Review of workplace accident compensation legislation

Final report

January 1998

Department of Treasury and Finance

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Executive summary

- This review clarifies and discusses the objectives of workers' compensation legislation in Victoria, identifies and analyses the effects of restrictions on competition, and assesses and proposes alternative models in accordance with the approved terms of reference (chapter 1).

- The Victorian workers' compensation scheme is administered by the Victorian WorkCover Authority, which bears ultimate risks through its reinsurance and underwriting functions. The WorkCover scheme and the Authority were established in 1992 to replace the earlier scheme (WorkCare). Workers' compensation insurance is compulsory in Victoria. Compensation is only payable for injuries or diseases where work is a 'significant contributing factor'. All worker entitlements are defined by statute and include weekly benefits that vary with the degree and duration of 'incapacity', and specific payments under the 'Table of Maims' (section 2.1).

- The legislative objectives identified by the review panel are:
  - to provide all Victorian workers with compensation in the event of work related injury or illness at reasonable cost; and
  - to reduce the incidence and duration of work related injury or illness through prevention and rehabilitation (section 2.2).

- Many of the features and objectives of the current workers' compensation scheme represent a hybrid of economic and equity objectives, and are the result of a long process of 'historical evolution' where changing perspectives and goals have given the scheme its particular shape today. The extent of Government involvement cannot be explained by market failures alone. Hence, Government policy needs to take into account the mix of economic and equity objectives to ensure the achievement of desirable goals and outcomes in the long term (sections 2.3 and 2.4).

- The role of the Victorian WorkCover Authority is distinct from the objectives of the workers' compensation system and its functions will require re-assessment in light of the overall scheme objectives (section 2.5).

- The review panel identified two broad elements of competitive restrictions in the workers' compensation legislation. These are:
  - public underwriting, and centralised premium setting and funds management; and
  - regulations which govern the eligibility for self-insurance, the licensing of authorised insurers and the approval of occupational rehabilitation providers (chapter 3).
- The identified restrictions can be summarised as having one or a combination of the following effects:
  - exclusion of certain potential market participants and therefore fewer pressures for price and service competition on existing insurers and providers;
  - increased costs of operating in the workers' compensation market which possibly discourage further entry; and
  - limited dimensions and muted incentives for the operation of competitive processes (chapter 4).
- Following qualitative analysis, the review panel concluded that the identified restrictions, at best, support the objectives at the expense of enhanced incentives for safety and innovation through more competitive processes, or at worst, are irrelevant to the achievement of the objectives. In particular:
  - public underwriting supports objectives but at the expense of more effective performance in the area of prevention and injury management;
  - centralised premium setting possibly supports objectives but does not entail strong incentives for insurers to pursue administrative efficiencies and premium and service innovation;
  - centralised funds management is not necessary for the achievement of objectives;
  - stringent restriction of self-insurance runs contrary to the objectives as such arrangements have been demonstrated to result in reduced incidence and duration of work related injury or illness;
  - licensing of insurers supports the objectives but currently there is 'excessive' regulation of processes which ties up many resources and stifles innovation among insurers; and

- the current approval processes for occupational rehabilitation providers do not appear to be necessary for meeting objectives (chapter 5).

♦ In examining alternatives for achieving the legislation's objectives, the case for maintaining the status quo and the option of establishing a monopoly insurance fund were first considered. The preferred alternative which was considered is to introduce competitive insurance. This would meet the legislation's objectives at least cost and generate the greatest benefits (chapter 6).

♦ The preferred model was tested against possible concerns that may be raised and the recommendations were found to be robust provided that they are implemented systematically (chapter 7).

Recommendations

♦ The review recommendations are premised on the assumption that essential scheme features such as universal and compulsory coverage, no fault liability, and benefit structures will be maintained. The review panel's recommendations are:

1. The Victorian WorkCover Authority cease to be a provider of reinsurance and all underwriting risks be borne by private insurers.

2. Premium setting should be more decentralised with insurers competing, at a minimum, on the basis of administrative costs and services such as risk and injury management.

3. All premium funds be owned and managed by insurers.

4. Insurers, underwriters and self-insurers be licensed by an independent regulator subject to satisfying 'appropriate' prudential requirements.

5. Current approval criteria for occupational providers be removed.

6. The quality of service delivery by insurers, self-insurers and occupational rehabilitation providers be monitored by the regulator with a focus on outcomes.

7. The regulator facilitate the collection and dissemination of information with minimal burden on insurers and other parties.

♦ These recommendations imply significant reform of the existing scheme. As a means of addressing the issues involved and extracting sustainable benefits it is further recommended that -

8. The Government undertake an industry review prior to implementation. This will be consistent with Clause 4 of the Competition Principles Agreement regarding the 'Structural Reform of Public Monopolies'. *Inter alia* this should consider:

   - the appropriate commercial objectives for participants;
   - the most effective means for separating policy, regulatory and commercial functions; and

- the need for, and form of, price and service regulations.

These principles for the 'Structural Reform of Public Monopolies' have been applied successfully in the electricity and gas industries (chapter 6).

1. Context of the legislative review

1.1 Why is the legislation being reviewed?

1. The workplace accident compensation legislation review is one of an extensive program of legislative reviews being undertaken in all portfolios. The Victorian Government has committed to complete these reviews by the year 2000.

2. In 1995, Victoria, along with all other jurisdictions, signed the National Competition Policy agreements. These committed all Governments to a consistent national approach to fostering greater economic efficiency and improving the overall competitiveness of the Australian economy.

3. As part of the agreements, Governments adopted the following 'guiding legislative principle':

Legislation should not restrict competition unless it can be demonstrated that:

the benefits of the restriction to the community as a whole outweigh the costs; and
the objective of the legislation can only be achieved by restricting competition.

