACHMENTS	
1. Earlier reviews of fire services funding	34
2. Estimate of Government’s stamp duty windfall from FSL in 2009/10	36
3. Tabular summary of bias, errors and unsupported conclusions in the 2002/03 review	39

## WHY IS THE VICTORIAN GOVERNMENT SO COMMITTED TO RETAINING FSL?

### Background

In Victoria over many years, a number of official and independent reviews have recommended replacement of FSL with more equitable, broader-based funding arrangements.<sup>2</sup>

Despite this consistent recommendation, successive Victorian governments of different political flavours have resisted the call for change.

Government resistance to change was particularly noticeable in 2002/03 when the Department of Victorian Treasury and Finance undertook a review of fire services funding. The review recommended retention of FSL but was deficient in its methodology and heavily biased in favour of FSL in its assumptions and analysis. The credibility of its findings and recommendations was compromised.<sup>3</sup>

The refusal of successive Victorian governments to seriously consider changing the fire services funding model has continued despite:-

- Widespread recognition of fundamental failings of FSL, as described in the various reviews.
- A progressive worsening of the adverse effects of FSL, as reflected in rapidly increasing, penal levels of taxation on property policies, particularly in rural areas,<sup>4</sup> and evidence of significant levels of non-insurance in areas devastated by bushfire.
- A move to broad, property-based funding schemes in a number of states and territories that are more efficient, equitable, simple and transparent than the FSL schemes they replaced.<sup>5</sup>

In the face of growing pressure, why have Victorian governments been so resistant to change?

### Possible reasons for resistance to change

I believe there are three major factors influencing governments' decisions to resist replacement of FSL, none of which bears any relationship to the reasons typically advanced by government.<sup>6</sup>

- The principal reason appears to be the considerable benefit accruing to government from the fact that FSL generates significant levels of tax revenues (\$509 million in 2009/10<sup>7</sup>) and that these revenues, sourced through the insurance industry, are "off-budget".

Being off-budget means the funds are not subject to parliamentary scrutiny: decisions about FSL matters can be made administratively by the Government. This gives the Government freedom and flexibility in setting the level of insurer contributions and in allocating them.

A related reason for Victoria's continued resistance to change while other jurisdictions have replaced their FSL schemes could be that Victoria is more densely settled and consequently has a

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<sup>2</sup> See the Attachment to this submission, page 34., "Earlier reviews of fire services funding".

<sup>3</sup> See pages 18-29 in this submission for a description of the limitations of the review.

<sup>4</sup> See page 12 in this submission.

<sup>5</sup> Queensland, South Australia and Western Australia replaced their FSL schemes with broad property-based funding arrangements, while the ACT, which previously funded its fire service from consolidated revenue, recently also introduced a property based funding arrangement. See details on pages 31-32.

<sup>6</sup> The government's stated reasons are discussed in detail on pages 15-17.

<sup>7</sup> See the Government's Green Paper, "Fire Services and the Non-Insured", page 6.

greater capacity to generate funds (dollars per brigade) than other states. This would make FSL comparatively more attractive to government in Victoria than elsewhere.

- A second important, likely reason for the government's strong commitment to FSL is the significant stamp duty windfall provided by FSL.

The windfall arises from an extraordinary methodology used for calculating stamp duty liabilities. Under FSL, stamp duty liabilities are not assessed against risk premium (ie the insurer's operating income from a policy) but against a value constructed by compounding risk premium by GST and compounding that result in turn by the FSL rate. This is the infamous "tax on a tax on a tax" feature of FSL.<sup>8</sup>

When the FSL tax rate is 84% (the rate currently applying to commercial properties in the CFA region), for example, the effective the stamp duty rate is 20.24%, more than twice the nominal stamp duty rate of 10%.<sup>9</sup>

The Victorian Treasury advised that an extra \$25 million was collected in 2002/03 as a result of the tax on a tax on a tax feature of FSL.<sup>10</sup>

I estimate that the stamp duty windfall to the Government from FSL in 2009/10 has doubled in size to around \$51 million.<sup>11</sup>

- A third significant advantage provided to government by FSL is that, since insurers collect FSL contributions from policy holders on behalf of the government and remit accumulated contributions direct to the fire services, the government's administration and collection costs associated with fire services collections are practically nil.

It would appear that the large, off-budget, revenue generating capacity of FSL, the stamp duty windfall and the absence of administration costs have provided sufficient incentive for Victorian governments over many years to hold tight to FSL, regardless of its effects on the community and despite pressures for change.

To successfully resist change, however, successive Victorian governments have had to ignore burgeoning problems that FSL poses for the Victorian community. These problems are described in the following section.

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<sup>8</sup> See comment on the "tax on a tax on a tax" phenomenon on page 11 of this submission.

<sup>9</sup> See the calculation on page 11 of this submission.

<sup>10</sup> See the report of the Victorian Treasury review of fire services funding, 2002/03, page 70.

<sup>11</sup> See the calculation of the estimated 2009/10 stamp duty windfall on pages 36-38 of this submission.

**LIMITATIONS OF FSL**

Are there any limitations for FSL? What are the main problems associated with it?

**Is FSL good public policy?**

The fire services levy scheme in Victoria:-

- Taxes part of the community, insured property owners, for the benefit of the whole community, including non-insured and under-insured property owners.
- Generates the highest levels of tax on insurance in the world<sup>12</sup> – up to 123% at present<sup>13</sup> - with tax rates continuing to rise.
- Distorts the insurance market.<sup>14</sup>
- Is complex and difficult to understand, especially for tax payers.<sup>15</sup>
- Lacks transparency.<sup>16</sup>
- Because of its high and increasing tax rates, ultimately is unsustainable.<sup>17</sup>

Given these problems in design and outcome, could FSL be considered as good public policy?

**Does FSL meet standard criteria for assessing tax systems?**

Contrary to Victorian Government assertions,<sup>18</sup> the FSL scheme is a system of indirect tax imposed on property insurance policy holders by the state government.<sup>19</sup> Insurers administer the tax scheme for the Government.

The standard economic criteria for assessing tax systems are tax efficiency, equity, simplicity and transparency. Sustainability is usually also a key consideration. How does FSL measure up against these standards?

*Tax efficiency of FSL*

An efficient tax is normally defined as one that minimises the impact on consumer and producer behaviour and therefore does not distort the efficient allocation of resources.

FSL rates currently extend up to 84% in Victoria,<sup>20</sup> creating total tax rates (GST compounded by FSL compounded by state stamp duty) of up to 123%<sup>21</sup>. These are the highest tax rates on insurance in the world and, as will shortly be demonstrated, they are increasing quickly.

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<sup>12</sup> See ICA Submission to the Victorian Parliamentary Economic Development & Infrastructure Committee Inquiry Into State Government Taxation & Debt, October 2009, page 15.

<sup>13</sup> See page 11 in this submission.

<sup>14</sup> See ICA report, "Non Insurance: Who, Why & Trends", page 1.

<sup>15</sup> Few people, including tax payers, would understand, for example, how FSL rates are determined. As discussed later in this submission, even the Victorian Government appears to misunderstand why insurers sometimes over-collect FSL contributions amounts.

<sup>16</sup> The basis for determining amounts of upcoming fire services budgets, the greater part of which insurance policy holders fund through fire services contributions, for example, is not publicly advised or discussed with the insurance industry.

<sup>17</sup> See comment in this submission, page 13.

<sup>18</sup> For example, see Victorian Treasury review of fire services funding, 2002/03, page 22, "FSL is not a tax imposed by government".

<sup>19</sup> See page 15 in this submission for a discussion of this issue.

<sup>20</sup> For commercial property policies in the CFA region.

<sup>21</sup> A \$100 risk premium compounded by GST, FSL and stamp duty ( $\$100 \times 1.1 \times 1.84 \times 1.1$ ) gives a total premium, inclusive of tax, of \$223. The tax rate applied to risk premium, in this case, is 123%.

In 2002/03, at the time of the Government's last review of fire services funding, the equivalent FSL rate was 47% and corresponding total tax rate was 78%. The FSL rate has increased by 79% in this time.

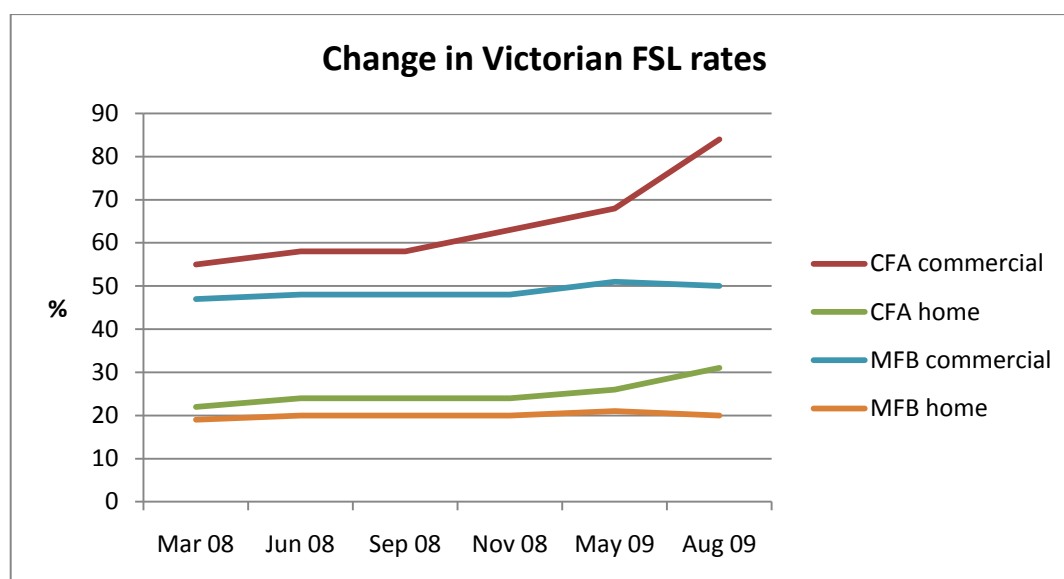
Hidden in the progression of FSL rates in Victoria over the past 18 months is interesting evidence regarding the lack of tax efficiency of FSL.

### Change in Victorian FSL rates

Policy type	Recommended FSL rates notified ...					
	Mar 08	Jun 08	Sep 08	Nov 08	May 09	Aug 09
	%	%	%	%	%	%
<b>CFA</b>						
Commercial	55	58	58	63	68	84
Home	22	24	24	24	26	31
<b>MFB</b>						
Commercial	47	48	48	48	51	50
Home	19	20	20	20	21	20

Source: Derived from Insurance Council of Australia FSL rates recommendations to insurers.

This data on FSL rates is represented in graphical form as follows.



The obvious feature of this graph is the difference in the rates of change in FSL rates between CFA and MFB. While MFB rates remain reasonably constant over the 18 month period, CFA rates increase significantly, particularly for commercial policies rates but also for residential, from September 2008.

To understand how these changes in FSL rates indicate changes in tax efficiency, we need first to consider some simple mathematics about how FSL rates are derived.

Total insurer contributions to the fire service are determined for the year ahead by the Government when it sets the CFA and MFB budgets. Insurers engaged in the property insurance market must contribute to the fire services' budgets in percentages determined by law.<sup>22</sup>

Insurers recover (actually fund) their contributions to the fire services by applying a rate – the fire services levy – to their premium income. In very simple terms ...

$$\text{Total insurer contributions} = \text{Total premium receipts} \times \text{FSL rate}$$

By transposition ...

$$\text{FSL rate} = \frac{\text{Total insurer contributions}}{\text{Total premium receipts}}$$

As indicated by this equation, an increase in FSL rates, by and large, will reflect either (or both):-

- a) An increase in the value of the numerator (total insurer contributions) – which essentially will be an increase in a fire service's budget, or
- b) A reduction in the value of the denominator (total premium receipts) – essentially a decline in insurance policy renewals and/or a reduction in sums insured.

