Submission

By

Business NZ

to the

Accident Compensation Corporation

on the

2006/07 Levy Rate Consultation Documents

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2006/07 ACC LEVY RATE CONSULTATION DOCUMENTS
SUBMISSION BY BUSINESS NEW ZEALAND[1]

1.0 INTRODUCTION

1.0 Business New Zealand welcomes the opportunity to comment on the 2006/07 ACC Levy Consultation Documents.

1.1 The ACC scheme and ACC levies loom large in the consciousness of New Zealand businesses both large and small, in low and high-risk occupations. On the proposed figures New Zealand businesses will pay around $452.8 million in levies to the Employers Account for the year ended 30 June 2006, a significant figure in itself. Complying with the Injury Prevention, Rehabilitation and Compensation Act and associated regulations also represents a significant compliance cost in itself.

1.2 Given that the Employers Account is the most important ACC account for stakeholders of Business New Zealand this submission will focus on that account but comments made may also be applicable to other ACC accounts, particularly the self-employed. Nevertheless, it is noted that significant premium rises are proposed for the self-employed account which again raises the question of why should employers and the self-employed not be allowed to shop around for the best accident insurance cover?

1.3 Nor do we wish to comment on changes to specific classification unit levies. Other industry associations will no doubt provide submissions on this issue. In the absence of Experience Rating we support ACC's proposal to have 121 risk groups.

[1] Background information on Business New Zealand is attached as Appendix 1.

2.0 RECOMMENDATIONS

Business New Zealand **recommends** that:

- **ACC should return the "Reserves" proportion of the Employers Account (in excess of ACC's new policy position of retaining reserves equivalent to 110% of projected claims liabilities) to Employers.**

- **ACC should note that interest rates have recently firmed and will continue to increase in the short to medium term placing downward pressure on prospective levies.**

- **ACC should further reduce the prudential margin for the Employers Account to match the unique circumstances of New Zealand's ACC scheme.**

- **ACC consider implementing a system of targeting reserves at between say 95% and 105% of estimated liabilities (for all accounts apart from the non-earners account) to minimise the risk of current employers, self-employed, earners and motor vehicle owners, either over funding or under funding claims costs.**

- **If ACC projects that the reserves proportion of claims liability is likely to fall outside the range of 95% to 105%, then the reasons why premiums are not adjusted to bring the reserves within the range should be made public to minimise the risk (either intended or unintended) of accusations of political bias in premium setting.**

- **All pre-1999 residual claims should be funded out of general taxation, or at the very least, the non-work residual claims from pre-1992.**

- **ACC proposed premiums and the rationale for such premiums be audited by independent third party actuaries (and the results made public) to ensure transparency in the premium setting process.**

- **Given that ACC is a statutory monopoly, if the Minister decides to reject or modify the premium recommendation(s) of ACC, the reasons for doing so, including actuarial analysis, should be made public to allow both premium payers and ACC to scrutinise the decisions of the Minister.**

- **The Self-Employed Work Account and the Employers' Account be retained as separate Accounts.**

- **ACC should reinstate experience rating either as a stand–alone system or in conjunction with the Workplace Safety Management Practices (WSMP) scheme.**

- **ACC proceed with the Workplace Safety Discount Scheme to "at risk" sectors and, if successful, expand the scheme to *all* sectors.**

3.0 COMMENT ON EMPLOYERS ACCOUNT

3.1 The ACC Employers Account is made up of funds paid by all New Zealand employers to cover the costs (with the exception of pre-1992 non-work injuries) of work-related personal injury. The amount that employers will pay to the account is estimated at $452.8 million for the 2006/07 year.

Reserves to maintain levy stability

3.2 ACC proposes to maintain the 2006/07 average composite employer rate at the current average rate of $1.21 per $100.00 of payroll.

3.3 The $1.21 levy (based on an interest rate return of 6.75%) is constituted by the Employers Account levy ($0.86, which is $0.02 less than the current average) plus the pre-1999 claims levy ($0.35, which is $0.02 more than the current average).

