THE TREASURY
Kaitohutohu Kaupapa Rawa

Reference: 20170335

24 January 2018

Thank you for your Official Information Act request, received on 9 October 2017. You requested the following:

> *"My understanding is that the ACC scheme went from a pay as you go scheme to a fully funded scheme around 1999.*
> *Was that change in policy on the advice of Treasury? If so can Treasury please provide all related material doc [sic] in relation to any advice recommended by Treasury in terms of changes to the ACC scheme as above? And the relevant Government tenure of that time whom [sic] introduced the policy changes to the ACC scheme from a pay as you go to a fully funded scheme.*
> *Please amend the above if necessary in order to assist. "*

As you know, we transferred part of your request to the Ministry of Business, Innovation & Employment, as the former Department of Labour was the lead agency for these policy changes. We also extended the time limit for deciding on your request until 24 January 2018.

Information Being Released

Please find enclosed the following documents:

Item	Date	Document Description	Decision
1.	5 September 1997	Making Progress on ACC	Release in part
2.	29 September 1997	ACC Meeting with Minister for ARCI and Prime Minister on Tuesday 30 September 1997	Release in part
3.	14 November 1997	ACC reform strategy and ACC premiums	Release in part
4.	15 June 1998	ACC Reform – Funding of Existing Claims	Release in part
5.	3 July 1998	ACC Reforms – Review of Fiscal Impact	Release in part

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Wellington
New Zealand
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6.	14 July 1998	ACC: Funding Of The Tail In The Employers Account And Fiscal Effect Of The Reforms	Release in part

I have decided to release the documents listed above, subject to information being withheld under one or more of the following sections of the Official Information Act, as applicable:

- personal contact details of officials, under section 9(2)(a) – to protect the privacy of natural persons, including deceased people, and
- advice subject to legal privilege, under section 9(2)(h) - to maintain legal professional privilege.

The views and advice presented in these documents do not necessarily represent the current views and advice of the agencies concerned.

In making my decision, I have considered the public interest considerations in section 9(1) of the Official Information Act.

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website.

This reply addresses the information you requested. You have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Davin Hall
Acting Manager, Health

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TOIA 20170335

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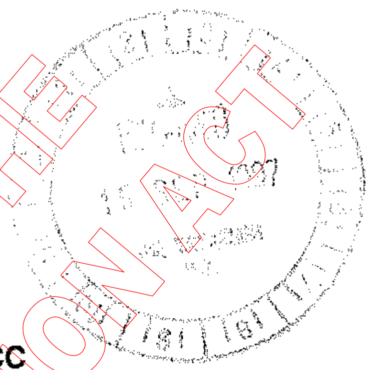
05 SEP 1997
in The Office of
Hon Winston Peters

TREASURY REPORT COVER SHEET



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Report No: T97C/3155

Date: 5 September 1997

Security Classification: In Confidence

Subject: **Making Progress on ACC**

	Action Sought	Deadline
Treasurer	Agree to discuss with Treasury	Prior to the meeting with the Minister for ARCI.
Minister of Finance	Agree to discuss with Treasury	Prior to the meeting with the Minister for ARCI.
Associate Treasurer	Read	

Contact for Telephone Discussion (if required):

Name	Position	Telephone Direct Line	Telephone After Hours	Suggested First Contact
Peter Bushnell	Social Policy Branch Manager	s9(2)(a)		✓
Ken Heaton	Manager, Health Regulation and Funding			

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IN CONFIDENCE

5 September 1997

Treasurer
Minister of Finance

cc: Associate Treasurer

MAKING PROGRESS ON ACC

Summary

1. At the "Next Six Months" discussion with Treasury officials you asked for a report on how to make substantial progress with ACC.

2. You have also written to the Minister for Accident Rehabilitation and Compensation Insurance (ARCI) suggesting a discussion on setting premiums in the context of addressing the ACC's underlying problems.

3. We recommend that you seek agreement from the Minister for ARCI to maintaining Employers' Account premiums at current levels while announcing changes to the management of the Scheme to be made as soon as possible. The priority is the Employers' Account because of its size and economic importance. Changing the Motor Vehicle Account would also provide significant gains.

4. The approach we suggest for the Employers' Account involves:

a separating new from existing claims;

b new claims fully-funded and competitive from a given date (we suggest 1 April 1998); and

c old claims separately managed (either by the Corporation or privately, continuing on a pay-as-you-go basis) with the aim of significantly reducing the number of long term (at least 12 months) earnings related compensation recipients.

5. In the Employers' Account this is likely to be possible with a new premium only slightly above the current premium, or — with the cross-subsidisation of other accounts removed from the Employers' Account and more innovative claims management — with no increase to premiums.

6. The proposal would be consistent with the Coalition's statement on improving the management and administration of the ACC and would retain a publicly mandated scheme — the core of the ACC.

7. We are arranging a meeting to discuss these ideas with you.

The Current Compulsory No-Fault Framework

8. The ACC Scheme is a compulsory, no fault, personal injury insurance scheme for accidents. Insurance is provided by the ARCI Corporation. The Corporation is a Crown entity with a governing Board that reports to the Minister for ARCI. It is a statutory monopoly provider of accident insurance, insofar as all earners, employers, self-employed, and motor vehicle owners are compelled to pay premiums. It also services non-earners with costs met by the Crown. Appendix 1 summarises the structure and funding of the Scheme and Corporation.

9. The Scheme has the two goals of minimising the costs of accidents and providing quick and certain access to compensation. It is an attempt to design an approach that gets the best possible balance between the two.

Defining the Problem

10. The problem can be expressed as follows:

a delivery of the Scheme is very poor, in terms of the overall management of claims and costs;

b this generates significant costs to business and the economy by raising the cost of labour by around 2%;

c while the Scheme has reduced the costs of litigation associated with accidents, this is at the expense of good pricing. This discourages accident avoidance and raises costs overall;

d the fundamental problem is the status of the Corporation as a monopoly provider;

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e the key improvement required is to move to competitive provision as a means of increasing innovation and quality, and lowering costs.

11. **Delivery of the Scheme is Very Poor** — The delivery of personal injury insurance by the Corporation is very poor, with little cost control, poor quality services, and no real relationship between the customer (premium payer) and the Corporation. This leads to poor risk management in the economy, and continuing high risk for Government. Major indicators are:

a the Corporation's failure to meet most of the targets in its 1996/97 Service Agreement (see Appendix 2);

b ineffective return to work processes, leading to a burgeoning and badly managed long term (at least 12 months) tail. This currently stands at 31,000 (compared to 34,000 unemployment beneficiaries of the same duration). Many of these people are able to work — an estimated minimum of 9,500 when ACC last investigated the tail about two years ago;

c a consequently large outstanding claims liability (future claims costs of claims that have already been accepted), currently at $8.3 billion. If this continues to increase it will inevitably lead to premiums doubling or tripling in 10 to 20 years;

d little cost control and so generally increasing expenditure — $500 million in 1983/84, currently $1,600 million and forecast to rise to $2,000 million by 2000/01;

e limited risk based pricing, providing few incentives for safe behaviour and safety investment;

f volatile premiums, especially in the Employers' Account making business planning difficult — e.g., a 20% rise for 1995/96 and now an ACC-proposed 36% decrease for 1997/98; and

g other poor management, for example —

- claims by the Corporation (made during the pre-Budget baseline update) that it cannot control its labour costs;
- introduction of the Complex Personal Injury Regulations with no financial management systems;
- the recent attendant care contingent liability estimated to be $263 million, about 40% of which could involve extra costs for the Crown;
- recent IT investment problems highlighted by the media.

12. Appendix 2 contains more detail on the Corporation's recent performance.

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13. **Costs to Business and the Economy** — The current delivery of the ACC imposes costs on business and the economy by raising the costs of employing people in New Zealand. In particular the Corporation:

a allocates the costs of old claims in ways that disadvantage industries making significant efficiency gains, or where the size of the industry has decreased (e.g., this is a particular issue in the meat industry);

b fails to price premiums to reflect insured parties' true risk (risk based pricing). This leads to cross-subsidies of high risk industries by low risk and good performers, poor allocation of resources and poor use of inputs;

c does not try new ways of managing claims or the tail. What innovation there is, is generated by Government rather than the Corporation (e.g., the 1996 Amendment Act's introduction of the work capacity test);

d fails to ensure the efficient use of labour through poor return to work processes, leading to people who could work not working and remaining in poverty traps; and

e the additional tax on business from the annual costs of old claims.

14. ACC expenditure is a significant proportion of GDP — 1.7% in 1996/97 — so losses from lack of innovation and poor use of inputs are potentially large. As well, these factors mean that there are more injuries than there need to be and so an additional financial burden on the economy.

15. **The Fundamental Problem Is the Corporation's Monopoly** — The reason for the Corporation's poor performance fundamentally stems from its status as a monopoly provider. This structure means that however good Corporation staff are, there are very few incentives on the Corporation to:

a adopt high quality financial management;

b introduce innovation;

c use resources efficiently; or

d focus on a key client group — premium payers.

16. Even if substantial improvements are made to the Corporation, under current structures these are unlikely to be sustainable.

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Improving Scheme Delivery

17. In order to achieve its goals, the ACC Scheme must:

a offer products (compulsory personal injury insurance for accidents) that are properly designed and priced; and

b face competition in delivery of these products.

18. The approach we recommend is to take the opportunity afforded by the Corporation's premium proposals to make a fundamental and rapid improvement to the delivery of the Scheme — introducing a competitive scheme in the Employers' and possibly Motor Vehicle Accounts at a specific and early date (we suggest 1 April 1999, the end of the ACC's 1998/1999 premium year). This could be signalled at the premium round in October, with details of the strategy announced in the 1998 Budget.

19. Expenditure on the Employers' Account is one half of total Scheme expenditure. Earnings related compensation expenditure on that Account is one third of total ERC expenditure. We therefore think that this is the priority Account. The Motor Vehicle Account is the one where the greatest gains could be made from pricing improvements, so we think it is the second highest priority.

20. This approach of rapid and fundamental improvement would:

a directly address the real reason for problems in the ACC;

b provide earlier and more certain results; and

c act immediately to boost business confidence.

21. It would also support some of the key ways Government can assist economic development:

a improving the functioning of the market by privatising where possible;

b encouraging enterprise and innovation by reducing business costs; and

c designing social welfare assistance so that it reinforces socially responsible behaviour.

22. Introduction of competition could be done gradually or more quickly. While the Department of Labour agrees with us that reform is necessary, its work programme currently favours a slower approach. It suggests:

a extending the Accredited Employers' Scheme and allowing employers to club together to qualify;

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b removing responsibility for regulation of the Scheme from the Corporation its; and

c moving towards separating the Scheme Accounts from the Corporation with the Accounts formally contracting for services from the Corporation.

23. However, even under a gradual approach the same issues of the future of the Corporation, the funding basis of the Scheme and how to meet the costs of old claims, would arise.

Financial Implications

24. Providing for competition in the delivery of ACC will very likely require *new claims* to be fully-funded. Full-funding means the premiums paid in a year, for claims arising in that year, are sufficient to cover all of the costs — current and future — of those claims. This reflects normal insurance practice. Moving any of the ACC Accounts on to a fully-funded basis clearly has implications for the level of premiums and how those premiums are financed.

25. There are also issues around how *old claims* are funded and managed: old claims might continue to be funded on a pay-as-you-go basis or might be fully-funded; ACC might continue to manage them or they might be managed by other providers.

26. The three basic options for who would finance a move to full-funding are:

a premium payers;

b the Crown (i.e., taxpayers);

c premium payers partly and the Crown partly.

27. The arguments are reasonably clear that new claims should be funded by premium payers. The arguments are not as clear cut in respect of old claims. Here the key issues are:

a the relative losses generated by tax-based funding versus funding through surcharges on specific groups (e.g., employers) — some work we commissioned argues that the losses from tax funding will be clearly lower than those from collecting funding from more limited sectors of the economy;

b the costs of tax funding to the economy in a time of fiscal constraint; and

c political economy factors — for example, the acceptability of a premium surcharge to the group it is levied on (e.g., employers).

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28. It terms of premium impacts, it seems clear that:

a If both new and old claims were fully-funded, the resulting premiums would be very significantly higher than current premiums.

b If new claims were fully-funded and old claims pay-as-you-go, the resulting premiums would be significantly higher than current premiums for most Accounts.

29. We have already requested the ACC to undertake financial modelling of a number of funding scenarios. Preliminary results will be available within one month. From informal discussions with ACC we understand that, for the Employers' Account — given its maturity, reserves position, and current premium level — the option in (b) above might result in a new premium only slightly higher than the current premium.

30. This difference would be further reduced if, at the same time as option (b) were introduced, the cross-subsidisation of the Earners' and Non-earners' Accounts by the Employers' Account (for pre-1992 accidents) were eliminated. If this assessment of the premium impact is correct, a potentially significant obstacle to the introduction of competition for the Employers' Account would not arise. Similarly, more innovative claims management that reduced claims costs, to be expected with competition, would make premiums lower than otherwise.

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What Would Be Required?

31. A substantial amount of work is needed to implement this proposal. We think that an inter-departmental taskforce would be required (led by the Department of Labour). The key issues to address include: developing the minimum contract, ensuring adequate protection of workers in cases of business failure, and getting some surety about the private market.

32. Some legislative change would be needed.

Relationship With the Coalition Agreement

33. The proposed approach would be consistent with the Coalition Agreement's statement on modernising the management and administration of the Scheme.

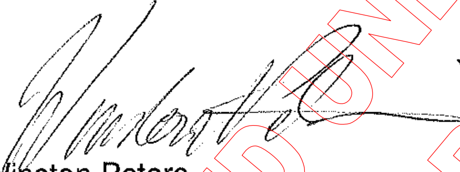
34. The Agreement also includes — "The provision of publicly owned comprehensive ACC services by the ARCIC". The proposal would retain a publicly mandated ACC Scheme — the core of the ACC.

35. While there would be a significant change to the Corporation, it would have a role for at least a significant transitional period.

