EMBARGOED UNTIL 3.00 PM MONDAY 20 JULY 1998

IIR 'INTRODUCING COMPETITION INTO ACC MANAGEMENT' CONFERENCE

CURRENT ISSUES IN ACC REFORM

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

WELLINGTON
20 JULY 1998

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1 Introduction

The New Zealand Business Roundtable welcomes the initiatives being taken by the government to introduce competition into the Accident Compensation Scheme. The reforms are a great advance on any other changes made to the Scheme since it was set up in 1972. However, they do not go far enough. There is no reason to limit competition to the Employers' Account. The government's goal should be the removal of mandatory cover for all accounts and the privatisation of the Accident Rehabilitation and Compensation Insurance Corporation. The steps currently proposed should be seen as transitional. In addition, there should be a basic review in due course of the legal regime governing personal injury from accidents, namely the current no-fault system.

In this paper I want to focus on four critical issues that the government must address if New Zealanders are to be able to make the most of the introduction of limited competition in the accident insurance market next year. These issues are:

- the continued presence of a government-owned insurer in a competitive market;
- the treatment of 'hard cases';
- the framework for prudential regulation; and
- the treatment of the unfunded liability.

2 Problems with a government insurer

The greatest concern with the new arrangements is the continued existence of a government-owned insurer in the market for accident insurance. With the exception of earthquake insurance (which should also be privatised), the government no longer provides other types of insurance. There is no justification for a different arrangement in the accident insurance market.

A government-owned insurer is likely to be perceived by many employers as having an implicit government guarantee. It will be difficult to calculate accurately the value of this guarantee to the Corporation. Other insurers must provide their owners with an adequate return on capital, thus 'paying' for their credit ratings. Correspondingly, the Corporation should pay the government for its implicit guarantee, or it will have a head start on entrants into the market for accident insurance because it will have lower costs than its competitors.

The current structure of the Corporation makes it very difficult to monitor its performance. The Corporation has no shares and no balance sheet. It has been given multiple objectives with no basis on which to make trade-offs among them. Historically, its board and the government agencies charged with monitoring its performance have had an impossible task.

The Corporation should be re-established as a State-Owned Enterprise with shares, a balance sheet, and the single objective of making a profit. Profitability is a key measure of how well a business is meeting the needs of those who pay for its services. However, as we have seen elsewhere in the health sector, the goal of operating as a profitable business will be difficult to sustain over the medium term. Political pressure on the company will be great. There are plenty of cases of commercialisation without privatisation which have led to political intervention when tough decisions are required. In this case, ongoing government ownership carries a significant risk that the state insurer will set prices below the actuarially fair level. This might occur because the company focuses on market share instead of profit, or because its owners want to avoid negative public reactions to premium increases for businesses that have historically been cross-subsidised. New insurers may face an uphill battle to compete with the state-owned insurer.

Announcements made to date indicate that the government is attempting to create as level a playing field as possible for new insurers. The separation of the existing workers' compensation part of the ARCI Corporation into a new entity is a step in the right direction. The government should consider requiring the new entity to tender the management of its new claims to private insurers. Because of the difficulties of creating a competitive environment which is genuinely neutral, and because there is no long-run case for a government insurer, the government should pare back its role as far as possible.

3 Treatment of 'hard cases'

The requirement for employers to take out accident insurance at a mandated level raises two issues – non-compliance, because employers are unwilling to pay the premia they are quoted, and inability to find an insurer to quote.

The likelihood of non-compliance in the accident insurance market is increased by the government's proposed guarantee that it will meet the obligations of employers who fail to insure. Without this guarantee employees would have an incentive to see that their employer had accident insurance. Fewer government resources would be needed to check that employers had complied with the requirement to buy cover. The combination of mandatory cover and a government guarantee

means that employees will have an incentive to monitor their employer's insurance arrangements only if the employer has agreed to provide a higher level of cover than the statutory requirement.