3.4 Business New Zealand considers that the proposed average premium rate of $1.21 is full of distortions and reflects a "smoke and mirrors" approach to levy setting. To briefly expand on this, ACC proposes "adding" 2 cents to the 2006/07 average rates to ensure levy stability in future years while retaining significant reserves over and above those required. The Employers' Account had "Reserves Proportion of Claims Liability" sitting at 145.6% as at 30 June 2005 with the reserves only projected to drop slightly to around 135.3% by 30 June 2006 and 127.2% for the year ended June 2007. Such reserves in excess of 100% full funding are Employers' money which is being used to effectively "subsidise" future premiums, given the expectations of future growth in the cost and number of claims.

3.5 The funds accumulated in the Employers Account reserves do not belong to ACC but are held in trust for New Zealand employers' who have essentially been overtaxed. By determining that the money will be kept in the interim to off-set (probable) future levy rises, ACC is refusing a legitimate rebate to employers. Employers value current cash-flow higher than levy stability. The opportunity cost of ACC keeping around $400 million (see ACC Account Surplus p.62 of 2006/07 Levies for Employers Consultation Document) is that employers will be unable to use their own funds for additional investment in the economy.

3.6 Increasingly, ACC appears to be making ad hoc decisions concerning premium setting processes, which act to distort the amount of premium being paid. ACC's belated decision to reduce the “prudential margin” from 115% to 110%, while a move in the right direction, is a case in point. Second is the decision by ACC to “freeze” the relativities applicable to each risk group in respect to pre-1999 residual claims. While Business New Zealand considers that such claims should be funded by general taxation, it yet again emphasizes the politically motivated approach ACC is taking to the whole question of premium setting. Third, the decision to increase the reserve adjustment period from three years to five years spreads excess reserves over a longer period. This means more reserves are held initially than justified but premiums may not need to rise as rapidly in the future. In short the decision represents a move towards cross-subsidisation from current employers to future employers and is inconsistent with a fully-funded model.

3.7 One of the advantages of a fully-funded model, amongst other things, is that changes in policy decisions or issues which affect costs (either positively or negatively), are immediately reflected in premium rates. The ad hoc process adopted by ACC masks potential cost drivers and makes monitoring ACC performance all the more difficult.

Business New Zealand **recommends** that:

ACC should return the “Reserves” proportion of the Employers Account (in excess of ACC’s new policy position of retaining reserves equivalent to 110% of projected claims liabilities) to Employers.

Interest Rate

3.8 The average employers composite levy is based on an anticipated interest rate of 6.75%. This is currently based on estimates of the 90-day bill rate, which is in turn influenced by the Reserve Bank’s official cash rate. The potential for further interest rate rises in the short to medium term does not seem to have been taken into account in ACC’s projections.

Business New Zealand **recommends** that:

ACC should note that interest rates have recently firmed and will continue to increase in the short to medium term placing downward pressure on prospective levies.

Prudential Margin

3.9 One of the greatest benefits of a fully-funded model is that the cost of the scheme is transparent and any changes to the scheme (for example additional benefits) are immediately captured within premium settings.

3.10 While Business New Zealand accepts that private sector insurers may build in a margin for “risk” in insurance premium setting, it is not at all obvious why ACC would or should do likewise. As the accident insurance market has now been returned to ACC as a state-monopoly, ACC (via government legislation) has the power to tax future employers should premiums collected in any one year fail to be sufficient to fund the ongoing costs of claims associated with accidents in that particular year.

3.11 ACC is still proposing building in a 10% prudential margin on top of the estimated claims liability for further claims (and retaining a 15% prudential margin for pre-1999 work and pre-1992 non-work claims). While Business New Zealand acknowledges that ACC has belatedly taken on Board the comments made by Business New Zealand and other business groups that the need for ACC to retain a prudential margin of 15% is unjustified, Business New Zealand would question why a margin of even 10% is justified and would recommend that an even lower margin (say 5%) would be prudent both in respect to future claims and also the unfunded liabilities associated with previous (residual) claims.

3.12 As stated above, ACC’s power to tax future employers would suggest that the need to build in such a high premium buffer would only be necessary if ACC faced competition from private sector insurers and couldn’t recoup any losses.