4. Governments have agreed to review, and where appropriate, reform all existing legislative restrictions on competition against the guiding legislative principle stated above. Thus, application of the principle will help establish whether particular legislated restrictions on competition remain necessary to achieve public policy objectives. Legislative reviews will assist this through, wherever possible, a rigorous assessment of the costs and benefits of alternatives in achieving the objectives.

1.2 Terms of Reference

5. Each piece of legislation in Victoria being reviewed has approved terms of reference to guide its review. Terms of reference for the review are approved by the Premier. The terms

of reference for the review of workplace accident compensation legislation are reproduced below.

NATIONAL COMPETITION POLICY REVIEW OF LEGISLATIVE RESTRICTIONS ON COMPETITION

REVIEW *OF ACCIDENT COMPENSATION ACT 1985*, *ACCIDENT COMPENSATION (WORK COVER INSURANCE ACT) 1993*, ACCIDENT COMPENSATION REGULATIONS 1990

TERMS OF REFERENCE

The review of the *Accident Compensation Act 1985*, *Accident Compensation (WorkCover Insurance Act) 1993*, and *Accident Compensation Regulations 1990*, has been commissioned by the Minister for Finance in accordance with the Victorian Government *Timetable for the Review and Reform of Legislation That Restricts Competition*, determined in accordance with National Competition Policy.

Legislation to be reviewed

The review will examine the case for reform of legislative restrictions on competition that exist in the Acts and Regulations, in accordance with the Victorian Government's *Guidelines for the Review of Legislative Restrictions on Competition.*

In particular, the review will provide evidence and findings through its report in relation to the following:

- Clarify the objectives of the legislation. Together, the Acts and regulations are a framework to operate a scheme, funded by employers, that provides for compensation and rehabilitation because of workplace injury. The review will clarify the objectives and examine the framework as an efficient means of achieving them.
- Identify the nature of the restrictions on competition. The chief restrictions on competition within the scheme appear to be the licensing arrangements for authorised insurers, the criteria set out in legislation for an employer to qualify as a self-insurer and the administration of certain funds by State Trustees on behalf of beneficiaries[1]. The review will examine these arrangements and further examine the Act and regulations to identify restrictions on competition.
- Analyse the likely effects of the restriction on competition and the economy in general. The review will describe the impacts of the identified competitive restrictions.
- Assess and balance the costs and benefits of the restriction. The review will assess the costs of identified restrictions against the benefits judged to be achieved from those restrictions.

[1] The National Competition Policy legislation review of State Trustees legislation has been completed by the review panel located within the Department of Treasury and Finance. The administration of workers' compensation awards by State Trustees was considered in that review and the panel's recommendations are currently being considered by the Departments of Treasury and Finance and Justice, and the relevant ministers.

- Consider alternative means of achieving the same result including non-legislative means. The review will seek to identify practicable alternatives that will meet the identified objectives.

Reform options

The review should specifically address the appropriateness of modifying or removing the restrictions while meeting the requirements articulated in the identified objectives.

Review arrangements

The review is to be established and conducted in accordance with the **"In-house" review model** contained in the Guidelines. The working panel will have the assistance of the WorkCover Authority on the operation of the scheme. The working panel will consult selected authorised insurers, self-insurers and peak employer associations. This will help identify the effects of restrictions on markets and practical alternatives.

Key Dates

The review will report its findings and recommendations to the Minister by 31 August 1997.

Secretariat

The review Secretariat will be located in Reform Policy Branch, Privatisations and Industry Reform Division, Department of Treasury and Finance. The Secretariat may be contacted on
5th floor
1 Treasury Place
Melbourne 3002

Phone 9651-2148
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1.3 Administrative arrangements

6. This report has been prepared for the Minister for Finance who is responsible for the relevant legislation. The review has been conducted in accordance with the in-house review model as described in the *Guidelines for the Review of Legislative Restrictions on Competition*. In addition, an interim report that addressed the first three sections of the review - clarification of objectives, identification of restrictions and assessment of their effects - was made available to a number of stakeholders. Some comments were received and where considered appropriate they have been incorporated into the report. A list of external parties to whom the interim report was sent appears in Appendix 6.

7. This document is a report to Government and therefore the views contained herein are those of the review panel and do not necessarily represent the views or policies of the Government. It is important to recognise that in conducting a review of legislation it is a separate task for Government to respond to the findings of a review panel. In developing a response, it is expected that there will be public consultation and interested parties will be given opportunity to comment on the findings of the review panel.

8. Review panel members have been drawn from the Reform Policy Branch in the Department of Treasury and Finance. In addition, the report has been written under the supervision of the Department of Treasury and Finance Legislation Review Steering Committee. The Committee has been responsible for coordinating all reviews under the portfolio of the Treasurer and the Minister for Finance and Gaming.

1.4 Structure of the report

9. The next section of the report briefly describes current workers' compensation arrangements and discusses the Government's objectives in this area. Section three identifies the legislative restrictions on competition and section four briefly examines their possible effects. Section five conceptually analyses the benefits and costs of the competitive restrictions while some alternative arrangements and the review panel's recommendations are contained in section six. The final section tests the recommendations against some possible concerns.

2. Existing framework and government objectives

10. This chapter outlines current workers' compensation arrangements in Victoria and identifies the objectives of the legislation. The aim is to examine the underlying rationale for these objectives to better understand current scheme design and to help distinguish the *objectives* from the *form* of intervention.

11. The chapter consists of six parts: the first provides an overview of current arrangements for compensating workplace injury and illness; the second delineates the objectives found in the legislation; the third section attempts to 'explain' the existence of the legislative objectives; a fourth section examines the objectives in light of contemporary policy settings and, in particular, competition principles; the fifth section looks at the distinction between the Government's objectives and the way it has chosen to intervene in workers' compensation; and, a final section contains the main conclusions.