One hundred percent compliance has never been achieved even with the government operating as a monopoly supplier of accident insurance and all premia being paid through the Inland Revenue Department. Non-compliance will continue when competition is introduced. Who should fund the costs of non-compliance – employers or taxpayers? The risk associated with non-compliance is that a worker is injured and the employer has no insurance. Taxpayers bear this risk, since the government has to pay claims for uninsured employers. The government should tender its obligation to pay out on claims made by employees of non-compliant employers. The winning bidder would have strong incentives to improve compliance to the point where the marginal cost of identifying non-compliant firms equalled the marginal benefit from doing so. Such a tender would make transparent one of the costs to taxpayers of a mandatory level of insurance and guaranteed payouts. The cost of the tender would depend on the credibility of the government's commitment to impose penalties on non-compliant employers.

The second problem is more difficult. What if an employer cannot find an insurer that is willing to provide insurance? In the United States, different methods of handling such cases have had major effects on the stability and cost of workers' compensation insurance. In some states more firms are turned down than are accepted for private insurance. This is largely due to extensive rate regulation, but the problem of obtaining insurance can arise in any compulsory scheme. For example, suppose an employer is involved in a business activity with a high probability of accident risk, such as a heli-skiing firm. An insurer in the New Zealand market might be unwilling to write a policy for such a firm because of a lack of knowledge about expected claim costs or a shortage of other businesses with similar risk, making risk pooling difficult. Alternatively, an insurer might have a policy of refusing to cover anyone with a history of insurance fraud or of being frequently in arrears on premia. What will happen to such firms?

One common but unattractive approach is to form a mandatory risk pool for employers unable to get a quote for insurance. The operation of mandatory risk pools in the United States varies significantly from state to state, but the basic idea is that employers in the pool pay regulated premia. Individual insurers administer the claims of the employers in the pool, but the risks are reinsured. The reinsurance cost is shared among all the insurers, usually based on their market shares in the voluntary market. Risk pools usually run deficits, which must then be passed on to the employers in the voluntary market. This leads to cross-subsidisation from safe employers to high risk employers.

Risk pools tend to grow over time. If there is significant concern about the affordability of cover for employers in the residual risk pool, the regulated premium level is likely to be reduced, leading to a corresponding increase in the size of the cross-subsidy. In the worst cases, more and more employers will seek to self-insure to avoid the cross-subsidy. This trend to self-insurance shrinks the voluntary market, which increases the share of the residual market deficit to be paid by every employer. In some states this has led to the collapse of the voluntary market. For example, in a recent study of the effect of rate regulation on the costs of workers' compensation insurance, Patricia Danzon and Scott Harrington noted that in 1992 nearly 90 percent of insurance policies in Rhode Island were written in the residual market.[1]

Fortunately, the New Zealand government is not proposing regulation of premia when the Employers' Account is opened to competition next year. This reduces the chance that insurers will refuse to provide a quote to an employer except in unusual circumstances. Danzon and Harrington note that:

> In a competitive environment without significant regulatory restrictions on price, there is little reason to expect that a significant proportion of employers will be persistently unable to find coverage at any price. In markets with high underlying claims costs, rapid growth in claims costs, and substantial uncertainty over the likely magnitude of claims costs, however, the price needed to induce the voluntary supply of coverage may be high enough to create significant affordability problems for some employers and their employees. These affordability problems can, in turn, produce significant pressure for the use of regulation to limit rate increases.[2]

When the Employers' Account is opened to competition the regulatory framework must be robust to the pressure to regulate rates. The pressure will be great when difficult cases face possibly dramatic increases in premia relative to those formerly charged by the ACC.

Many of the benefits of competition depend on giving insurers incentives to match premia to expected claims. Setting up a risk pool creates strong pressure to regulate rates, especially in a political environment where cross-subsidies for risky activities and dangerous employers have been claimed to be justified on the basis of community responsibility.

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[1] Patricia Danzon and Scott Harrington, 1998, *Rate Regulation of Workers' Compensation Insurance,* American Enterprise Institute, p 7.

[2] *ibid*, p15.

