14 November 2017

Productivity Commission

By email

Review of Horizontal Fiscal Equalisation

The Financial Services Council (FSC) welcomes the opportunity to make submissions on the Productivity Commission (PC) review of Horizontal Fiscal Equalisation (HFE).

The FSC has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. The industry is responsible for investing more than $2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

The FSC notes with concern the following finding in the PC's Draft Report (with added highlights): "For the most part, States considering tax reforms would generally not be deterred by the effects on GST redistribution. However, there are circumstances where the GST effects can be material — such as for a State undertaking large-scale tax reform — and **act as a significant disincentive to States implementing efficient tax policy. These disincentives are likely to be exacerbated where the State is a first mover on reform**" (p26).

This finding is a troubling finding as it means the system of GST distribution (or HFE) is a potential reason for the lack of State tax reform. Not only that, the PC has also found that HFE has the worst incentives for the most inefficient taxes. The PC uses insurance duties as an example, noting: "if a State with high insurance taxes legislated a lower tax rate, the reduced cost of insurance would lead to greater take-up by households and businesses. But this larger tax base would mean the State is assessed as having a higher revenue-raising capacity, and so receives less in GST payments. If the State's capacity was initially below average, the effect on GST payments would be exacerbated by the downward impact on the average tax rate" (p92).

This is an absurd and perverse result.

Insurance duties, including those relating to life insurance, are amongst the most inefficient taxes levied by any level of government; according to modelling by KPMG life insurance duties are much more inefficient than stamp duty on land, corporate income tax, personal tax, payroll tax and the GST.[1] In particular, this modelling finds insurance duties are:

- more than 50% more inefficient than corporate and payroll taxes;
- about twice as inefficient as stamp duty on land;
- almost three times as inefficient as personal taxes; and
- more than eight times as inefficient as the GST.

Furthermore the KPMG modelling indicates the efficiency costs of state taxes are likely to be underestimated as the economic costs caused by differences in taxes between the states has not been taken into account.[2] The relative inefficiency of insurance taxes is also a key finding of research by Access Economics.[3]

Not only are taxes on life insurance inefficient, they also discourage the takeup of life insurance, which leads to higher costs to government. For example, research by KPMG for the FSC found that every one dollar increase in insurance coverage results in a 50 cent reduction in spending on the Disability Support Pension. This is also not a small problem. According to a survey of FSC members, life insurance stamp duties grew by a staggering 84% in the five years to 2014 when the estimated revenue was $453m. The compliance costs of the duty are large, estimated to be $85.4m in 2015.[4]

As a result, the abolition or reduction of life insurance duties should be an important tax reform priority.

However, State governments have been reluctant to act on this important area for reform. This emphasises the importance of the PC recommending, and governments adopting, changes to HFE to reduce or remove the disincentives to state level tax reform.

As a consequence, the FSC sees merit in the various proposals considered in the PC's Draft Report, including equalisation to the average fiscal capacity of all States, but the FSC does not have a view on which model is preferred.

We do make the following comments:

- The devolution of Federal Government taxing powers to the States would give states more options to replace inefficient taxes (such as life insurance duty) with more efficient taxes. This reform would also increase the accountability of state governments for their own taxing and spending decisions.
    - This devolution of taxing powers would reduce the pervasive problems caused by vertical fiscal imbalance as raised in the PC's draft report in Section 9.3. The PC cites this imbalance creates incentives for States to maintain inefficient taxes (p204).
- The PC estimates the HFE system creates only a small disincentive for reform to insurance taxes (see table 4.1 on page 98). However, this result assumes no change in tax base — there is no increase in takeup of life insurance if tax goes down. The PC should recalculate this making reasonable assumptions about elasticities of the tax base.[5]

[1] See Table A of https://taxreview.treasury.gov.au/content/html/commissioned_work/downloads/KPMG_Econtech_Efficiency%20of%20Taxes_Final_Report.pdf
Inefficiency here refers to the marginal excess burden.

[2] Ibid, footnote j.

[3] Access Economics (2011) Analysis of State Tax Report, p2.

[4] Figures in this paragraph are from FSC surveys and commissioned studies. Further details are available on request.

[5] One estimate of elasticity of life insurance is in http://www.nber.org/papers/w9925 but this paper is from the US and is somewhat dated.

- The PC's examples of reform (cameos) are somewhat misleading as there is no indication of the size of revenue changes, in dollars or relative to state economy (see Table 4.2). The change in HFE relativities could be large or small compared to the revenue change in each example. As a result, he change in HFE would benefit from being presented relative to revenue changes (for example, the dollar change in HFE redistribution for each dollar of revenue change).
- Given the extreme inefficiency of insurance duties, we recommend the PC provide cameos of how HFE impacts on reforms relating to insurance (as long as the cameos adopt the previous recommendation about presenting relative changes in HFE redistribution).
- State governments are clearly reluctant to engage in worthwhile tax reform — as shown by their ongoing reliance on inefficient taxes and decisions to reduce the efficiency of otherwise efficient taxes such as payroll tax.[6] So what state governments need is incentives to *encourage* tax reform. The system of HFE does not provide any such positive incentive.

We would be happy to discuss this submission; I can be contacted on (02) 9299 3022.

Yours sincerely,

[signed]

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[6] The KPMG review, cited earlier, found that state payroll taxes were surprisingly inefficient; this was because of deliberate state government policy decisions including high exemption thresholds.