2.1 Summary of current workers' compensation arrangements in Victoria

12. Victoria's workers' compensation arrangements are governed by the *Accident Compensation Act 1985*, the *Accident Compensation (WorkCover Insurance) Act 1993* and Accident Compensation Regulations 1990. The scheme is administered by the Victorian WorkCover Authority (VWA) which also conducts research on workplace injury and disease, initiates education and advertising campaigns, and provides policy advice to the Minister.

13. Workers' compensation insurance is compulsory with employers purchasing insurance policies from authorised insurers on behalf of employees. There are currently 14 authorised insurers in Victoria who price the insurance product according to a Premiums Order[2], which specifies the formula by which premiums are calculated, and are required to place all premiums collected into statutory accounts held by the VWA. The scheme is publicly underwritten as insurers are required to reinsure their liabilities with the VWA. As a consequence, it is the VWA which bears the ultimate risk of the scheme's viability. Insurers effectively act like claims agents as their functions are limited to collecting premiums and managing WorkCover claims.

[2] The Premiums Order is an Order of the Governor-in-Council.

14. There are 23 self-insurers in Victoria who manage their work-related accident risks without third party insurance (although they must purchase excess cover for 'catastrophes') and are not required to reinsure with the VWA. Self-insurers also make contributions to the WorkCover Authority Fund according to a formula appearing in section 12 of the Accident Compensation Regulations 1990. Self-insurers are required to contribute toward court and tribunal costs arising out of the operation of the *Accident Compensation Act* and expenses in connection with medical panels. The proportion paid by self-insurers is weighted by the amount of leviable remuneration that would be calculated if they were required to pay premiums compared to total leviable remuneration for all employers[3].

15. Compensation is only payable for injuries or diseases where work was a "significant contributing factor". All worker entitlements are defined by statute and include weekly benefits that vary with the degree of assessed incapacity and the duration of injury, and specific payments under the Table of Maims for claims on, for example, loss of limbs and pain and suffering. Until recently, common law claims were available to workers assessed as seriously injured - those that are at least 30 per cent incapacitated - but they have now been abolished. Journey claims are not allowed under the workers' compensation scheme which since 1992 have been covered by the *Transport Accident Act*.

16. There is also some emphasis on rehabilitation as a method of reducing long term claims costs and returning injured workers to productive employment. Employers with a payroll in excess of $1 million must establish an occupational rehabilitation program. This program must nominate at least one approved occupational rehabilitation service provider, identify a return to work policy, and specify an individualised plan for every employee off work for more than 20 days.

17. For a discussion of the development and operation of workers' compensation insurance in Australia and for background on the development of the VWA as the Victorian scheme administrator, the reader is referred to Appendices 1 and 2, respectively.

[3] The review group did not attempt to ascertain the extent to which contributions from self-insurers reflects the costs of assessing and reviewing applications for self-insurance and any other costs brought onto the scheme by self-insuring employers. However, given the basis for calculating contributions, it is unlikely that these exactly correspond with the administrative costs borne by the scheme as a result of self-insurance arrangements. This then raises the possibility that self-insurers might be subsidising the costs of the workers' compensation scheme or vice versa.

2.2 Objectives of the current legislative framework

2.2.1 Key objectives

18. The broad thrust of the Victorian scheme's objectives can be paraphrased as:

- *Providing all Victorian workers with compensation in the event of work related injury or illness at reasonable cost.*

This objective is based on *affordability* and *no fault liability*. That is, all employees must be provided with insurance cover by their employer at premiums that employers can *reasonably* be expected to pay. In addition, *all* workers must be covered for any injury or illness arising out of or in the course of employment. This approach does not seek to assign 'blame' for any such injury or illness[4]; and

- *Reducing the incidence and duration of work related injury or illness through prevention and rehabilitation.*

The legislative framework aims to promote *accident prevention* by reinforcing employers' and employees' incentives to improve workplace safety. In particular, the scheme seeks to reward employers whose efforts lead to a reduction in the level of industrial accidents and penalise employers with poor accident records. It does this through an experience based premium rating system which is used as the basis for calculating employers' workers' compensation premiums. Moreover, the framework intends to provide incentives for employees, employers, insurers and occupational rehabilitation service providers to agree on desirable workplace based programs to ensure effective *rehabilitation* that emphasises the return and reintegration of formerly injured or ill employees to the workplace.

2.2.2 Objectives as stated in the legislation

19. The objectives of the *Accident Compensation Act 1985* (as amended) are found in section 3 which is reproduced below:

> "**3. Objects of Act**
>
> (a) reduce the incidence of accidents and diseases in the workplace;

[4] This contrasts with the more traditional adversarial common law system where it is necessary to prove fault (negligence) in order to receive compensation.

(b) make provision for the effective occupational rehabilitation of injured workers and their early returns to work;

(c) increase the provision of suitable employment to workers who are injured to enable their early return to work;

(d) provide adequate and just compensation to injured workers;

(e) ensure workers' compensation costs are contained so as to minimise the burden on Victorian businesses;

(f) establish incentives that are conducive to efficiency and discourage abuse;

(g) enhance flexibility in the system and allow adaptation to the particular needs of disparate work situations;

(h) establish and maintain a fully funded scheme; and

(i) improve the health and safety of persons at work and reduce the social and economic costs to the Victorian community of accident compensation."

20. Further insight into the objectives of workers' compensation arrangements is provided by the following extract from the second reading speech to the 1992 amendments of the *Accident Compensation Act 1985*:

> "The reforms proposed in this Bill are the first part of a legislative reform process that fulfils the Government's commitment:
>
> to adequately and fairly compensate injured workers;
>
> to reduce the costs of workers compensation;
>
> to make Victorian industry more competitive with other States; and
>
> to make return to work, rather than compensation, the main objective of the scheme."

