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ACC the lessons from history

Introduction

The 2008 National-led government, concerned with what it saw as an explosion in costs, claimed that the Accident Compensation Corporation (ACC) board did not have the skills to secure the financial stability of the ACC scheme. In March 2009 the minister, Nick Smith, dismissed the chair of the board, Ross Wilson, and appointed in his place accountant John Judge.

As at June 2009, ACC's reported outstanding claims liability was \$23.8 billion, while invested reserves were just \$10.4 billion. The \$13.4 billion 'unfunded' liability had grown from \$8.4 billion the year before. This 'blow-out' reflected a

rising number of claims, increased costs, a poorly-performing share market, and, most importantly, accounting changes to the actuarial assumptions behind the valuation of outstanding claims.

While income exceeded expenditure for the 2008/2009 financial year by \$1 billion, the change in value of outstanding claims had resulted in a reported loss of \$4.8 billion. The minister described the choices ahead for ACC as 'pretty ugly', and insisted that without change 'ACC is on course to go broke'. He claimed:

This will go down in New Zealand history as the biggest corporate loss of any entity, public or private, and is actually bigger than any deficit that the government has run collectively across all portfolios. (Sunday Star-Times, 2009)

The Labour opposition pointed out that a surplus of revenue over current expenditure meant that ACC was more than paying its way. Unfortunately, Labour did not question the underlying presumption that ACC should be fully funded. Instead, ACC spokesman David Parker argued that, to ease the burden on levy payers, the 2014 date for the full

funding of historic claims should be extended.

The funding debate is full of semantic ambiguities that confuse the debate. In this article, 'full funding' or 'full pre-funding' means funding in an insurance sense: the actuarial requirement that current assets are sufficient to meet all accrued obligations. 'Pre-funding', a more general term, implies a scheme that has some assets but is not necessarily fully funded. A pay-as-you-go (PAYG) scheme may have contingency reserves, but a reserve fund is not an essential part of PAYG.

In late 2009 the National government introduced the Injury Prevention, Rehabilitation, and Compensation (IPRC) Amendment Bill, with changes to levies and entitlements designed to 'facilitate cost containment' and to improve financial 'reporting and accountability'. While the date for achievement of full actuarial funding was extended from 2014 to 2019, the principle of fully funding ACC to ensure sustainability was strongly reinforced.

By this time, serious questioning of the funding requirement had begun.² The purpose of full funding for a private insurer is clear: policy holders require

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certainty that their claims can be met if the firm should go out of business. In any given year, enough revenue must be raised to meet the costs of that year's claims, no matter when they fall due.

On the other hand, critics argued that there was as little economic rationale for fully funding ACC as there would be for fully funding education or state pensions. Governments do not have to fully fund. They do not face the prospect of insolvency and can always fund their social commitments from higher levies or taxes. Social insurance schemes in other countries are generally not fully-funded, but some reserves may be held. In the case of the United States social security programme, for example, the trust fund holds government bonds as a reserve buffer for periods of deficit that might arise, say in a recession (Rejda, 1984).

In the case of New Zealand, the New Zealand Superannuation Fund (NZSF)

our history points in the direction of the need for a buffer of reserves, set at a level agreed to by all relevant political parties.

History matters

When you are peering into the future to see where you are going it is not at all a bad idea to remember where you have been. (Woodhouse, 1999)

The purpose of this paper is to locate the funding debate in a frame that reflects ACC's history over more than 40 years. This history reveals that there is nothing new in the current ACC debate. From the beginning there were tensions between the view that ACC was insurance and should be funded as such, and the view that ACC was more like a welfare system and could have a PAYG basis. Rather than be prisoners of our history, we could draw important lessons from it for future policy development.

Royal Commission of Inquiry on Workers' Compensation, 1967, p.90).

Operating under the Workers' Compensation Act 1956, the scheme was financed by a system of differential premiums that reflected industry risk. It was run on insurance principles, including being fully funded and tightly circumscribed, with limited no-fault benefits for 'workers' only, with the right to sue for damages in cases where it was believed that fault could be proven. Demarcation between work and non-work accidents was a clear problem:

the dividing line between a man hurt on his way to work and the one injured within the factory gates has at times been so thin as to be almost imperceptible. (Young, 1964, as quoted in Royal Commission of Inquiry on Workers' Compensation, 1967, p.82)

The shortcomings of that scheme provoked Woodhouse's radical rethink of how a modern society should treat accidents. One key parametric change (Royal Commission of Inquiry on Workers' Compensation, 1967) was to see that, in determining fair compensation, it did not matter whether or not the accident was at work, nor did it matter who was at fault. Woodhouse argued that the revolutionary 24-hour/7-day ACC scheme he proposed should not be based on private insurance principles. It required an entirely new frame, more fitting to the social innovation it represented.