Recommendations

36. We recommend that you **agree** to meet with Treasury officials to discuss this proposal.

Peter Bushnell
Deputy Secretary to the Treasury



Hon Winston Peters
Deputy Prime Minister and Treasurer

Rt Hon W F Birch
Minister of Finance

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Appendix 1: Structure of the ACC and ARCI Corporation

1. The ACC Scheme is established by the Accident Rehabilitation and Compensation Insurance Act 1992. It consists of four major accounts, the Employers', Earners', Non-Earners' and Motor Vehicle Accounts, plus the smaller Medical Misadventure and Subsequent Work Injury Accounts.

2. The Scheme is administered by the ARCI Corporation, a Crown entity established under the ARCI Act. The Corporation:

- manages the Accounts;
- provides services to the accounts (e.g., claims management, rehabilitation, assessment for Earnings Related Compensation (ERC) and Independence Allowance, investment of reserves);
- provides a claimant dispute resolution process (appealable to the courts);
- provides business and premium setting advice to government; and
- is responsible for consultation with premium payers.

3. The Corporation is tax exempt and does not face a capital charge. As a Crown entity it is subject to the Ombudsmen and Official Information Acts.

4. Total Scheme expenditure was $1,633 million in 1996/97 — 1.7% of GDP.

5. The Scheme does not separately account for the Corporation and the Accounts — they are treated as a single entity. The Scheme is consolidated into the Crown Accounts at the end of each financial year. The Scheme's end of year surplus directly impacts on the Crown's operating balance.

6. The Corporation does not recognise future years' costs of current claims (i.e., the outstanding claims obligations) as a liability in its accounts. It is noted in those accounts only, and so is also noted in the Crown's accounts.

7. The Government is responsible for setting premiums, for specifying the contract between the Corporation and premium payers (e.g., the level of ERC and Independence Allowance) and for establishing a Service Agreement setting out performance expectations with the Board of the Corporation.

8. The Scheme is funded on a pay-as-you-go basis. This means that the premiums collected in any one year meet: that year's costs of claims made in that year, and that year's costs of claims made in past years. This contrasts with a fully-funded scheme where the premiums collected in any one year are set to meet the total estimated costs of claims (current and future costs) made in that year.

9. The characteristics of the four major accounts are summarised in Table 2.

TABLE 2: THE FOUR MAJOR ACC ACCOUNTS

	Motor Vehicle	Employers'	Earners'	Non-Earners'
What costs are covered?	Injuries that involve motor vehicles.	Work injuries to employees and self-employed. Currently also non-work injuries that occurred before 1/7/92.	Non-work and non-motor vehicle injuries to earners (including self-employed).	Non-motor vehicle injuries to non-earners.
Who funds the account?	Registered motor vehicle owners and petrol buyers.	Employers and self-employed.	Wage and salary earners.	Taxpayers.
How is the account funded?	Through a premium included in vehicle registration, and an excise on petrol.	An annual premium.	An annual premium.	Appropriation under Vote: ARCI.
What is the current premium rate?	$90 for a car. 2 cents per litre of petrol = $65 million for 1996/97.	The average is 2.61% of wages and salaries.	0.62% of earnings.	1996/97 funding = $212 million. This approximates an average annual premium of $145.
What is the premium range?	Depends only on vehicle type, e.g., — motorcycle: $94.50; mopeds, tractors, vintage vehicles: $31.50.	Rates for premium classification units (PCUs) range from 1.21% to 10.02%. PCUs are based on industry type.	Zero — all earners pay the same rate.	Zero
How are premiums collected?	Premiums collected through the vehicle registration system; and excise by Customs from oil companies.	By IRD	By IRD — employers pay for employees through the PAYE system.	From general taxation
Compensation expenditure, 1996/97	$136.2 m. (47% of account exp.)	$617.9 m. (71%)	$158.6 m. (55%)	$15.1 m. (9%)
Total expenditure, 1996/97	$288.2 m.	$873.2 m.	$290.8 m.	$170.0 m.
TOTAL SCHEME EXPENDITURE	$1,633 million (1.7% of GDP)			
Compensation claims, 1996/97	11,569	71,815	44,330	Including Medical Misadventure Account: 2,347
Total Scheme compensation claims	130,000			
TOTAL SCHEME CLAIMS	1996/97 figure unavailable. 1995/96 = **1.45 million** (90% medical only).			

10. The two minor accounts provide cover for medical errors, rare and severe consequences of medical treatment, and work injuries that recur more than 28 days after full rehabilitation, respectively. Total costs for 1996/97 were $7.8 million and $0.98 million respectively. Funding for the Subsequent Work Injury

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Account comes from each of the four main accounts, and that for the Medical Misadventure Account from the Earners' and Non-Earners' Accounts.

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Appendix 2: The Performance of the ARCI Corporation

1. Since 1995/96 the Board of the Corporation and the Minister for ARCI have negotiated an annual Service Agreement that specifies targets and key performance indicators that the Corporation will achieve. Table 1 below outlines the performance of the Corporation against the key targets in the 1996/97 Agreement. As the crosses indicate, the Corporation achieved none of its key targets.

TABLE 1: ACC PERFORMANCE AGAINST 1996/97 SERVICE AGREEMENT KEY TARGETS

	Target	Actual	Variance	Change from 1995/96
Long term claimants (≥ 1 year)	28,000	30,483 ✗	+2,483	+839 (worse)
3 month continuance rate (% of claimants whose duration exceeds 3 months)	21.1%	24.2% ✗	+3.1%	+2.0% (worse)
1 year continuance rate (% of claimants whose duration exceeds 1 year)	10.7%	11.3% ✗	+0.6%	+0.1% (worse)
Weekly compensation claim reactivation rate	7.0%	9.3% ✗	+2.3%	0.0%
Other claim reactivation rate	16.5%	19.2% ✗	+2.7%	+1.8% (worse)
Review of ACC decisions (i.e., successful appeals)	33%	35% ✗	+2%	–0.7% (better)
Communications monitor — favourable perception of ACC	70%	57% ✗	–13%	–6% (worse)

2. The Corporation did achieve an improvement in claims processing timeliness for non weekly compensation claims (exceeding the 25 day target by 3.5 days, and last year's result by 1.7 days). However, claims timeliness for weekly compensation claims was 1.6 days worse than the 25 day target (but improved over 1995/96 by 1.1 days).

3. The Corporation's reaction to this failure was to argue that the targets were poorly defined and not in its control.

Signed Sim targets for 97/8.

Poor Rehabilitation Performance

4. Despite a stated management focus on rehabilitation, the Corporation's rehabilitation performance has not improved and continues, for example, to compare badly with the Victorian Workcover workers' compensation scheme. The Victorian scheme provides cover comparable to the ACC Employers' Account (perhaps with even greater incentives on workers to remain on the scheme).

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5. A key measure of the success of rehabilitation is the size of the long term (at least 12 month) tail. The ACC's tail of claimants in receipt of ERC for at least a year continues to grow. It is now nearly 31,000, compared to 36,000 long term unemployment beneficiaries. Some analysis of the characteristics of long term claimants was carried out about two years ago and indicated that a significant proportion would be able to work.

6. In the Victorian Scheme in 1994/95, 7.4% of claimants continued on the scheme for more than a year. This compares with the latest ACC performance of 14% in the Employers' Account.

7. The Accredited Employers' Scheme is the one area in the Scheme where some opting out from Corporation provision is permitted. It allows, with Corporation approval, large employers to self insure for the first year of accident coverage. Currently accredited employers cover about 4% of the labour force. This is the one area where rehabilitation performance is as good as the Victorian Scheme — latest figures (from December 1996) are identical: a continuance rate of 7.4% at one year.

8. The cost of the tail is significant, forming about 59% of Employers' Account premiums, 43% of Motor Vehicle Account premiums and 31% of Earners' Account premiums.

9. The latest estimate of the future cost of current claims (the outstanding claims liability) is $8.3 billion at June 30 1997. This measures the sum that would be needed, invested at current rates, to meet these future costs.

Poor Pricing

10. With the exception of the Employers' Account, there is almost no risk based pricing in the Scheme. Risk based pricing of cover is one of the most effective ways of signalling good and bad behaviour, and providing incentives for investment in safety. The Motor Vehicle Account has three premium rates, depending only on vehicle type, which is only very loosely related to risk. There is no risk differentiation in the Earners' Account.

FIGURE 1: EMPLOYERS' PREMIUMS

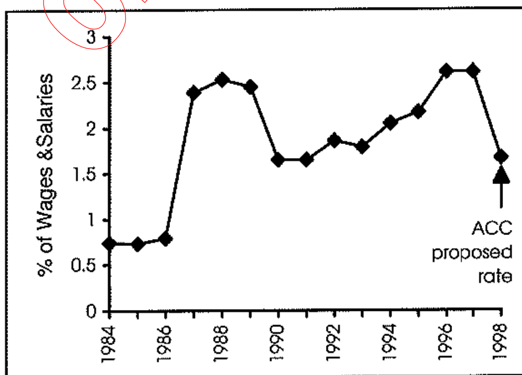
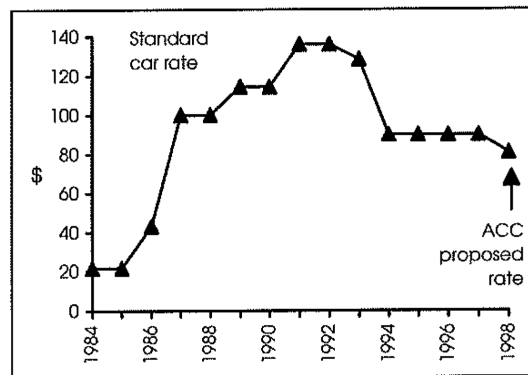


FIGURE 2: MOTOR VEHICLE PREMIUMS



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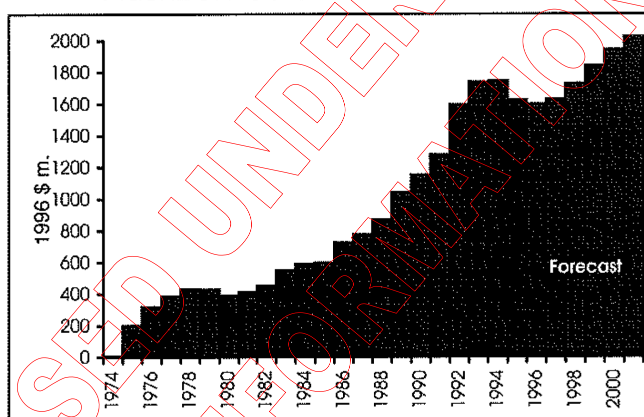
11. As shown in the figures above, premium rates have been generally volatile. This is a major concern to employers especially, as it makes their financial planning difficult and undermines the safety incentives provided by experience rating.

Financial

12. The 1992 ARCI Act was passed partly as a response to rapid and uncontrolled increases in the costs of the Scheme. Expenditure continued to rise after the 1992 Act and is forecast to continue increasing.

FIGURE 3: ACC SCHEME EXPENDITURE



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13. The Corporation also stated in the process of the Pre-Election Baseline Update, that it considered its own labour costs to be uncontrollable.

Risks

14. Government is often faced with crises that are difficult to manage because they have already happened, or are difficult to repair, or it is too hard to know what to do. Recent examples are:

- the attendant care risk — estimated to be $263 million, with around $103 million falling directly onto the Crown through Vote: ARCI,
- recent IT investment problems, including expenditure that exceeded Board approvals and an apparent failure of the project to provide any returns, and
- inadequate management since introduction, of the Complex Personal Injury Regulations, including poor financial and operational systems and little if any management oversight, leading to uncontrolled price increases.

TREASURY REPORT COVER SHEET

Report No: T97C/3498

Date: 29 September 1997

Security Classification: In Confidence

Subject: **ACC Meeting with Minister for ARCI and Prime Minister on Tuesday 30 September 1997**

	Action Sought	Deadline
Treasurer	Forward copy of this note to the Minister and Associate Minister for ARCI and the Prime Minister Read	By Monday evening Before your meeting at 3:30 Tuesday 30 September 1997
Minister of Finance	Read	Before the meeting at 3:30 Tuesday 30 September 1997
Associate Treasurer	Read	Before the meeting at 3:30 Tuesday 30 September 1997

Contact for Telephone Discussion (if required):

Name	Position	Telephone Direct Line	Telephone After Hours	Suggested First Contact
Peter Bushnell	Manager, Social Policy Branch	s9(2)(a)		✓
Ken Heaton	Manager, Health Regulation and Funding			

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T97C/3498

IN CONFIDENCE

29 September 1997

Treasurer
Minister of Finance

cc: Associate Treasurer

ACC MEETING WITH MINISTER FOR ARCI AND PRIME MINISTER ON TUESDAY 30 SEPTEMBER 1997

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Executive Summary

1. You are meeting with the Minister for ARCI and Prime Minister on Tuesday 30 September to discuss ACC issues.

2. A reduction in the ACC Employers' premium would have significant consequences on the Crown's fiscal position, especially in 1998/99 and 1999/2000.

3. Further reductions in the Crown's operating surplus projections may damage the credibility of the Government's commitment to prudent and sustainable fiscal policies, and would limit the Government's other fiscal options.

4. The current monopoly status of the ARCI Corporation is a serious problem for the ACC scheme.

5. At your meeting we recommend that you pursue the following objectives:

a agreement in principle to:

i introduce significant competition into at least the Employers' Account; and

ii retain Employers' premiums at current levels;

b establishment of an ad hoc Ministerial Committee for progressing ACC reform, consisting of the Minister of Finance, Minister for ARCI, Associate Treasurer and Associate Minister for ARCI.

6. Annex 1 attaches a paper that includes an outline of current institutional arrangements and the Department of Labour's work programme.

7. We have consulted the Department of Labour in the preparation of this paper. We understand that they are preparing a separate briefing note setting out their views.

8. Copies of this report are attached for referral to the Minister and Associate Ministers for ARCI and the Prime Minister if you agree.

Immediate Fiscal Problem

9. Ministers face an immediate issue - a decision on ACC premium reductions needs to be made by December (see paragraphs 16 ff).

10. A reduction in the ACC Employers' premium would have significant consequences on the Crown's fiscal position, especially in 1998/99 and 1999/2000.

11. The ARCI Corporation has consulted on options for significant reductions in the Employers' premium for 1998/99. Employers are thus expecting big premium reductions.

The Effects of the Fiscal Problem

12. The current forecast level of the Crown's operating surplus is low and already close to the "danger zone" according to some commentators.