21. Finally, the remaining relevant stated objectives of the legislative framework are found in section 1 of the *Accident Compensation (WorkCover Insurance) Act 1993*, which are reproduced below:

"**1. Purpose**

(a) to impose the liability to pay compensation under the Accident Compensation Act 1985 on employers and to require employers to hold WorkCover insurance against that liability at common law or otherwise in respect of injuries arising out of or due to the nature of employment;

(b) to provide for the licensing of authorised insurers for the purpose of issuing and renewing WorkCover insurance policies;

(c) to provide for the levying and collection of premiums;

(d) to transfer the existing liability of the Authority as specified in this Act to authorised insurers;

(e) to require authorised insurers to reinsure against their liability with the Authority;

(f) to further improve the operation of the Accident Compensation Act 1985; and

(g) to amend the Accident Compensation Act 1985, the Workers' Compensation Act 1958, the Stamps Act 1958 and the Accident Compensation (WorkCover) Act 1992."

2.3 Understanding the objectives

22. The workers' compensation 'product' is complex, exhibiting features found in both general insurance markets and in the provision of social security payments. Much of the complexity results from the different perspectives and interests of various parties which have a stake in outcomes in this area - workers, employers, governments, and insurers - and their ability over time to influence various features of the scheme. This is clearly reflected by the historical development of compensation for workplace injury. The role of incentives and economic arguments are also important in understanding both the objectives and specific features of the scheme.

23. This section examines some of these influences to better understand various elements of the legislative objectives such as universal and compulsory coverage, no-fault, fair compensation, and prevention and rehabilitation. The historical aspects are discussed first, followed by a brief look at the key equity and economic grounds for the main features of the scheme.

2.3.1 History of compensation schemes - changing goals

24. Work injuries have been a serious social concern since the 18th century, when injuries became widespread following the adoption of industrial processes. At this time, injured workers only had remedies available at common law but a combination of high court costs, a low standard of care owed by employers, and harsh judicial interpretations[5] meant that very few workers could recover damages.

25. By the latter part of the 19th century (early 20th in Australia), statutory schemes with compulsory and universal coverage began to emerge as a result of more sympathetic attitudes to workplace accidents and in response to the failings of the common law system. Initially, compensation was only paid for loss of earning capacity but over the years benefits increased and were expanded to include factors such as pain and suffering. Although there were many legislative changes made during this century, the focus of the statutory schemes remained the provision of just compensation and they were increasingly regarded by many as a form of social support.

[5] For example, contributory negligence was allowed as a complete defence for employers so that even if the latter were mostly at fault for a work injury no damages would be paid to the worker.

26. More substantial legislative change in Australia occurred during the 1980s and this was most apparent in Victoria with the establishment of the WorkCare scheme. Although there was continued emphasis on fair compensation of workers, for the first time the connection between workers' compensation and occupational health and safety was formally recognised. That is, the role of incentives on the behaviour of stakeholders was afforded larger importance and consequently greater emphasis was placed on prevention and, more particularly, rehabilitation. Another aim of the WorkCare system was to continue to provide fair benefits to workers but at lower cost for employers.

27. In more recent years, and especially since the introduction of WorkCover, the focus has substantially shifted toward ensuring the financial viability of the scheme. This is evidenced by the high priority placed on returning the scheme to a fully funded position and the increasing restrictions and thresholds on certain benefits. Incentives for both prevention and return to work have also been given a higher profile. The former is reflected by the move from a 'community rating' premium setting system to one that is experience rated. The importance now placed on rehabilitation is best summarised in the second reading speech to the 1992 amendments of the *Accident Compensation Act 1985*, where it was stated that the Government is committed "to make return to work, rather than compensation, the *main* objective of the scheme" (emphasis added).

2.3.2 Equity and economic arguments

Equity

28. In line with the historical origins of statutory schemes, many today continue to consider workers' compensation a key component of the social welfare system. Compensation for injury is said to constitute a fundamental right of workers. Moreover, according to this reasoning, employers should be liable for compensation because employees take on tasks at the behest of their employers and can rarely reject the risks they encounter.

29. While compensation of injured workers is a significant element, it is important to recognise that the workers' compensation scheme should not be viewed as a social welfare scheme as conventionally understood - that is, a system for *redistributing income* according to notions of horizontal and vertical equity. The receipt of compensation is predicated on the occurrence of a particular event, namely, a workplace injury or illness. This (unfortunate)

event has no obvious correlation with the income or wealth of individuals and, therefore, workers' compensation schemes cannot ensure that those who are most in need of income support receive assistance. Most importantly, the unemployed who are likely to constitute a large proportion of low income people are entirely ineligible for benefits[6]. Hence, it is hardly probable that workers' compensation can meet desirable redistributive goals.

Economic rationale

30. There are also economic arguments for having compensation for injury and holding employers liable. Having employers pay compensation for work related injury and illness ensures that the price of goods and services reflects all the costs incurred in producing and delivering them. Moreover, when there is a difference in knowledge about the riskiness of activities, the cost of reducing risks will be lower if the party with the superior knowledge - and, hence, the least cost avoider - has the responsibility of controlling those risks. In most cases this will be employers, so it is efficient to hold them liable for workplace injury and illness. This will provide the incentive for the party with greater knowledge of workplace hazards, and lower avoidance costs, to decide how to control those hazards and risks.