ACC was to be social insurance

Thus, the 1967 Woodhouse Report suggested that the replacement for workers' compensation should be viewed as *social insurance*. As Woodhouse emphasised:

As the scheme will be a Government scheme of social insurance it must in the final resort receive the backing of the state ... It is for this reason that a formal system of funding cannot be regarded as essential to the stability of the whole scheme. (Report of the Royal Commission of Inquiry on Workers' Compensation, 1967, p.175)

This clarity has been lost in the current debate in which the goal of fully funding ACC has become the tail that wags the

... it is ... argued that the [ACC] scheme can only be stable if it is fully funded. [The] whole point of having social insurance is to enable society to escape from the strictures of private insurance.

may be seen as a device to smooth tax rates in the light of demographic change, but falls far short of fully funding New Zealand Superannuation. The money invested in NZSF might equally have been used to repay debt or increase other assets such as infrastructure.

In a somewhat ahistorical context, Littlewood (2009) mounted a persuasive argument for the ACC fund to be abolished, with ACC placed on a pure, PAYG basis. Levies could be set on whatever basis was appropriate, but, he argued, the ACC should not itself manage a fund of invested assets. Requiring ACC to be fully funded, he argued, exposes the Crown to unnecessary financial risk (Littlewood, 2009).

This paper argues that ACC should return to its original inception as social insurance with PAYG principles, but that

Workers' compensation rights

The first workers' compensation legislation, introduced in 1900, required limited no-fault compensation for accidents at work. In an amendment in 1943, every employer was obliged to insure against the risk. There were criticisms of the profits of private insurers, and a further amendment in 1947 gave the state-owned insurer the monopoly on this business. Then, from 1951, it was opened up to private participation once more (with 61 insurers) as a result of pressure from the industry (Campbell, 1996, p.16; Royal Commission of Inquiry on Workers' Compensation, 1967, p.80).

Woodhouse found this 'interpolation' of private insurers into what was essentially mandatory social insurance inappropriate and 'extremely expensive', with no corresponding advantages (Report of the

dog: it is now argued that the scheme *can* only be stable *if* it is fully funded. Yet the whole point of having social insurance is to enable society to escape from the strictures of private insurance. The benefits under social insurance can be more redistributive and comprehensive than under private insurance. The small print does not have to limit coverage and scope, and evolution or change of the scheme is not only possible, it is desirable as new risks emerge. Weekly compensation for long-term accidents can be inflation- and wage-growth-adjusted – a near impossibility for private insurance; and, importantly, the scheme does not have to meet the funding standards of private insurance.³

Far from these disappearing as economies develop, as Barr (2001) argues, the 21st century has new risks and insecurities that increase rather than lessen the need for social insurance. Nowhere is this more true than for the provision in an increasing unpredictable world of full compensation and rehabilitation for all accidents on a no-fault basis.

The funded basis of the 1972 Accident Compensation Act

In the 1967 royal commission report, Woodhouse suggested that a levy of 1% of all wages would approximately replace the existing insurance premiums. In the first years of ACC the outgoings for current accidents would be less than income. Although this surplus was to be invested in the short term, there was no suggestion that the scheme would operate on a full-funding basis. Built-in inflation adjustments, wage indexation and the subsequent expansion to meet new needs would make full funding entirely inappropriate. Furthermore, Woodhouse intended that the levy rate be fixed, with additional funds in the future to come from general taxation as and if required (see Royal Commission of Inquiry on Workers' Compensation, 1967, p.176)

While it is possible and logical to fund social insurance by general taxation on a PAYG basis, Woodhouse argued that he had to take account of the premiums on industry that were already in place. To change to general taxation would unduly benefit industry. Accordingly, he

said 'logical argument is an insufficient reason for shifting these costs in such a fashion' (ibid., p.171). However, he did recommend a flat rate levy with no risk- or performance-based differentiation as a more appropriate way to finance ACC. Reserves were seen as a useful by-product which would cover a contingency such as a major earthquake, but not essential to PAYG.

