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Dear Kelly

FIRE SERVICE REVIEW PANEL CONSULTATION – INSURANCE COUNCIL SUBMISSION

The Insurance Council of New Zealand ("the Insurance Council") appreciates the opportunity to comment on the Department of Internal Affair's Terms of Reference for the 2012 Fire Service Review. The Insurance Council would also appreciate the opportunity to present orally to the Panel in support of our submission.

1. Insurance Council of New Zealand

The Insurance Council is the industry representation body for fire and general insurance in New Zealand. We have 27 members which write the substantial majority of New Zealand's insurance business.

The Insurance Council is active in self-regulating the insurance industry. We promote the Fair Insurance Code that requires insurers to act ethically. Our members fund the Insurance & Savings Ombudsman Scheme that offers independent review of decisions and we apply an Insurance Council solvency test that confirms the financial stability of our members. We also require members to be independently rated and to publish these ratings. We perform an important role in informing and educating consumers about key insurance issues and risks.

The Insurance Council has been closely involved with the Department of Internal Affairs in previous reviews of the New Zealand Fire Service. We appreciate the opportunity to consult directly with the Panel during this current review and we are available to provide any assistance, support and advice necessary.

2. Executive Summary

We support the intent and need for review of the Fire Service. In particular, we support the need for review of the Fire Service's current funding mechanism.

The Fire Service is currently funded through the Fire Service Levy which is a Government tax collected by the Insurance Industry. This collection method is outdated and no longer accords with the manner in which fire services are undertaken or provided.

Fire brigades in metropolitan New Zealand were originally funded in a private capacity, by insurance companies. Insurers issued fire marks which were affixed to buildings to indicate which properties should be protected from fire. Property owners without fire-marks received no fire service support. This manner of private funding made sense when fire services were provided in a private/commercial capacity.

The New Zealand Fire Service has moved on exponentially from this early system and now provides a wide array of services beyond fire suppression, to all New Zealanders. Nevertheless, the funding mechanism has failed to move with these changes and has now become unsustainable, inefficient and inequitable. A new funding mechanism is required which (in accordance with the Terms of Reference):

- is stable and predictable;
- reflects the changing nature of services provided;
- correlates more equitably to those who utilise the service;
- is efficient;
- does not encourage under/non-insurance;
- does not allow or encourage avoidance;
- does not rely solely on the taxation of a voluntary product;
- is affordable; and
- is consistent with other similar jurisdictions.

The Panel has been tasked with providing recommendations as to "*how improvements could be made to the current insurance-based levy*" and, importantly, "*whether there are other viable funding sources.*" There are a number of alternative funding mechanisms detailed below that would better reflect the principles outlined in the Terms of Reference. There are established models in Australia, as well as models within New Zealand, such as the Police Service and even the Rural Fire Service, which can be utilised as potential prototypes.

It is important to note the overall welfare costs for Government in moving away from an insurance-based tax. Overall, New Zealanders would be in a much better financial position to reduce the current rates of under and non-insurance, in turn reducing crown liabilities.

3. Fire Service Review Terms of Reference – Outcomes

The Insurance Council would like to firstly make brief comment on the three outcomes that have been identified for the review of the Fire Service.

Outcome one

That New Zealand's Fire Service has a clear mandate and operating plan for the functions they perform and that it is clear how these intersect with functions formed with other emergency services.

This is currently not possible. The Fire Service is mandated only to collect its income from those who insure for fire, yet the role of the Fire Service is far broader and encompasses fire suppression, motor accident recovery and response, community disaster and climate change response and a wider range of emergency response requirements.

A clear mandate must be given to the Fire Service which identifies how it should operate as an emergency response organisation and which clearly separates out the costs and time allocated to each of the individual functions that it is performing. Then the collection of the Fire taxes required to run the service must be calculated and collected through a single efficient and equitable mechanism.

Outcome two
That the New Zealand Fire Service Commission and Fire Service are organised and operating as effectively and efficiently as possible and will provide value for money in the future.

The current funding of the Fire Service means that the Fire Service is unable to fund all it activities effectively and efficiently.

The Insurance Council believes that in a wide range of areas, the Fire Service is not funded adequately for the new roles it is performing. Some form of consolidation is required. Internal Affairs must look at whether there should be a centralised structure to the Fire Service Commission so that all operating functions are brought into a single centralised and funded structure.

Outcome three
That there is sustainable, stable and equitable funding for fire services with the services of that funding aligned with the functions that they perform.

The Insurance Council believes that there currently is not sustainable, stable or equitable funding of the Fire Service.