31. It is true that the party with the lowest accident avoidance costs will depend on the situation and, in some circumstances, it may be best to create a stronger incentive for employees to monitor the behaviour of their fellow workers. However, in deciding on a liability rule that covers a large range of situations, the pertinent question is "...are the gains created by this incentive [on employees] greater than what is lost by *removing* the incentive for the *employer* to monitor and discipline employee behaviour?" (italics in original)[7]. The same authors answer this question as follows:

> "Intuitively, it would seem that the range of situations in which accidents might be efficiently prevented by the employer is greater than those that might be more efficiently avoided by workers. The employer, for instance, can design and implement procedures and processes that reduce the likelihood and/or severity of accidents, even where employees are careless. The employer has control over who is an employee, and often a wide range of techniques for monitoring and disciplining the employee is available."[8]

[6] This is only one example of the anomalies associated with using a workers' compensation scheme as a redistributive mechanism. It is also unlikely that such a scheme would satisfy other preconditions of welfare schemes such as efficiency and effectiveness, administrative simplicity, and transparency.
[7] Dewess, Duff D. and Trebilcock, M., *Exploring the domain of accident law; Taking the facts seriously*, Oxford University Press, New York, 1996, p.349.
[8] *ibid.*

32. *It appears then that many of the features and objectives of the current workers' compensation scheme represent a hybrid of economic and equity objectives, and are the result of a long process of 'historical evolution' where changing perspectives and goals have given the scheme its particular shape today*.

2.4 Competition principles and Government objectives in workers' compensation

33. While the history of workers' compensation schemes helps us understand the objectives as they exist now, it is pertinent to examine these objectives in the context of contemporary policy settings. In particular, the objectives - especially the compulsory and universal coverage element - need to be assessed in light of competition principles which require the Government to intervene only when markets fail and if the benefits of intervention exceed its costs. The intention is not to question the objectives but to examine whether they are consistent with a market failure analysis. If they are not and it is shown that the Government is pursuing goals that go beyond efficiency considerations, there may be implications for the achievement of those goals through commercial arrangements.

34. The next sub-section outlines the sources of market failure in this market, while the subsequent sub-section explores whether these potential sources of failure are sufficient in explaining existing Government objectives.

2.4.1 Potential sources of market failure in the workers' compensation market

35. There are a number of potential sources of market failure inherent in all workers' compensation markets - information asymmetries, imperfect information, three party transactions, and externalities. A brief discussion of each of these follows.

Information asymmetries

36. Asymmetric information exists where one economic agent has superior information - in this case, about the nature and dimensions of risk - to another agent. Information asymmetry affects the behaviour of economic agents and generally manifests itself in the form of 'adverse selection' and 'moral hazard'. Moreover, these behavioural responses characterise

all insurance markets. For a discussion of the economics of insurance markets and the implications of adverse selection and moral hazard, refer to Appendix 4.

37. There are various potential moral hazard problems that might arise in the workers' compensation area. For example, once insured, employers may have few incentives to invest in preventive activity and return to work programs. However, to the extent that premiums are linked to firms' safety experience, one would expect that a safety incentive will persist. Insurance coverage can also create potential moral hazard problems on the part of workers. If insurance covers financial losses and medical expenses associated with a workplace injury, workers may have an incentive to exercise little care on the job. However, one would expect this incentive to be small because many workplace injuries and diseases can involve irreversible and irreplaceable effects on workers' lives and health, such as permanent disability, rather than purely financial losses. A more probable moral hazard problem that might arise on the part of workers is that higher benefits can lead to increased claims reporting and/or the filing of claims for accidents that have not occurred at work or at all.

38. To reiterate, these behavioural responses, to the extent they occur, arise from the presence of asymmetric information and the inability to monitor or observe behaviours and actions. As discussed in Appendix 4, both moral hazard and adverse selection may have implications for the viability of insurance schemes.

Imperfect information

39. Workers' compensation insurance markets tend to be characterised by what are termed 'long tail liabilities' where the effects of some work related injuries or diseases may not fully emerge for some time[9]. More importantly, the risks and long term costs associated with such injuries and diseases may not be verifiable or able to be predicted before occurring. In the absence of such knowledge or information, it is difficult for insurers to set premiums to cover all liabilities. The emergence of long tail liabilities may then jeopardise the financial viability of insurers and worker entitlements. In addition, investment in prevention becomes difficult if the source of injury or disease is unknown or not readily identifiable.

Three party transactions

[9] Long tail liabilities are also a feature of transport accident insurance markets.

40. The insurance contract in the workers' compensation market involves three parties. The premium is paid by the *employer* to an *insurer* to provide a specified payment from the *insurer* to the *worker*[10]. Effectively, the parties paying the price (employers) are different to those receiving the benefit (workers). The problem with three party transactions is that they exacerbate moral hazard problems. For example, the incentive for insured employers to undertake little investment in safety mentioned earlier, is more acute in this instance. Thus, "while house and contents insurance may encourage a householder to be a little less security conscious, at least, it's her house and her contents. With one two-party contract in a three party relationship, workers' compensation insurance is likely to induce the employer to be less safety conscious about workplace issues severely affecting somebody else's health"[11].

41. Another manifestation of the three party transaction is that employers may have the incentive to seek lower premiums and benefits for injured workers while workers might seek higher benefits. However, this wedge between the desired level of benefits may be due to inaccurate perceptions as there is some evidence suggesting that the cost of workers' compensation benefits to employers is offset by a reduction in the wage bill[12].

42. Before proceeding, it is worth noting once again that these types of three party transactions are not specific to the workers' compensation market. For example, similar contracts and associated moral hazard problems arise in the case of public liability insurance.

Externalities

43. Another source of potential market failure is the presence of externalities. That is, the social cost of workplace injuries and diseases might be greater than the direct and indirect costs suffered by workers and employers. In this case private incentives and actions will result in inadequate levels of workplace safety, and perhaps levels of compensation and return to work rates. Some costs which may be borne by the community beyond those incurred by the immediate parties concerned include the following: the need for support groups and

[10] Strictly speaking, under current arrangements, there are four parties to the contract as the contents of the insurance policy are determined by the VWA.
[11] Marsden Jacob Associates, *Accident Compensation Market Structure - Preliminary Paper for National Competition Policy Review of (Workplace) Accident Compensation Legislation*, May 1997.

associations to provide moral and other assistance to injured workers, foregone unpaid productive work, the loss of 'human capital' (in other words, society's investment in trained and productive workers), and the distress suffered by the family of the injured (or deceased) worker. It is difficult to ascertain the extent to which the presence of such externalities may result in underprovision of safety as there has been little work to date to estimate the magnitude of the costs involved.