The Law Commission's report in 1988 notes how the unavoidable transition from workers' compensation to ACC contributed to the subsequent misunderstandings:

[it] left behind for some people the misconception that it is simply a new means of obtaining cover against new risks, it is wrong and a cause of confusion to think of it in this way. This scheme is not in any sense an insurance system (New Zealand Law Commission, 1988, S2)

... it is unnecessary on any grounds of prudence, such a system is far more expensive in operation than the method of pay as you go and I think it is unfair to those who may later be asked to pay the extra costs.

The report of the 1970 select committee, chaired by George Gair, was strongly influenced by the insurance basis of workers' compensation. Thus, the 1972 Accident Compensation Act legislated an insurance-based approach, with differential levies set by order-in-council, with possible penalties and rebates.

The scheme also paralleled its predecessor in being set up on an apparently fully-funded basis, requiring actuarial reports at five-yearly intervals to assess whether levies were 'sufficient to meet the current and future liabilities of the Fund' (Accident Compensation Act 1972, p.7).

Campbell (1996) questions whether these requirements as set out in the act

implied a clear obligation for a funded scheme 'in the strict sense'. It appeared not to have operated this way in the 1970s. Woodhouse is in no doubt that this piece of the act was based on a misconception of the nature of the scheme, and he noted in 1979 that his views and those of the commission 'had been on a collision course for some time':

The notion that an instrumentality of the State engaged upon the administration of a social welfare programme should be obliged to act on a private enterprise funded principle of finance is, in my opinion, based on economic misconceptions. In the present context it is unnecessary on any grounds of prudence, such a system is far more expensive in operation than the method of pay as you go and I think it is unfair to those who may later be asked to pay the extra costs. (Woodhouse, 1979)

In 1977 Geoffrey Palmer was sceptical that the idea of full funding made much sense. He pointed to the event of rapid inflation in the 1970s and the emergence of a long tail of claims, which 'makes the estimate of contingent liabilities very much a matter of guesswork'. But, he claimed,

it may be worthwhile preserving the pretence of a funded scheme until the plateau is reached and it is possible to know with some certainty what the annual payout would be under a [PAYG] scheme (Palmer, 1977, p.202)

Palmer described the end result as 'a curious mixture that provides useful insulation and flexibility'. Thus, the

arrangements as they evolved in the 1970s were a pragmatic mix of PAYG and pre-funding. Eventually, as the scheme matured, with stable demographics it would be expected that inflows would equal outflows. At this point, the scheme would be essentially PAYG.

Nevertheless, the National government's 1980 Cabinet caucus committee, chaired by Derek Quigley, under pressure from employers and failing to see the point made by Woodhouse recommended a PAYG basis which was then endorsed in the Accident Compensation Act 1982 (s.19).

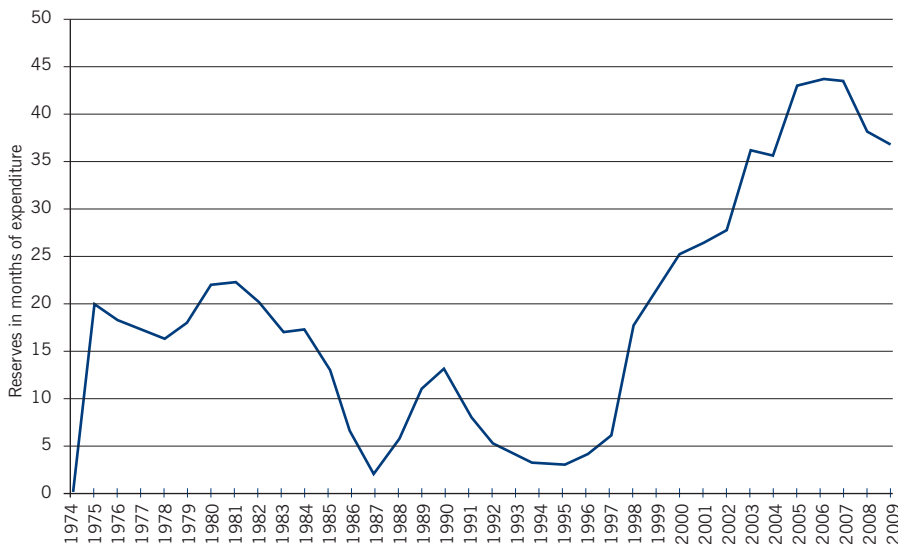
amid strident demand for review of this 'costly' scheme.