Taking this explanation into account, the very large increases in FSL rates for the CFA region, advised by the ICA in August 2009 (see table above), would reflect in large part the 35% increase in the CFA budget for 2009/10 which came into effect on 1 July 2009, although reductions in premium receipts are also likely to have had an effect.

From a tax efficiency perspective, however, the interesting data are the equally significant increases in FSL rates in the CFA region from September 2008 to May 2009, which took place over a period when the CFA budget did not change.

Since the CFA budget did not change in this time, the essential reason for the increase in FSL rates must lie with a decline in total premium receipts, resulting from a fall in policy renewals and/or a reduction in sums insured.

Anecdotal evidence from insurers confirms an increase in non-renewals and a trend to lower sums insured in the rural property insurance market in this period.

While a number of factors influence the uptake of insurance, including cash flow problems arising from the prolonged drought and the global financial crisis, increasing costs of insurance would exacerbate an already difficult financial situation. Insurance is a discretionary item of expenditure so, for policy holders in financial difficulty, higher insurance taxes would be an incentive to reduce sums insured or not renew policies at all.

The sharp increases in FSL rates illustrated in the graph above reflect in part reductions in total premium receipts and thereby provide striking evidence of the tax inefficiency of the FSL scheme.

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<sup>22</sup> Prescribed in the CFA Act 1958 and MFB Act 1958. Insurers must contribute 77.5% of the CFA budget and 75% of the MFB budget.

The poor tax efficiency of FSL has been addressed in a number of published reports, including recent papers by the Insurance Council of Australia.

- In a submission to the Victorian Parliamentary Economic Development and Infrastructure Committee Inquiry into State Government Taxation and Debt (October 2009) the ICA stated, “ ... taxes on insurance represent one of the most inefficient of all Victorian State taxes, meaning that not only do insurance taxes detract from the prudent take up of insurance, they result in large deadweight costs to the Victorian economy and represent a drag to economic well being.”<sup>23</sup>
- In its paper, “Non Insurance: Who, Why & Trends”, the ICA demonstrated, among other things, that affordability is a significant constraint on insurance and that state taxes impact on insurance affordability and, in turn, on levels of non insurance.<sup>24</sup>

There is ample evidence of the lack of tax efficiency of FSL.

#### *Equity of FSL*

An outstanding feature of FSL is that part of the community – those who insure their property – subsidises the fire services for all the community, including those who do not insure and who under-insure.

Not only do insured property owners subsidise those who do not insure and who under-insure, they are penalised by being taxed at world-record high and increasing rates.

Even among insured property owners who, by definition, contribute to FSL, there is discrimination. As the table on page 7 demonstrates, insured property owners pay significantly higher levels of tax in the CFA region than they do in the MFB region, despite having generally lower levels of fire service.

The Government argues that equity is restored in part by the fire services charging the uninsured for the cost of call-outs.<sup>25</sup>

The real situation is more prosaic. The fire services have a degree of discretion in charging costs and, even when recoveries are claimed, full costs are rarely recovered:<sup>26</sup>

*“Achievement of full cost recovery by increased charges will be difficult to achieve in practice ... Compliance and bad debt difficulties will also increase as charges rise.”<sup>27</sup>*

As the community saw in the aftermath of Black Saturday, sometimes it is impractical, in both human terms and politically, to charge for call-outs at all. Cost recoveries, in fact, have limited value in increasing fire services’ income and, consequently, little material effect in reversing the inequities of FSL.

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<sup>23</sup> ICA report, page 1

<sup>24</sup> See ICA report, “Non Insurance: Who, Why & Trends”, page 1.

<sup>25</sup> Government Green Paper, “Fire Services and the Non-Insured”, October 2009, page 7.

<sup>26</sup> Victorian Treasury review of fire services funding, 2002/03, page 66.

<sup>27</sup> Ibid, page 66.

There are other considerations relating to equity:-

- While an uninsured property owner might be charged part of the cost of a call-out, that payment will be a one-off event. People who insure their property, on the other hand, make regular contributions to the fire services through the FSL charge on property premiums, typically for many years. Most will never make a call on the fire services.
- The provision of government compensation payments and public donations following a major catastrophe like Black Saturday create “moral hazard” for government and the community, reducing to some extent the incentive for property owners to insure their property.

Inequity is a structural weakness inherent in FSL. While insured property owners continue to subsidise contributions to the fire services for the non-insured and under-insured in the community, there can be no equity in the funding of fire services in Victoria. The recoveries of fire services costs make no material difference.

#### *Simplicity and transparency of FSL*

FSL a complex funding arrangement, lacking in transparency, that few people understand.

If a property policy holder wanted to find out, for example, the reasons for the size of the FSL rate on his or her policy, the complexities in the rates calculation process from both a procedural and a mathematical point of view would preclude the policy holder from finding out.

Even the Victorian Government has trouble, it seems, in understanding why insurers sometimes over-collect FSL contributions amounts.<sup>28</sup>

The complexities of FSL include arcane rules to allocate contributions obligations between different classes of insurance, extraordinary arrangements for compounding the application of FSL rates and state stamp duty to risk premium amounts (see an explanation immediately below under “Tax on a tax on a tax effect”), special arrangements that try to capture tax revenues from insurance placed outside Australia and an FSL rate setting mechanism that is incapable of generating precise revenue amounts.

The lack of transparency of FSL relates to its complexity. A direct consequence of the lack of transparency is that FSL is a difficult system to audit. The Government can never be sure, for example, that all policies placed offshore are contributing fully to the scheme. While legislation requires such contributions to be made, compliance depends on the goodwill of insurers, brokers and the insured. I am not suggesting for a moment that there is a high rate of non-compliance. My point is that the Government has no real way of knowing.

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<sup>28</sup> See pages 13-14 of this submission for an explanation of the under-collection and over-collection issue associated with calculating FSL rates.

### The “tax on a tax on a tax” feature of FSL

The FSL scheme includes an extraordinary method of calculating tax liabilities on the risk premium that insurers charge their policy holders. The method is described as the “tax on a tax on a tax” feature of FSL. Its effect is to increase the effective tax rates of FSL and state stamp duty.

Calculation of contributions amounts under FSL requires:-

- GST (10%) to be applied to the risk premium amount of an insurance policy.
- The appropriate FSL rate to be applied to the risk premium amount compounded by GST.
- The state stamp duty rate to be applied to the risk premium amount compounded by GST and compounded again by the FSL rate.

Because of the compounding nature of the tax calculations:-

- The effective FSL rate is 1.1 times the nominal FSL rate because GST increases the risk premium base by 10%.
- The effective stamp duty rate currently is up to twice the nominal stamp duty rate, because the risk premium amount against which stamp duty is charged is inflated first by GST and then compounded by the FSL rate.

As shown in the table below, when the FSL tax rate is 84%, the effective the stamp duty rate is 20.24%, more than twice the nominal stamp duty rate of 10%.

The following example of the “tax on a tax on a tax” calculation method uses the current FSL rate of 84% levied on farmers and other commercial policy holders in rural areas:-

	Tax rate	Tax amount	Cumulative tax amount
Risk premium (assume \$100 for calculation purposes)		\$100.00	\$100.00
GST	10%	10.00	110.00
FSL (Rate for commercial policies in rural areas)	84%	92.40	202.40
Stamp duty	10%	20.24	222.64
Total gross premium		222.64	

In each step of the calculation process, the relevant tax rate is applied against the cumulative tax amount rather than the risk premium.

**FSL generates the world's highest tax rates on insurance**

The confluence of rapidly increasing fire services budgets, a limited and, in some rural regions, possibly a declining tax base and the tax-inflating effects of the “tax on a tax on a tax” feature of FSL together generate the world's highest tax rates on insurance.<sup>29</sup>

As mentioned, tax on property insurance policies in Victoria currently extend to 123%.

The extraordinarily high tax rates effectively place FSL in the same public tax policy framework as alcohol and tobacco. In view of the tax rates applied to property policies, it is difficult to believe insurance is considered to be a public good, an essential risk management tool for the community.

A funding system that has to charge penal levels of tax to meet its revenue generating requirements is not only tax inefficient, it is ultimately unsustainable.

**What an off-budget source of revenue means for the Government**

As mentioned, FSL is an “off-budget” source of revenue for the Government, which means FSL revenues are not part of the state budget and do not require the consideration and approval of parliament. Decisions about FSL, including the size of insurer contributions, are an administrative matter for the Government.

Government has to refer to parliament only those parts of the fire services budgets – 12.5% of the MFB budget, 22.5% of the CFA budget - for which it is responsible.

Not only does the Government not have to consult with parliament about FSL contributions, it does not consult with the community that has to pay the FSL contributions or with the insurance industry which administers the FSL scheme for the Government.

Increases in the CFA budget, in particular, have been huge. The budget grew by some 35% in 2009/10 alone, reflecting in large part the Government's response to the Black Saturday fires.

The level of increase in CFA budgets over a longer period has also been impressive. From \$160.4 million in 2001/02,<sup>30</sup> immediately before the Government's last review of fire services funding,<sup>31</sup> the budget has grown to \$391.2 million in 2009/10<sup>32</sup>, representing a compound annual growth rate over the intervening eight years of 11.8%.

These are extraordinary rates of growth on both an annual and a sustained, multi-year basis. They are possible in large part because the Government has to consult with no-one in setting new budget levels for the fire services. The lack of accountability is a primary reason for the large increases in FSL rates.

This is not an argument that the fire services should not be adequately funded. It is an argument that because the FSL funding system lacks transparency, is not open to scrutiny and can be used to generate whatever revenues the Government wants without reference to the community that provides the funds, FSL rates will continue to increase.

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<sup>29</sup> See ICA Submission to the Victorian Parliamentary Economic Development & Infrastructure Committee Inquiry Into State Government Taxation & Debt, October 2009, page 15.

<sup>30</sup> Source: Auditor General's Office

<sup>31</sup> The review was carried out by the Victorian Department of Treasury and Finance in late 2002 and early 2003. The report was published in July 2003.

<sup>32</sup> Green Paper, “Fire Services and the Non-Insured”, October 2009, page 6.

31 December 2009

As FSL rates and therefore total taxes on insurance rise to even more stratospheric levels, the capacity of the tax base to meet the new fire services funding requirements will deteriorate.

### **Why FSL is ultimately unsustainable**

As tax rates on policies increase, affordability of insurance falls. And as affordability and uptake of insurance fall, rates must increase to replace insurer contributions lost. High and accelerating FSL rates and their negative effects on the uptake of insurance become locked together in a destructive spiral.

Total insurance tax on farmers and other commercial policy holders in the CFA region is already 123%, up from 78% in 2002/03. As fire budgets increase and total premium receipts erode, the rate of increase in tax rates is likely to accelerate – as represented by the rising slope on the graph on page 7 - because of limits to the elasticity of demand for insurance.

Dependence on a shrinking tax base for increasing amounts of revenue would not enhance sustainability of any funding arrangement. The accelerating slope in the graph presents a clear danger signal, suggesting that the FSL scheme may have passed the tipping point and be heading towards collapse.

### **Explaining under- and over-collections of FSL contributions**

The Government informs insurers of their contributions obligations for the year ahead at the beginning of a year. Insurers then remit their funding obligations to the fire services in four equal quarterly instalments.

Once insurers receive notification of their funding obligations, they have to determine what FSL rates they will apply to their policies to generate the required amount of recoveries.

The rates calculation process necessarily involves insurers (in fact, the ICA on behalf of insurers) making assumptions about future market conditions, including levels of demand, movements in premium income and changes in product mix. The calculation of FSL rates, therefore, is based not on certainties but on predictions.

Once it calculates revised rates, the ICA provides them to insurers in the form of a recommendation. Insurers are free to apply whatever rates they decide are necessary to generate their contributions to the fire services.

Because the insurance market is dynamic and complex, unfolding market conditions will never match precisely the assumptions that were made about them in advance. Insurers change market strategies, new products emerge, product mix changes, consumer preferences change and the external economic environment changes. These and other market factors can never be predicted with certainty.