13. Further reductions in the Crown's operating surplus projections have the potential to damage the credibility of the Government's commitment to prudent and sustainable fiscal policies.

14. Currently New Zealand is running a large current account deficit. Interest rates do not fully reflect this because financial markets have confidence in the Government's fiscal policy. Loss of fiscal credibility would put pressure on interest rates as investors would regard New Zealand as a riskier destination for their funds.

15. Reductions in the Crown's operating surplus due to changes in ACC premiums would limit the Government's other fiscal options.

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Underlying Economic Problem

16. There is also a serious and fundamental underlying problem with the ACC Scheme - the current monopoly status of the ARCI Corporation. As a monopoly the Corporation faces very weak incentives to perform. The current issues generated by the premium decision is just one example of what can happen with current structures.

How to Manage the Two Problems

17. The fiscal position could be protected and employers' expectations managed by announcing a decision not to reduce Employers' premiums, along with a plan to move to fix the monopoly status of the Corporation.

18. This would respond to employers' complaints about the volatility of premiums and poor ACC performance. (See Annex 2).

19. Fixing the monopoly status would require:

a full funding of the Employers' Account; and

b introducing competition initially into the delivery of accident compensation insurance to employers.

20. This would support the Coalition Agreement's intention to build a world-leading ACC Scheme. It would encourage more responsible behaviour and investment in safety, and less welfare dependency, by improving the pricing of insurance cover and the management of injured claimants. A publicly owned Scheme would remain.

Timing Issues

21. An ACC premium decision needs to be announced before Christmas.

22. As this will affect the Crown's fiscal position, the decision needs to be made in time for inclusion in the December Economic and Fiscal Update (DEFU).

23. Practically, this means that the absolute last date for the decision is 24 November 1997.

24. Ideally, an announcement on premiums should be made prior to DEFU publication (currently planned for 11 December 1997).

25. Lead sector groups have asked for contestable delivery of the ACC Scheme. An approach consistent with these requests would be to announce that premiums would be maintained, in part for fiscal reasons, but mainly to ease a transition to a fully funded regime where the ACC would face competition from private firms from a specific date. This date and implementation details could be announced at the 1998 Budget.

26. Annex 3 contains an indicative timetable for progressing these issues through the process of government.

Work required

27. Before Ministers could make a decision along these lines, work would be required to ensure that key implementation questions were scoped so that changes would result in the maximum benefits net of transition costs. Some questions include:

a What are the key issues that need to be addressed for implementation?

b Do officials see general solutions to these issues?

c How long will it take to develop these solutions?

d What communications strategy should be adopted?

28. These will need to be addressed by early November.

29. Particular issues we have identified so far include:

a ensuring that the ACC does not waste resources as reserves build up, especially as the resources are large and ACC is not renowned for good financial and claims management. Some possible solutions, ranging from light handed to more directive, include:

i additional administrative requirements (e.g., through the Service Agreement or directions to the Board) as to the general uses that reserves can or cannot be put;

ii requiring ACC to invest a certain part of its reserves in specified instruments (e.g., government stock) for specified terms;

iii transferring a part of reserves into a separate account that would be managed by another party, that ACC would not have access to, and from which monies would be transferred back to ACC as and when needed;

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b the appropriate regulations:

i definition of the minimum package to be offered, i.e., minimum cover and entitlements;

ii ensuring adequate financial security of providers so that purchasers of insurance can be confident in the product; and

iii ensuring a cheap and effective dispute resolution process;

c the extent and mechanisms for competition, some examples include:

i full competition between price, product (above the minimum required), and quality; or

ii central specification of risk groups and the contract to be offered, with competition for the pricing and management of these groups, e.g., via an auction; or

iii central specification of risk groups, the contract to be offered and the price insured individuals pay (i.e., centrally based risk and experience rating), with competition in claims management, via competitive tendering; or

iv splitting the current scheme into statutory funds, with explicit management contracts between the funds and competition in the management of these funds;

d arrangements for the best way of managing the tail of existing claims; and

e the medium term fiscal implications of a move to a fully funded scheme.

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Recommendation

30. We recommend that at your meeting on Tuesday 30 September Ministers:

a **agree** that Government's strategy for ACC reform be included in the agenda for Premier House;

agreed/declined agreed/declined

b **direct** officials to report to the Minister of Finance, Minister for ARCI, Associate Treasurer and Associate Minister for ARCI by Friday 5 October with a timetable and work programme to enable Ministers to make decisions before 24 November on ACC premiums;

c **agree** that interim reports against this timetable be made to an ad hoc Committee consisting of the Minister of Finance, Minister for ARCI, Associate Treasurer and Associate Minister for ARCI;

agreed/declined agreed/declined

d **direct** officials to:

i identify the key issues that need to be addressed for implementing significant competition into at least the Employers' Account;

ii provide assurance that there are general solutions to these issues;

iii develop a timeframe and work plan for developing specific solutions; and

iv report back to Treasury Ministers, the Minister and Associate Minister for ARCI and the Prime Minister by the 28 October 1997:

– on (i), (ii) and (iii) above;

– with an outline of a strategy for introducing significant competition into at least the Employers' Account;

– with clear guidance on what can realistically be announced on or before the DEFU release date; and

– a work plan for developing a detailed announcement for the 1998 Budget.

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Peter Bushnell
for Secretary to the Treasury

Hon Winston Peters
Deputy Prime Minister and Treasurer

Rt Hon W F Birch
Minister of Finance

TREASURY REPORT COVER SHEET

Report No: T97C/4087

Date: 14 November 1997

Security Classification: Budget Secret

Subject: **ACC Reform Strategy and ACC Premiums**

	Action Sought	Deadline
Treasurer	Read before meeting with Minister for ARCI If you agree, circulate copies of this paper to your Cabinet colleagues	4:30 pm, Tuesday 19 November
Minister of Finance	Read before meeting with Minister for ARCI	4:30 pm, Tuesday 19 November
Associate Treasurer	For your information	None

Contact for Telephone Discussion (if required):

Name	Position	Telephone Direct Line	Telephone After Hours	Suggested First Contact
Peter Bushnell	Manager Social Policy Branch	s9(2)(a)		✓
Ken Heaton	Manager Health Funding and Regulation			

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CA/1/0
T97C/4087

BUDGET SECRET

14 November 1997

Treasurer
Minister of Finance

cc: Associate Treasurer

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ACC REFORM STRATEGY AND ACC PREMIUMS

Introduction and Summary

1. You are meeting with the Minister for ARCI at 4:30 pm on Tuesday 19 November to discuss three papers for HSP on: ACC Reform, the ACC Employers' Premium, and the ACC Earners' Premium.

2. We recommend that you indicate to the Minister for ARCI that:

a the Coalition Agreement objectives for ACC cannot be achieved without introducing full competition;

b full competition is consistent with and will significantly improve the delivery of comprehensive, no fault, 24 hour cover — the core of the Scheme;

c full competition is also consistent with a publicly owned provider competing in the market, allowing people who value public provision to continue to purchase from the ARCI Corporation;

d Ministers are in a position to make a robust and fully defensible decision to introduce full competition, and that more investigation will not throw much more light on the pros and cons of competition, but would only serve to increase the risk of the strategy losing focus;

e consequently, the Employers' premium should remain at its current level in order to reduce the unfunded liability in that account;

f the Earners' premium should increase to 1.0667% to stop the growth of the unfunded liability in that account;

g the additional income from these premiums be quarantined from the ARCI Corporation for use only to meet the outstanding claims liabilities in these accounts upon introduction of competition; and

h there are a number of clear and strong communication points that can be made in addressing public expectations and concerns.

3. You may wish to refer this paper to your Cabinet colleagues prior to the Cabinet Committee on Health and Social Policy (HSP) on Wednesday 19 November.

The Government's Goals for ACC

4. The Coalition Agreement's Statement of General Direction for the ACC Scheme is to *Rebuild public confidence in ACC by restoring it to a world-leading, 24 hour, comprehensive but affordable accident cover*; and one of the key initiatives is *Modernising the administration and management of ACC*.

5. A world leading scheme would deliver 24 hour, comprehensive no fault accident cover, so that:

a the price people pay depends on their risk taking behaviour so that low risk good performers don't pay for high risk poor performers' costs;

b injured people receive generous, cost effective assistance, but are not permitted to languish in long term dependency;

c the costs of accidents that occur today are not loaded on to tomorrow's premium payers;

d people are offered and able to choose additional cover that allows them to better meet their insurance needs; and

e this all happens without constantly increasing costs, with rigorous financial management and at a fair price.

Problems with the Scheme

6. Under the current Scheme these criteria are not met. Delivery of the Scheme is poor:

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a only the Employers' Account has any risk or experience rating. Thus, parachutists or drunk drivers get cover at a considerably discounted price;

b there is serious dependency on the Scheme — the number of greater than 12 month claimants continues to increase (currently 29,000). This leads to an outstanding claims liability estimated at $8.1 billion at 1 April 1997, forecast to be $8.6 billion by 1 April 1998 and $10.4 billion by 1 April 2001;

c there are regular complaints of lack of generosity on the one hand (e.g., the recent attendant care problems), and misdirected assistance on the other (e.g., for travel to treatment but not for travel to work);

d the pay as you go funding of the Scheme is unfair and inefficient. In the Earners' Account which is immature and so has relatively few old claims, premium payers pay far less than the true cost of cover. In the Employers' Account, firms are forced to pay for the costs generated by old, defunct poor performers; or if they are a poor performer, their long term costs are transferred to other future firms;

e there is no choice in level of cover. Additional cover must be purchased from other insurers. This requires people to pay for an additional layer of administration, allows (or requires) private insurers to shift much of their risk to the ACC, and stifles innovation in product design;

f the Scheme's costs continue to increase — $500 million in 1983/84, currently $1,600 million and forecast to be nearly $2 billion by 1999/2000;

g premiums are volatile, especially in the Employers' Account — e.g., a 20% rise for 1995/96 and now ACC are proposing a 35% fall for 1998/99; and

h financial management and accountability structures are poor, e.g., resulting in no capital budgeting process and primitive cost allocation.

7. We do not think that a world-leading Scheme can be achieved without introducing full competition. The fundamental problem with the current Scheme is the protected monopoly structure of the Corporation. Such a structure provides very few and weak incentives for high quality management, innovation, efficient resource use or effective client focus.

The Effects of Competition

8. Even though a number of caveats need to be put around the empirical evidence available on workers compensation, in our view, the evidence is clearly positive about the benefits of competition. It can be expected to lead to a more efficient, fairer and safer Scheme delivered at lower cost by:

a improved pricing — by increased experience rating and better risk pools, and so less cross-subsidisation of poor performers by good performers;

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b increased focus on what premium payers want — through innovative product design, including add-ons to the basic package and bundled insurance, risk-sharing arrangements such as various combinations of deductibles and co-payments, changes to the way benefits are delivered, e.g., voluntary introduction of lump sums;

c improved administration and claims management — insurers would have strong incentives to assist genuine cases but not malingerers;

d improved funds investment that takes account of insurers' underlying risk profiles; and

e generally improved management because of competition for customers and through ownership pressures (e.g., takeovers).

9. There are risks associated with competition, but as the ACC Reform paper points out, these risks can be addressed. We are confident that detailed solutions can be designed for New Zealand.

A Sketch of How Competition Could Be Introduced

10. The first step would be Government defining a minimum contract that employers would be required to purchase. This would be based on the current contract, and would continue to be comprehensive, no fault, 24 hour cover.

11. At implementation all new claims would be fully funded. Any insurer who met the relevant prudential requirements would be permitted to offer insurance. This could include a Crown-owned insurer (the ARCI Corporation). The Employers' Account outstanding claims liability would be recognised on the Crown's balance sheet and set directly against net worth. The unfunded portion of the liability (i.e., the liability less reserves) would be financed by a surcharge on premiums.

Winners and Losers

12. In the transition employers who currently bear the costs generated by past high cost, poor employers who have now ceased to exist, will enjoy a premium reduction. The best example of this is probably the meat industry, which has significantly improved its accident record at the same time as becoming much more efficient. The result is that current good meat processing firms pay large premiums to meet the costs of defunct bad processors.

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13. Other employers in low risk industries (e.g., banks and insurers) will therefore probably face higher premiums over this transitional period. This is fair because it evenly spreads past costs that current employers have no control over.

14. In the longer-term, more effective risk and experience rating will lead to higher risk employers (measured by an assessment of their activities and their past performance) facing higher premiums and lower risk employers facing lower premiums. The immediate impact may be that some high risk, poor performing, marginally profitable employers end up facing profitability issues.

15. In the long run, this will lead to improved safety and fewer accidents.

16. The short-term direct impact on employees will be small. With continued low cost, non-confrontational dispute resolution procedures, and given that the minimum contract is based on current legislation, employees will receive similar benefits to current entitlements. The long-term impact will be safer working conditions as the financial incentives on employers begin to bite.

Implications for Premium Setting

17. Unless Minsters decide NOT to introduce competition — i.e., if they decide now to introduce competition, or decide to delay the decision to introduce competition — we think that the premium decisions should:

a be *compatible* with the introduction of competition; and therefore

b have regard to the level of the *unfunded liability* in the accounts; and

c not be focused narrowly on the ACC's *short term cash management* needs which the current PAYG system is based on.

18. This approach is fully consistent with the obligations of the Minister for ARCI to take into account *the broad public interest* — the Minister is not obliged to accept the ACC Board's recommendations.

19. This approach suggests that premiums should be set so that the unfunded liability reduces or does not get worse. This makes the transition to full competition much easier because:

a the smaller the unfunded liability the easier it is to finance; and

b the smaller will be the pressure on premiums when competition is introduced.

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Employers Premium

20. Our comments are set out in paragraphs 40 to 51 of the Employer Premium paper.

21. A premium reduction now would:

a risk a premium increase being required to introduce competition;

b increase the size of the surcharge needed to finance the tail of old claims because reserves would be smaller at the time competition is introduced (reserves reduce the size of the unfunded liability);

c send a signal that employers might read as meaning:

i the Government is not serious about competition;

ii the reduction is not durable and not one that they can act on with confidence (i.e., if there is no competition, the historical volatility in premiums will continue — if there is to be competition, a future increase in the premium will be required for the transition).