3.13 The danger with significant levels of reserves (over and above those required to fully-fund the cost of existing claims) is that there is the potential for significant “creative accounting” in respect to premium setting which creates distortions. More cynically, it can be seen as a mechanism for ACC (and the Government) to fudge increased costs associated with the ACC scheme.

3.14 This is clearly the case in the Employers Account for example, with ACC holding a “Reserves Proportion of Claims Liability of 145.6% as at 30 June 2005, when ACC’s “new” policy is targeted at holding 110% reserves, down from 115% previously. The Reserves Proportion of the Employers Account is projected to still be at 135.3% (June 2006) and 127.2% in 2007.

3.15 Business New Zealand notes that a report to the ACC Board[2] stated that *"ACC is not precisely akin to a private insurer, since it is government-owned – and effectively government guaranteed" (page 9).* Moreover, the report also noted that some government-owned insurers such as Workcover in South Australia do not have a prudential margin. Workcover is required to ensure that its reserves stay within a range of 90 to 110 percent of estimated liabilities. While Business New Zealand would not advocate lowering reserves to under 100 percent of liabilities (believing that having reserves less than estimated liabilities is as dangerous, if not more so, than retaining reserves well above estimated liabilities), requiring a prudential margin of 10 percent (and 15% for residual claims) for what is in effect a Crown run monopoly is nonsensical.

3.16 The other problem with including a significant prudential margin within premium levies, is that it can encourage new policies to be introduced which add to costs associated with the scheme, but which tend to get "hidden" within the prudential margin. In the absence of prudential margins, the costs associated with new policy decisions are much more transparent because they feed through immediately into pricing decisions thus allowing the public, and more particularly, premium payers, to assess the costs associated with changes in ACC policy. This point was touched on in the report to the ACC Board: *"Arguments against a prudential margin [include] …a prudential margin may encourage ACC to gather more funding than its truly needs, and later it may try to find ways to spend that additional funding in ways which are not directly consistent with its legislative authority" (page 12).*

3.17 While the concentration above has been largely on the pitfalls of "over funding" the accounts, there is also a potential danger of "under funding" which also needs to be recognised.

3.18 While the Employers' Account could be seen to be in a very healthy position with significant reserves over and above those required to fund existing claims, the same cannot be said for the Self-Employed Account. While it is outside the sphere of Business New Zealand to comment in detail on the Self-Employed Account, it is noted that the Self-Employed Account is projected to move from having a "Reserves Proportion of Claims Liability" of 100% (as at 30 June 2005) to a situation of significant deterioration to around 90.5% forecast for the year to June 2006 and even worsening slightly thereafter to 90% by June 2007. While some might argue that the Self-Employed Account is much smaller than the Employers' Account and therefore significant fluctuations can be expected, as a general principle, running projected deficits of around 10% of future claims costs would not appear to Business New Zealand to represent sound business practice. Running projected deficits represents a cost which must be funded by the future self-employed.

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[2] "Prudential Margins in Premium Setting", A report to the ACC Board from Cathy Scott, General Manager, Policy and Assurance - 3 May 2002.

3.19 Business New Zealand would comment that this yet again emphasises the rather ad hoc approach taken to different accounts which arguably cannot be justified and raises the real issues of whether political rather than sound commercial disciplines are driving proposed levy rates for particularly the Employers' and Self-employed Accounts.

Business New Zealand **recommends** that:

ACC should further reduce the prudential margin for the Employers Account to match the unique circumstances of New Zealand's ACC scheme.

Business New Zealand **recommends** that:

ACC consider implementing a system of targeting reserves at between say 95% and 105% of estimated liabilities (for all accounts apart from the non-earners account) to minimise the risk of current employers, self-employed, earners and motor vehicle owners, either overfunding or underfunding claims costs.

Business New Zealand **recommends** that:

If ACC projects that the reserves proportion of claims liability is likely to fall outside the range of 95% to 105%, then the reasons why premiums are not adjusted to bring the reserves within the range should be made public to minimise the risk (either intended or unintended) of accusations of political bias in premium setting.

Pre-1999 (Residual) Claims Levy

3.20 Business New Zealand notes that ACC proposes to increase slightly the average residual claims levy to $0.35 per $100 of payroll/liable earnings (up from $0.33 currently).