This means it is impossible in practice for insurers to collect precisely the amount that they are required to contribute to the fire services. The only certainty is that insurers will either under-collect their contributions, or over-collect them.

When insurers under-collect, they must make up the difference from their own resources, usually from profits. Not unexpectedly, no-one other than the insurers is concerned in these circumstances.

However, when insurers over-collect, they keep the difference. That is when problems arise. It is usually insurance brokers, acting on behalf of their clients, who alert Government to over-collections. The Government normally responds by expressing moral outrage.

As further background to the under-collections and over-collections issue:-

- While insurers are free to apply their own FSL rates, in my work with the ICA I was not aware of any insurer that did not apply the ICA-recommended rates. Why is this?

The property insurance market is fully supplied and highly competitive. If insurers were to apply lower FSL rates than those recommended in order to advance their competitive positions, and subsequently under-collect, they would have to make up the difference from their own resources.

If, on the other hand, insurers were to apply rates higher than those recommended, they might benefit their bottom lines in terms of higher FSL collections in the short term, but would sabotage their competitive positions and end up with poorer commercial outcomes overall.

FSL is not a mechanism that confers competitive advantage.

- The ICA changes its recommended FSL rates a number of times during a year to account for changes in market conditions. Insurers are not in a position to finesse FSL rates, beyond those rates changes provided by the ICA, because indications of pending over- or under-collections would not normally become apparent until late in the year. Actual levels of over- or under-collection would not be known until after year-end.
- In the past, Government has suggested that insurers should find ways to pay back over-collected amounts. There is no practical way to do so. Variability of market conditions throughout the year, and changes in FSL rates, product mix, policy terms, sums insured and policy holders would preclude any realistic calculation of what amount an individual policy holder might be “owed”.
- In fairness, there would be little point in dealing with over-collections if there were no balancing process to recover under-collections. However, there is no practical way for under-collections to be pursued – for the same reasons explained for over-collections and because to do so would be to create a competitive nightmare.

In the report of the 2002/03 Treasury review of fire services funding, the Government addressed the over-collections issue. It decided that amounts collected and amounts contributed by each insurer should be published each year by the fire services as a means of improving system transparency.<sup>33</sup> The assumption, presumably, was that insurers could somehow be shamed into doing the impossible - controlling in a precise manner the amounts they collect.

While there is a major problem with transparency within the FSL scheme, it has nothing to do with over- and under-collections.

The problem is intractable: over-collections and under-collections are part and parcel of the FSL model. They exist as a symptom of a structural fault (the expectation that insurance can generate precise tax amounts) and will continue for as long as the FSL system exists.

There was, however, a lighter moment in the over-collections saga. It was explained to the Government that if it, rather than insurers, were to set FSL rates, insurers would pass on the full amounts collected from policy holders and the over-collections problem would disappear instantly. The arrangement would be simple to implement and to administer. The Government refused to countenance the idea.

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<sup>33</sup> See Victorian Department of Treasury and Finance report: July 2003, page 63.

**SCRUTINISING GOVERNMENT ARGUMENTS IN SUPPORT OF FSL**

The Government describes a number of reasons for retaining FSL. None of them bears close scrutiny.

**“FSL is not a tax imposed by government”<sup>34</sup>**

Contributions to the fire services are imposed on insurers by legislation<sup>35</sup>. Each year the Government sets specific contribution amounts for each insurer that sells property insurance and insurers recover their contribution amounts from policy holders by means of the fire services levy scheme. In setting FSL rates to be applied to policy holders, insurers effectively act as agents for the Government in generating the required funds.

This process meets the basic definition of an indirect tax.

*An indirect tax is a tax paid by an entity other than the one on which it is levied. For example, a retail sales tax is an indirect tax collected and remitted to the government by a business even though the tax is ultimately paid by the consumers.*<sup>36</sup>

FSL amounts are collected and remitted to the fire services by insurers even though the tax is ultimately paid by policy holders.

The Government argues that FSL is not a tax because there is no legislative requirement on an insurer to recover its contributions from policy holders.<sup>37</sup>

While it is true that there is no legislative requirement, it strains credibility to suggest that insurers can contribute 75% of the MFB budget and 77.5% of the CFA budget (a total of \$509 million in 2009/10) without recovering these funds from policy holders. Regardless of whether they are described in legislation, recoveries are an integral part of the FSL scheme and the scheme would not work without them.

**“Insurance should pay because insurance benefits”<sup>38</sup>**

Premiums are set for the most part on the basis of claims history. If claims costs were shown to have increased (for example, because of a hypothetical withdrawal of fire services), then premiums would increase to reflect the higher costs. A similar argument applies when claims costs have fallen. Because property insurance is a fully supplied and highly competitive market in Victoria, any sustained reduction in claims costs would be reflected quickly in reduced premiums.

In neither case are insurers' commercial returns likely to be affected in any material way. If anything, returns might increase slightly if the effectiveness of fire services were to decrease substantially, since insurers may need to charge additional premium to cover the higher risk.

The activities of the fire services do not materially benefit commercial returns to insurance companies.

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<sup>34</sup> Victorian Treasury review of fire services funding, 2002/03, page 22.

<sup>35</sup> The CFA Act 1958 and the MFB Act 1958.

<sup>36</sup> “Wall Street Words: An A to Z Guide to Investment Terms for Today's Investor”, David L. Scott. 2003. Ed Houghton Mifflin Company.

<sup>37</sup> Government's green paper, “Fire services and the Non-Insured”, page 6.

<sup>38</sup> See page 11 of the 2002/03 Treasury report, “Insurers benefit from the extinguishment and containment of fires as this directly reduces insurance payouts ... (and) ... directly benefits the commercial returns to insurance companies.” See also page 5 of the government's green paper, “Fire Services and the Non-Insured”

**“Other (non-FSL) schemes offer less incentive for fire risk management”**

In its 2002/03 report, the Government argued that, “It (a property-based funding model) reduces efficiency because there is less incentive for owners of high risk assets to manage those risks.”<sup>39</sup>

There is nothing inherent in the imposition of a tax, even an onerous one like FSL, that strengthens attitudes to fire risk management. Even if this proposition were true, removal of FSL would still leave risk premium and GST for the property owner to pay and, presumably, there would also likely be a fire or emergency services levy imposed to replace FSL.

In any case, property owners who are concerned enough about their financial well-being to insure, are not likely to become less responsible for their financial well-being if the fire services funding scheme changes and they end up with lower insurance premiums.

Nor are there any indications from South Australia, Western Australia or the ACT that their change-over to property-based schemes has led to less responsible attitudes to fire risk among property owners.

In contrast, FSL actually undermines fire risk management to the extent that it inhibits the uptake of insurance, given that insurance is a vital fire risk management mechanism within the community.

**“Many would pay more under a property-based scheme”**

The Government’s 2002/03 report stated that “Most low risk properties that are fully insured are likely to pay significantly more under a uniform rate property levy.”<sup>40</sup>

No evidence was provided in support of this conclusion.

A broader tax base, such as that offered by a property-based funding system, where all beneficiaries of the fire services contribute to their funding, is likely, on the basis of simple arithmetic, to produce lower average contributions rates. If the tax base were widened to include motor vehicles as well as real property, reductions in average payments by real property owners could be even greater.

In practice, actual contributions amounts would depend on the specifics of the funding model chosen. Detailed quantitative modelling would be needed to properly assess different options.

**“Other funding schemes have higher administration costs”**

The Government argues that a property-based system would be administratively more costly than FSL.

*“Administration and collection processes are generally more costly ... under a property-based system, as there are far more direct contributors (ie all property owners) and a separate enhanced database of property owners is needed.”<sup>41</sup>*

The administration costs to government would depend on the specifics of the funding model chosen. However, a proper assessment of administration costs should include costs incurred by all participants in the scheme, including insurers and the insurance industry which, in the case of FSL, can be significant.

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<sup>39</sup> Victorian Treasury review of fire services funding, 2002/03, page 71-72.

<sup>40</sup> Ibid, page 72.

<sup>41</sup> Ibid, page 50.

In South Australia, where an enhanced central bureaucracy was put in place to administer the new scheme, costs ended up higher than expected. But, the South Australian Government made a series of mistakes in designing and implementing the new funding arrangement that led directly to these higher costs.<sup>42</sup>

Western Australia, by contrast, learned from the South Australian experience and put in place a simple and effective administration and collection arrangement based on already existing local government data and collections systems. Once implemented, the new system costs the state government and local government virtually nothing to administer.<sup>43</sup>

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<sup>42</sup> See page 31 of this submission.

<sup>43</sup> See page 32 of this submission.

**ASSESSING THE 2002/03 REVIEW OF FIRE SERVICES FUNDING IN VICTORIA**

In late 2002 and early 2003 the Victorian Department of Treasury and Finance undertook a formal review of fire services funding. Its report was published in July 2003.<sup>44</sup>

A close reading of the report revealed that the methodology was unnecessarily limited and assumptions and analysis were heavily biased in favour of FSL. The conclusions of the report consequently lacked credibility.

The principal shortcomings of the Treasury review are described below.

**The absence of detailed quantitative modelling**

Despite repeated requests from the ICA for detailed quantitative modelling of alternative funding systems to be undertaken as part of the review, Treasury did not carry out the modelling needed.

As a result, there was no basis to compare alternative funding systems in sufficient detail and with enough supporting data to give the comparisons credibility.

Without access to detailed quantitative modelling, Treasury was unable to consider important options for funding systems design not covered under FSL, such as mechanisms to reflect service availability (heavily populated urban locations receive better service than sparsely populated rural areas), minimum levies for vacant land (vacant land is a significant source of fire services call-outs) and adjustments for pensioners and other persons expecting tax relief.

The absence of detailed quantitative modelling also precluded consideration of contributions ceilings and floors, which are a vital component of the successful West Australian scheme.

Funding arrangements for complex communities like Victoria's cannot be assessed credibly by qualitative assessment alone because qualitative assessment cannot provide the depth and spread of data needed to allow confidence in the results of analysis.

**Unnecessary link with fire risk**

A major criterion used for comparative assessment of funding models throughout the Treasury review was the extent to which fire risk is reflected in the different funding mechanisms. FSL, being insurance-based and, therefore, supposedly reflective of fire risk, was ranked high on this benchmark.

However, under FSL in Victoria:-

- Fire risk generates only a minor part of residential property claims: storm damage and theft are more significant perils. In commercial property claims, too, fire risk is not necessarily a major factor.
- According to the Victorian fire services, attendance at "fire only" events constitutes less than 50% of all call-outs.<sup>45</sup>

The link between fire risk and equity of contribution therefore is not strong, even under FSL in Victoria. Treasury's strong and persistent assertions in this regard were unwarranted and the analysis based on this assumption consequently has little merit.

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<sup>44</sup> Victorian Department of Treasury and Finance: A Review of Victorian Fire Services Funding Arrangements, July 2003

<sup>45</sup> See further comments on fire services' callouts on the next page under "Who are the beneficiaries of the fire services?"

With the exception of Queensland, the states and territories that have introduced broad, property-based schemes have done so without including fire risk in their system designs. The equity of their funding systems has not been adversely affected in any way by this intentional omission.

### **Summary of the biases favouring FSL**

Many assumptions and much of the analysis undertaken in the review were strongly biased towards retaining FSL. The report treated FSL leniently but extended harsh treatment to property-based options.

An extensive list of the various items of bias follows.<sup>46</sup>

In general:-

- Major flaws in the FSL scheme were glossed over or not addressed at all, while the assessment of property-based funding schemes was harsh, often focusing on issues of little or no importance to a serious comparison of alternative funding models.
- Emphasis was directed selectively to certain matters such as the link between contributions and benefits and the absence of fire risk management, without considering other important issues such as consideration of expectation of service adjustments to contributions and the benefits of administrative simplicity and transparency.
- Since there was no detailed quantitative modelling, a number of assumptions in the report could not be supported and there was no rigorous consideration and assessment of replacement options or informed comparisons of them with the FSL scheme.
- The review and its report focused on questions of insurance rather than the fundamental issue of what model is best suited to ensuring Victoria has a fair, efficient, simple and transparent funding arrangement that can confidently fund the fire services into the foreseeable future.