22. As highlighted in Table 1 below, any employer premium reduction would reduce the Crown's operating balance. The current forecast level of the Crown's operating surplus is low and close to the "danger zone" according to the some commentators. Further reductions in the Crown's operating surplus have the potential to damage the credibility of the Government's commitment to prudent and sustainable fiscal policies.

Table 1: Change in Crown Operating Balance for Employers Premium ($ m.)

	1997/98	1998/99	1999/2000	2000/01
Reduce to 1.70% (ACC)	–30.3	–356.5	–358.7	–385.7
Reduce to 1.95% (Labour)	–0.4	–235.6	–232.5	–253.4
Reduce to 2.20%	+34.0	–91.3	–60.5	+37.0
No change (Treasury)	+86.8	+126.3	+184.1	+224.9

23. There are also fiscal implications for the Crown associated with maintaining the premium and moving to competition and full funding. When competition is introduced the Crown would need to recognise as a liability the outstanding claims obligations for the relevant account or accounts. This would reduce the Crown's net worth but it would not have an operating balance impact. As at 30 June 1997 the outstanding claims obligations for the Employers' Account were estimated at $5.24 billion.

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Conclusion

24. Unless the Government does not wish to proceed with competition, we consider that the employer premium should be maintained for 1998/99.

25. Maintaining the premium will facilitate the transition to competition — it is likely that fully funded premiums plus a surcharge would approximate the current employer premium.

26. We think that it is a prudent way to manage risks in the period until the Government makes a firm decision on competition if it wished to defer this decision meantime.

27. It will be important to communicate the long term benefits of a decision to maintain the premium to employer groups, given the extra short term costs. It should be highlighted too that there are major fiscal implications for the Crown.

Earners Premium

28. The issues are similar for the Earners Account: a movement to full competition would be significantly eased by beginning to address the outstanding claims liability now.

29. In this account, because it is immature and funded on a pay as you go basis, the issue is even sharper:

a the Account is transferring current costs to future earners and so building up the outstanding claims liability; and

b current earners are receiving cover at substantially below its real cost.

30. We recommend that the premium be increased to the full funded rate to stop the growth of the unfunded liability. This would mean that earners paid the real cost of cover. It would also mean that when competition is introduced, the premium increase that might be necessary would be a lot smaller than it would otherwise have to be — because the unfunded liability is smaller.

31. The fiscal implications of the ACC's and our preferred options are in Table 2 below.

Table 2: Change in Crown Operating Balance for Earners Premium ($ m.)

	1997/98	1998/99	1999/2000	2000/01
Increase to 0.7111% (ACC)	–6.7	+42.4	+99.6	+131.0
Increase to 1.0667% (Treasury)	+34.5	+238.5	+314.9	+399.7

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Quarantining the Premium Increases

32. If the Government decides to increase premiums as we suggest, it is important that the additional income is quarantined for use only to reduce the outstanding claims liability. This will retain financial pressure on the Corporation to manage efficiently. Officials would report to the Minister for ARCI and the Minister of Finance on the details of how to do this.

Communications Strategy

33. The communications strategy needs to address the decision on competition as well as the premium decisions.

34. Even though their premiums are not being reduced, employers might be accepting of this given the linkage with competition:

a maintaining the premium will facilitate the transition to full funding of the Employers Account; and

b a fully funded account is critical to improving the overall management of ACC delivery with benefits for both employees and employers.

35. Employer groups have been calling for the Government to resolve the issues of competition and funding for the ACC so that these benefits can be realised. Some unions might also be receptive to this sort of move with a signal that insurance cover and benefits were not going to be reduced.

36. Earners will clearly not welcome any increase in their premiums. The important point to make here, however, is *that current earners are being heavily subsidised by*:

a employers in respect of pre-1992 non-work accidents; and

b future earners as the current earner premium does not reflect the full cost of claims (because the account is very new and pay as you go funded).

37. We therefore recommend the following broad communication strategy:

a announce now that competition will be introduced into workers compensation;

b announce now that Government is working towards a similar goal in the other Accounts;

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c coordinate these announcements with the Employers' and Earners' premium decisions. In particular, as discussed in the accompanying paper, that the Employers' premium be retained at current levels in order to continue to reduce the unfunded liability in the Employers' Account;

d indicate that more detailed announcements of how competition will be introduced and a target implementation date will be made at the 1998 Budget, and that stakeholders will have an opportunity to comment on specific proposals before they are finally adopted by Government.

38. Examples of the key messages that can be communicated are:

a competition is an important element in delivering the Government's Coalition commitment to a world leading scheme providing 24 hour, comprehensive no fault accident cover;

b the price people pay for that cover will depend much more on their risk taking behaviour so that low risk, good performers do not have to pay for the costs of high risk, poor performers;

c injured people will continue to receive the full entitlement of cost effective assistance, and, excepting those with very serious permanent incapacity, will not be permitted to languish in long term dependency;

d the costs of accidents that occur today will not be loaded onto tomorrow's premium payers;

e the whole financial footing of ACC will improved, and its long-term financial viability secured, as the scheme moves onto a full funding basis;

f the build-up of ACC reserves will be properly safeguarded so that they cannot be wasted;

g with the discipline of competition the quality of services and their cost-effectiveness can be expected to improve, providing much greater stability and predictability for claimants and premium payers alike.

Conclusion

39. Achieving a world-leading Scheme requires the introduction of full competition — i.e., competitive underwriting. We conclude therefore that:

a Ministers should decide now to announce full competition in the Employers' Account and that they are working towards competition in the other Accounts. This will mean the work programme is clearly focused;

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b the Employers premium should remain at its current average of 2.61%. This will begin to reduce the size of the outstanding claims liability in this account and so smooth the transition to competition. This will reduce the risk that a premium increase is required on implementation; and

c the Earners premium should increase to the full funded rate of 1.0667%. This will stop the growth of the outstanding claims liability in this account.

Recommendations

40. We recommend that you **support** the papers' Treasury recommendations:

a in the ACC Reform paper — to announce now that full competition will be introduced into the Employers' Account and that Government is working towards this in the other Accounts — recommendations b (iii), (iv) and (v), and h;

agreed/declined agreed/declined

b in the Employers' Regulations paper — to retain the Employers' premium at its current average level of 2.61% — recommendations h and i; and

agreed/declined agreed/declined

c in the Earners' Regulations paper — to increase the Earners premium to 1.0667% (GST exclusive) — recommendation b (ii).

agreed/declined agreed/declined

Ken Heaton
for Secretary to the Treasury

Hon Winston Peters
Treasurer

Rt Hon W F Birch
Minister of Finance

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TREASURY REPORT COVER SHEET

Report No: T98C/1892

Date: 15 June 1998

Security Classification: In confidence

Subject: **ACC Reform — Funding of Existing Claims**

	Action Sought	Deadline
Treasurer	Read before Cabinet	10 am, Monday 22 June
Minister of Finance	Read before briefing with Treasury	5 pm, Monday 15 June
Associate Treasurer	Read before STR	8:30 am, Wednesday 17 June

Contact for Telephone Discussion (if required):

Name	Position	Telephone Direct Line	Telephone After Hours	Suggested First Contact
Peter Bushnell	Branch Manager, Social Policy Branch	s9(2)(a)		✓
Carl Bakker	Director Education and Labour Markets			

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IN CONFIDENCE

15 June 1998

Treasurer
Minister of Finance

cc: Associate Treasurer

ACC REFORM — FUNDING OF EXISTING CLAIMS

Executive Summary

1. This report addresses how the existing claims liabilities in the Employer's Account of the ACC scheme should be funded. It also addresses associated fiscal issues. You are scheduled to discuss these issues with Treasury officials on Monday 15 June, prior to an STR discussion on 17 June. A subsequent Treasury report will comment on the other seven ACC papers being submitted to STR.

2. The main issue which Ministers need to decide is **who should fund** the outstanding claims liability in the Employer's Account.

We recommend that this is fully recovered by keeping the existing surcharge on all employers (Option A). We prefer full payment by employers rather having some Crown contribution because:

a the economic costs of foregone debt repayment and foregone tax cuts would be higher than the economic costs of an employer premium;

b employers and industry organisations would be more likely under option A to pressure ARCIC to rehabilitate those in the tail in order to get a lower surcharge;

c Option A would avoid increasing fiscal pressure right now and would signal the Government's commitment to increased fiscal restraint; and

d a Crown contribution is not needed to avoid competitive premiums increasing above the current level of 2.35%.

3. A decision is required on **who should collect the proposed surcharge** from employers.

We recommend that insurers collect it as they currently do with the Fire Service and EQC levies.

4. A separate decision is required on **how to set this surcharge** - whether by continuing the current method of regulating levies for 523 industry groupings or by a simpler method.

We recommend that the surcharge be set as a % loading on premiums collected by insurers, (if risk rating is required) or as a % of liable income (if no contribution to risk rating is required) or by a mix of the two approaches.

5. When the Employer's Account is opened to competition, about 70% of employers will change from payments in arrears for ARCIC premiums to payments in advance to insurers, including the new Crown insurance company. Ministers need to decide **who should collect these arrears** which will be owed to ARCIC.

We recommend that ARCIC should collect the money directly from employers.

6. While not critical, there are advantages in Ministers deciding now on the approach to setting **premiums in those accounts not being opened to competition** immediately.

We recommend that:

a full funding should be confirmed in the Earners Account;

b full funding should be introduced into the Motor Vehicle Account; and

c pay-as-you-go funding should be retained in the Non-earners Account.

7. The fiscal impact of our recommendations (including the impact of recognition of the unfunded liability) is shown in the table below.

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Changes to 1998 BEFU Forecasts for Operating Balance

($M)	1999/2000	2000/2001	Counts against $5 billion limit
Funding the Employers Tail:			
Option A: Employer pays	0	0	Yes
Full Funding Other Accounts:			
Earners Account	0	0	Yes
Motor Vehicle Account	100	116	Yes
Taxation Impacts:			
One-off reductions in tax from double deductions	(48.5)	(61)	Yes
Premiums owed by arrear payers collected over 5 years	(8)	(17)	Yes
Effect of Treasury Recommendations	**43.5**	**38**	**Yes**
Recognition of Outstanding Claims Liabilities:			
Employer's Account	(268)	(306)	No
Motor Vehicle and Earners Accounts	(67)	(49)	No
Total Fiscal Effects	**(291.5)**	**(317)**	

Note: Other fiscal impacts will occur, but are still difficult to estimate: transition costs (estimated around $15 - 25 million), plus costs to IRD, Health and Commerce; a capital injection; changes to net worth through the recognition of claims liabilities and assets in arrears. A significant component of the regulatory cost is included in the employers premium.

8. Options favoured by Department of Labour officials would have a fiscal cost of up to $148 million in 1999/2000. To offset the cost of some of these options Ministers might consider raising the Earners and Motor Vehicle premiums above the fully funded rates to include some contribution towards reducing the tail in these accounts.

Who Should Fund the Employer's Account Tail

9. Employers currently pay for the costs of all workplace injuries. The existing average premium[1], of 2.35% of wages, is made up of two components:

a 1.55% to cover the full cost of new claims; and

b 0.80% to fund the cost of past claims (reflecting Cabinet decisions of November 1997, which moved to meet these costs over a 15 year period).

[1] A full listing of premiums for all accounts is shown in Table 3.

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10. Ministers need to decide how the cost of those past claims should be funded after the introduction of competition in July 1999.

Options

11. The Minister for ARCI is presenting four funding options in his paper to Cabinet Strategy Committee. These are set out in Table 1. Apart from the status quo option (A) each other option shifts differing portions of the funding cost to the Crown. The costs of existing claims in the Employer's Account are forecast by the Department of Labour to be $5.487 billion on 1 July 1999, but are offset by reserves of $1.1 billion.

Table 1: Changes to 1998 BEFU Forecasts for Operating Balance

Funding the Employers Tail	Net Liability funded by Crown		Premium surcharge	Total avge premium	1999/ 2000	2000/ 2001
	$b	%	%	%	$m	$m
Option A: Employer pays all	0	0	0.8	2.45	0	0
Option B: Crown pays non-work injuries pre-1992	0.8	21	0.64	2.29	(90)	(91)
Option C: Crown pays all pre-1992 injuries	2.3	52	0.52	2.17	(148)	(140)
Option D: Crown pays all tail	4.5	100	0	1.65	(426)	(434)

Notes: 1 We question whether 2.45% for Option A is a likely premium to emerge under competition for the standard policy.
2 Options A and B involve repayment over 15 years, Option C over 10 years

Option Choice

12. The Department of Labour prefers Option C. It argues for this on the basis of:

a *incentives:* that this option retains incentives on employers to remain involved in the rehabilitation of most recent injuries over which they are most likely to have control;

b *distortions in taxation:* that Option C reduces inefficiencies by relying on the broadest tax base of the Government; and

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c *fairness:* that it is fairer to employers who only generated a portion of the outstanding claims liability.

13. In response, Treasury prefers option A — employer funding of the full outstanding liability over 15 years. In relation to the Department of Labour's argument, we would note:

a *incentives:* We agree that the relationship between employer and injured employee will wane over time, but we think that there is little incentive under any of the options for individual employers to get individual employees back to work because the premium they face will at best be an industry average. Rather, Option A would place greater incentives on employers and industry organisations than Option C to apply pressure on ARCIC to rehabilitate those injured employees represented by the tail faster and more cost effectively. This is especially so where employers can point to better management by insurers under competition.

b *distortions in taxation:* In contrast to the Department of Labour, we argue that Option A would be likely to involve lower economic costs than Government funding. Two points warrant comment:

i It is wrong to estimate the economic costs of taxation on the Government's broad tax base. The economic cost of Government funding will depend on what is foregone because of the Government funding the ACC liabilities. This could be a combination of delaying further tax cuts or debt repayments, or replacing other priority expenditure Therefore, the more likely that Government funding would mean that debt repayment and/or tax cuts were foregone (because of a lower operating surplus than otherwise), the more likely it is that the economic costs of Government funding would be greater than the economic costs of employer funding. This is particularly so if the tax cuts forgone were reductions in the top personal- and corporate-tax rates of 33%.

ii The Department of Labour also argues that employer funding would have higher economic costs than Government funding because the surcharge is proposed to be risk-rated, and hence its level would vary by industry. This would represent a variable tax on labour income, which would be more distortionary than a flat-rate tax on labour income. We agree that the efficiency costs of a variable tax are greater than those of a flat-rate tax. However, we consider that this effect is unlikely to be sufficient to offset the economic cost of forgone Government funding are likely to be sufficient to offset the economic costs of forgone tax cuts or debt repayment.

c *fairness:* Option C has taxpayers meeting the cost of all pre-1992 claims liabilities, including those involving workplace injuries. This could equally be seen as unfair.