Funding which is separately collected and aligned to the functions performed is problematic and unlikely to work. A central funding system must be developed which identifies first and foremost how much is required to fully fund a sustainable Fire Service Commission under a new structure and, secondly, what is the best method to collect a single payment from all New Zealanders and New Zealand businesses.

4. Principles of an Effective Funding Model

Any funding mechanism developed by Government needs to achieve the following key principals in order to be sustainable and effective going forward.

4.1. Equity

Any revised funding mechanism should be based upon equitable contribution.

4.1.1. Functions have changed

The current collection of an insurance levy, for a service which has become completely disassociated from its original function, is entirely inequitable. The Fire Service no longer devotes its resources solely to suppressing fires but also to motor accident rescues, medical emergencies and disaster recovery work. In the Fire Services 2011 Annual Report, the then Minister of Internal Affairs highlighted the number of disaster events responded to by the Fire Service in the 2010/11 year, including responses to:

> "*...the 7.1 magnitude Canterbury earthquake of 4 September 2010, to the Fox Glacier aircraft disaster of the same date, to the Southland snow event of 18 September 2010, to the Pike River mine explosion of 19 November 2010, to the 6.3 magnitude Christchurch earthquake of 22 February 2011, and to the urban search and rescue team deployment to Japan following the 11 March 2011 earthquake and tsunami*."[1]

[1] Pg 94 - http://www.taxreview.treasury.gov.au/content/downloads/final_report_part_1/00_AFTS_final_report_consolidated.pdf

As also noted in the 2010/11 Annual Report, the number of Non-Fire Related Emergencies has markedly increased in the past decade, increasing from 24% in 2000/01 to 37% in 2010/12.[2] In particular, the Fire Service performed a huge amount of work following the recent Canterbury earthquakes. That work was required to be funded and budgeted out of its existing budget, which again has placed pressure on the budget of the Fire Service.

4.1.2. Insureds subsidise others

Furthermore, the scheme is not fairly contributed to by all those who benefit from these widened services. Significant numbers of New Zealanders do not purchase insurance and therefore contribute nothing to the cost of the Fire Service. Nevertheless, they continue to receive the same protection and benefits as those who pay for it.

4.1.3. Public good

The Fire Service is, in the same manner as the Police Service, a public good. A public good should not be paid for solely by insured persons. There is a suggestion in the published Terms of Reference that the Government might make a contribution to a revised funding mechanism, but the basis of such a contribution is not established.

The New Zealand Treasury sets out the way in which a public good should be funded, in its "*Guidelines for Setting Charges in the Public Sector.*"[3] The Guidelines state at clause 3.2.1 that:

> "*A good is considered public when excluding people from its benefits is either difficult or costly, and its use by one person does not detract from its use by another. The second of these features implies that exclusion is not only difficult, but also undesirable. <u>There is a good case for recovering the costs of a public good from the community as a whole, either by general taxation, or (where the benefits are localised) from local government revenue</u>.*" [emphasis added]

There is certainly authority within the Government's current regulatory guidelines to allow funding of the Fire Service to come via either general taxation or a property levy which targets all New Zealanders.

4.1.4. Summary

The New Zealand Fire Service has become a completely different organisation since its inception and now provides a public good for the benefit of all New Zealanders. As such, the funding mechanism needs to be updated to correlate with the new functions performed. It is inequitable to continue to fund these additional public goods from an insurance based levy, simply because this has been done historically.

The Panel has been tasked with identifying an equitable funding mechanism, so that "...*those who receive the various services performed by the NZFS contribute to the costs*." Funding via general taxation or a property based levy would ensure that there is equitable funding of the Fire Service, as funding would come from a much wider source and would relate directly to the actual services provided. In fact, a wider collection would mean the majority of people would actually pay less than they currently do, for a better funded Fire Service.

4.2. Efficiency

It is imperative that any funding model is efficient, in terms of collection and contribution.

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[2] Pg.15, NZFS Annual Report for Year Ending 30 June 2011
[3] http://www.treasury.govt.nz/publications/guidance/planning/charges/charges-dec02.pdf

4.2.1. Collection

Outcome 3 in the Terms of Reference tasks the Panel with developing a funding mechanism that is administratively simple to calculate and collect. The current collection method is contrary to this principle.

Funding via an insurance levy is particularly inefficient because of the complex administration required by private organisations to collect that levy. Collection of the levy is undertaken directly by insurance companies and is complicated and expensive to administer. There are significant difficulties in interpreting the Act and calculating correct contributions. It is also important to note that the associated collection costs incurred by insurers will indirectly be passed back onto the insured, exacerbating further inefficiencies around discouraging insurance purchases.