While it would have been entirely reasonable to critically compare other funding models against the FSL scheme on the basis of appropriate criteria for the assessment of funding arrangements, it was not reasonable to use insurance mechanisms and concepts, such as fire risk and home contents contributions, as the criteria for assessing models that were not insurance related.

Specifically:-

#### ***Who are the beneficiaries of the fire services?***

*“Those who have high fire risk and expensive property will benefit most from the fire services” (p 7)<sup>47</sup>*

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The activities of the fire services are not limited to fighting fires. The major part of fire services' expenditure relates to infrastructure, standby costs and public education including school visits.

- Even in callouts, dealing with structural fires is not the principal source of activity. In Maribyrnong City Council, for example, of 1,269 callouts in 2000/2001 (most recent statistics at the time of the Treasury review), only 148 or 12% of callouts involved a structural fire. If callouts to systems-

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<sup>46</sup> A tabular summary of biases, errors and unsupported conclusions in the 2002/03 report is included as an attachment on pages 39-42 of this submission.

<sup>47</sup> The statements highlighted in italics are direct quotes from the 2003 Treasury report. The page numbers are the pages on which the quoted statement appears in the report.

generated false alarms (ie not deliberate or malicious false alarms) were included, the figure rose to 23%. Whitehorse City Council, which has a different constituent mix, showed similar results.

- Significantly, most beneficiaries of direct fire services attendance are unrelated to high fire risk or expensive properties.

Those who have high fire risk and expensive property will not necessarily benefit most from the fire services. As mentioned, the fire services have functions other than fire fighting.

The question of who should contribute more to fire services funding is a matter for funding policy.

If it is decided that more expensive properties with higher fire risk should make greater contributions to the fire services, then some equitable nexus is required between those properties and contributions levels. Fire risk is one, but not the only option and, as Queensland has shown,<sup>48</sup> not necessarily the most practical one. Property value is another, as is expectation of service.

This is an example where Treasury inappropriately established an insurance-related consideration, fire risk, to enhance the comparative position of the FSL model.

*“Insurers benefit from the extinguishment and containment of fires as this directly reduces insurance payouts and from greater certainty when assessing fire risk. The longer-term impact of reduced fire losses, resulting from the provision of fire services, directly benefits the commercial returns to insurance companies.” (p 11)*

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As mentioned in the body of this submission<sup>49</sup>, while at first glance this statement might appear to make sense, in fact it is false, reflecting a deep lack of understanding of the insurance mechanism.

Premiums are set for the most part on the basis of claims history. If claims costs were shown to have increased (for example, because of a hypothetical withdrawal of fire services), then premiums would increase to reflect the higher costs. A similar argument applies when claims costs have fallen. Because property insurance is a fully supplied and highly competitive market in Victoria, any sustained reduction in claims costs would be reflected quickly in reduced premiums.

In neither case are insurers' commercial returns likely to be affected in any material way. If anything, insurers' returns might increase slightly if the effectiveness of fire services were to decrease substantially, since insurers may need to charge additional premium to cover the higher risk.

Contrary to the Government's assertions, insurers do not benefit commercially or materially in any other way from the activities of the fire services.

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<sup>48</sup> See page 31 in this submission.

<sup>49</sup> See page 15 in this submission.

*“It is likely that the level of benefits received will largely be linked to the level of resources applied. For this reason, this Report assesses benefits received according to Fire Services resources utilised, in terms of applicable hours.” (p 12)*

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Clearly, manifest benefits in terms of fire suppression activity by the fire services will reflect to some extent the level of resources applied.

But there are errors of judgment in the statement above:-

- First, Treasury considered only *manifest* benefits, as measured by callout hours. They ignored the principal benefit conferred by the fire services which, theoretically at least, is the *potential* support provided to all property and all citizens at all times, the knowledge that the fire services are there if you need them.
- Second, as mentioned before, the fire services provide services other than fire suppression. These services, which are significant in terms of resources used, are not related to fire risk.

While an index of callouts might be a measure of fire services use, it is not a comprehensive measure of fire services' activities,<sup>50</sup> nor is it a relevant criterion for comparative assessment of funding schemes. Other criteria are needed.<sup>51</sup>

*“It is reasonable to assume that the level of fire-related property damage is closely linked to the degree of effort exerted by the Fire Services in attempting to minimise that damage.” (p 12)*

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This statement is presumed to mean that the amount of damage to a property is related to the resources available to the fire services in particular situations, including the ability of a service to attend a particular fire event. It is not clear what Treasury's intent was in making the statement, other than to highlight a link between fire services activity and insurance.

The statement does, however, raise an important consideration in assessment of funding options that was neglected in the Treasury review, that of different levels of expectation of service.

In Queensland, South Australia and Western Australia, expectation of service was a significant consideration in scheme design because fire service resources available within each of these states vary widely depending on location. Inclusion of a consideration for expectation of service automatically conferred greater equity to their funding arrangements.

The same expectation of service consideration applies in Victoria. Within the CFA region, for example, property owners in the Melbourne metropolitan area can expect a higher quality of service and faster call-out times than owners of property located in wilderness areas of NE Victoria or in remote areas of the Little Desert. Yet the basis for charging FSL on each of these properties in a similar category (eg residential property in the CFA region) is the same.

Under the FSL scheme in Victoria, insured property owners in rural (ie non-urban) areas are penalised by paying the same high prices for markedly lower levels of service. This major inequity of FSL would be addressed by consideration of expectation of service.

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<sup>50</sup> See page 19 in this submission, “Who are the beneficiaries of the fire services?”

<sup>51</sup> See page 6 in this submission, “Does FSL meet standard criteria for assessing tax systems?”

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Aligning contributions with fire risk is not the only option available in constructing a funding system, and it is not the best one.

- Including fire risk in a funding model (as Queensland has done) adds a degree of complexity and administrative cost and is not necessary for development of an efficient and equitable funding system.
- The South Australian and West Australian funding schemes have no link with fire risk but, unlike FSL in Victoria, are efficient, equitable, simple and transparent arrangements. They are also sustainable.

As mentioned, a strong emphasis on fire risk creates an inappropriate bias towards an insurance-based scheme. It also prejudices the prospect of including other emergency services under the funding scheme, such as has occurred in South Australia and Western Australia.

*“Increased (callout) charges to non-insureds may ... encourage them to insure.” (p 62)*

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Increased call-out charges may, theoretically, encourage non-insureds to insure.

In practice, however, non-insureds take a calculated risk that they are unlikely ever to call on the fire services. Unless they have reason to change their assessment, penal levels of tax on insurance remain as an immediate and strong disincentive to insuring.

The report also notes:

*“Compliance and bad debt difficulties will also increase as charges rise.” (p 66)*

A significantly better policy option than increasing charges to non-insureds would be to remove FSL altogether.

### **Assessment of insurance-based models**

*“Many disadvantages of the current (FSL) system can be addressed through modest enhancements and modifications.” (p 59)*

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The “modest enhancements and modifications” proposed by the Government<sup>52</sup> addressed none of the fundamental structural problems inherent in FSL. They:-

- Ignored the world-record high taxes associated with FSL and their associated inefficiencies.
- Ignored the major inequities inherent in FSL, including discrimination against people who choose to fully insure their property and against country Victorians who are burdened with the world’s highest tax rates on insurance despite having the least expectation of service.
- Did nothing to materially address the limited tax base that is a feature of FSL and the prospect of threats to sustainability of FSL as FSL rates continued to increase.
- Provided no credible answer to the problems of non-contribution from non-insureds and under-contribution from under-insureds.

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<sup>52</sup> See next page for a list of the “modest enhancements and modifications”.

- Incorrectly treated under- and over-collections of FSL contributions as a transparency problem. Transparency is a major problem with FSL, but it is not the issue causing under- and over-collections.

The main effect of the proposed modest enhancements and modifications would have been to further complicate the FSL scheme and add to the administrative burden on insurers. The proposals by the Government for modest enhancements and modifications to FSL were:-

- *A move to full recovery of callout costs.*

In explaining this proposal, Treasury noted:-

*Achievement of full cost recovery via increased charges will be difficult to achieve in practice ... Compliance and bad debt difficulties will also increase as charges rise.*<sup>53</sup>

It is difficult to understand the purpose behind making this proposal at all.

- *A decision to require insurers to identify separately on premium invoices the component of premium intended to go towards fire services funding.*

This proposal was intended to enhance transparency of FSL in relation to the over-collections issue. But it could have no impact on the problem of over-collections, which occur as a consequence of structural flaws in the FSL scheme, not because of a lack of transparency.<sup>54</sup>

- *An intention to increase contributions from major corporations that make use of deductibles.*

After considerable time and effort spent by the insurance industry trying to convince the Government that this proposal was unworkable and, if implemented, would lead to serious further distortion of the insurance market and an increase in administrative burden for insurers, the Government advised that it would not proceed because the costs of the proposed scheme would outweigh the benefits.

- *Adjustments to residential and content premium pool weightings.*

This proposal would have done nothing to address the fundamental inequities in FSL and would have the effect only of further complicating the FSL scheme.

- *Consideration of an apparent cross-subsidy between residential and commercial sectors and a proposal for an annual review of weightings.*

The Government was attempting to add precision where precision is impossible, particularly in an ever-changing insurance market. The proposal would only add further unnecessary complexity and administrative burden.

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<sup>53</sup> Victorian Treasury review of fire services funding, 2002/03, page 66.

<sup>54</sup> For a full explanation, see pages 13-14 in this submission.

These proposals were modest indeed: none of them addressed the real problems associated with the FSL scheme and none would have any material effect in remediating the “many disadvantages of the current system”.

### ***Assessment of property-based models***

In contrast to its minimal assessment of FSL, Treasury’s assessment of property-based models was detailed and strongly biased against property, as explained in the following pages.

*“Shortcomings: The extent to which the insurance sector passes on savings from abolition of statutory contributions to policyholders is not transparent” (p 69)*

*“The main shortcoming of any monitoring system is that it is difficult to convince policyholders that insurance sector savings are passed through. ... Secondly, even if the assessment concludes that savings have been passed through at a certain time, there is no guarantee this will continue” (p 75)*

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The process of passing on savings in the transition from FSL to a property-based scheme can be completely transparent.

When Queensland, South Australia and Western Australia changed from FSL to property based funding systems, the collection and transfer to the fire services of FSL taxes collected during the transition were arranged, implemented and audited. No problem of “insurers not passing on savings” was found in any of these states.

An independent review undertaken in Western Australia found no evidence of insurers not passing through all FSL collections.<sup>55</sup>

It makes no sense that there would have been problems. In addition to ethical considerations, there would be no commercial or competitive advantage to insurers from not passing on FSL collections.<sup>56</sup>

The outcomes in Victoria would be no different from those in the other states that have replaced FSL with property-based funding schemes.

*“It (a uniform rate property levy) ... reduces efficiency because there is less incentive for owners of high risk assets to manage those risks.” (pp 71-72)*

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There is nothing inherent in the imposition of a tax, even an onerous one like FSL, that strengthens attitudes to fire risk management. Even if the Government’s proposition were true, removal of FSL would still leave risk premium and GST for the property owner to pay and, presumably, there would also likely be a broad fire or emergency services levy imposed to replace FSL.

In any case, property owners, especially those with “high risk” properties, who are concerned enough about their financial well-being to insure, are not likely to become less responsible for their financial well-being if the fire services funding scheme changes and they end up with lower insurance premiums.

Nor are there any indications from Queensland, South Australia, Western Australia or the A.C.T. that their change-over from FSL to property-based schemes has led to less responsible attitudes to fire risk among property owners.

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<sup>55</sup> Sigma Plus Consulting, (2004), “Emergency services levy insurance compliance review”.

<sup>56</sup> Also see comment on under- and over-collections on pages 13-14 of this submission.

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In direct contrast to the Government's assertions, it is retention of FSL that directly undermines fire risk management because the exceptionally high tax rates associated with FSL promote higher levels of non- and under-insurance insurance (reference Black Saturday).