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14. In addition to these aspects, Treasury also argues full employer funding would lower the risk of the ACC reforms and hence the efficiency gains from competition being delayed because there would be no fiscal cost in 1999/2000, and hence no additional pressure on the Coalition's $5 billion spending limit.

15. The judgements about these economic impacts are finely balanced, but on the basis of reasonable assumptions, we consider that funding by employers would probably impose lower economic costs than Government funding. In light of the public comments to date, Ministers might expect employers and the business community to object to full employer funding of the tail on the grounds that they should not have to fund the cost of non-work injuries. It will be important for ministers to have a communication plan to explain the reasons for their decision.

Expected Premium Level in the Competitive Market

16. A key argument advanced for some element of Crown funding of the tail is the risk that premiums might rise after the introduction of competition. We have two concerns with the calculations of premiums made by the Department of Labour:

- pessimistic assumptions are made about the effect of competition; and
- the recovery of premium arrears is not factored into reductions in the unfunded liability.

17. Table 1 sets out the expected premium levels resulting from the funding options. We set out in Table 2 the Department of Labour officials' estimation of the potential premium of 2.45%, compared to the existing 2.35%. We do not agree with this calculation. A key difference between officials is the extent to which some of the expected additional costs associated with a change away from a monopoly, low-cost levy system will be offset by efficiency gains.

Table 2: Dept of Labour Derivation of Employer Account Premium

Fully funded claims cost (includes some administration)	1.31%
Additional insurance management/collection/marketing costs	0.2
Employers meeting full medical costs, as per ILO conventions	0.08
Regulation costs	0.05
Surcharge to fund tail liabilities	0.81
Total	**2.45%**

Note: In passing you might recall that when the Employer's Account premium was set at 2.35% in November last year the Department of Labour argued for a lower premium on the grounds that this would better reflect the premium expected to be required for competition.

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18. In Treasury's view, this assessment assumes too high an estimate of post-competition costs. While the fully funded claims cost and tail surcharge make some allowance for improved performance over the past few years, they exclude the effects of competition on injury rates and the improved management of claims. The estimate also includes the high end of the possible range of additional insurance costs, anticipating that higher marketing and collection costs will be involved.

19. Thus the 2.45% estimate assumes more costly claims management, with no advantage from competition. If additional claims administration costs and competitive incentives are unable to reduce the new claims cost and the tail surcharge, and/or provide enhanced service delivery, it is difficult to justify proceeding with the ACC reforms.

20. The ILO requirement is a quality enhancement which can be defended as such, but can be seen as not strictly relevant to a comparison with the existing premium. The regulatory charge may also be too high, as it would yield around $35 million per year (and would be in addition to existing monitoring costs).

21. In addition, the premiums have been calculated on the basis of the outstanding liabilities alone. The effect of the recovery of the premiums in arrears, amounting to an estimated $750 million as at 1 July 1999, has not been included. The Department of Labour's reason for excluding this effect is because for 70% of employers total costs of past accidents are still at these levels. This, however, confuses debt repayment with the ongoing costs of meeting the unfunded liability in the tail. The inclusion of the arrears asset would lower the net outstanding unfunded liabilities in the Employer's Account. Our estimate of the impact of recognising would be to lower the surcharge required from 0.81% to 0.67%. This would give the following result:

Table 2a: Treasury Derivation of Employer Account Premium

Item	
Fully funded claims cost (includes some administration)	1.31%
Additional insurance management/collection/marketing costs	0.2
Regulation costs	0.05
Surcharge to fund tail liabilities	0.67
Total	**2.23%**

Who Should Collect the Surcharge

22. The Department of Labour and IRD prefer that IRD continue to use existing processes on the basis that:

- this would have low collection costs; and
- the surcharge could be set in a way that meant employers' current costs would be least distorted by the costs of past accidents.

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23. We think that using insurance companies may be a better way to collect the surcharge. Neither argument raised by the other officials seems to have much force.

24. The first argument appears unlikely. Using insurers:

- is likely to be cheaper as it would piggy-back on to the insurer's invoicing systems. This should be a lower cost than IRD (which charges ARCIC some $26m pa currently); and

- it could also avoid the cost of ARCIC maintaining their 523 industry classification system in order to link the surcharge to risk since there are simpler ways to tie the surcharge to the premiums charged by insurers. If so, this would further increase the cost advantage of using insurers.

25. The second reason advanced by other officials is irrelevant. It is based on their view that it is desirable to use the existing ARCIC 523 industry classification scheme and set the surcharge for each industry under regulations as happens now. This approach could be used with insurer collection, and so is not a reason to prefer one collection method over the other.

26. There is not an immediate need to resolve the issue and officials could provide a more detailed analysis of the issues involved including consultation with the industry if Ministers wanted to pursue the option of insurers collecting the surcharge. Mechanisms would be required to deal with the surcharge to be paid by self-insured employers. There are also significant Vote implications if ARCIC was no longer required to pay IRD for premium collection.

How Should the Surcharge be Levied?

27. Officials differ in their views about what method of setting the surcharge best balances administrative costs and providing an efficient pricing signal to employers. To a large extent this reflects differing judgements about how much *current* employer risk is related to their *past* risk (and hence share of the costs of the unfunded liabilities).

28. The Department of Labour recommends a mixed approach. It would have a flat-rate charge for any non-work costs that employers were required to pay for (this would amount to 25% of the surcharge for Option A) and a risk-based component for the remainder. It recommends continuing to use the current 523 industry classifications as a basis for risk rating the surcharge at an industry level. These could be reviewed annually on the basis of performance in managing the tail, but would not include experience rating as the compliance costs would be too high with collection through IRD.

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29. If insurers are to collect the surcharge, then it would be possible to base the surcharge on either the premiums charged by insurers, or on the insured incomes or on a combination of the two. This approach would have the advantages of:

- avoiding the costs implied by the process of annual review and consultation under the current industry regulation;
- avoiding the problems that exist now with the industry levies whereby new firms or efficient firms are penalised for the poor safety of firms which might have since left the industry. Over time this problem is likely to occur more frequently with the entry and exit of firms.

30. The surcharge would reinforce the risk premia charged by insurers to the maximum extent if it was set as a percentage of the expected total premium income for the year. On the basis of premiums averaging 1.55% and the surcharge being 0.67% of wages this would translate to a premium surcharge of 43%. The relative risk rating would remain because a premium that was double the cost of another premium before the surcharge would remain double after the surcharge.

31. Alternatively the surcharge could be set as a flat percentage of the liable income. This would result in a flat surcharge of 0.67% for all employers. This approach would be appropriate if there was no correlation between current and past risk, otherwise it would tend to mask the risk premia.

32. A simple approximation of the mixed approach favoured by the Department of Labour could be obtained by a rule which based the surcharge on both the premium charged and the liable income.

33. Treasury consider that this approach would:

a minimise the cost involved in setting the surcharge each year;

b would be simple for insurers to apply; and

c would reinforce the incentives for firms to minimise accident costs.

Recovery of Arrears

34. At 1 July 1999 between $1.1 - $1.2 billion will be owed to ARCIC by employers and the self employed because of the payment of premiums in arrears. Ministers need to make three key decisions with respect to arrears:

- whether the arrears should be collected;
- if collected, how collections might be spread over time; and
- the mechanism used to collect the arrears.

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35. We recommend that the arrears should be collected. This is consistent with formally recognising arrears on ARCIC's and the Crown's balance sheets. It also matches the recognition of the outstanding claims liabilities.

36. For some employers with low risk ratings, arrears recovery in a single year may not pose a significant financial burden. Early full payment would reduce the administrative costs of dealing with arrears. For other employers with high risk ratings some spreading may be desired. Therefore, some flexibility in spreading the cost seems warranted to reduce the double premium impact. Spreading the premium also spreads the negative fiscal impact on tax revenue. Officials suggest allowing spreading over 5 years.

37. Arrears collection mechanisms could be administered by IRD or ARCIC. Officials do not favour collection by IRD for several reasons. IRD's collection mechanism is inflexible as it would require adjustments to distinguish those employers in arrears or to apply differential premium rates. The simplest approach by IRD of spreading arrears over all employers would also be seen an inequitable for those employers who had paid in advance. It would, however, involve low collection costs if IRD's system was also required for collecting the surcharge (but under Treasury's preferred surcharge collection mechanism IRD would no longer play a role).

38. Officials favour ARCIC being the collection agency. ARCIC prefers collection by IRD.

Full Funding Decisions in Other Accounts

39. This part of the Department of Labour's paper discusses whether premiums in the non-competitive ARCIC accounts should be set to cover the full costs of future injuries (full funding), increased further (full funding plus tail), left at the current rates, or lowered to cover only the expected costs for the next year (pay-as-you-go). We agree with the proposed approach of confirming the policy of fully funding the Earners Account from the 1999/2000 year, introducing full funding in the Motor Vehicle Account, and retaining pay-as-you-go funding in the Non-Earners Account.

40. The present situation in each of the ACC accounts is shown in Table 3. These numbers are subject to revision.

Table 3: Current and Fully Funded Premium Rates

Account	Outstanding Liabilities	Current premium rate	Fully Funded Rates (ie payments meet all future costs)			Tail surcharge - 15 yrs
			99/00	00/01	01/02	
	($b)	%	%	%	%	%
Employers	5.5	2.35	1.83	1.85	1.87	0.8
Earners	1.2	1.07	1.06	1.08	1.10	0.15
		$	$	$	$	$
Non-Earners	0.7	229	335	316	320	
Motor Vehicles	1.5	90	122	119	116	80

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41. The most significant change would occur in relation to the Motor Vehicle Account. Treasury favours full funding for the Motor Vehicle and Earners Accounts to achieve better pricing, to limit the growth of Crown liabilities and inter-generational inequities, and to position these accounts for the introduction of competition if Ministers decide on this in 2000. However, we are concerned that an financial accountability regime be established which adequately quarantines any increased revenue associated with this Account being fully funded. This is consistent with the decision taken last year to separate out the funds from the premium increases in the Employer's Account. Increases in premiums from $90 per annum to around $120/annum has a positive full year fiscal impact of around $100m.

42. The Ministry of Transport has signalled two concerns with the implementation of such a policy. Firstly, increasing the ACC levy component of the Vehicle Licensing Fee increases the likelihood of non-registration with potential safety ramifications. Secondly, Transport sees a need to integrate any implementation of full funding with the other reforms being proposed in the roading industry. Consequently, we agree with the proposed report back on implementation.

43. As with the Employer's Account, Ministers may with to consider increasing the premiums in the Earners and Motor Vehicle Accounts to progressively reduce the tail liabilities, amounting in the two accounts to $2.2 billion. Based on current estimates, premium and revenue impacts would be:

- *Earners:* approximately an extra 15 cents on existing premiums of $1.07, would yield an extra $40 million in a full year; and
- *Motor Vehicles:* approximately an extra $60 on the fully funded rate of $120 would yield an extra $200 million in a full year.

Fiscal Implications of Funding Decisions and ACC Reforms

44. Fiscal impacts of the decisions being proposed are assessed in relation to the 1998 BEFU forecasts. For completeness, some decisions already taken, particularly recognition, are also included. Further, other areas where fiscal costs are likely to arise are identified, where policy development in not sufficiently advanced to allow fiscal implications to be assessed. Table 4 sets out our present estimates of fiscal impacts.

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Table 4: Changes to 1998 BEFU Forecasts for Operating Balance

($M)	1999/2000	2000/2001	Counts against $5 billion limit
Funding the Employers Tail:			
Option A: Employer pays	0	0	Yes
Option B: Crown pays for non-workplace injuries	(90)	(91)	Yes
Option C: Crown pays all pre-1992 costs over 10 years	(148)	(140)	Yes
Option D: Crown pays all	(426)	(434)	Yes
Full Funding Other Accounts:			
Earners Account	0	0	Yes
Motor Vehicle Account	100	116	Yes
Taxation Impacts:			
One-off reductions in tax from double deductions	(48.5)	(61)	Yes
Premiums owed by arrear payers collected over 5 years	(8)	(17)	Yes
Recognition of Outstanding Claims Liabilities:			
Employer's Account	(268)	(306)	No
Motor Vehicle and Earners Accounts	(67)	(49)	No

45. Other fiscal impacts will occur in addition to those listed in the table, but are still difficult to estimate. These include transition costs (estimated around $15 - 25 million), plus costs to IRD, Health and Commerce; a capital injection; changes to net worth through the recognition of claims liabilities and assets in arrears and the extension of the pause period to 2 weeks. A significant component of the regulatory cost is included in the employers premium.

46. The Minister of ARCI has argued that fiscal benefits will flow from improved tail management, and these should be, in effect, anticipated and credited against the cost of any tail funding option. This argument is incomplete. Because the tail surcharge is designed to meet the costs of the tail, cost reductions should flow into a reduced surcharge - with, over time, no net benefit to the Crown. But it is possible, given current accounting treatments, for some of these changes to appear fiscally positive. (We measure the changed liability for all years but measure the offsetting reductions in premium revenue only for the years being counted.)

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Funding the Employer's Account Tail

47. Table 4 sets out the effects on the operating balance of each of the proposed options. These impacts would count against the $5 billion limit. It should be noted that Options A, B and D assume repayment over 15 years, whereas Option C assumes payment over 10 years. If the other options assumed payment over 10 years, this would increase the size of the surcharge and would have a positive fiscal impact

48. Table 4 also corrects the estimates of fiscal costs for Options C and D which appear in the paper to Cabinet Strategy Committee. Otherwise the data is consistent with the overall fiscal impact tables on page 5 of the STR paper, except that they start by adding on the increase in reserves which flow from the November 1997 decision to collect a tail surcharge.

Full Funding in Other Accounts

49. A policy of fully funding the Earners Account from the 1999/00 year is not expected to increase premiums from their current levels and so has minimal impacts on revenue flows. In contrast, moving motor vehicle premiums from $90 per annum to around $120, will have a possible positive full year fiscal impact of $100m. Table 4 includes the full amount in the 1999/2000 year, although this impact obviously depends on the timing of implementation.