4.2.2. Free-riding

Furthermore, the current collection system provides a number of legal loop-holes which encourage avoidance (see section 4.3 below) and non-payment by particular parties. There is clear evidence from international research that taxation on insurance is economically inefficient. A study undertaken by the Independent Pricing and Regulatory Tribunal of NSW in 2008 found that the NSW fire services levy:

> "*...adds to the multiple layers of taxation on insurance, discouraging households and businesses from acquiring an appropriate level of insurance cover. This has implications for the efficient allocation of resources within the economy*."[4]

Fire Service taxation can add hundreds of dollars to basic insurance costs, making insurance unaffordable for many communities. Overall, Government taxes can potentially add-up to around 30 or 40 percent of insurance costs. The tax system should not discourage people from protecting their assets. New Zealand's current collection method encourages 'free-riding', as anyone who doesn't insure receives free access to fire and rescue services. 'Free-riders' will also expect additional Government support and benefits following natural disasters, as they will have no insurance protection.

4.2.3. Consumer welfare

Evidence from Australia suggests that fire service levies actually cause significant loss in consumer welfare. Modelling undertaken for the New South Wales Treasury, by KPMG Econtech in 2011, suggests that welfare costs from insurance taxation are considerable:

> "*The value to consumers of insurance and other services forgone as a result of the emergency services levy has been estimated at about $419 million. That is, in addition to the direct $698 million effect of higher premiums on those who buy insurance, the emergency services levy has flow-on costs to the economy equivalent to 60 per cent of the revenue raised. The average excess burden of the emergency services levy is 60 per cent of the revenue raised...*"

4.2.4. Summary

Insurance taxes are inefficient because they are difficult and costly to collect, and they encourage free-riding. A property based levy, or general taxation, would be a much more efficient and effective funding method as it would be easier to enforce and collect, and would not reduce the value of insurance services bought by households and businesses.

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[4] Pg 109, Final Report available at - http://www.ipart.nsw.gov.au/Home/Industries/Other/Reviews_All/Taxation/Review_of_State_Taxation

4.3. Stability and Predictability

Funding of the Fire Service needs to be sustainable long-term and should not rely solely on the taxing of a discretionary product.

4.3.1. Avoidance

The current funding mechanism is not stable or predictable as it allows for avoidance by certain parties. Many New Zealanders are able to avoid payment of the Fire Tax through under insurance and non-insurance and increasingly we are seeing other methods of reducing or avoiding paying the tax contribution to the Fire Service.

The current scheme encourages innovative legal schemes to reduce liability to the Fire Service. In particular a long standing scheme called "the first loss scheme" allows businesses to legally insure one building, rather than possibly five or more, and only pay the Fire Service levy on that one building as opposed to paying the Fire Service levy on the five or more buildings that are covered by a single policy.

We are also seeing a growing number of vehicles that are no longer being fully insured or not insured at all. The Fire Service is not collecting levies from these vehicle owners, yet all owners receive the same service from emergency fire services.

4.3.2. Government contribution

Many, including the Central government and Local Authorities, do not pay for the Fire Service through the levy because they self-insure. Much government-owned property, including Housing New Zealand property, is self-insured by the government. The government's contribution to the Fire Service funding is minimal, which is unfair to the majority of insured New Zealanders who contribute to Fire Service funding. Some government agencies even pay what they believe they *should* pay as a gesture to overcome suggestions that they are not paying a government tax. This seems a perverse and inefficient legislative outcome.

4.3.3. Reliance on a voluntary-purchase product

The above avoidance issues are a significant concern for the current scheme, particularly given the fixed nature of the funding pool which is 96% reliant on a product which is purchased on a voluntary basis.[5] If there are increases in rates of under and non-insurance, then funding of the Fire Service may be threatened going forward.

4.3.4. Summary

Concerns around stability and predictability would be effectively redressed through establishing a wider funding pool which does not allow avoidance and which is more appropriately aligned to those who use the service.

4.4. Affordability

Any proposed levy must not exacerbate affordability issues around insurance going forward.

4.4.1. Under and non-insurance

Outcome 3 in the Terms of Reference requires the Panel to investigate future funding options that "*...minimise distortions in... insurance price and coverage.*" The current Fire Service Levy tax makes the cost of Insurance unaffordable for some. Insurance taxes raise the price of insurance and have a direct correlation with the level of protection that households and businesses would otherwise have.