*"Most low risk properties that are fully insured are likely to pay significantly more under a uniform rate property levy." (p 72)*

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The Government offered no evidence to support this conclusion. In the absence of detailed quantitative modelling in the Treasury review, there was no credible basis for it.

A broader tax base resulting from a change to a property based funding system, where all beneficiaries of the fire services contribute, is likely, on the basis of simple arithmetic, to produce lower average contributions rates. If the tax base were widened to include motor vehicles, for example, reductions in average payments by real property owners could be even greater. However, reliable indications of changes in contributions amounts would require application of detailed quantitative modelling.

*"Removing risk (as a design feature) impacts more on the distribution of funding within the commercial sector than within the residential sector as it has large risk variations across industries." (p 72)*

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While the range of fire risk within the commercial and, particularly, the industrial sectors clearly is greater than in the residential sector, it does not automatically follow that "removing risk" impacts more on the distribution of funding in the commercial sector. Nor is this statement necessarily relevant.

This statement by Treasury appears to arise more from the limited, desktop nature of the Treasury review, untested by detailed quantitative modelling, than it does from informed analysis. It also takes no account of the policy option, applied effectively in Western Australia, of employing minimum and maximum contribution levels.

Clearly, moving from an insurance-based system to a property-based system would change the distribution of funding from within the commercial sector. Whether the change is material, however, would depend on the funding system and its parameters since contributions amounts would be a function essentially of base values, contribution rates, adjustment arrangements and use of floors and ceilings. Detailed quantitative modelling is the only credible way to assess the outcomes.

Considerations that are likely to be considerably more critical than fire risk in assessing the impact of a property-based system on the commercial sector are the standard economic principles of efficiency, equity, simplicity and transparency.

By moving to a simpler, more efficient and transparent system, the problems of high taxes, market distortion and unwelcome complexity closely associated with FSL are likely to disappear. This would be a major advantage of replacing FSL.

*"Shortcomings: Major transitional issues because of significant redistribution of funding contributions and the need to establish a new collection system" (p xiii)*

*"Transitional costs would be high due to the need to establish a new tax base and tax collection systems. Transitional arrangements where both funding systems overlap may also create substantial complexities." (p xiv)*

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Transition from one funding system to another involves change and, obviously, there will be associated establishment and transition costs. This is true for any major system change.

Treasury offered no supporting evidence for its assertion that there will be “major transitional issues” and that “transition costs would be high”.

Clearly there would be the need to establish a new tax base and tax collection system. However, as was the case in Western Australia, an existing tax base and tax collection system may be accessible, in which case establishment and transition costs could be limited.

*“Transitional arrangements where both funding systems overlap may also create substantial complexities”*

Transitional arrangements in moving from FSL to property-based systems have been demonstrated to be manageable in other jurisdictions. There is no reason why Victoria cannot do likewise.

*“The experience of Western Australia indicates that substantial planning and consultation would be required to implement a transitional year arrangement and that extensive consultation with the insurance sector is required. This would delay the introduction of a full property-based system for one or two years following the announcement of any in principle decision by the Government to move to such a system.” (p 86)*

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Clearly, substantial planning and consultation would be required. This would be the case for any major change of system.

The time required for planning and consultation could be reduced if Victoria is prepared to learn from the Queensland, South Australian and West Australian experiences and the very recent A.C.T. experience as well.

*“Administration and collection processes are generally more costly (my emphasis) ... under a property-based system, as there are far more direct contributors (ie all property owners) and a separate enhanced database of property owners is needed.” (p 50)*

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This statement is not correct. Administration and collection costs will depend on the design of the collection arrangement put in place.

As the West Australian experience has demonstrated, once establishment costs are met, ongoing-administration costs through existing local government channels can be negligible.

The number of direct contributors in a funding system (ie all property owners) is immaterial from a system design point of view. Once the required data is made available and the collection system established, any number of contributors can be handled easily.

Data bases of Victorian properties and their owners already exist. The suggestion of a need for a “separate enhanced database of property” was not supported by evidence.

*“Administration and collection processes are generally more ... complex (my emphasis) under a property-based system, as there are far more direct contributors (ie all property owners) and a separate enhanced database of property owners is needed.” (p 50)*

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For the same reasons as given immediately above, the complexity of administration and collection processes will depend on the funding arrangement put in place. The West Australian experience

provides an excellent example. The administration and collection processes there are sublimely simple. Once the local government database was set up for emergency services levy transactions, administration was simple.

*(... insurance based systems) "... are the simplest to administer" (p 50)*

This statement is true only from the Government's perspective. Insurers administer the FSL scheme for government so, for government, administration is simple.

For insurers, however, FSL can be difficult to administer. The intractable problems posed by under- and over-collections, for example, create unwanted administrative complexity.

*"Those who only have building insurance will ... pay more as they will be bearing the loss of contribution from contents insurance policyholders." (p 71, footnote 111)*

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A funding model does not have to include contributions from home contents policy holders to be fair, efficient, simple, transparent and effective. The South Australian, West Australian and A.C.T. models demonstrate that.

There is no basis for the conclusion that those who only have building insurance will pay more. The outcome of change for insured property owners depends entirely on the system design of the replacement funding option. Extensive, detailed quantitative modelling would be required to arrive at a reliable indication of where costs would change under the different options.

Significantly, Treasury's statement ignores the high levels of non-insurance and under-insurance of residential property contents.

*"Based on arrangements in other states, it is ... likely that property levy concessions will be offered to some individuals, though this will increase the levy for others and may reduce the alignment of their benefits to funding. The cost of providing concessions could also be substantial." (p 73)*

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- Any decision about the granting of concessions is a matter ultimately for Government.
- While the granting of concessions could increase the funding burden for other contributors, the extent of any change would depend on the model used and parameters employed.
- Alignment of benefits to funding, including concessional arrangements, would be a design element of the replacement funding arrangement.

It is interesting to note that, except for the expectation of service component, the emergency services concessions granted in Western Australian are identical to the concession regime for local government rates. An effective and generally accepted concessions system already existed in the local government system when the new emergency services scheme was introduced.

As a result, the Western Australian system, including its concession arrangements, is efficient, equitable, transparent and simple for rate payers to understand. It is also easy for local government to administer.

Clearly, the costs to a funding scheme of providing concessions can be acceptable.

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**Sustainability of FSL**

*“The main funding source under current funding arrangements, the insurance industry, appears to have the financial capacity to fund its statutory contributions on an ongoing basis. This is because insurance companies are able to pass on their cost of their contributions through their premiums.”*

*“The main threat to revenue stability for the current funding system would be if increases in premium rates which insurance companies need to fund their contributions led to a significant decline in insurance coverage or to under-insurance. But there is no evidence of a link between increasing FSL rates and insurance coverage – insurance coverage is increasing while FSL rates have moved both up and down.”*

*“Based on this analysis, there is no evidence that the current funding arrangements pose a threat to future revenue stability.”<sup>57</sup>*

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The main funding source in FSL is not the insurance industry but insurance policy holders. The industry simply administers the FSL scheme on behalf of the government. A fundamental error of understanding like this by the Victorian Treasury speaks volumes about the complexity of FSL.

As the chart on page 7 of this submission shows, the rate of increase in FSL rates for farmers and other commercial policy holders in the CFA region is accelerating, sounding a warning signal for future revenue stability from FSL.

As explained on page 8, the increase in FSL rates is as much a reflection of reductions in premium receipts (comprising both reductions in sums insured and falls in the number of policy renewals) as it is of increases in the CFA budget.

The tax increases associated with FSL are outstripping the capacity of policy holders to pay. The limits of sustainability, at least for the commercial class of insurance in the CFA region, appear to be approaching quickly.

**Terms of reference for the 2002/03 Treasury review**

*Any alternative funding arrangements considered or recommended by the Review will have a broadly neutral impact on the State’s total expenditure on fire services ...” (Terms of reference 3(a))*

*Investigations and modelling shall not extend to issues of GST, stamp duties or other taxes on property or financial instruments ...” (Terms of reference 3(b))<sup>58</sup>*

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While the terms of reference specifically preclude consideration of “GST, stamp duties or other taxes on property or financial instruments”, a critical question for the community is, what is the Government’s attitude to replacement of FSL given that removal of FSL from insurance policies would significantly reduce stamp duty receipts from insurance?<sup>59</sup>

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<sup>57</sup> Victorian Treasury review of fire services funding, 2002/03, page 43.

<sup>58</sup> Victorian Treasury review of fire services funding, 2002/03, page 2.

<sup>59</sup> If the FSL scheme were replaced, the effective stamp duty rate would fall to 11% (nominal 10% inflated by 10% GST).

FSL has an extraordinary capacity to generate stamp duty revenues.<sup>60</sup>

A requirement for revenue neutrality in assessing alternative funding models could effectively prolong continuation of the FSL system, regardless of its major problems and regardless of how attractive alternative schemes might be, because of the capacity of FSL to generate enhanced stamp duty revenue.

As if to confirm this view, the Government states in its executive summary:-

*“Where there is a loss in State Government stamp duty revenue or additional costs are imposed on State Government or local government, the statutory contribution may need to be adjusted to ensure overall budget neutrality.”<sup>61</sup>*

Then, in the body of the Treasury report:-

*“The property levy would need to raise an additional \$25 million<sup>62</sup> to maintain budget neutrality, given the \$25 million stamp duty reduction due to the decrease in insurance premiums caused by the reduction in insurance company statutory contributions.”<sup>63</sup>*

If the Government is wedded to its windfall stamp duty receipts from insurance, a requirement for revenue neutrality would create an considerable bias in favour of retention of FSL.

### **Seeking an explanation for the inadequacies of the Treasury review**

While the FSL scheme creates serious difficulties for the Victorian community, particularly in rural areas, while it threatens sustainability of funding for the fire services, particularly the CFA and while it meets none of the standard criteria for assessing tax systems (efficiency, equity, simplicity and transparency), it provides extraordinary benefits for the Victorian Government. In 2009/10, FSL is generating special “off-budget” tax revenues of \$509 million and a stamp duty windfall of around \$51 million,<sup>64</sup> funds that would not be available to the Government under a property-based funding arrangement.

Could these extraordinary financial benefits have been sufficiently attractive for the Government to decide, before the 2002/03 Treasury review got underway, that there should be no change to the fire services funding model in Victoria? To direct the reviewers to find in favour of FSL?

It beggars belief to suggest that a group of professional Treasury economists, the people who carried out the survey and prepared the report, could produce work of such a questionable, unprofessional standard had they not been directed to ignore normal process.

The irony of the 2002/03 review was that, despite the long list of biases, errors of fact and analysis and unsupported conclusions evident in the report,<sup>65</sup> on close consideration none of its arguments either in favour of FSL or against alternative funding models was convincing.

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<sup>60</sup> See page 11 of this submission for a description of the “tax on a tax on a tax” compounding mechanism of FSL which can effectively double the nominal stamp duty rate.

<sup>61</sup> Victorian Treasury review of fire services funding, 2002/03, page v, footnote 1.

<sup>62</sup> If \$25 million was the relevant figure in 2003, it would be higher in 2009 because of the substantial increases in FSL rates in the meantime.

<sup>63</sup> Victorian Treasury review of fire services funding, 2002/03, page 70.

<sup>64</sup> See details on pages 4 and 5 of this submission.

<sup>65</sup> See attachment 3 on pages 39-42 of this submission for a tabular summary of the biases, errors and unsupported conclusions in the report.

### **The Government's 2009 Green Paper**

In the light of the Government's approach to the 2002/03 review of fire services funding, it is interesting to note that the Government's current Green Paper, "Fire Services and the Non-Insured", has the same strong focus on insurance and fire risk as did the 2002/03 review.

Like the Government's earlier review, the Green Paper shows limited interest in alternative funding models, focusing instead on insurance mechanisms and assessments of the insurance option.