2.4.2 Market failure and Government objectives

44. Although the above potential sources of market failure are recognised, it does not follow that current legislative objectives or the form of intervention are consistent with, or indeed necessary to overcome, these failures. As mentioned earlier, some of these sources of market failure exist in other insurance markets. These operate under the general oversight of the Insurance and Superannuation Commission and have not necessitated the establishment of monopoly reinsurers like the VWA.

45. While asymmetric information and the associated adverse selection and moral hazard problems can theoretically result in scheme failure, experience from other insurance markets suggests that mechanisms can be developed by market participants that allow the market to function. This does not mean that all employers and workers would be covered by insurance - this would require adverse selection and moral hazard to be completely eliminated - but *a* market for workers' compensation insurance could exist. This then suggests that the Government's objective of universal coverage stems from a desire to ensure that *every* worker will be compensated in the event of workplace injury or illness which overrides efficiency considerations.

46. The latter goal is a perfectly legitimate social objective on the part of Government, but it may create tension if it is sought to be achieved in a purely commercial environment. This mix of social, or equity, and economic objectives characterises the fundamental 'friction' in the design of any workers' compensation scheme. Equity objectives represent Government's desire to ensure an available safety net to all workers for the consequences of workplace related accidents or diseases. This is mixed with efficiency or, more correctly,

[12] See, for example, Moore, M.J. and W.K. Viscusi, *Social Insurance in Market Contexts: Implications of the Structure of Workers' Compensation for Job Safety and Wages*, in Dionne, G. (ed.), Contributions to Insurance Economics, Norwell, Mass. and London: Kluwer Academic, 1992, pp.399-422.

financial objectives which seek to control overall scheme costs by promoting safety, return to work and a general rehabilitation culture. The problem is that in the workers' compensation area 'equity' payments affect behaviour - for example, increased filing of claims that have not occurred at work. In other words, 'equity' payments in this instance have substantial efficiency/financial consequences that need to be managed.

47. The issue then is how to best manage these efficiency consequences. It may be that the extensive Government control that currently exists may not be required. While the existing form of Government intervention provides for substantial powers to manage consequences, it may also breed complacency, lead to a narrow set of solutions, and create an environment which is not conducive to innovation. As a result, the costs of controlling efficiency consequences may in fact increase. The substantive part of this report will examine these issues more closely.

48. Potential sources of market failure from the absence of 'perfect' information and the presence of three party transactions also do not appear to require the type of Government intervention currently observed. Information problems can be dealt with by the Government providing that information itself or offering incentives for private parties to collect and disseminate the requisite information. Concerns about the financial viability of insurers due to inaccurate predictions about long tail liabilities may be addressed through prudential regulations. Problems arising from the three party contract may be adequately remedied by some regulation of service standards and safeguarding of worker benefits[13].

49. The remaining issue to consider is that of externalities. Universal coverage is indeed one mechanism for ensuring that all social costs are internalised and that more 'appropriate' levels of workplace safety, compensation to injured workers and return to work rates are achieved. However, it is not the only policy available and not necessarily the best; neither is it entirely clear that universal coverage is necessary to internalise all social costs. It would be helpful if more work was done in this area to ascertain the magnitude of social costs and to develop optimal policy responses.

50. *Current legislative objectives and the extent of Government involvement cannot be explained on the basis of market failures. By implication, there must be some broader*

[13] The implications of imperfect information, long tail liabilities, and three party contracts for the operation of the workers' compensation market are further discussed in section 5 of this report.

social objectives underlying the scheme. If the maximum benefits available from commercial and competitive arrangements are to be realised, the review panel believes that these objectives need to be separately identified. Where a market failure case for Government involvement exists, the extent of failure needs to be established and appropriate policy responses developed. These are all issues beyond the scope of this paper, but the review panel strongly recommends that they be given serious consideration if desirable long term outcomes in workers' compensation are to be achieved.

2.5 Legislative objectives and the role of the Victorian WorkCover Authority

51. A final distinction that needs to be made in assessing legislative restrictions on competition is that between the objectives of the *legislative framework* and the objectives of the *VWA.* The objectives of the Act - that is, compulsory coverage at reasonable cost - are broader than those of the VWA which entail administration and funds management. As the scheme administrator, the VWA is the primary institution through which the government achieves its objectives.

52. The objectives of the VWA are contained in section 19 of the *Accident Compensation Act 1985* (as amended):

> "**19. Objectives of the Authority**
>
> (a) manage the accident compensation scheme as effectively and efficiently and economically as is possible;
>
> (b) administer this Act, the Accident Compensation (WorkCover Insurance) Act 1993, the Workers' Compensation Act 1958, the Occupational Health and Safety Act 1994, the Dangerous Goods Act 1985 and any other relevant Act;
>
> (c) assist employers and workers in achieving healthy and safe working environments;
>
> (d) promote the effective occupational rehabilitation of injured workers and their early return to work;
>
> (e) encourage the provision of suitable employment opportunities to workers who have been injured;
>
> (f) ensure appropriate compensation is paid to injured workers in the most socially and economically appropriate manner and as expeditiously as possible; and
>
> (g) develop such internal management structures and procedures as well as enable the Authority to perform its functions and exercise its powers effectively, efficiently and economically."

53. The VWA, therefore, is best seen as the tool or mechanism by which the government has determined how its wider objectives in workers' compensation legislation will be achieved. This distinction is a significant one. It suggests a separation is possible between the policy objectives of government and the mechanisms to implement these policy goals. In

particular, the distinction suggests that the two pronged wider objective - compulsory coverage and reduction of incidence/duration of workplace accidents - may be delivered by a variety of configurations.