3.21 Business New Zealand once again expresses its concern that pre-1999 work injuries will continue to be funded by employers. More worrying however is that about 35% of this cost relates to pre-1992 injuries caused outside of the workplace. These claims at least must be funded by general taxation for ACC's policy to be regarded as fair and logical.

3.22 The costs associated with pre-1999 work accidents and pre-1992 non-work accidents are, in economic terms, sunk costs. In other words, charging people for previous claims cannot affect the outcome of those claims – they have already been made. In this respect the funding of those costs should arguably have been borne by general taxpayers as the most efficient and least distortionary method of funding.

3.23 In light of the fact that Residual Claims are effectively a payroll tax on employers (and ultimately a tax on employment), Business New Zealand would encourage ACC to refer back to the independent work of Professor Lewis Evans (then Executive Director of the New Zealand Institute for the Study of Competition and Regulation) and Professor Neil Quigley, Professor of Economics and Executive Dean, Faculty of Commerce and Administration, Victoria University of Wellington.) In particular, an article which appeared a significant time ago in the National Business Review (25 September 1998) by Evans and Quigley, entitled "Efficiency suffers if employers have to pay" is still particularly relevant.

3.24 In respect to the Government's decision that employers and self-employed fund the residual claims (unfunded liabilities), Evans and Quigley stated that this *"….is inconsistent with both employers' legitimate expectations and with the theory of incentives in insurance contracts. The "tail" should be a liability of the state.*

Imposing the liability on employers represents a specific tax that is likely to retard economic performance and growth. Funding the liability from a broadly-based general tax would be more efficient".

3.25 Even if the Government decides to continue with its current policy approach of requiring employers and the self-employed to fund the total unfunded liabilities associated with pre-1999 work accidents and pre-1992 non-work accidents, it is important to understand that the unfunded liability will not influence future behaviour. This means that the costs should be spread among as many people as possible, and over a significant period of time, to ensure the distortions associated with unfounded liability payments are minimised to the extent possible.

3.26 Business New Zealand notes that ACC is proposing to "freeze" the relativities applicable to each risk group in respect to pre-1999 claims. Business New Zealand considers that this proposal misses the point. The costs of previous claims are sunk and as such should be funded equitably out of general taxation.

Business New Zealand **recommends** that:

All pre-1999 residual claims should be funded out of general taxation, or at the very least, the non-work residual claims from pre-1992.

Transparency in Premium Setting

3.27 Business New Zealand notes that ACC levy recommendations are not binding on the Minister (of ACC) who can "accept, reject, or modify the Corporation's recommendations". While it is useful for the Minister to be able to change the recommendations of ACC in respect to premium rates if new information comes to hand which suggests that ACC's actuarial advise was flawed, there has been a tendency for ACC Ministers over the years to tinker with ACC's recommendations, and make their own recommendations.

3.28 While it is possible that these changes are soundly based on actuarial analysis, there is a danger that changed recommendations from the Minister may reflect wider "political" judgements as to what ACC premiums should be.

3.29 Business New Zealand considers that if the Minister decides to reject or modify ACC's recommendation(s), then the Minister must clearly outline to the public and premium payers, why ACC's recommendations have not been accepted, and the actuarial advice on which the changed recommendations have been made. It is not acceptable for the Minister to change ACC's recommendations without full and comprehensive advice on the basis of which the decision has been made.

3.30 In the absence of such transparency, there is a risk that premiums will be considered to have been set, rightly or wrongly, to take account of political realities rather than sound commercial practice. Business New Zealand would suggest that the proposed premium levies for 2006/07 for the Employers', Self-Employed, and Motor Vehicle Accounts reflect a degree of political decision-making rather than being set on sound commercial disciplines.

Business New Zealand **recommends** that:

ACC proposed premiums and the rationale for such premiums be audited by independent third party actuaries (and the results made public) to ensure transparency in the premium setting process.

Business New Zealand **recommends** that:

Given that ACC is a statutory monopoly, if the Minister decides to reject or modify the premium recommendation(s) of ACC, the reasons for doing so, including actuarial analysis, should be made public to allow both premium payers and ACC to scrutinise the decisions of the Minister.