The list of seven "options" included in the Green Paper are:-

1. Retain the existing approach
2. Retain the existing approach and charge a levy on non-insured and under-insured property owners
3. Retain the existing approach and mandate banks to issue compulsory insurance
4. Introduce compulsory fire services insurance
5. Introduce compulsory property insurance
6. Replace FSL with an across-the-board property tax (which could be risk based)
7. Require mandatory collection of costs from non-insured by the CFA and MFESB.

Five of the seven options are insurance related and one involves compulsory cost recovery by the fire services. Only one (option 6) deals with a system that is not insurance-based. Even there, Treasury indicates that it could be "risk based".

Is the Government's approach to its current review of fire services funding to be a repeat of its biased, deeply flawed, earlier review?

## EVALUATING OTHER FUNDING OPTIONS

Victoria is in the privileged position of being able to learn from the experiences of Queensland, South Australia, Western Australia and the A.C.T. about the introduction and operation of property-based funding schemes.

### Principles of assessment

As mentioned previously in this submission,<sup>66</sup> the standard criteria for assessing tax systems are tax efficiency, equity, simplicity and transparency. Sustainability is usually also an important consideration.

### Queensland model

Queensland was the first jurisdiction in Australia to abandon FSL. In 1984-5, Queensland introduced a comprehensive property-based scheme. It includes a fire risk rating component and a component for expectation of service. I understand there are some 168 categories of fire risk with a dollar contribution amount set for each.

The scheme funds the fire services, including rescue. Collections are administered by local government. Pensioners receive a discount on their place of residence.

The inclusion of risk rating was intended to enhance the fairness of the funding scheme, providing a link between risk and contribution. With experience, however, it became apparent that the risk rating aspect of the scheme was administratively cumbersome.

### South Australian model

South Australia replaced FSL with a comprehensive property-based scheme in late 1999. The South Australians learned from the Queensland experience and based contributions on real property, vehicles and boats. There was no consideration for fire risk.

The value of land is assessed by the Valuer General and vehicles are assessed at prescribed rates. Real property contributions are adjusted to reflect availability of services and land use. There are seven land use categories and four regional areas.

The scheme funds the fire services, SES, marine rescue, surf lifesaving and SA police rescue. Revenue SA, Transport SA and the Emergency Service Levy Office, which allocates funds, administer it.

The South Australian Government made a number of significant errors in designing its new scheme:-

- Various emergency services took advantage of the system change to lobby for bigger budgets. As a consequence, aggregate budgets of the emergency services funded under the new scheme grew from \$88 million before the changeover to \$144 million immediately after.
- Government ministers agreed to allow a number of contributions concessions for special interests.

These two factors together meant that the Government was unable to meet its commitment made in selling the scheme to the electorate that, on average, South Australians would pay less under the new system. To overcome this problem, the Government was obliged to increase its own contribution.

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<sup>66</sup> See page 6 of this submission.

- A further significant error was that administration of the new scheme was allocated to centralised agencies. This decision resulted in a high level of establishment and administration costs and some dilution of administrative efficiency.

While the South Australian scheme is more efficient, equitable, simple and transparent than the FSL scheme it replaced, serious issues were experienced with its implementation.

### **West Australian model**

Western Australia replaced its FSL scheme with a broad-based property scheme in 2003.

The West Australians learned from the experiences of both Queensland and South Australia and introduced a sublimely simple arrangement based only on real property. There is no consideration for fire risk.

The scheme funds the fire services and SES.

Contributions are based on the same land values used in local government rates assessments, against which prescribed emergency services rates are applied. Rates are differentiated according to five delivery of service zones, each with a rating factor. The factors range from 100% for metropolitan Perth to 10% for rural areas, such as the Pilbara, which have no access to fire services.

Special variations include a cap on commercial property contributions, a flat fee for vacant land (which accounts for a significant percentage of callouts) and a minimum contribution per property. Other terms and conditions (eg pensioner discounts, late payments penalties) are identical to those applying to local government rates.

Emergency services contributions are collected by municipal councils as part of their normal property rates collection activities. Administration is effective and its costs are negligible.

### **General assessment**

The replacement of FSL with property-based schemes was made in each case to provide a fairer, more efficient, simple and transparent system to generate funds for the emergency services.

A critical outcome of the reforms has been the establishment of a broader, more efficient tax base in each case with the potential to sustain emergency services funding into the future.

In neither South Australia nor Western Australia has the absence of fire risk as a design component led to distortions in system efficiency or equity, reductions of system capacity to generate required funds or dilutions in quality of service delivery.

## FINDINGS AND CONCLUSIONS

- The FSL scheme is a scheme of indirect tax on insured property owners, administered by insurers. It meets none of the standard criteria for assessing effective tax systems. FSL in Victoria generates the highest taxes on insurance policies in the world.
- Evidence suggests that rapid increases in FSL tax rates are leading to reduced sums insured and higher rates of non-renewals among farmers and other commercial property policy holders in rural Victoria. The accelerating rate of increase in FSL rates in the CFA region provides a strong indication that the FSL scheme is unsustainable.
- With the notable exception of the Victorian Treasury review of fire services funding in 2002/03, major tax reviews over more than 25 years have consistently recommended replacement of FSL with a more efficient and equitable funding arrangement.
- A close reading of the report of the 2002/03 Treasury review revealed that the methodology was inadequate and the assumptions and analysis used could not stand up to scrutiny. The review was heavily biased in favour of FSL and its conclusions consequently lacked credibility.

Despite the report's strong and obvious bias towards FSL, the Government was unable to marshal strong, coherent arguments in favour of FSL and against alternative funding schemes. Ironically, the Treasury report, in itself, is a major indictment of the FSL model.

- Given the extensive professional shortcomings of Treasury's 2002/03 review, can the community accept the Government's bona fides in undertaking its current review of fire services funding?
- Queensland, South Australia, Western Australia and the ACT now fund their fire services through a levy on all property owners, not just those who insure. Their systems are more efficient, fairer, simpler and more transparent than FSL. Unlike Victoria, these jurisdictions can be confident that funding for their fire services is sustainable.
- What is required now is a commitment from the Victorian Government and Opposition to a fully independent, open and professional assessment of funding alternatives, not one that holds tight to insurance as its benchmark.

## RECOMMENDATION

I recommend that the 2009 Victorian Bushfires Royal Commission play a crucial role in calling on the Government and Opposition to commission an independent and professional review of fire services funding for Victoria.

The review should allow Victorian households, farmers and other business operators to finally see how they would fare under alternative funding schemes, such as those introduced in other States. Its recommendations should lead to the introduction of a sustainable funding system for the fire services to which all property owners would be willing to contribute.

In order for the recommendations of the review to receive fair, open and proper consideration, it would be essential for the independent reviewers to report to community representatives, perhaps a bipartisan parliamentary committee, and not to the Government alone.

**ATTACHMENT 1****EARLIER REVIEWS OF FIRE SERVICES FUNDING**

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**Victoria**

Over the past 25 years or more there has been a number of official, independent and professional reviews of Victoria's fire services funding arrangements.

- In 1983, the Public Service Board recommended that the FSL system be abolished and a new system introduced with funding from owners of motor vehicles (20%), owners of real property (60%) and the State Government (20%).
- In 1985, an official Working Party with representatives from government, local government, the fire and emergency services, farming interests, insurance and the public service recommended the introduction of a funding system similar to that operating in Queensland. They proposed that funding be raised from property owners and government.
- In June 1993, a Funding Review of Victoria's Fire and Emergency Services by the Department of Justice concluded: "The insurance based system is both inequitable and inefficient as a collector of revenue from property owners for the fire services". "Moreover, contributions collected through fire service levies bear no relationship to assets being protected nor to an equitable share of all property owners' responsibility to support the fire and emergency services".
- In October 1993, a Public Bodies Review Committee enquired into the Metropolitan Fire Brigades Board. The summary of findings included: "The Committee believes the existing system of funding is demonstrably inequitable and partial and needs to be changed to ensure that it is equitable and uniformly applied to all persons".
- In 2001, the Harvey "Review of (Victorian) State Business Taxes" recommended that the existing fire services levy raised on insurance premiums be replaced by a separately identifiable charge on all rateable property.
- In July 2003, the Victorian Department of Treasury and Finance published "A Review of Victorian Fire Services Funding Arrangements". This report was strongly in favour of retaining FSL. The report has been considered in this submission.
- In October 2009, ICA made a comprehensive submission to the Victorian Parliamentary Economic Development & Infrastructure Committee inquiry into state government taxation and debt. It recommended priority be given to abolition of taxes on general insurance, including statutory contributions to the fire services.

**Other states' and national reviews**

Reviews undertaken nationally or in other states comment on insurance matters. Among them:-

- The HIH Royal Commission (2003) recommended that States and Territories that have not already done so, abolish fire services levies (FSL).

- Sigma Plus Consulting, (2004), “Emergency services levy insurance compliance review” (Independent audit of insurer compliance with transitional arrangements in Western Australia). The review found no evidence that insurers had not passed on all FSL collections during the transition.
- ASIC (2005), “Getting home insurance right: a report on home building underinsurance”. The review found that Canberra homeowners affected by the fires in January 2003 were underinsured by between 27 per cent and 40 per cent on average.
- NSW Independent Pricing and Regulatory Tribunal (2008), “Review of State Taxation – Report to the Treasurer: Other Industries Final Report”. Recommended statutory contributions by insurance companies to fund fire services in NSW should be replaced by an equivalent, transparent, property-based levy collected by local councils.

## ATTACHMENT 2

### ESTIMATE OF GOVERNMENT'S STAMP DUTY WINDFALL FROM FSL

The report of Victorian Treasury's 2002/03 review of fire services funding noted:-

*"The property levy (ie a property-based fire levy) would need to raise an additional \$25 million to maintain budget neutrality, given the \$25 million stamp duty reduction due to the decrease in insurance premiums caused by the reduction in insurance company statutory contributions."* (p 70)

FSL rates have increased substantially since the 2002/03 review: taxes on commercial property policies in the CFA region totalled 78% in 2002/03, in 2009/10 they total 123%. Importantly, average sums insured will also have increased in this time. The stamp duty windfall enjoyed by the Government in 2009/10 therefore will be considerably more than \$25 million.

The following calculation shows that the Government's windfall as a result of the FSL scheme is likely to be in the order of \$51 million in 2009/10, more than twice the windfall amount reported by Treasury in 2002/03.

### CALCULATION DATA

Knowns:-

#### Fire services' budgets and insurance contributions

	2009/10 budget	Insurance contribution
• CFA	\$391 m	\$303 m
• MFB	275 m	206 m
Totals	666 m	509 m

Source: Government Green Paper, "Fire Services and the Non-Insured", p 6.

#### Current FSL rates (from August 2009)

	CFA	MFB
• Residential	31%	20%
• Commercial	84%	50%

Source: Derived from Insurance Council of Australia's FSL rates recommendations to insurers.

Unknowns:-

Unknown	Assume
Allocation of contributions between domestic and commercial insurance policies	
• CFA (domestic : commercial)	50:50
• MFB (domestic : commercial)	50:50

**Note:** There is no data available to me on these allocations, so the assumed proportions are indicative. However, perhaps counter-intuitively, the allocation of contributions between domestic and commercial policies has no effect on the size of the windfall stamp duty gains for Government. The stamp duty amount stays the same regardless of the allocation. The reason is that the figures for total risk premium, total GST and total FSL contributions, on which the stamp duty calculation is based, remain constant regardless of the allocation of contributions.

## CALCULATION

### 1. CFA

- Total insurer contribution to the CFA \$303 m
- Assumed split between domestic and commercial sectors 50:50
- Therefore contributions by sector (domestic : commercial) \$151.5 m : \$151.5 m

- Since:- Contribution = Total risk premium x 1.1 (GST multiplier) x FSL rate

$$\text{Therefore:-} \quad \text{Total risk premium (TRP)} = \frac{\text{Contribution}}{1.1 \times \text{FSL rate}}$$

$$\text{- for domestic policies} \quad \text{TRP} = \frac{\$151.5\text{m}}{1.1 \times 31\%} = \$444.3 \text{ m}$$

$$\text{- for commercial policies} \quad \text{TRP} = \frac{\$151.5\text{m}}{1.1 \times 84\%} = \$164.0 \text{ m}$$

So ...