In its 1988 report on the ACC scheme, the Law Commission made several recommendations to address the many perceived problems of ACC. They had this to say about the role of reserves in their proposed draft legislation for a new act:

1. In estimating its income needs for any financial year, the Corporation shall set aside a sum amounting to not less than half its estimated expenditure for that financial year as a reserve fund.
2. The Corporation may draw on that reserve fund as a source of working capital and to meet any unforeseen contingency. (New Zealand Law Commission, 1988, p.154)

The report was largely ignored and the subsequent lack of attention to the determination of an appropriate level of reserves, and the purpose of those reserves, paved the way for the future funding debate.

Figure 1: ACC reserves in months of expenditure



Source: St John, 1999, p.161, and ACC annual reports, 1997-2009

Funding and the 1980s

By 1980 the ACC fund had reserves equal to 20 months of expenditure (see Figure 1). There was pressure from employers for a return of these funds, as they were concerned about their levy costs. However, as Woodhouse later reflected, the build-up in funds should not have been regarded as evidence that levies were too high:

'The fact that the scheme had some years to run before it reached maturity was never discussed. Nor was it said that an upgraded workers' compensation scheme would have been far more costly. Instead, the early confusion about the nature of the reserves as a painless side advantage of a still maturing scheme led directly to their remarkable political decision that they could now be eroded in order to supplement a reduction in the levies. It was rationalised on the basis that the scheme should now become a pay as you go operation – a method the system was already operating.' (Woodhouse, 1995)

The National government's 1980 decision has been widely derided as ill-fated. Rennie (2003, p.348) refers to it as 'disastrous', producing a 'short-term reduction in levies but a subsequent 'blow out' in levy rates and the obliteration of reserves'. Chapman (2009), however, locates the problem in the non-stipulation of a minimum level of reserves that should have been maintained under PAYG.

By 1985 levies had been reduced by 30%, and by March 1986 the reserves had fallen to less than was considered necessary to support a PAYG scheme (Rennie, 2003, p.340). By 1987 reserves were down to only two months' worth of expenditure (Figure 1), with claims of a cost blow-out and angry demands for review and cutbacks. In response, levies were increased sharply, 238% on average. There was recognition that the PAYG scheme had to have sufficient emergency reserves for an unforeseen event such as a major earthquake, in addition to six months of estimated expenditure, but this was never enacted (Chapman, 2009). By 1990 the reserves were back to 13 months,

Funding and the 1990s

In 1990, National repeated the cycle by once again bowing to employer pressure and reducing levies. 'The result was another serious rundown in reserves over the next five years [see Figure 1] creating the conditions once again for claims of a blow-out in costs, possible insolvency, and thus the need for sharp levy increases in the future' (St John, 1999, p.160). Employers had been resentful of the tail of long-term claimants and their obligation to fund non-work accidents. National MP Bill Birch had fomented this resentment by claiming costs had mushroomed out of control between 1985 and 1990, and calling for cutbacks and more individual responsibility. The result was the Accident Rehabilitation and Compensation Insurance Act 1992. This was supposed to make ACC 'fairer' by scaling back benefits and reintroducing more of an insurance basis: for example, by removing non-work accidents from the earners' account, and by renaming levies as premiums (St John, 1999, p.163). The ACC was, however, kept on a PAYG basis in the meantime. By 1995, reserves were again down to only three months of expenditure (Figure 1).

By 1997 reserves had improved to

equal six months of expenditure and the then chair of ACC suggested that levy reductions were possible, amid lobbying by business interests. In the 1996 Budget, however, large tax cuts had been announced by the minister of finance. In December 1997, while the average employers' premium was reduced by 10%, the earners' premium was increased from 70c to \$1.20, perhaps to partly offset the 'inadvisable' tax cuts of 1997–98 (St John, 1999). Under the new GAAP (generally accepted accounting practice), 'whole of government accounting', the increase in funding of ACC would have had favourable consequences for the operating surplus and balance sheet.

It is at this time that the government began to talk of requiring ACC to be fully funded over 15 years to align it more with private insurance. This was to allow a greater degree of competition, and, by signalling this direction, to somewhat mollify disappointed employer interests (St John, 1999, p.169).