[5] Pg 9, NZFS Annual Report for Year Ending 30 June 2011

Following the catastrophic 2012 Canterbury earthquakes, the cost of insurance has increased significantly to reflect the higher risk profile, increased reinsurance costs and increased Earthquake Commission ("EQC") levies. Furthermore, the EQC premium was recently trebled. Data is already beginning to indicate that levels of insurance are starting to drop in some communities as a result of this. When people stop insuring, they no longer have the protection of the Earthquake Commission. Therefore in any future earthquakes, those that are not insured will not be covered by the Earthquake Commission and that liability will fall on the Crown. The increased liability to the crown will far outweigh the budget of the Fire Service.

4.4.2. Encourages risk-taking

It is possible that businesses that end up paying more in Fire Service levies will have less of a budget for undertaking appropriate fire protection measures, such as installing or maintaining fire sprinkler systems, and using low fire-load materials in construction and furnishings. A discriminatory fire tax levy on the Fire Service will encourage high-risk activities by businesses, which could result in even greater losses particularly in the small communities.

4.4.3. Summary

The Insurance Council agrees with the Australian Government's 2009 Henry Review, which recommended that "*all specific taxes on insurance products, including the fire services levy, should be abolished*."[6] A removal of the Fire Service Levy from insurance contracts would lower the cost of insurance and, in turn, decrease the levels of non-insurance and under-insurance in New Zealand communities.

4.5. Consistency with Best International Practice

Any future funding mechanism should be consistent with effective funding schemes in similar jurisdictions.

Despite economic and geographical differences between New Zealand and Australia, there is significant merit in looking to Australian Government reviews to understand the negative implications of funding emergency services through product taxes. New Zealand's system of funding the Fire Service through an insurance tax does not follow international trends and is effectively outdated. In Australia there has been a strong move away from this system of funding, as noted above.

From 1 July 2013, Victoria will move away from its current "*inequitable insurance-based fire services levy*" to a "*fairer, more transparent property-based levy*."[7] New South Wales, the only remaining solely-insurance-based levier, is similarly committed to abolishing taxes on insurance going forward.[8]

In Australia, it is a firmly established principle that taxation on insurance is inefficient, inequitable and unsustainable. All Australian states are either currently funded, or moving towards being funded, via some form of general taxation, consolidated revenue, or a property based levy – as opposed to insurance levies.[9]

[6] Pg 94, Recommendation 79: http://www.taxreview.treasury.gov.au/content/downloads/final_report_part_1/00_AFTS_final_report_consolidated.pdf
[7] http://www.premier.vic.gov.au/media-centre/media-releases/4732-coalition-to-introduce-fairer-system-to-fund-victorias-fire-services.html
[8] http://haveyoursay.nsw.gov.au/ESL
[9] Pg 4 - Paper available at http://haveyoursay.nsw.gov.au/ESL

Importantly, revision of the Australian states funding mechanisms has been accompanied by a number of studies which indicate that fire service levies actually encourage under and non-insurance, which in turn has negative implications for consumer welfare and state-liability.

It is important that these lessons are taken into account during New Zealand's review, to ensure sustainability and certainty for the New Zealand Fire Service going forward.

5. Possible Structural Issues Going Forward

5.1. Volunteer Fire Fighters

Volunteer fire fighters are currently under-resourced and under-staffed. They do not have the same allocation of funds to the development of their professional skills, their technology and their resources that professional fire fighters have.

The rural sector is possibly the most disadvantaged group in not obtaining the full protection of the Fire Service, despite paying full taxes for it. Many in the rural sector pay their full levy for the Fire Service and yet are served by under-resourced and under-staffed volunteer fire brigades. The volunteer fire brigades, simply due to geographical reasons, are often very late to fires because of the travelling time involved. Therefore, the rural community will suffer total losses of their buildings and yet they are required to pay full costs and receive relatively limited services in all aspects of fire protection.

In fact, the rural community is even more disadvantaged as they contribute to the fire service levy through their contracts of insurance as well as through funding of Rural Fire Authorities via rates. They are, in essence, being taxed twice.

These discrepancies should be addressed by the Review Panel.

5.2. Professional Fire Fighters

Increasingly, professional fire fighters do not have the resources and technology invested in them to cope with high rise fires in highly congested areas requiring disaster recovery and earthquake response, as was seen following the Canterbury earthquakes. The requirement for highly sophisticated and expensive technology and height-achieving technology, to suppress fires in high-rise buildings, is not sufficiently available and is another reason why funding for the Fire Service should be increased through a wider funding pool. It is important to note that any increases to the current funding mechanism would simply exacerbate current shortcomings of the insurance-based model, so it is imperative that the current funding mechanism is updated.