	<u>Domestic</u>	<u>Commercial</u>	<u>Total</u>	
• Total risk premium	\$444.3 m	\$164.0 m	\$m	
• GST (10%)	44.4	16.4		
• Total risk premium + GST	488.7	180.4		
• FSL (31% and 84%)	151.5	151.5	303.0	
• Total risk premium + GST + FSL	640.2	331.9		
• Stamp duty (10%)	64.0	33.2	97.2	(A)
• Stamp duty calculated against total risk premium inflated only by GST	48.9	18.0	66.9	(B)
• Stamp duty windfall as a result of FSL(A – B)			30.3	

**CALCULATION****2. MFB**

- Total insurer contribution to the MFB \$206 m
- Assumed split between domestic and commercial sectors 50:50
- Therefore contributions by sector (domestic : commercial) \$103 m : \$103 m

- Since:- Contribution = Total risk premium x 1.1 (GST multiplier) x FSL rate

$$\text{Therefore:- Total risk premium (TRP)} = \frac{\text{Contribution}}{1.1 \times \text{FSL rate}}$$

$$\text{- for domestic policies TRP} = \frac{\$103\text{m}}{1.1 \times 20\%} = \$468.2 \text{ m}$$

$$\text{- for commercial policies TRP} = \frac{\$103\text{m}}{1.1 \times 50\%} = \$187.3 \text{ m}$$

So ...

	<u>Domestic</u>	<u>Commercial</u>	<u>Total</u>	
• Total risk premium	\$468.2 m	\$187.3 m	\$m	
• GST (10%)	<u>46.8</u>	<u>18.7</u>		
• Total risk premium + GST	515.0	206.0		
• FSL (20% and 50%)	<u>103.0</u>	<u>103.0</u>	206.0	
• Total risk premium + GST + FSL	618.0	309.0		
• Stamp duty (10%)	61.8	30.9	92.7	(C)
• Stamp duty calculated against total risk premium inflated only by GST	<u>51.5</u>	<u>20.6</u>	<u>72.1</u>	(D)
• Stamp duty windfall as a result of FSL(C – D)			\$20.6 m	

**TOTAL ESTIMATED GOVERNMENT STAMP DUTY WINDFALL FROM FSL IN 2009/10**

- From CFA sources \$30.3 m
- From MFB sources 20.6 m

Total estimated stamp duty windfall from FSL \$50.9 m

## ATTACHMENT 3

## BIAS, ERRORS AND UNSUPPORTED CONCLUSIONS IN 2002/03 TREASURY REVIEW AND REPORT

Evidence of bias	Errors of fact or analysis	Unsupported conclusions
<p><i>Bias in project design</i></p> <ul style="list-style-type: none"> <li>The review did not allow detailed quantitative modelling of optional funding systems. As a consequence, insufficient data was available for proper analysis and assessment of property-based systems and for credible comparisons with FSL.</li> <li>The qualitative analysis used by Treasury was not only flawed (see opposite columns) but inadequate to the task of providing credible assessments of complex funding models.</li> </ul> <p><i>Bias in assessment criteria</i></p> <ul style="list-style-type: none"> <li>Absence of attention to standard criteria for assessing tax systems (efficiency, equity, simplicity and transparency) strongly biased analysis in favour of FSL, which does not measure well against any of them (pp 6-10).</li> <li>Replacement of the standard criteria with insurance attributes, notably fire risk, cemented in the strong bias in favour of FSL.</li> <li>Inclusion of revenue neutrality as a central criterion skewed assessments in favour of FSL because FSL creates an extraordinary stamp duty windfall for the Government. (pp 5, 36-38)</li> </ul>	<p><i>Beneficiaries of the fire services</i></p> <ul style="list-style-type: none"> <li>Insurance should pay because insurance benefits: “Insurers benefit from the extinguishment and containment of fires as this directly reduces insurance payouts ... and ... directly benefits the commercial returns to insurance companies.” <i>The logic is flawed: insurance does not benefit in any material way from activities of the fire service.</i> (pp 15, 20)</li> <li>“Those who have high fire risk and expensive property will benefit most from the fire services”. <i>Untrue.</i> (pp 18,19)</li> </ul> <p><i>Assessment of insurance-based models</i></p> <ul style="list-style-type: none"> <li>“Many disadvantages of the current (FSL) system can be addressed through modest enhancements and modifications”. <i>Untrue. None of the major problems of FSL was addressed by the “modest enhancements”.</i> (p 22) <i>Further, the “modest enhancements” proposed were either impractical or ill-conceived and ineffective in dealing with the matters identified.</i> (p 23)</li> <li>Increased (callout) charges to non-insureds may ... encourage them to insure”. <i>Unlikely. Furthermore, the Government acknowledges that, “Compliance and bad debt difficulties will also increase as charges rise”.</i> (p 22)</li> </ul>	<ul style="list-style-type: none"> <li>“Most low risk properties that are fully insured are likely to pay significantly more under a uniform rate property levy.” <i>Unsupported and untrue.</i> (p 25)</li> <li>“Those who only have building insurance will ... pay more as they will be bearing the loss of contribution from contents insurance policyholders”. <i>Unsupported and untrue.</i> (p 27)</li> <li>“... a separate enhanced database of property owners is needed”. <i>Perhaps, but not necessarily.</i> (p 26)</li> </ul>

**NOTE:** Page numbers in brackets refer to the pages in the Jamvold submission in which the subject matter is discussed.

Evidence of bias	Errors of fact or analysis	Unsupported conclusions
<p><i>Bias in assessment criteria (continued)</i></p> <ul style="list-style-type: none"> <li>• In comparing funding systems, no consideration was given to expectation of service as an important design element that promotes equity, despite it being a central feature of the Queensland, South Australian and West Australian schemes. Expectation of service is not part of the FSL scheme in Victoria. (p 21).</li> </ul> <p><i>Bias in assessment process</i></p> <ul style="list-style-type: none"> <li>• In comparing different funding models:- <ul style="list-style-type: none"> <li>- Major flaws inherent in FSL were totally ignored. (p 22)</li> <li>- The few recommended changes to FSL were impractical or ill-conceived and ineffective. (p 23)</li> <li>- In contrast to the limited and benign assessment of FSL, analysis of property-based systems was detailed, extensive and harsh. In many cases, the analysis was contrived (see details in columns opposite).</li> </ul> </li> </ul>	<p><i>Transitional issues</i></p> <ul style="list-style-type: none"> <li>• “Shortcomings: The extent to which the insurance sector passes on savings from abolition of statutory contributions to policyholders is not transparent”. <i>Untrue.</i> (p 24)</li> <li>• “... even if the assessment concludes that savings have been passed through at a certain time, there is no guarantee this will continue”. <i>Untrue.</i> (p 24)</li> <li>• “Shortcomings: Major transitional issues because of significant redistribution of funding contributions and the need to establish a new collection system”. <i>Untrue.</i> (p 25)</li> <li>• “Transitional costs would be high due to the need to establish a new tax base and tax collection systems”. <i>Not necessarily so.</i> (p 25)</li> <li>• “Transitional arrangements where both funding systems overlap may also create substantial complexities”. <i>Unlikely, but manageable in any case.</i> (p 25)</li> </ul> <p><i>Assessment of property-based models</i></p> <ul style="list-style-type: none"> <li>• “It (a property-based funding model) reduces efficiency because there is less incentive for owners of high risk assets to manage those risks.” <i>Untrue.</i> (p 24)</li> <li>• “Most low risk properties that are fully insured are likely to pay significantly more under a uniform rate property levy”. <i>Untrue.</i> (p 25)</li> </ul>	

**NOTE:** Page numbers in brackets refer to the pages in the Jamvold submission in which the subject matter is discussed.

Evidence of bias	Errors of fact or analysis	Unsupported conclusions
	<p><i>Assessment of property-based models (continued)</i></p> <ul style="list-style-type: none"> <li>• “Removing risk (as a design feature) impacts more on the distribution of funding within the commercial sector than within the residential sector as it has large risk variations across industries”. <i>Perhaps, but irrelevant. Distribution of funding is determined by the funding model and, as the Queensland, South Australian and West Australian systems show, fire risk is not a necessary basis for allocating funding obligations in an efficient and equitable manner. (p 25). Nor is funding allocation based on fire risk necessarily equitable. (pp 18,19)</i></li> <li>• “Administration and collection processes are generally more <u>costly</u> (<i>my emphasis</i>) ... under a property-based system, as there are far more direct contributors (ie all property owners) and a separate enhanced database of property owners is needed”. <i>Untrue ... eg the WA scheme. (p 26)</i></li> <li>• “Administration and collection processes are generally more ... <u>complex</u> (<i>my emphasis</i>) under a property-based system, as there are far more direct contributors (ie all property owners) and a separate enhanced database of property owners is needed”. <i>Untrue ... eg the WA scheme. (p 26)</i></li> <li>• (... insurance based systems) “... are the simplest to administer”. <i>Untrue. The WA scheme is far simpler. And considerably more transparent. (p 27)</i></li> </ul>	

**NOTE:** Page numbers in brackets refer to the pages in the Jamvold submission in which the subject matter is discussed.

Evidence of bias	Errors of fact or analysis	Unsupported conclusions
	<p><i>Assessment of property-based models (continued)</i></p> <ul style="list-style-type: none"> <li>• “Those who only have building insurance will ... pay more as they will be bearing the loss of contribution from contents insurance policyholders”. <i>Unsubstantiated and most unlikely because of the broader tax base under a property-based system.</i> (p 27)</li> <li>• “Based on arrangements in other states, it is ... likely that property levy concessions will be offered to some individuals, though this will increase the levy for others and may reduce the alignment of their benefits to funding”. <i>Concessions are likely. However, with the benefit of the South Australian and West Australian experiences, the risk of concessions materially increasing the amount of levy paid by others and materially reducing alignment of benefits to funding is negligible.</i>(p 27)</li> <li>• The cost of providing concessions could also be substantial”. <i>Possible but, as evidenced in West Australia, highly unlikely.</i> (p 27)</li> </ul> <p><i>Sustainability</i></p> <ul style="list-style-type: none"> <li>• “The main funding source under current funding arrangements, the insurance industry, appears to have the financial capacity to fund its statutory contributions on an ongoing basis. <i>Untrue.</i> (p 28)</li> <li>• “... there is no evidence that the current funding arrangements pose a threat to future revenue stability”. <i>Untrue.</i> (p 28)</li> </ul>	

**NOTE:** Page numbers in brackets refer to the pages in the Jamvold submission in which the subject matter is discussed.



*Disadvantages for insured property owners*

While uninsured and under-insured property owners are rewarded by subsidies for not meeting their risk management responsibilities, fully insured property owners are penalised by world record high tax rates for being responsible.

*Disadvantages for the insurance industry*

FSL creates a range of major disadvantages for the general insurance industry. They include:-

- Market distortions caused by penal levels of tax on property policies.<sup>2</sup>
- The ever-present threat of further market distortions arising from Government proposals to amend the FSL scheme in order to address adverse side effects of FSL, such as high levels of non-insurance and under-insurance (see the Government's Green Paper and recommendations in the report of the 2002/03 review of fire services funding<sup>3</sup>).
- Government disinterest in consulting about market distortions created by FSL. This was particularly noticeable in relation to a Government proposal following its 2002/03 review of fire services funding to tax the deductible amounts of larger commercial policies.<sup>4</sup>
- Administration costs associated with FSL, including costs incurred by the Insurance Council in its periodic recalculations of FSL rates.
- The threat of reputation risk to the insurance industry arising from public attacks by Government following unavoidable over-collections of FSL contributions by insurers.<sup>5</sup>

*Disadvantages for the CFA*

Sustainability of FSL is a major concern for the CFA. Its funding is derived in significant part from farmers and other commercial operators in rural communities whose policies currently attract tax at 123%.<sup>6</sup> Recent evidence indicates that average sums insured are declining and the incidence of non-renewals is increasing among both commercial and residential property owners in the CFA region. Furthermore, the rate of decline in the uptake of insurance in this region appears to be accelerating.<sup>7</sup>

While the CFA can expect the Government to stand behind it if FSL funding were to collapse, the sheer size of the FSL contribution suggests that the CFA budget could be significantly trimmed in these circumstances.