Transparency between the Self–Employed Work Account and the Employers' Account

3.31 Business New Zealand notes that ACC requested comments at the time of last year's review responses on a number of future issues. These included whether the Self-Employed Work Account and the Employers' Account should be amalgamated or remain separate.

3.32 ACC stated in their Discussion Documents that amalgamating the two accounts would address the issue of equity relating to business form and could potentially result in administrative efficiencies.

3.33 Business New Zealand believes that this view by ACC is simplistic and fails to consider the incentive arguments for having separate accounts.

3.34 The nature of the ACC scheme is that it is insurance-based. As with any insurance market, individuals should face the costs associated with their behaviour, acknowledging that the nature of insurance is to pool risks within similar risk profiles.

3.35 Notwithstanding the comments made above, the fact that ACC have even considered merging the Employers' and Self-Employed Accounts together would suggest that it is absolutely critical that both accounts are on a sound financial footing. Then, if at a later date it is determined that there would be net gains from merging the accounts (which Business New Zealand would dispute), at least there would be minimal risk of cross-subsidisation between accounts if such a merger did eventuate.

3.36 At the moment the Employers' Account is grossly over funded (145.6% compared to an optimal of around 100% or 110% if ACC's new policy is to be followed). On the other hand, the Self-Employed Account is currently funded at 100% but projected to slip over the next two years to around 90%. In other words the Self-Employed Account will have insufficient reserves to cover the cost of projected claims in 2006/07 and 2008/08, whereas the Employers' Account will continue to have significant reserves.

3.37 The risk is that there will be political pressure to fold in the Self-Employed Account into the Employers' Account given the sound financial state of the Employers' Account to date.

Business New Zealand **recommends** that:

The Self-Employed Work Account and the Employers' Account be retained as separate Accounts.

Workplace Safety Management Practices (WSMP) and Experience Rating

3.38 The cost of running this discount scheme remains static at $0.03. Business New Zealand submits that WSMP on its own is an ineffective injury prevention tool because there is no link to actual injury incidence, only to the implementation of systems which may or may not be effective. Conversely, notwithstanding incurring a large increase in injuries, an employer enjoying the rewards of participation may not be penalised merely because audited systems are in place.

3.39 Extending the WSMP would not be appropriate for small businesses as the compliance costs of meeting the audit requirements mean that only a small proportion of enterprises (mainly medium to large sized) are in a position where the level of discount available will be greater than the audit requirement costs.

3.40 Currently, there is little ability for small and medium sized enterprises to reduce their premium levels irrespective of their claims record. This is particularly significant given that over 95% of all enterprises in New Zealand employ fewer than 20 persons).

3.41 Business New Zealand therefore continues to support the reintroduction of experience rating either as a stand-alone system or in conjunction with a modified WSMP scheme. Such an initiative was, for a considerable time, the discount scheme of choice and provided positive incentives for employers (and the self-employed) to strive to improve their workplace's safety practices and help to minimise risks. Experience rating is beneficial also to small businesses that cannot enter the Partnership Programme or for whom the WSMP scheme is too cumbersome.

3.42 While Business New Zealand supports WSMP, the scheme is "systems-based" rather than output based which means there is an assumption that if employers have received a satisfactory audit from ACC, the risk of accidents in the workplace is lower.

3.43 Business New Zealand considers that it is much better to have an outcomes-based approach where the rate of injury is the relevant factor in setting premiums.

3.44 Business New Zealand considers that experience rating is essential in ensuring strong incentives are placed on employers so that those with consistently lower than average accident rates (within their risk class) are rewarded. On the other hand, those with poorer than average accident rates will experience a negative impact.

3.45 Within similar industry and risk classes there are often substantial and consistently different accident rates attributable to a range of factors. Often similar businesses within the same industry have significant ongoing differences in accident claims and associated claims costs reinforcing the need to focus on individual enterprise risk. Experience rating is therefore crucial in ensuring that employers benefit from better than average outcomes within their risk category.