54. The focus of the remainder of this review is to determine whether legislation that underpins restrictive institutional arrangements, such as monopoly provision of reinsurance by the VWA, is the most effective means of achieving the Government's stated objectives - both social and economic[14].

2.6 Conclusions

55. The Victorian workers' compensation scheme is administered by the Victorian WorkCover Authority, which bears ultimate risks through its reinsurance and underwriting functions.

56. The legislative objectives identified by the review panel are:

- to provide all Victorian workers with compensation in the event of work related injury or illness at reasonable cost; and
- to reduce the incidence and duration of work related injury or illness through prevention and rehabilitation.

57. Many of the features and objectives of the current workers' compensation scheme represent a hybrid of economic and equity objectives, and are the result of a long process of 'historical evolution' where changing perspectives and goals have given the scheme its peculiar shape today.

58. Current legislative objectives and the extent of Government involvement cannot be explained on the basis of market failures. By implication, there must be some broader social objectives underlying the scheme. If the maximum benefits available from commercial and competitive arrangements are to be realised, these objectives need to be separately identified. Where a market failure case for Government involvement exists, the extent of failure needs to be established and appropriate policy responses developed.

59. It is important to distinguish between the *objective* of intervention and the *form* of intervention. The VWA has been established by legislation and given the organisational

responsibility for delivering a statutorily defined product and to determine the criteria by which other market participants may deliver or purchase related products. The question which remains to be considered is whether this institutional arrangement continues to be the most effective means for achieving the Government's stated objectives.

[14] That is, this report does not attempt to unbundle the social element of the objectives discussed earlier.

3. Restrictions on competition

60. The Victorian workers' compensation legislative framework contains provisions that may impede the competitive process. Such restrictions, to the extent that they limit the scope for innovation, flexibility, and consumer choice, may reduce overall economic welfare. There are two main forms of potential restrictions on competition:

- public underwriting, and centralised premium setting and funds management; and
- regulations governing the structure and operation of the scheme.

These restrictions are outlined below.

3.1 Public underwriting, and centralised premium setting and funds management

61. The VWA cannot issue a licence to an incorporated body or renew a licence to an authorised insurer unless the corporation or authorised insurer enters into an arrangement to *reinsure* all statutory liabilities with the Authority (section 34, the *Accident Compensation (WorkCover Insurance) Act 1993*) and bank all collected premium income in statutory funds. As such, the VWA assumes the underwriting of all insurers' liabilities, except in cases of self-insurance.

62. The 'price' of workers' compensation insurance is formally determined by a Premiums Order approved by the Governor-in-Council on the recommendation of the VWA. Section 15 of the *Accident Compensation (WorkCover Insurance) Act 1993* provides for the VWA to recommend to the Governor-in-Council to make a Premiums Order. Insurers calculate employers' premiums based on a formula that is linked in part to employers' safety record and claims experience - this is often referred to as the experience factor or rate. The formula used in the calculation of premiums, including the experience rate, is prescribed by the Order.

63. As mentioned above, all premiums collected by insurers are placed in statutory funds which are owned by the VWA. Insurers are therefore not permitted to manage their premium incomes. The VWA contracts out this function to the Victorian Funds Management

Corporation. The relevant provisions are contained in Part IV of the *Accident Compensation (WorkCover Insurance) Act 1993* which state that:

- the VWA must establish and maintain a statutory fund for each authorised insurer (section 43(2)); and
- amounts held in statutory funds maintained by the VWA may be invested in any manner approved by the Treasurer under section 32(6) of the *Accident Compensation Act 1985* (section 43(3)).

3.2 Regulations

64. WorkCover insurance licences are subject to conditions imposed on applicants under the *Accident Compensation (WorkCover Insurance) Act 1993* and conditions imposed by the VWA under the same Act (section 32). Section 27 states that an incorporated body in Victoria may apply to the VWA for the issue of a bi-annual licence to be an authorised insurer. The application must be in a form approved by the Authority and accompanied by such documents and fees as the VWA determines. In accordance with these provisions, a number of operational, audit and other requirements have been imposed on insurers. These raise the cost of operating in the market and can deter the entry of other insurers.

65. Other barriers to entry and therefore potential restrictions on competition created by existing regulations include:

- the type of firms permitted to self-insure (that is, those firms who employ over 500 employees and who have a net asset base in excess of $200 million). This restriction was originally found in section 141, Part V of the *Accident Compensation Act 1985*. Currently, there are 23 firms - out of a potential pool of 300 firms employing more than 500 employees in Victoria - who have been licensed by the VWA to self-insure. However, in December 1996 an amendment was made to the Act that provides for increased opportunities for self-insurance. Specifically, both the capital threshold and minimum employee requirements have been replaced by the more general requirement that employers meet financial strength and viability criteria (section 141). In addition, a new section has been inserted (138A) that allows employers to self-manage various aspects of claims. These sections are expected to become operative in the financial year 1998-99.

- The VWA has the exclusive power to approve occupational rehabilitation providers (Part VI, *Accident Compensation Act* 1985). The approval process for such providers requires rehabilitation officers to have at least 20 WorkCover cases per annum in addition to satisfying a number of VWA internal guidelines. Providers must reapply for approval every two years.

3.3 Conclusions

66. The review panel identified two broad elements of competitive restrictions in the workers' compensation legislation. These are:

- public underwriting, and centralised premium setting and funds management; and
- regulations which govern the eligibility for self-insurance, the licensing of authorised insurers and the approval of occupational rehabilitation providers.