The levy increases and the move to full funding were hotly debated, with the leader of the opposition asking the minister for accident rehabilitation, compensation and insurance, Jenny Shipley, to explain the sudden conversion to full funding:

Does the Minister recall telling a women's forum in Auckland as recently as March: 'I want to bring the average levy down over the next 3 years.' If so, when did her road to Damascus conversion on the need to move to a fully funded scheme occur? (Clark, *Hansard*, 4 December 1997)

The minister responded in terms that have echoes in the debates of 2009:

The members may scoff, but they should go back and look at their own history in managing the accident compensation scheme. We are trying not only to bring the scheme to a mature state in terms of all the accounts but to get the four accounts under control. It is in the interests of workers and levy payers to see that accident compensation does fund itself so that we can have confidence in the 24-hour cover of that scheme. (Shipley, *Hansard*, 4 December 1997)

The Accident Insurance Act (AIA) 1998 required employers to purchase accident insurance for their employees, and legislated for full funding of the motor vehicle (MV) account and earners' account. Premiums were to reflect the full funding of the current year's accidents and funding of the outstanding claims liability by no later than 30 June 2014. A clear connection was made between full funding and private insurance principles of incentives at numerous times in the debates. For example:

The sorts of things that have influenced me are when I visit, for example, a motorway development in Auckland where the employer and the workers tell me how proud they are of their non-accident record even though they are a major construction company, then in the next breath they tell me how they resent the fact that they are lumped together with other employers who have lousy work records. Those workers and those employers are entitled to have the experience-rating mechanism reward them for their performance. The only way we can do that is to go to the full funding of the scheme. (Shipley, *Hansard*, 2

that from time to time there had been glimpses of insight:

Ruth Dyson was absolutely spot on when she said that the reason the Government is doing this right now is to get that scheme ready for privatisation. Just as the employers' account has been privatised, the motor vehicle account is the next on the block. But in order to get it into shape for privatisation, the Government has to bring it into the fully funded scheme. (Dalziel, *Hansard*, 20 May 1999)

The curious 2000s

The election of Labour saw the social insurance principles of ACC firmly reinstated. The purpose of the new Injury Prevention, Rehabilitation, and Compensation Act (IPRC) 2001 was to 'reinforce the social contract represented by the first accident compensation scheme' (preamble). It also reversed the privatisation experiment of the AIA which had seen the employers' account opened to competition, removed the term 'insurance' from the title, and renamed premiums as 'levies'.

Surprisingly, Labour kept full actuarial funding by 2014 for the scheme as a whole,

The purpose of the new Injury Prevention, Rehabilitation, and Compensation Act (IPRC) 2001 was to 'reinforce the social contract represented by the first accident compensation scheme' ...

December 1999)

In 1999, facilitated by the move to full funding (Caygill, 2003, p.400), private competition was introduced for work accidents. Labour had, however, promised to repeal the AIA if elected in late 1999, so that the privatisation experiment was to be short-lived.

While Labour failed to appreciate adequately the connection between the goal of actuarial full funding and the end game of privatisation, *Hansard* reveals

including the non-earners' account in the IPRC. Did it not just pave the way for the new government in 2008 to claim that ACC was insolvent? Was it the influence of Treasury? Was it to enable higher levies to produce more favourable operating surpluses under the GAAP accounting rules?

A possible scenario is that Labour wanted to prevent the Quigley and Birch scenarios ever again threatening the security of the scheme. Perversely, the stick of full funding has threatened the

scheme anyway, even when reserves have actually been at an historic high in the last decade (see Figure 1).

Although Labour's conversion to full funding ACC has been hard to understand, it is unmistakable that it saw the move to full funding as a good thing:

As a consequence of improved performance by ACC, its overall unfunded liability has reduced considerably and some schemes are now approaching full funded status.

... I do remember that the National Government that held office before 1984 ran down the reserves of the corporation dramatically and put it on the point of insolvency, but of course that is not possible under the full funding model formula. (Cullen, *Hansard*, 14 March 2000)

Both pure PAYG and full-funding concepts have been used by the National government in power to attack ACC. Labour in turn failed to see the dangers of full funding and failed to question the flawed basis of using GAAP rules for a social insurance scheme when it had the opportunity

Another explanation might lie in the fiscal conservatism of the Labour government: Caygill argued that while full funding was a precursor to competition, it could be justified on its own merits. Quite clearly, the consolidation of ACC into the Crown accounts would involve the accrual of future liabilities and require levies to meet more than current needs.