Again, these discrepancies need to be addressed by the Review Panel.

6. Alternative Funding Mechanisms

There are a number of alternative funding mechanisms that could be applied uniquely or in combination. These include;

1. Funding by the Crown;
2. Motor vehicle taxes; and
3. Property taxes.

Funding by the Crown is noted as beyond the scope of the Panel's authority to comment on. Nevertheless, it should be noted that this is the most equitable option as, with limited exceptions, all potential users of the system would pay for it.

Motor vehicles are currently taxed through the application of the fire service levy if they are insured. However, if the vehicle is uninsured, no levy will be applied. An alternative would be the application of a tax imposed at the time of registration. This would be relativity straight forward to administer in comparison with the current model and would ensure 100% collection.

The most preferred option from the Australian point of view has been primary funding through property taxes. In Victoria, the following principles guided the design of a property-based fire services funding model:

- efficiency;
- equity;
- sustainability and stability of the revenue base;
- simplicity and transparency; and
- minimising administration and compliance costs.

This option is preferable to the current means of funding as property taxes are not optional and will create a much broader pool of revenue. Again this would be relativity straight forward to administer in comparison with the current model and would ensure 100% collection. Further, a handling fee could be paid to local government for collecting the levy. This would potentially alleviate some concerns from local government.

7. Insurance Council Recommendations

Fire and rescue delivery will be one of New Zealand's most important service resources going forward - a resource equally as important as the Police. Therefore it must be supported by a robust funding base that will prove sustainable well into the future.

The current funding mechanism poses significant stability and predictability issues. Should fewer property owners decide to insure then the funding pool for the Fire and Rescue Service will reduce, so the levy tax would need to be increased to maintain the operating revenue. This will only exacerbate current issues with the funding model by adding to the cost of insurance, driving fewer property owners to insure and reducing the funding pool even further. This would bring about market failure.

Further, any alteration of the current insurance-based system, so as to capture more insurance-tax from more policyholders, would only further exacerbate the current inefficiencies and complexities of the insurance-based model. The current collection method would be preferable to a new, expanded version of insurance taxation.

Accordingly, we would encourage the Government to look at funding the Fire Service through the abovementioned alternative funding mechanisms. Funding from general taxation or a property based levy would satisfy the principles addressed in Section 4 above and would also accord with the specific principles outlined in the Terms of Reference (i.e. to be administratively simple to calculate and collect, to be stable and predictable, to be equitable, and to create minimal distortion in insurance price and coverage).

All previous government research on this topic, from both sides of the political spectrum, has concluded that the current system is inequitable and requires change. However, previous reviews have failed to instigate any meaningful change. The challenge for the current Panel will be to develop and articulate a feasible alternative model which the Government can implement.

Some within Government will be apprehensive to move away from an insurance-based taxation, toward either a general taxation or property-based tax. There is obviously strong competition for access to those funding sources, from a number of public sector groups. However, this does not change the fact that the current system does not accord with the identified principles within the Terms of Reference, whereas the suggested alternative mechanisms do. An important point, for the Government to remember, is that the overall welfare costs for Government, from moving away from an insurance-based tax, would decrease. Overall, a move away from the current funding mechanism would reduce the Government's balance sheet liabilities.

There would be potential transitional issues in altering the current funding mechanism, but these would be actively addressed by the industry together with Government. Insurers would need to ensure reductions were passed through to consumers and thorough consultation could be undertaken to ensure that any transitional anomalies were either removed or mitigated.

Overall, New Zealanders would be in a much better financial position and would be able to effectively reduce current rates of under and non-insurance. In particular, the decreased liability to the crown in reducing rates of under and non-insurance would outweigh the budget of the Fire Service.

During any secondary period of policy development, we would be more than happy to provide assistance in any manner possible. There has been significant financial and economic research undertaken by organisations in Australia, during similar reviews, which could be utilised to evaluate the benefits that would be achieved from each of the alternative funding models. Similar information is available to identify transitional concerns which might arise (i.e. to ensure there is no temporal tapering off of levy funding). However, before undertaking this secondary development, Government must firstly make the fundamental decision to abolish insurance taxation for the purposes of Fire Service funding.

8. Conclusion

Thank you again for the opportunity to provide input on the review document. It is imperative that the current funding mechanism is reviewed and updated, as it is unsustainable, inefficient and inequitable. We are happy to discuss our submission in more depth and, as noted above, would appreciate the opportunity to present orally to the Panel in support of our submission. Please contact Chris Ryan on (04) 472 5230, or at chris@icnz.org.nz, to discuss.

Yours sincerely

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