3.46 Four arguments by critics of experience rating are worth mentioning briefly. The first is that accidents are unfortunate random occurrences and as such, a system of experience rating cannot affect their outcome.

3.47 On the one hand, many accidents (and health states) are purely random with little that can be done to minimise them (at least without great cost). On the other hand, a number of so-called "accidents" can be avoided through appropriate management of health and safety.

3.48 The second criticism of experience rating is that it provides limited incentives for employers to reduce the number of workplace accidents because of the ability to pass on costs to consumers or employees, presumably through higher cost of product and/or lower wages than might otherwise be the case.

3.49 In an insulated and protected environment where employers are not subject to competition, the above might be true. However, in reality, the ability to pass on costs is strictly limited. Most businesses are subject to both international and domestic competition; therefore the ability to sustain cost increases (even on the margin) is likely to be low.

3.50 The third criticism of experience-rating is that in some cases an employer may be experience-rated on an alleged "work-related" accident which they believe was completely beyond their control. While there will no doubt be some cases where employers feel unduly punished by experience-rating, the benefits of experience-rating need to be clearly understood.

3.51 Finally, the argument is sometimes put forward that introducing experience-rating will encourage employers to put pressure on their employees to either not report work-related claims or alternatively to encourage them to report claims as non-work related. Claims will then be funded out of the Earners Account with reduced impact on the employer's experience-rating. As mentioned in response to the previous criticism, there may theoretically be cases on the margin where such behaviour could occur, but these should not be used to diminish the positive impacts of experience-rating. Moreover, effective monitoring of claims should ensure that this kind of employer or employee behaviour is minimised.

3.52 It should also be noted that (irrespective of the existence of experience-rating) in some cases there may be incentives for employees to report "non-work" related accidents as having occurred at work. Again this misreporting of accidents can be minimised through effective monitoring of claims and having appropriate systems in place to minimise and detect fraud.

3.53 It is important, given that ACC is a monopoly insurer, that a degree of experience rating is introduced to ensure that premiums reasonably closely reflect what would occur in an open insurance market. Under a state-monopoly model of accident insurance, there may well be a tendency to try and retain premiums at similar levels and rates through "smoothing" of premiums. This appears already to be occurring as evidenced by the latest premium setting both in respect to the Employers, Self-employed, and Motor Vehicle Accounts. Experience-rating under these circumstances could play a very crucial role in ensuring premiums faced by employers more closely reflect risk in the individual enterprise while retaining the essential element of insurance, which is to pool risks within similar risk-rated enterprises.

Business New Zealand **recommends** that:

ACC should reinstate experience rating either as a stand–alone system or in conjunction with the Workplace Safety Management Practices (WSMP) scheme.

Workplace Safety Discount Scheme

3.54 Business New Zealand notes that this proposal is a discount scheme designed to encourage small businesses (fewer than 20 employees) in various high risk sectors to introduce hazard reduction programmes and is aimed at redressing the claims imbalance between small and large employers.

3.55 Business New Zealand supports the proposal, but notes that the scheme does not reward those employers who reduce accidents, only those who comply with the paperwork. The two do not necessarily follow, although we accept that better systems generally mean a lower likelihood of injury.

3.56 Secondly, it is noted that the programme would initially be available to a few sectors only – those with significant numbers of work-related injuries. Business New Zealand believes that such a programme should be progressively available for all employers. Nevertheless, it should not be seen as a substitute for experience-rating.

Business New Zealand **recommends** that:

ACC proceed with the Workplace Safety Discount Scheme to "at risk" sectors and, if successful, expand the scheme to *all* other sectors.

APPENDIX 1

BACKGROUND INFORMATION ON BUSINESS NEW ZEALAND

Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' & Manufacturers' Association (Central), Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), Business New Zealand is New Zealand's largest business advocacy body. Together with its 57 member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, Business New Zealand is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy on behalf of enterprise, Business New Zealand contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.

Business New Zealand's key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services). An increase in GDP of at least 4% per capita per year is required to achieve this goal in the medium term.

The health of the economy also determines the ability of a nation to deliver on the social and environmental outcomes desired by all. First class social services and a clean and healthy environment are possible only in prosperous, first world economies.