This may seem a trivial argument for retaining full funding and indeed there are stronger arguments (for example the more accurate costing requirement of any proposed change to the level or form of future benefits). On the other hand, I suspect the balance sheet argument would be sufficiently persuasive for any future Minister of Finance. (Caygill, 2003, p.400)

From 2000 to 2007 (see Figure 1)

the value of ACC's reserves increased significantly. Most of the growth was due to retained investment income and strong returns in equity markets, but the economy was also strong and levy revenue was higher than forecast. ACC used the extra funds from the surplus to expand the investment portfolio in order to accumulate sufficient funds to cover the claims liability. The stated aim in the ACC annual report for 2007 was for ACC to be fully funded (ACC, 2007, p.49).

2008–09: ACC under attack

Labour bought into the concept of full funding, at least in part, because of the extreme pressure it witnessed on ACC under the PAYG approach in the 1980s and 1990s, with each period leading to large levy rises and accusations of insolvency and entitlement cuts. Although the 2000s

produced a large increase in reserves, it was not large enough to meet the requirement for full funding by 2014. The scheme was thus vulnerable once again to National's claims that the scheme was in crisis and 'technically insolvent'.

In 2009 the ACC minister, Nick Smith, used the full funding requirement as a justification for sharply increased levies and reduced ACC entitlements. However, even after share market losses in 2008, reserves were still at about 37 months of expenditure (Figure 1). The justification for full funding was the GAAP accounting requirements imposed on the government, even though these have applied selectively and should be no more applicable to ACC than to New Zealand Superannuation or health care costs (Littlewood, 2009). The driver of full funding is arguably a political and ideological agenda.

Repeating the scenario of the late 1980s, it is also convenient for the government to raise revenue via ACC levies as this will strengthen the GAAP accounts and offset the effect on the operating surplus of what may be viewed as 'fiscally inappropriate' tax cuts granted by National in late 2008. In a repeat of former history, the employers have been mollified with the promises of privatisation and competition for the work account, and by the fact that the bulk of the increase in levies would be raised from employees and motor vehicles.

Lessons to be learned

What can be learned? There are clear patterns from our past. Both pure PAYG and full-funding concepts have been used by the National government in power to attack ACC. Labour in turn failed to see the dangers of full funding and failed to question the flawed basis of using GAAP rules for a social insurance scheme when it had the opportunity (Littlewood, 2009). It also failed to point out why some level of reserves is required under a social insurance-PAYG type scheme.

The experience of PAYG is that reserves can be quickly dissipated in an evolving scheme, leading to panic about cost blow-outs and financial failure. Destabilising increases in levies follow. The more recent experience is a variation on that theme. This time, instead of reserves disappearing under PAYG, reserves have been growing strongly for some years with economic growth and favourable asset markets. The benchmark, however, has become some mythical fully-funded nirvana and the stability of the scheme is now determined by actuarial projections that are notoriously difficult to make. '[Actuarial projections] as a scientific exercise are almost as pointless as the debate in mediaeval scholasticisms as to the number of angels that can dance on the head of a pin' (Clayton, 2003, p.460).

If full funding is actually achieved at any point, share markets may still crash again, or the discount rate may fall, or the ACC may have to accommodate unforeseen expenditures or new risks in an uncertain world. Full funding is therefore a chimera as well as an inappropriate goal. The current full-funding 'crisis' may force the partial privatisation of ACC,

when what is required is a dispassionate investigation of what design of ACC, including the financing arrangements, is in society's best interests.

There is a way to prevent these destabilising attacks. First, we need to acknowledge that ACC is a form of social insurance and has clear advantages over private insurance. Second, we need to acknowledge that while full funding is an inappropriate goal, a buffer of reserves can be useful and prudent. The reserves could be, say, set as a range of years of expenditure, or set in relation to levy income, as the Law Commission (1988)

suggested. A possible rationale is to have a contingency fund sufficient to meet a large disaster and to allow practical day-to-day management, especially in unusual times such as a recession.

While levies should never be adjusted in a discontinuous way to meet some reserve objective, the level of reserves should be allowed to fluctuate in line with the economy and markets. This would give employers, individuals and markets a degree of certainty about levies over the short-to-medium term. The entitlements and design of ACC should be reviewed, independently of any actuarial

projections, to ensure New Zealand has the best possible scheme. Unfortunately, it is not presently clear how to achieve the multi-party political agreement and the economic understanding that this solution requires.

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2 For example, a forum on ACC funding was held on 15 December 2009 at the School of Business, University of Auckland. See www.rprc.ac.nz.

3 This is in some ways the core of the argument. The accounting standards of private insurance require full funding, i.e. that, each year, the company raises enough revenue to cover the all the current and future costs of accidents incurred in that year.