There is a related problem for the CFA in that its workforce comprises large numbers of rural volunteers who are directly affected by FSL. There is steady background criticism among volunteers that they give solidly and freely of their time despite costs to their families and work, but still they are required to pay high tax rates on their property policies as further contributions to the CFA.

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<sup>2</sup> See detailed comments in my earlier submission, pages 6-9.

<sup>3</sup> See detailed comments in my earlier submission, pages 22 and 23.

<sup>4</sup> See comments in my earlier submission, page 23.

<sup>5</sup> See an explanation of the under-collections and over-collections issue in my earlier submission, pages 13 and 14.

<sup>6</sup> See CFA Annual Report for 2009, page 12.

<sup>7</sup> See detailed comments in my earlier submission, pages 6-9.

### *Disadvantages for the Victorian community*

The high levels of non-insurance and under-insurance in Victoria that are a reflection in large part of the inefficiency of FSL, seriously disadvantage the community by limiting its ability to manage its own risks through insurance.

The Victorian community continues to be disadvantaged because the Government refuses to seriously consider alternative funding schemes that promise significantly greater efficiency, fairness, simplicity and transparency than FSL.<sup>8</sup>

## **2. What are the advantages and disadvantages of applying a levy to non-insured and under-insured properties while maintaining the FSL on other properties?**

There are a number of questions about this proposal that suggest it may not be a practical option.

- If the levy were to be based on insurance principles, who would determine the rate? If it were not determined commercially, how would it be determined? Who would administer it?
- How would required levels of insurance be determined? How would levels of under-insurance be determined? Would any amount of self-insurance be appropriate?
- Given that self insurance through deductibles is a universal and commercially important feature of commercial policies, how would the market distortion that would arise from the application of a levy on the “under-insured” portion of the policy be made good? Would the Government be in any way concerned about this distortion?<sup>9</sup>

## **3. What are the advantages and disadvantages of funding fire services through a property-based levy on all Victorian property and vehicle owners? Are there any factors that make a property-based levy more or less practicable in Victoria compared with other states?**

There are considerable advantages to introducing a broad, property-based scheme in Victoria:-

- The Victorian community as a whole would benefit because a broad, property-based scheme would be significantly more efficient, equitable, simple and transparent than FSL. Unlike FSL, it would also be sustainable.<sup>10</sup>
- FSL-caused distortions to the insurance market would be eliminated.
- Levels of non-insurance and under-insurance are likely to decline as market distortions are removed and policy prices fall. Furthermore, without the impediment of FSL-generated market distortions, the insurance industry would be in a better position to address factors causing non-insurance and under-insurance on a proper commercial basis.
- The fire services would benefit from greater certainty of funding.<sup>11</sup>

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<sup>8</sup> See detailed comments in my earlier submission, pages 6-10.

<sup>9</sup> When the Government attempted to implement a levy on commercial deductibles following a recommendation in the report of its 2002/03 review of fire services funding, not only was the insurance industry not properly consulted on the proposal, the Government showed no interest in proper consultation. The proposal was abandoned only after strong, persistent representations from the insurance industry about its impracticability.

<sup>10</sup> See detailed discussion on this question in my earlier submission, pages 6-14.

<sup>11</sup> See CFA 2009 Annual Report, page 12.

Whether or not vehicles should be levied would be a matter for determination: there is no obvious answer. The South Australian scheme levies vehicle owners, the West Australian scheme does not. Determining factors are likely to include the amount of potential revenue available from vehicles and the costs of administering this option.

There are no factors that would make introduction of a property-based scheme any less attractive in Victoria than in other jurisdictions. In fact, Victoria has the distinct advantage of being able to learn from the experiences of other states and territories in designing and implementing a truly effective fire services funding scheme that benefits the whole community.

**4. What are the advantages and disadvantages of all Victorian property owners contributing to one fund for the funding of both the MFB and the CFA?**

In simple terms, combining funding for the two fire services could advantage the CFA by enabling cross-subsidised funding from urban revenue sources to neutralise risks to CFA's funding base arising from economic difficulties in rural communities and uncertainties about trends in rural population numbers.

On the other hand, rural populations may be concerned about the propensity for Government in Melbourne to manipulate the allocation of funds to the advantage of Melbourne electors and, therefore, of the MFB.

Replacement of FSL with a broad, property-based scheme would provide an excellent opportunity to seriously consider the option of establishing a single fund.

**5. What are the advantages and disadvantages of introducing compulsory property insurance to address issues associated with FSL?**

This is an interesting question, but a tangled one. For proper consideration, the compulsory insurance issue needs to be divorced from any association with FSL.

Non-insurance and under-insurance are serious community issues in their own right. While their incidence is exacerbated by the high tax rates imposed by FSL, they would continue to exist even if FSL were replaced by a property-based scheme. The essential purpose of considering compulsory insurance, therefore, should be to address issues of non-insurance and under-insurance, not to correct shortcomings in FSL.

As a public policy issue, there may be advantages in considering compulsory property insurance because, depending on how it is implemented, it could help to ensure that the community is insured.

However, there could be serious questions about its practicability, given that price is a significant determining factor in non-insurance and under-insurance. Furthermore, compulsory insurance may not eliminate problems of under-insurance. And there may be other, more effective ways than compulsory insurance to deal with issues of non-insurance and under-insurance.

The introduction of compulsory property insurance would not overcome fundamental flaws inherent in FSL. While problems of inequity might be addressed to a greater or lesser extent, other significant issues of tax inefficiency, system complexity and lack of transparency would remain, to the detriment of the Victorian community. Furthermore, the longer-term sustainability of FSL may remain in doubt. These major flaws can only be addressed by replacing FSL with a fairer, more efficient, simpler and more transparent scheme.

## INSURANCE – DISCUSSION QUESTIONS

### 6. Is non-insurance and under-insurance a problem in Victoria? Do we have accurate data on this issue?

The answer, unequivocally, is yes – non-insurance and under-insurance are problems in Victoria. The aftermath of Black Saturday provided compelling evidence.

As the Commission's Discussion Paper notes, "DHS and ICA data suggest that approximately 13% of total loss properties were not insured in the affected areas."<sup>12</sup> Anecdotal evidence indicates that levels of non-insurance in particular locations, such as Kinglake, were much higher than this average figure. If the experience from the ACT bushfires in 2003 is any guide,<sup>13</sup> very high levels of under-insurance are likely as well.

In its Green Paper, the Government states, "There are a currently range (sic) of estimates making it difficult to assess whether it (ie non-insurance and under-insurance) is a significant issue ..."<sup>14</sup>

Whether the rate of non-insurance is 13% or 30% is almost irrelevant. As the Discussion Paper notes, "... the data does indicate a significant level of non-insurance."<sup>15</sup> The Green Paper admits the same.<sup>16</sup>

Do we have accurate data on this issue? Is existing data sufficient for policy development purposes? The answers depend on what we intend to do with the data.

If the community considers that the levels of non-insurance that became evident in February 2009 were unacceptably high and that action should be taken to address the problem, then the answer is yes, the data is both accurate and sufficient. Further definition of the data would not materially alter the community's understanding of the problem or help define the solution.

The essential task then would be to consider means to reduce levels of non-insurance and under-insurance in the community. There are options, ranging from compulsory insurance (as mentioned in relation to question 5 above) to removing distortions in the insurance market by replacing FSL. With FSL-generated distortions removed, the insurance market would be free to function effectively and insurers would be better placed to find commercial solutions.

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<sup>12</sup> Commission Discussion Paper, page 10.

<sup>13</sup> Commission's Discussion Paper, page 11, referring to Insurance Council of Australia, Submission to the House Committee into Recent Bushfires, 2003, page 6.

<sup>14</sup> Green Paper, page 12.

<sup>15</sup> Commission Discussion Paper, page 11.

<sup>16</sup> Green Paper, page 11.

The very worst policy option would be to attempt to reduce levels of non-insurance and under-insurance by adjusting FSL further. The fundamental flaws of FSL would remain, FSL-generated distortions would continue in the insurance market and, as the Government found when following the recommendations of its 2002/03 review, the further interventions might be impracticable.<sup>17</sup>

**7. What reasons, if any, are there for the government to ensure residents in bushfire prone areas are adequately insured. What form should any government involvement take?**

There is no inherent reason for the Government to ensure that residents in bushfire prone areas are adequately insured, just as there is no reason for Government to ensure a community's protection against most other "perils", such as economic disturbances or storms.

What the Government can reasonably do, however, is assist communities to take responsibility for themselves.

One effective means to do this is to remove impediments to a community's ability to deal with its own issues. The FSL scheme is an impediment to insurance. As such, it is an impediment to a community's ability to manage its risks in a cost effective manner.

With farmers and other commercial policy holders in the CFA region now paying 123% tax on risk premium, the price effects of replacing FSL with a carefully designed property-based scheme would be significant. By removing market distortions caused by FSL, the Government would materially assist residents in areas prone to bushfire, storm and other natural disasters to manage risks better themselves through insurance.

Another effective means open to the Government is to extend its current program, implemented through local government, the CFA and SES, of educating people about how to prepare for and deal with fire, storm and other natural disasters, including the necessity of maintaining adequate insurance cover to ensure financial survival in the event of a disaster occurring.

**8. What effect would removing the FSL and stamp duty on premiums have on the uptake of insurance?**

The Insurance Council of Australia has commissioned expert studies on the demand elasticity of insurance. I expect the Commission will have studied the ICA's reports.

**9. Are there better tools, for example web sites, ready reckoners, etc that could be made available to property owners to assist them in accurately calculating the replacement cost of their property? Would the availability of such tools reduce under-insurance?**

An interesting outcome from the ACT fires in 2003 was that, almost regardless of the adequacy of sums insured before the fires hit, the high rate of materials and labour cost inflation brought about by the sudden surge in demand for building in the aftermath of the fires resulted in many people finding, when they submitted claims, that they were under-insured.

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<sup>17</sup> See detailed comments in my earlier submission, pages 22 and 23.

The answer to the under-insurance problem is not necessarily bigger and better web-based tools and more elegant ready reckoners but, as Canberra demonstrated, a different approach to insurance in which cover is sought on a full replacement basis rather than on a prescribed sum insured.

This is a topic on which the Commission might usefully seek the expert opinions of insurance brokers and insurers.

**10. Would it be practical for insurers to rate houses in bushfire prone areas for fire safety? If so, would this affect premiums? What are the practical advantages and disadvantages of involving the CFA (or persons accredited by the CFA) in reporting a property's fire readiness for insurance purposes?**

I expect the Commission will talk with insurers about this matter.

## **CONCLUSIONS**

The events of Black Saturday clearly demonstrated that non-insurance and under-insurance are major issues for the Victorian community. While their effects are exacerbated by FSL, finding an effective, long-term solution requires non-insurance and under-insurance to be addressed as issues in their own right.

Dealing with non-insurance and under-insurance through adjustments to the FSL scheme, such as introduction of compulsory insurance, would create added difficulties for property owners who already can't afford property cover, extend existing market distortions and perpetuate the deeply flawed FSL scheme.

The far better approach would be to address the fundamental issue first, replacing FSL with a broad, property-based funding arrangement that is significantly more efficient, equitable, simple and transparent than FSL. That approach would eliminate FSL distortion, significantly reduce premiums and automatically make policies more affordable.

Residual levels of non-insurance and under-insurance could then be dealt with by insurers by normal commercial means. Compulsory property insurance might also be considered as an option.

Other states and territories have led the way in removing their inefficient, unfair, complex and non-transparent FSL schemes. Victoria can learn from them, to the advantage of its community.