An alternative is for the government-owned insurer to act as the *de facto* insurer of last resort. Suppose an employer with a disastrous track record or a previous conviction for insurance fraud goes to a private insurer for a quote. The privately owned insurer might not want to take on such a bad risk, no matter what the price. The employer's next step might be to seek a cheaper quote from the government-owned insurer. It will be very difficult for the government insurer not to provide a quote. How will the Corporation's board be able to refuse to quote to employers when its owner has mandated insurance cover for workplace accidents and when the Corporation itself has previously argued that its premia no longer have significant cross subsidies?[3] As long as it sets the prices at an actuarially fair level, the government's fiscal risk will not be increased relative to the status quo. Currently, taxpayers bear significant risk due to inadequate premium differentiation.

Even if the Corporation ends up with a 100 percent market share of difficult cases, competition will flush out the cross-subsidies that have existed for the last 26 years and significant efficiency gains will be made. In a competitive market with a government insurer, all employers are likely to be offered premia that reflect their accident risk. If the government-owned insurer decides to offer policies to high-risk employers, the cross-subsidies that previously existed will be exposed. Safer employers will be able to get cheaper insurance, either from the Corporation or from a privately owned insurer, because they will be able to use the threat of switching to a policy with higher benefits or lower costs if the insurer does not perform adequately. Higher-risk employers will no longer be able to rely on the fact that they are being cross-subsidised because employers charged more than an actuarially fair rate will be able to change insurer.

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[3] See, for example, the Corporation's web site, http://www.acc.org.nz. The commentary on the six accounts states (in relation to the Employers' Account) that "The process of achieving a truly risk-based premium setting is now almost complete. All except six premium classes have reached their true risk rate; the process should be completed by the end of the 1998/99 premium year."

A third option to ensure that all employers will be quoted an accident insurance premium is for the government to tender the role of being the insurer of last resort. One issue in designing such a tender would be whether the government-owned insurer should be permitted to bid for this role.

4 Prudential regulation/regulatory creep

The government has stated that it will guarantee to pay benefits to employees if the insurer chosen by the employer cannot pay claims.[4] Unless the government charges employers (and indirectly employees) for this risk, it will incur significant fiscal risk. In the absence of a guarantee, the employer's choice of insurance would depend on its arrangements for sharing the risk of insurer default with employees. If the employee carried the risk of insurer failure, the employer would need to pay the employee more to reflect that risk than if the insurer had a lower default risk. If the government guarantees to pay claims to employees when an insurer defaults, it must somehow ensure employers have incentives to choose insurers with adequate capacity to pay claims to protect itself from fiscal risk.

There are two ways the government could do this. It could charge employers for the government's cost of underwriting their choice of insurer. For example, an employer which chose an insurer with a credit rating of BBB would pay less than one which chose an insurer with an A rating. To find prices to reflect the risk of insurer default, the government could tender its reinsurance obligations so that it discovered the value of its guarantee. This would significantly reduce the fiscal risk to the government, because its obligation to pay claims would take effect only if both the insurer and the reinsurer defaulted. It would mean that employers faced the full cost of their insurance choice. Designing a competitive tender process for the government's default risk could take time, and would probably require initial experience with a competitive accident insurance market before insurers were willing to participate in it.

Instead of explicitly pricing the government's underwriting risk, the government could require employers to take out insurance with an insurer that had an adequate credit rating. If an employer wanted to insure with a company whose rating fell below a specified level, it would have to pay a deposit to cover the risk of insurer failure.

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[4] See, for example, Question 10 in the Frequently Asked Questions section of the press release from the minister and the associate minister for ARCI on 14 May 1998.

The government guarantee would impose costs on employers and employees who, in the absence of the guarantee, would have maximised their welfare by choosing a lower rated insurer and bearing the risk that the insurer would fail.

By guaranteeing insurers' obligations to pay workplace accident claims, the government is increasing the potential for further regulation of the insurance industry. The government will find it more difficult to make a credible commitment not to intervene if insurers in other markets fail. If an insurer offers loss of earnings insurance for both accidents and sickness, what rationale will the government have for guaranteeing the claims of beneficiaries receiving payments for accidents but not for those receiving payments for serious illness? The pricing of the government guarantee of ACS claims should be an issue between the government and employers, not between the government and insurers.

5 Treatment of the unfunded liability

The Accident Compensation Scheme has an actuarial deficit of approximately $7.5 billion. The treatment of this liability will have an important effect on the achievement of competitive neutrality.