Taxation Impacts

50. Tax impacts arise from the effects of moving to competition (with the payment of premiums in advance), and the recovery of arrears. There will be a transitional period in which employer's premiums will be paid both in arrears and in advance. In any year in which the 1998/99 arrears premiums are collected (in part or in full) tax revenue will be lower by one-third of the arrears amount.

51. The more recent estimation of this tax impact indicates that the one-off reductions has been greatly reduced by the move to a July 1 1999 starting date. Given the size of the double payments of premiums for employers with high risk ratings, scope may be provided for spreading the collection of arrears over several years. Table 4 reflects the situation where some employers pay the double premiums in the financial year when they fall due, while other employers opt to spread arrears payments over 5 years.

Recognition of Outstanding Liabilities

52. As published in the Budget Economic and Fiscal Update 1998, ARCIC outstanding claims obligations will be recorded on the Crown's balance sheet at 30 June 1999 and at the same time premium income will be adjusted so that the amount owed to ARCIC by premium payers, who currently pay in arrears, is also brought fully onto the balance sheet as an asset. This change in accounting policy brings ARCIC's accounts in line with generally accepted

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accounting practice and has been agreed in consultation with both the ARCIC board and the Auditor-General.

53. The change in accounting treatment brings to account an obligation that has built up over a number of years and which will have a major effect on the government's financial position. It is therefore appropriate that this accounting policy change does not impact on the current year's operating balance, but rather that it should be recognised in the statement of movements in equity as an adjustment against the Crown's net worth. This treatment is allowed under GAAP if the change in accounting policy is made to comply with a statutory requirement specifically requiring the accounting entry to give retroactive effect to the changed policy.

54. To meet this requirement we propose that a clause be included in the legislation on the ACC reforms requiring the accounting entry to be made against the Statement of Movements in Equity. The Audit Office have been consulted on this approach, and they have confirmed that it is appropriate. We will provide draft wording to Labour to cover this issue.

Recommendations

55. We recommend that you:

a **note** that Treasury officials will discuss this report with you at 5.00pm on Monday 15 June;

b **decide** whether you wish to circulate copies of this report to other ministers prior to STR on 17 June;

c **support** Option A where employers would continue to pay all the costs associated with the outstanding claims liability in the Employer's Account (this is recommendation b (i) in the STR paper);

d **support** the use of insurers to collect the surcharge rather than IRD (this is recommendation c (ii));

e **seek** a report back to STR by July 1 on how the surcharge should be set (this defers any decision on recommendation (d);

f **support** the choice of ARCIC as the collecting agency for arrears payments (recommendation f (i));

g **support** the recommendations in the STR paper on the possible move to full funding in the earners and motor vehicle accounts (j to n);

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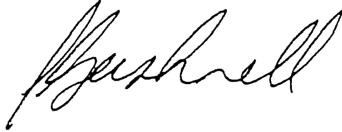
h suggest to STR that the report back above also address issues associated with a decision to implement tail funding in those accounts.



Peter Bushnell
for Secretary to the Treasury

Cabinet Strategy Committee members
Minister for ARCI

Referred: Yes/No

Rt Hon Winston Peters
Treasurer

Rt Hon W F Birch
Minister of Finance

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TREASURY REPORT COVER SHEET

Report No: T98C/2172

Date: 3 July 1998

Security Classification: In Confidence

Subject: **ACC Reforms - Review of Fiscal Impacts**

	Action Sought	Deadline
Treasurer	Read before STR	8:30 am, Wednesday 8 July
Minister of Finance	Read before briefing with Treasury, if desired	Before Ministerial Monitoring Group at 4.30 pm on Monday 6 July
Associate Treasurer	Read before STR	8:30 am, Wednesday 8 July

Contact for Telephone Discussion (if required):

Name	Position	Telephone Direct Line	Telephone After Hours	Suggested First Contact
Carl Bakker	Director, Labour Markets and Education	s9(2)(a)		✓
Steve Rylands	Manager, Working Age Policy			

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T98C/2172

IN CONFIDENCE

3 July 1998

Treasurer
Minister of Finance

cc: Associate Treasurer

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ACC REFORMS - REVIEW OF FISCAL IMPACTS

Executive Summary

1. This paper sets out various fiscal issues associated with the ACC reforms. It also includes a full set of potential recommendations to replace those tabled as part of STR (98) M 17/8.

2. We have seen a draft paper prepared for the Minister of ARCI on fiscal issues. This paper is offered as an alternative presentation on the issues it raises.

Introduction

3. Cabinet Strategy Committee discussed options for the funding of existing claims in the Employer's Account at its meeting on 17 June [STR (98) M 17/8 refers]. Additional information was sought for the 8 July meeting on:

a the state of the economy and the Crown accounts *[Treasury]*;

b updated actuarial advice on the size of the claims "tail" *[Minister for ARCIC]*;

c comprehensive and balanced information on the fiscal impacts and premium levels of funding options and other proposed entitlement changes *[Department of Labour/Treasury]*; and

d employers access to ACC related historical information on past employees *[Labour]*.

4. In addition, this note comments on mechanisms for the collection of the "tail" surcharge and the premium arrears.

5. This note comments on each item in turn. It concludes with a listing of the recommendations, including the choice between Options A and B.

State of the Economy and Impacts on the Crown Accounts

6. Extensive reports have been provided to you recently on this. The summary of the economic and fiscal outlook is attached.

Updated Actuarial Advice

7. We understand that the Minister of ARCI is advising Cabinet that ACC are presently undertaking another valuation of the outstanding claims liabilities. Preliminary estimates indicate that these liabilities are likely to be revised downwards. However, insufficient new actuarial information is available on the size of the tail in the Employer's Account to warrant adjusting our estimates of fiscal costs.

8. The new valuation of liabilities will be incorporated into the fiscal forecasts in the December Economic and Fiscal Update. It is being recommended that ARCIC, Treasury and the Department of Labour report on 5 August to the Minister of ARCI and the Minister of Finance on the process for providing assurance on ACC's valuation.

9. The Minister for ARCI has claimed positive fiscal impacts of $650 million per annum from potential improvements in long term claims. We are unsure of the source of this figure. Even taking the figure at face value:

- of this amount, the Minister states $560 million was included in the 1998 BEFU forecasts; and

- if significant cost reductions through better tail management were to eventuate, we would expect the surcharge premium to fall.

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Analysis of the Funding Options

10. The table below presents the fiscal impact of the decisions facing Ministers on ACC reform. The table shows the impact on the Crown's Operating Balance in 1999/2000 only relative to the Budget baselines (BEFU), as well as the impact on the Coalition Agreement operating limits (the counting effect):

Impact relative to BEFU ($m)	Option A	Option B	Option C	Counts?
Recognition of tail:				
- Employers Account	-268	-268	-268	No
- Earners and Motor Vehicles	-217	-217	-217	No
Subtotal for recognition	***-485***	***-485***	***-485***	
Fully funding the tail	0	-89	-148	Yes
Tax revenue effect	-36	-13	4	No
Subtotal for funding the tail	***-36***	***-103***	***-144***	
Fully funding the Motor Vehicles Account	100	100	100	Yes
Transition Costs	-20	-20	-20	Yes
Total effect on operating balance	**-441**	**-507**	**-549**	
Total counting effect	**80**[1]	**-9**	**-68**	

11. The key points to note regarding the fiscal impacts are:

- The costs of recognition ($485 million) are unavoidable at this point[2]. They do not count against the Coalition Agreement operating limit.

- Option A for fully funding the tail in the Employers Account has a net fiscal impact of -$36 million in 1999/2000, due to tax revenue effects. However, this does not count against the Coalition Agreement operating limit.

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1 This is a positive counting impact, i.e. Option A increases the resources available for Coalition Agreement new initiatives.

2 We have been advised of the Minister for ARCI's suggestion to defer recognition for the Motor Vehicles and Earners Accounts. Our initial view is that recognition simultaneously in all three accounts will be very difficult to avoid while maintaining credible Crown Accounts. We are seeking further views on this issue and will provide more advice on Monday.

- Option B has a net fiscal impact of -$103 million, of which $90 million counts against the Coalition Agreement, and Option C has a net fiscal impact of -$144 million, but a counting impact of $148 million (under Option C the tax revenue effect, which does not count, is slightly positive).

- In policy terms, the decision to fully fund the Motor Vehicles Account is separate from the option chosen to fund the tail in the Employer's Account.

- The table above assumes fully funding the Motor Vehicles account takes effect from 1 July 1999. If this date is pushed back, the positive fiscal impact in 1999/2000 is obviously reduced. The Minister's paper does not specify a start date for fully funding the Motor Vehicles account – this is the subject of a report back by officials by October this year.

Effects on Premiums

12. The table below shows possible premium levels faced by employers once competition is in place. These depend on the option chosen for funding existing claims in the Employer's Account:

	Option A	Option B	Option C
Fully funded claims cost	1.31%	1.31%	1.31%
Extra admin/marketing costs	0.20%	0.20%	0.20%
Entitlements: full medical costs	0.06%	0.06%	0.06%
Regulation costs	0.01%	0.01%	0.01%
Tail surcharge	0.80%	0.64%	0.52%
Total premium	**2.38%**	**2.22%**	**2.10%**
Arrears collection	0.34%	0.34%	0.34%
Total (for those paying arrears)	**2.72%**	**2.56%**	**2.44%**

Current premium 2.35%

13. Key points to note are:

- The estimates for the fully funded claim costs (of 1.31%) and for the tail surcharge reflect existing costs, and assume there is no advantage from competition. We think there will be downward pressures from competition on these costs.

- The premium for the tail surcharge is based on an estimated outstanding liability in the Employer's Account of $5.5 billion (the most recent available figure). If the actual liability is lower then the surcharge could also be lower. For example, if the liability was $1 billion lower, at $4.5 billion and the tail surcharge was reduced accordingly, then the table would look like:

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	Option A	Option B	Option C
Fully funded claims cost	1.31%	1.31%	1.31%
Extra admin/marketing costs	0.20%	0.20%	0.20%
Entitlements: full medical costs	0.06%	0.06%	0.06%
Regulation costs	0.01%	0.01%	0.01%
Tail surcharge	0.55%	0.39%	0.34%
Total premium	**2.13%**	**1.97%**	**1.92%**
Arrears collection	0.34%	0.34%	0.34%
Total (for those paying arrears)	**2.47%**	**2.31%**	**2.26%**

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- More recent actuarial information suggests that the effect of co-payments by employers is being revised downwards.

- Around 70% of employers will pay arrears. Figures for arrears collection are based on the arrears being collected over five years. If arrears are collected over 10 or 15 years the premiums would be lower.

14. It is also worth noting that some of the policy decisions now being made have the potential to put upward pressures on premium levels under competition, although at this stage these effects cannot be quantified:

- an ill-defined high level objective which, with litigation, raised the level of employee entitlements over time;

- the extent of insurer liability (or any imposition of employer liability) in the event of insolvency of an accident insurer;

- any levy that is charged to accident insurers to ensure funding of the non-complier's fund; and

- recovery of any regulatory costs the insurer faces, such as market entry and reporting/monitoring requirements.

Access to ACC Historical Data

15. At the 17 June Strategy Committee meeting, the Prime Minister asked if the choice of options was affected by the access of employers to information on past employees for the purposes of rehabilitating claimants. The Department of Labour is of the view that ACC is legally able to release this information, but does not have a consistent policy for doing so. We understand that the Minister of ARCI has asked ACC to clarify its policy on this issue.

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Surcharge and Arrears Collection

16. With the introduction of competition in the Employer's Account, there is an opportunity to consider an alternative surcharge collection mechanism. Moving to paying premiums in advance and recognising premium arrears in the DEFU will also emphasise the need for a more active collection of arrears. Thus, decisions are required on how the "tail" surcharge and the arrears are to be collected. Each is discussed in turn.

"Tail" Surcharge

17. Officials differ on how the surcharge should be collected. The Department of Labour proposes that IRD continue to collect the surcharge, whereas Treasury proposed a shift to collection by accident insurers. (This could occur along the lines of the addition of the Earthquake Commission levy to fire insurance.) There are two main reasons for differences of view:

a *collection costs:* We argued in our earlier Treasury report that piggy-backing on insurers' invoicing systems should lower costs relative to using IRD and maintaining the ACC's 523 industry classification scheme for risk rating purposes. IRD have since indicated that, of the $26 million paid per annum by ACC to IRD for collection, collecting premiums in the Employer's Account costs only $11 million. Of this, about 70% is claimed by IRD to be unavoidable as it relates to the cost of maintaining IRD's collection mechanism. We need to investigate this further, but if correct it means these costs will be passed on to the other accounts.

The cost of collecting the Earthquake Commission Levy is around 2.35%, which, for the annual surcharge revenue of $430 million, would yield $10 million. A lower collection cost could be expected here, as a much larger amount is to be obtained from 50% fewer insurance contracts.

b *risk rating:* Treasury's proposal is to set the surcharge as a common percentage of the premiums levied by insurers. The Department of Labour is concerned that this would exaggerate the premiums for risky activities beyond their efficient level. In our view, the surcharge risk rating could be set in a way that balanced administrative costs and maintained clear price signals. We do not see this issue as significantly affecting the choice of collection mechanism.

18. In terms of the Employer's Account alone, there is not a strong case for either mechanism. However, if the introduction of competition into the Earners Account was being considered, there is a stronger case for moving away from IRD collection. If insurer collection was chosen, a mechanism would be required to deal with the surcharge to be paid by self-insured employers.

Premium Arrears

19. Collection of premiums arrears (estimated to be $750 million as at 1 July 1999) could be made by ACC or IRD. IRD collection is not favoured, as the IRD collection system is too inflexible. It would require modification to distinguish those employers in arrears, or to allow differential arrears recovery rates. We therefore favour arrears collection by ACC.