Three issues concerning existing ACS claims need to be addressed. The first is the separation of the Corporation's old claims from its new business. The second is how the government can minimise the size of the 'tail', given its existing obligations. The third concerns the most efficient way to fund the tail.

The government should aim to minimise distortions to competition in the accident insurance market. If the Corporation continues to be responsible for managing the liability, it will need ongoing government funding to meet the costs of the claims in the tail, including the costs of case management and claims administration. It will be very hard to monitor the Corporation's performance in the market for new policies if the government is providing it with funds for old claims. The government is following the right path by establishing a new SOE with a commercial objective of maximising profits, and the tail should be separated from the business of writing new policies. It would be sensible to separate existing claims for the other accounts at the same time so that the government can prepare those accounts for competition.

The second issue concerns the size of the tail. In past years the Corporation's track record for managing the claims on the tail has been poor. From the perspective of claims management,

removing the possibility of lump sum settlements was a retrograde step. Recently the Corporation's performance has begun to improve and for the first time the number of long-term claimants has decreased significantly. One option for dealing with the outstanding claims would be to tender out the management of the tail to private insurers. The government could pay an insurer to manage the tail and pay claims. However, tendering the obligations could be difficult. The government would continue to bear the risk that an insurer would default and there would be strong political pressure for the government to intervene in disputed cases. Paying the successful bidder on a yearly basis could reduce the residual risk of insurer default. In the event that the insurer responsible for existing claims management became bankrupt, the government would be liable for the claims payments for a single year. The contract could specify, for example, that the government could suspend payment if the insurer's credit rating were downgraded. The government could then re-tender the contract for the management and payment of existing claimants. Whether or not existing claims management is tendered, the government must continue to focus on rehabilitating accident victims and ensuring that only those who cannot work remain on ACS benefits. Experience in Australia shows that the tail can be reduced quite dramatically.

The final issue is who should pay for the liability once it has been separated from the Corporation. There are two main options – to fund the tail from general taxation or impose what would effectively be a payroll levy on employers. Approximately $5 billion of the $7.5 billion unfunded liability is currently allocated to the Employers' Account. The funding of the liability does not affect incentives for future behaviour relating to safety in the workplace. Even if employers that under-contributed to premia in the past had anticipated that they would have to make up the difference later, it is not obvious that there is a case on efficiency grounds for levying them now for the liability associated with the tail of claims. How can we identify the beneficiaries of the past underfunding? Why should current and future employers and employees pay for the underfunding of past employers? The accidents generating the liability have already happened. The cost of the past liabilities is sunk. Recovering the full costs from those who were insured cannot change those accidents. Where costs are sunk, an efficiency criterion suggests that funding should be raised in a way that least distorts decision making.

Generally, broad-based taxation is most likely to minimise the deadweight costs of taxation. Given New Zealand's reasonably well-designed tax system, the introduction of a payroll tax would have higher deadweight costs associated with it. While employers would pay the tax in the first instance, its final incidence might well fall on employees through wage reductions. On efficiency grounds a payroll tax is not a good option and funding for the liability should be from general

taxation. If the accounts were in surplus, a symmetrical argument would suggest the surplus should belong to the Crown.

The decision about the funding of the liability should not be influenced by the government's current operating balance – whether this is in surplus or deficit – or by considerations such as tax cuts. The liability should just be regarded as part of the Crown's total debt, as the government intends, and financed in the same way as the rest of the stock of debt. It would not be the first time the Crown has had to pick up the pieces of a well-intentioned but fundamentally flawed policy.

6 Conclusion

The development of a competitive market for workplace accident insurance is perhaps the government's most important current microeconomic reform. The constraints imposed on competition have created some difficult regulatory issues which have the potential to limit efficiency gains in the new environment. There will be many pressures from special interests to regulate in ways that would reduce overall community welfare. The government should focus directly on ensuring that employers fulfil their obligation to take out accident insurance instead of further regulating the insurance industry. To allow the insurance market to do its job well, the government must keep regulation to a minimum and be mindful of the risks of regulation becoming more rather than less intrusive over time. For that reason it should be developing current policies within a framework which envisages moves to full competition and privatisation in a short period of time.