Recommendations

20. We recommend that you provide the attached revised recommendations to the Cabinet Strategy Committee.

Carl Bakker
for Secretary to the Treasury

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Rt Hon Winston Peters	Rt Hon W F Birch
Deputy Prime Minister and Treasurer	Minister of Finance

Economic And Fiscal Outlook - Summary

- The Budget forecasts projected modest growth in the first half of 1998 and an acceleration of growth in the second half of the year.
- Since finalisation of the Budget forecasts in early April, data releases suggest that the first half of 1998 has been significantly weaker than Treasury expected. Business and consumer confidence has remained low and drought-related effects have been larger than expected.
- In addition, the last three months have seen a further deterioration in the Asian situation resulting in volatility in New Zealand financial markets. This moved monetary conditions towards a lower exchange rate/higher interest rate mix.
- Treasury's current assessment is that the economy will pick up in the second half of this year, but less strongly than assumed in the Budget.
- The weak first half of 1998 means that the pick up in growth will start from a much lower base.
- The combination of these factors suggests significantly subdued growth in 1998/99.
- Beyond 1998/99, a number of uncertainties remain. For example, it is unclear how the world economy will offset or support potential gains from the exchange rate depreciation.
- The economy is expected to strengthen in 1999/2000 in line with the gradual recovery scenario in the Budget.
- Lower economic growth in the second half of 1997/98 and 1998/99 has significant implications for the fiscal position.
- Treasury's preliminary assessment is that the operating surplus for 1998/99 could be significantly lower than projected in the Budget.
- In 1999/2000 the operating surplus is likely to be lower than projected in the gradual recovery scenario in the Budget.

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ACC REFORM: FUNDING OF EXISTING CLAIMS

Employer Account Existing Claims

a **note** that on 4 May 1998 Cabinet directed officials from the Department of Labour to report back on issues around the funding of existing claims [CAB (98) M15/15 refers];

b **note** the estimated total liability in the Employers' Account as at 1 July 1999 is $5.5 billion, of which 79% or $4.3 billion relates to the cost of workplace injuries from 1974-99 and 21% or $1.2 billion relates to the cost of non-workplace injuries from 1974-92;

c **agree** to levying employers for the cost of past workplace injuries from 1974 to 1 July 1999;

AND EITHER (Option A):

d **agree** to also levying employers for the costs of non-workplace injuries from 1974-92 currently paid for by the Employers' Account;

e **note** that including recognition of the liability, and the decisions in paragraphs (c) and (d) above involve an estimated annual reduction in the forecast Crown operating balance of $304 million from 1999/00 (of which $268 million is due to recognition of the outstanding liability and $36 million is a reduction in tax revenue due to the tax deductibility of premiums and arrears by employers), which does not count against the operating limits of the Coalition Agreement;

OR (Option B):

f **agree** that the Crown meet the costs of non-workplace injuries from 1974-92 currently paid for by the Employer's Account, at a fiscal cost of $90 million per annum, from 1 July 1999;

g **note** that including recognition of the liability, and the decisions in paragraphs (c) and (f) above involve an estimated annual reduction in the forecast Crown operating balance of $370 million from 1999/00 (of which $268 million is due to recognition of the outstanding liability, $89 million is due to the Crown meeting the costs of non-workplace injuries, and $13 million is a reduction in tax revenue due to the tax deductibility of premiums and arrears by employers), of which $89 million counts against the operating limits of the Coalition Agreement;

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h **agree**:

i ***either*** *that* **(***Department of Labour)*

A the IRD collect the surcharge using the current premium collection mechanism*;* and

B the surcharge be set in regulation by the Government; and

C be risk rated at industry levels using the current ANZSIC classification system; and

D not include experience rating;

ii ***or*** *that* (Treasury)

A insurers be required to collect the surcharge at the time they write their policies; and

B the surcharge be levied each year at a set common percentage for all premiums levies by insurers for their accident insurance policies;

C direct officials to report back by 5 August on the best mechanism to cover employers who self-insure.

g **direct** the ACC and the Department of Labour to report-back to the Health and Social Policy Committee by November 1998 on the level of the surcharge to be put in regulations for the 1999/2000 premium year;

h **agree** that the premium arrears owed by employers to ARCIC as at 1 July 1999 be collected by:

i **either** ARCIC directly from employers *(IRD, Department of Labour and Treasury*); **or**

ii IRD from employers using via self-assessment by employers in the 1999/2000 and 2000/01 tax returns *(ARCIC);*

i **note** that paragraph h (ii) will increase costs to the IRD by $2.5 to $3.5 million to administer and that IRD would not be able to include flexible payment terms;

j **if recommendation h(ii) is agreed to**, **direct** IRD to report back on how they intend to collect the arrears and the costs of implementing the collection of the arrears payment;

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k **if recommendation h(i) is agreed to direct** ACC to report to the Minister for ARCI in consultation with the Department of Labour, on how they intend to collect the surcharge, and a re-estimate of the value of the arrears by October 1998;

Funding Earners, Motor Vehicle and Non-earner Accounts

l **confirm** the policy of full funding the Earners Account for the 1999/00 premium year which is not expected to increase premiums from their current levels and has no fiscal cost;

m **agree** to introduce full funding in the motor vehicle account, which is likely to lead to an increase in the motor vehicle premium of around $30 per vehicle, from $90 per annum to $120 per annum, with an expected full-year fiscal gain of $100 million, which if introduced in the counting period will count toward (increase) the Coalition spending cap;

agreed/declined agreed/declined

n **note** that recognition of the liabilities in the Earners and Motor Vehicle Accounts will involve an estimated annual reduction in the operating balance of $217 million from 1999/00 which will not count against the operating limits of the Coalition Agreement;

o **direct** officials from the Department of Labour, in consultation with ACC, the Ministry of Transport and the Treasury to report back by October 1998 on the appropriate implementation date for full funding the motor vehicle account and the potential for risk-rating in the motor vehicle and earners accounts;

p **agree** to continue pay-as-you-go funding in the non-earners' account;

q **note** that, as part of the 8 July report back on the accountability arrangements for the ARCI Corporation, advice will be provided on how to ensure the efficient financial management of the funds accumulated as a result of introducing full funding to the Earner and Motor Vehicle Accounts;

r **direct** officials from the ACC, Treasury and the Department of Labour to report back to the Minister for ARCI and the Minister of Finance by 5 August 1998 on the process for providing assurance on ACC's valuation of its outstanding claims;

s **note** that the effects associated with liability recognition are intended to be incorporated in the 1998 December and Economic Fiscal Update; and

t **invite** the Minister for ARCI to issue drafting instructions to the Chief Parliamentary Counsel to give effect to the changes referred to in the recommendations above for inclusion in the ARCI Amendment Bill [CAB (98) M 15/15 refers].

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TREASURY REPORT COVER SHEET

Report No: T98C/2288

Date: 14 July 1998

Security Classification: Budget Secret

Subject: **ACC: Funding Of The Tail In The Employers Account And Fiscal Effect Of The Reforms**

	Action Sought	Deadline
Treasurer	Note contents	None
Minister of Finance	Note contents and discuss with the Minister for ARCI	None
Associate Treasurer	Note contents	None

Contact for Telephone Discussion (if required):

Name	Position	Telephone Direct Line	Telephone After Hours	Suggested First Contact
Carl Bakker	Director Education and Labour Markets	s9(2)(a)		✓

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CA/1/0/12
T98C/2288

BUDGET SECRET

14 July 1998

Treasurer
Minister of Finance

cc: Associate Treasurer

ACC: FUNDING OF THE TAIL IN THE EMPLOYERS ACCOUNT AND FISCAL EFFECT OF THE REFORMS

1. As requested by the Minister of Finance's Office, attached is a draft report covering:

- the fiscal impact of the ACC reforms; and
- the options for Ministers on funding the tail in the Employers Account.

2. This report could be used to replace the Minister for ARCI's earlier report which went to the Cabinet Strategy Committee on 16 June.

3. Also attached as an annex is advice from the Treasury Solicitor s9(2)(h)

Recommendations

4. It is recommended that you:

a **note** the contents of this report; and

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b **refer** the report to the Minister for ARCI.

Carl Bakker
for Secretary to the Treasury

Minister for ARCI

Referred: Yes/No

Rt Hon Winston Peters
Deputy Prime Minister and Treasurer

Rt Hon W F Birch
Minister of Finance

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14 July 1998

Chair
CABINET STRATEGY COMMITTEE

ACC: FUNDING OF THE TAIL IN THE EMPLOYERS ACCOUNT AND FISCAL EFFECT OF THE REFORMS

Estimated Fiscal Impacts Of The ACC Reforms – 1999/2000

1. The table below presents the fiscal impact of the decisions facing Ministers on ACC reform. The table shows the impact on the Crown's Operating Balance in 1999/2000 only relative to the Budget baselines (BEFU), as well as the impact on the Coalition Agreement operating limits (the counting effect):

Operating Balance Impact Relative to BEFU ($m)	Option A	Option B
Changes in the value of the liability over 1999/2000		
- Employers Account	-268	-268
- Earners and Motor Vehicles	-217	-217
Tax revenue effect	-36	-13
Total effect on operating balance	**-521**	**-498**

Effect on Coalition Agreement operating limits	Option A	Option B
Funding the tail in the employers account	0	-89
Fully funding the Motor Vehicles account	100	100
Transition Costs	-20	-20
Total counting effect	**80**	**-9**

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2. The operating balance effects will flow through to the Crown's net worth. In addition, recognition of the liability will significantly reduce the Crown's net worth, but have no effect on the operating balance.

Net Worth Impact Relative to BEFU ($m)	**Option A**	**Option B**
Recognition:		
- Employers Account	-5,487	-5,487
- Earners and Motor Vehicles	-2,609	-2,609
- Employers premium arrears	750	750
Subtotal for recognition	***-7,346***	***-7,346***
Operating balance effects	***-521***	***-498***
Total effect on net worth	**-7,867**	**-7,844**

Key Decisions for Ministers

3. There are two key decisions facing Ministers in relation to the fiscal impact of the ACC reforms:

- how to fund the liability in the Employers Account; and
- whether or not to introduce full-funding in the Motor Vehicles Account (and if so, when).

Funding the Liability in the Employers Account

4. The liability in the Employers Account is made up of two components:

- $4.338 billion for work related injuries from 1974 to 1999; and
- $1.149 billion for non workplace injuries 1974 to 1992;

for a total estimated liability of $5.487 billion.

5. Offsetting these liabilities are an estimated $974 million of assets held by ACC as at 1 July 1999 (these assets are already accounted for on the Crown's balance sheet). Therefore the unfunded liability is $4.513 billion. In addition, at the same time the liability is recognised on the Crown's balance sheet (1 July 1999) an offsetting asset of around $750 million for arrears in employers premiums will also be recognised (this asset is not currently on the Crown's balance sheet).

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6. There are two main options for funding the liability:

Option A: employers pay all the costs of the liability over 15 years via a surcharge;

Option B: employers pay all the costs related to workplace injuries, while the Crown pays for non-workplace injuries from 1974 to 1992.

7. The fiscal effects of the two options are presented in the tables above. In summary, Option A will reduce the Crown's operating balance by $36 million in 1999/2000, but will have no effect on the Coalition Agreement operating limits. Option B will reduce the Crown's operating balance by $103 million in 1999/2000, of which $89 million would count against the Coalition Agreement operating limits.

Fully-Funding the Motor Vehicles Account

8. Currently the Motor Vehicles Account is funded on a pay-as-you-go basis by a premium of $90 per annum. Increasing this premium to $120 per annum would switch this account to full-funding, and would have a positive fiscal impact of around $100 million per annum (which would count as a saving against the Coalition Agreement operating limit).

9. Currently the issue of fully-funding the Motor Vehicles Account is scheduled for a report back in October. This is to allow any decision on fully-funding to be integrated with decisions on roading reform.

10. Ministers may wish to bring forward this report back so that a decision on fully-funding can be taken now, and factored into the savings process currently being undertaken.

11. Alternatively, Ministers could take a decision now on full funding of the Motor Vehicles Account, and count the revenue generated by this decision as part of the savings process, and then consider the specific means of raising the revenue as part of the October report back. However, this would require Ministers to make a decision now on the exact timing for the introduction of full-funding (as this will affect how much of the revenue generated is within the Coalition Agreement counting period).

Effect of Decisions on Premium Levels

12. The table below shows possible premium levels, dependent on the option chosen by Ministers, and assuming:

- the value of the liability in the Employers Account is $5.5 billion as at 1 July 1999, of which $4.5 billion is unfunded;

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- all employers pay a surcharge of 0.66% to fund $3.75 billion of the unfunded liability; and

- the remaining $750 million of the unfunded liability is funded via premium arrears, which are collected from the 70% of employers who pay in arrears over a 5 year period, through an additional surcharge of 0.48%.

	Option A	**Option B**
Fully funded claims cost	1.31%	1.31%
Extra admin/marketing costs	0.20%	0.20%
Entitlements: full medical costs	0.04%	0.04%
Regulation costs	0.01%	0.01%
Tail surcharge	0.66%	0.50%
Total premium	**2.22%**	**2.06%**
Arrears collection	0.48%	0.48%
Total (for those paying arrears)	**2.70%**	**2.54%**

The current Employers premium is 2.35%.

Surcharge Collection

13. The mechanism for collection of the Employers tail surcharge needs to be chosen by Ministers. Currently IRD collects it as part of the premium. IRD could continue to do so. Alternatively, insurers could administer the surcharge in a similar way to the method used for the EQC and Fire Service Levies with general insurance companies.

14. Key dimensions of this choice are: administration and compliance costs; the desirability of retaining some incentive for employers or industries to manage down historical claim costs; the importance of charging correctly for the risk of future accidents and not masking this with the tax to cover past costs.

Collection Agency

15. If collected by IRD, officials propose that the surcharge would:

- be set in regulation by Government; and

- be risk rated at industry levels using the current ANZSIC classification system. Employer premiums would have around a flat 0.2% surcharge associated with non-work pre-1992 injuries if the Crown did not pick up these costs. Estimated industry rates would range from 0.10% to 4.2% for an average employer surcharge of 0.80%; or

- not include individual employer experience rating. Retaining the current system, would lead to high compliance costs. Employers would be likely to face two rather than one experience rating formulae. Employers would still have to use one method for paying or receiving money from the

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ARCIC and would also be likely to have one for paying or receiving money from their new insurer. If there were an experience rated surcharge, ARCIC also advise that their current system, which is not year 2000 compliant, would require a capital investment to remain operational.

16. This approach balances the need to minimise compliance costs placed on employers with the need for them to retain some financial incentive to manage recent accident costs at least at an industry level.

17. Officials apart from Treasury favour the continued use of IRD for collecting the surcharge, at least in the short-term. They can leverage off current collection mechanisms and there are economies of scale in the collection of what is essentially a tax on employers. The alternative of collecting through the insurance industry is likely to create more complexity e.g., there is likely to be more than ten collection agencies.

18. Treasury prefer to require insurers to collect the surcharge. They recommend an approach based on the premiums charged by insurers. It would operate by setting the surcharge as a percentage of the expected total premium income for the year. On the basis of premiums averaging 1.55% and the surcharge being 0.80% of wages, this would translate to a premium surcharge of 52%. A premium that was double the cost of another premium before the surcharge would remain double after the surcharge.

19. Setting the premium in this fashion would rely on estimates of the total premiums in any year. Any errors in these estimates could be picked up in the setting of the surcharge for the following year.

20. Treasury consider that this approach would:

- minimise the cost involved in setting the surcharge each year;
- would be simple for insurers to apply; and
- would reinforce the incentives for firms to minimise accident costs.

21. Officials have not consulted with insurers or employers about alternative collection methods. This would be essential if Ministers wish to consider this option. However, the Department of Labour considers the Treasury proposals for insurer collection to have serious shortcomings:

- Treasury supports employers funding the "tail" as a lower cost way of raising taxes. However, the effective tax rates would vary significantly between industries and even firms, which is generally inefficient. It favours some industries over others. The tax would be a tax on employment in industries where labour demand is more sensitive to prices.

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- The price for future accident risks would be indistinguishable from the price for past claims.

- The price of risky activities would be exaggerated beyond the efficient level. Where it is efficient for, say, forestry firms to be charged 9% of wages, under the proposal they would be charged 13%, causing them to over-invest in safety or, for example, to reduce labour relative to capital.

- Desirably, firms and industries would be rewarded for managing down historical claims. Under the proposal, firms could successfully rehabilitate past ACC claimants but gain virtually no reduction in their premium, if their current accident rate remained unchanged for whatever reason.

- Firms that self-insure - particularly large ones- would face a fraction of their liability for the tail.

Money Owed to ARCIC to Fund Outstanding Liability

22. At 1 July 1999 approximately $1.1 to $1.2 billion will be owed to the ARCIC by employers and the self-employed. The asset will be made up of the following ‘creditors’:

- all employers and self-employed will owe three months worth of premium related to the period between 1 April 1999 and 1 July 1999. Options for collecting these premiums will be reported in a paper being prepared on transitional issues; and

- around seventy percent of employers will owe 12 months of premium to ARCIC and the self-employed will owe 1 to 12 months. These are employers who began business after 1980 and self-employed who began after 1979.

23. The Corporation does not currently recognise this asset in its financial accounts but is proposing to recognise it from 30 June 1999 onwards. The recognition and collection of the premium arrears asset will partially offset the recognition of the liability in 1998/99 by increasing net worth by around $750 million. There will also be some negative fiscal implications for tax revenue as the premium in arrears is collected and deductions claimed. If collected over five years, tax revenue would be reduced by around $40-$80 million per year.

24. Any arrears that are collected will reduce the amount of revenue that the surcharge needs to cover for the outstanding claims liability. The average premium for advance payers would be lower by 0.15% for all 15 years of the surcharge. The average premium would be 0.49% higher for arrears payers for 5 years and then drop to the same level as advance payers for the remaining 10 years.

25. Ministers need to make the following decisions with respect to arrears:

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- whether the arrears should be collected;
- who will be responsible for collecting arrears; and
- a process for establishing how the arrears will be collected.

26. Officials propose that arrears be collected.

27. IRD or ACC could administer the collection of arrears. Officials do not favour collection by IRD for several reasons. IRD's collection mechanism is inflexible as it would require adjustments to distinguish those employers in arrears or to apply differential premium rates. The simplest approach by IRD of spreading arrears over all employers would also be inequitable for those employers who had paid in advance. It would, however, involve low collection costs if IRD's system was also required for collecting the surcharge.

28. Alternatively ACC could separately and directly collect arrears from employers using the IRD as an information source only. Approximately 597,000 employers would need to be invoiced by ACC and a debt collection system would need to be established. This option would not require any major additional changes to the IRD premium collection system but costs would be involved in establishing a separate collection system.

29. IRD, the Department of Labour and Treasury propose that ARCIC be given responsibility for collecting the arrears. It is recommended that ARCIC report to the Minister for ARCI in consultation with the Department of Labour and IRD, on how they intend to collect the surcharge and a re-estimate of the value of the arrears, by October 1998.

30. ARCIC favour the IRD collecting the arrears payment because they consider that:

- if IRD, ARCIC and insurers are all simultaneously collecting premiums there is scope for increased confusion; and
- if they collect arrears it would be likely to be more expensive than IRD; and
- requiring ARCIC to collect arrears may create an unfair competitive advantage.

Legal Implications

s9(2)(h)

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s9(2)(h)

Recognition of Outstanding Liabilities

32. As noted above, recognition of the outstanding liabilities will not impact on the Crown's operating balance. This treatment is allowed under Generally Accepted Accounting Practice if the change in accounting policy is made to comply with a statutory requirement specifically requiring the accounting entity to give retroactive effect to the changed policy.

33. To meet this requirement officials propose that a clause be included in the legislation on the ACC reforms requiring the accounting entry to be made against the Statement of Movements in Equity. The Audit Office have been consulted on this approach, and they have confirmed that it is appropriate.

Reconciliation to the Table in the Earlier Cabinet Paper [STR (98) 122]

34. An earlier paper to the Cabinet Strategy Committee presented the impact of the ACC reforms in a slightly different manner:

Fiscal Impacts of ACC Reforms - 1999/00

Option ($m)	A	B	C
Employers recognition and funding of tail	125	35	-23
Other Accounts Recognition	-74	-74	-74
Tax implications	-56	-56	-56
Motor Vehicle Full Funding	+100	+100	+100
Potential improvements in long-term claims	*+650*	*+650*	*+650*
Total	**+745**	**+655**	**+597**
Less Budget 1998	-560	-560	-560
Impact Against Forecast	**+185**	**+95**	**+37**

35. In relation to the figure for "potential improvements in long-term claims", the earlier paper stated: "A substantial part of the improvements depend on the scenario eventuating for improved performance in the management of long-term

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claims in the 1999/00 year". This scenario assumes around 500 more very long term claimants exit the scheme per year and the surcharge on employers is retained at a constant level.

36. In addition the 1998 Budget already included $560 million worth of these gains in it and therefore the impact of the decisions against forecast will be less positive".

Comment

37. The description of the numbers in this table as fiscal impacts was misleading. They do represent, on current forecasts, the net difference between inclusion of the Employers Account in the Crown Accounts and excluding it entirely. They do **not** represent the difference (the typical understanding of the impact) between the current forecasts (which have always included the Employers Account) and any changes associated with policy decisions.

38. If Option A is chosen, the Employers Account will have a surplus in 1999/2000 of $125 million. This will flow through to the Crown's Operating Balance. This is the figure used in the table above.

39. However, the 1998 Budget forecasts assumed the Employers Account surplus in 1999/2000 would be $393 million. Therefore, if Option A is chosen, the fiscal impact **against the Budget forecasts** would be -$268 million (i.e., $125 million less $393 million).

40. Similarly, the figure of $35 million in the table is the surplus in the Employers Account if Option B is chosen. The fiscal impact against baselines is -$358 million ($35 million less the $393 million assumed in the 1998 Budget).

41. The figure in the table above for tax implications has been re-estimated; the tax effects now depend on the premiums paid by employers (and therefore in the more recent version of the fiscal table, vary between Options A, B and C).

42. The other significant difference between the two presentations of the fiscal impacts is the figure of $650 million quoted for "potential improvements in long-term claims". This appears to refer to changes in the value of the ACC unfunded liability. Therefore:

- $560 million of the $650 million claimed improvement cannot have been included in the 1998 Budget forecasts, as the unfunded liability has not yet been recognised in the Crown accounts;

- the figure is a net worth effect, rather than an operating balance effect (recognition of the unfunded liability, when it occurs, will not affect the Crown's operating balance). Therefore including it in a table with operating balance figures is confusing.

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43. If there was a significant reduction in the value of the unfunded liability prior to 1 July 1999, this would mean a smaller reduction in the Crown's net worth when the liability is bought onto the Crown accounts. There would be no impact on the Crown's operating balance.

44. Any changes (positive or negative) in the value of the unfunded liability after 1 July 1999 will impact on the Crown's net worth. There would also be an impact on the Crown's operating balance, but this would depend on what happened to premium levels as a result of the changed valuation.

45. The change in the valuation would directly impact net worth and the Crown's operating balance by the same amount. Premium levels could remain the same despite the change in the valuation – if the change was a reduction in the value of the liability, this would mean the liability would be fully funded sooner than otherwise. In this case there would be no additional effect on the Crown's net worth.

46. Alternatively, premiums could increase/reduce to match the change in the liability. Increases in the premiums would have a positive impact on the Crown's operating balance; reductions in premiums would have a negative impact. This would partially offset the initial impact of the change in the valuation on the Crown's operating balance.[1]

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Recommendations

1. It is recommended that the Cabinet Strategy Committee:

Employer Account Existing Claims

a **note** that on 4 May 1998 Cabinet directed officials from the Department of Labour to report back on issues around the funding of existing claims [CAB (98) M15/15 refers];

b **note** the estimated total liability in the Employers' Account as at 1 July 1999 is $5.5 billion of which 79% or $4.3 billion relates to the cost of workplace injuries from 1974-99 and 21% or $1.2 billion relates to the cost of non-workplace injuries from 1974-92;

c **agree** to levying employers for the cost of past workplace injuries from 1974 to 1 July 1999;

AND EITHER (Option A):

---

1 Over time the impact would exactly offset the change in the valuation, as the net present value of the change in premium revenue must equal the change in the valuation. However in the short term (e.g., over a 3-year forecasting horizon) the change in premium revenue would be smaller than the change in the valuation.

d **agree** to also levying employers for the costs of non-workplace injuries from 1974-92 currently paid for by the Employers' Account;

e **note** that including recognition of the liability, and the decisions in paragraphs (c) and (d) above involve an estimated annual reduction in the forecast Crown operating balance of $304 million from 1999/00 (of which $268 million is due to recognition of the outstanding liability and $36 million is a reduction in tax revenue due to the tax deductibility of premiums and arrears by employers), which does not count against the operating limits of the Coalition Agreement;

OR (Option B):

f **agree** that the Crown meet the costs of non-workplace injuries from 1974-92 currently paid for by the Employers' Account, at a fiscal cost of $90 million per annum, from 1 July 1999;

g **note** that including recognition of the liability, and the decisions in paragraphs (c) and (f) above involve an estimated annual reduction in the forecast Crown operating balance of $281 million from 1999/00 (of which $268 million is due to recognition of the outstanding liability, and $13 million is a reduction in tax revenue due to the tax deductibility of premiums and arrears by employers), and also counts as $89 million against the operating limits of the Coalition Agreement;

h **agree**:

i ***either*** *that (Department of Labour)*

A the IRD collect the surcharge using the current premium collection mechanism*;* and

B the surcharge be set in regulation by the Government; and

C be risk rated at industry levels using the current ANZSIC classification system; and

D not include experience rating;

ii ***or*** *that* (Treasury)

A insurers be required to collect the surcharge at the time they write their policies; and

B the surcharge be levied each year at a set common percentage for all premiums levies by insurers for their accident insurance policies;

C direct officials to report back by 5 August on the best mechanism to cover employers who self-insure.

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g **direct** the ACC and the Department of Labour to report-back to the Social Policy Committee by November 1998 on the level of the surcharge to be put in regulations for the 1999/2000 premium year;

h **agree** that the premium arrears owed by employers to ARCIC as at 1 July 1999 be collected by:

 i **either** ARCIC directly from employers *(IRD, Department of Labour and Treasury)*; **or**

 ii IRD from employers using via self-assessment by employers in the 1999/2000 and 2000/01 tax returns *(ARCIC);*

i **note** that paragraph h (ii) will increase costs to the IRD by $2.5 to $3.5 million to administer and that IRD would not be able to include flexible payment terms;

j **if recommendation h(ii) is agreed to**, **direct** IRD to report back on how they intend to collect the arrears and the costs of implementing the collection of the arrears payment;

k **if recommendation h(i) is agreed to direct** ACC to report to the Minister for ARCI in consultation with the Department of Labour, on how they intend to collect the surcharge, and a re-estimate of the value of the arrears by October 1998;

Funding Earners, Motor Vehicle and Non-earner Accounts

l **confirm** the policy of full funding the Earners Account for the 1999/00 premium year which is not expected to increase premiums from their current levels and has no fiscal cost;

m **agree** to introduce full funding in the Motor Vehicles Account, which is likely to lead to an increase in the motor vehicle premium of around $30 per vehicle, from $90 per annum to $120 per annum, with an expected full-year fiscal gain of $100 million, which if introduced in the counting period will count toward (increase) the Coalition spending cap;

n **note** that recognition of the liabilities in the Earners and Motor Vehicle Accounts will involve an estimated annual reduction in the operating balance of $217 million from 1999/00 which will not count against the operating limits of the Coalition Agreement;

o **direct** officials from the Department of Labour, in consultation with ACC, the Ministry of Transport and the Treasury to report back by October 1998 on the appropriate implementation date for full funding the motor vehicle account and the potential for risk-rating in the motor vehicle and earners accounts;

p **agree** to continue pay-as-you-go funding in the non-earners' account;

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q **note** that as part of the report back on the accountability arrangements for the ARCI Corporation advice will be provided on how to ensure the efficient financial management of the funds accumulated as a result of introducing full funding to the Earner and Motor Vehicle Accounts;

r **direct** officials from the ACC, Treasury and the Department of Labour to report back to the Minister for ARCI and the Minister of Finance by 5 August 1998 on the process for providing assurance on ACC's valuation of its outstanding claims;

s **note** that the effects associated with liability recognition are intended to be incorporated in the preliminary Economic Fiscal Update in September; and

t **invite** the Minister for ARCI to issue drafting instructions to the Chief Parliamentary Counsel to give effect to the changes (including liability recognition) referred to above for inclusion in the ARCI Amendment Bill [CAB (98) M 15/15 refers].

Remainder of document withheld under s9(2)(h)

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