4. Effect of restrictions on competition

67. This section identifies the effects of potential restrictions on competition by looking at each restriction separately[15] - it does not comment on the broader question as to the merits of the current restrictions (that is, weighing costs and benefits) nor does it consider alternatives to these restrictions. These broader questions will be addressed in the next two sections.

4.1 Public underwriting, and centralised premium setting and funds management

68. The assumption of all underwriting responsibilities by the VWA is based on the supposition that, in the absence of public underwriting, the bankruptcy of a private insurer/underwriter will deprive workers of their entitlements to compensation. In addition, it is argued that a major benefit of retaining public underwriting is that it ensures licensed insurers compete for market share on the basis of service delivery rather than premium cost cutting. However, by requiring all prospective insurers to reinsure with the VWA as a condition of their license, the degree of competition (including service competition) among approved insurers may be limited. As insurers do not bear the costs of claims management nor benefit from cost savings and reduced risks, they have few incentives to compete through innovations and cost/risk reductions[16].

69. The setting of premiums through the Premiums Order, implies that price competition between insurers is non-existent. Centralised premium setting, and in particular experience rated regulation of premiums, seeks to keep costs to employers lower than they may otherwise be, to attract business to Victoria, to provide a discipline on overall benefits, and to avoid movements in premiums that may not otherwise be based upon movements in insurance risks. That said, prescriptive setting of premiums eliminates price competition between insurers. This reduces opportunities for insurers to engage in innovative premium and product competition and dampens incentives for cost-minimisation.

[15] That is, the interdependency between each restriction is not discussed for ease of exposition. Where there are non-trivial interdependent effects, these will be discussed in sections five and six of the report.
[16] The lack of service competition and incentives among authorised insurers was noted by a number of the parties during consultation.

70. By restricting approved insurers from managing and investing their premium income, competition may be further restricted principally for two reasons. First, insurers who may have otherwise entered the industry on the basis that they could manage and invest their premium incomes better than the VWA will be deterred. Second, in conjunction with public underwriting, centralised premium setting and regulations governing the claims management process, the activities of existing insurers are severely restricted thereby muting incentives for competition and innovation.

4.2 Regulations

71. The legislative framework restricts the number of firms permitted to self-insure to those firms who employ over 500 employees[17]. Firms that pass this threshold must also meet other criteria determined by the VWA. In an unfettered market, insurers would face competitive pressures to provide a range of services at attractive prices or risk losing business to employers who could choose to self-insure. For instance, self-insurers may determine that they can provide better tailored workers' compensation packages and claims management to their workers, and with lower administration costs. To the extent that legislative requirements prohibit some employers from being able to self-insure who would otherwise be able to do so, the degree of competition in the market is reduced.

72. Under the legislative framework, there are a range of restrictions on the functions that insurers can perform, and a series of statutory requirements which approved insurers must comply with, including licensing conditions and auditing and legal requirements. There may be significant costs of complying with these requirements which raise the cost structure of insurance providers in the market[18]. This has the potential to restrict entry particularly by smaller niche players who cannot amortise initial compliance costs as easily as larger insurers. It also reduces competition among existing insurers as they increasingly come to treat the VWA as their client rather than employers and workers.

[17] As mentioned earlier, the eligibility criteria for self-insurance have now changed but will probably not supersede current requirements until the financial year 1998-99.

[18] During consultations, insurers confirmed that the cost of complying with the various regulations was substantial. It was argued that much of insurers' time and resources were directed toward meeting VWA requirements rather than concentrating on employer and worker needs.

73. The approval process for occupational rehabilitation providers may also restrict competition in this segment of the market. For instance, approved providers must have at least 20 WorkCover cases per annum and reapply for approval every 2 years. In addition, potential providers must meet the VWA internal guidelines to gain approval to be a provider. This restriction has the potential to preclude a segment of the market that may be characterised by low cost providers of rehabilitation services that are 'fit for the purpose'. It would also preclude entry by service providers specialising in sports injuries or who have Comcare (Commonwealth workers' compensation scheme) clients.

4.3 Conclusions

74. The identified restrictions can be summarised as having one or a combination of the following effects:

- exclusion of certain potential market participants and therefore fewer pressures for price and service competition on existing insurers and providers;
- increased costs of operating in the workers' compensation market which possibly discourage further entry; and
- limited dimensions and muted incentives for the operation of competitive processes.

75. Given the objectives of the legislation and the inherent complexity of workers' compensation systems discussed in section 2, it may be that the benefits of restricting competition in the manner described above outweigh the costs and, further, the restrictions may be necessary in achieving desirable outcomes. The remainder of this report examines whether this is the case.

5. Costs and benefits of identified restrictions

76. This section considers the costs and benefits associated with the restrictions on competition identified in previous sections. A numeric cost-benefit analysis is not undertaken because it is difficult and perhaps impractical to quantify all costs and benefits. For example, while it is generally accepted that, where certain preconditions hold, increased competition delivers lower prices (resulting from enhanced efficiencies) and/or better quality services, it is difficult to estimate the magnitude of these benefits. Similarly, the types of innovations in service delivery that are foregone under current arrangements but which may be engendered under a more competitive market are, by their nature, not easily predicted.

77. Consequently, the approach adopted here is to determine the *nature* of costs and benefits and on the basis of objective, logical and considered analysis, inferences are made about the relative merits of each of the restrictions. The costs and benefits of the identified restrictions are outlined in the following table with some accompanying comments. The views of the review panel regarding the *balance* of the costs and benefits appear after the table. Some concluding comments complete this section.

Benefits / Costs	Comments
Public Underwriting	
Benefits • Ensures protection from the costs of insurer insolvency thereby protecting workers' entitlements to compensation.	• While public underwriting ensures protection from the costs of insurance company failure, private underwriting with accompanying safeguards (discussed in sections 6 and 7) can also meet this purpose while allowing the potential benefits of competition to be realised.
• Guarantees the stability of the system.	• Stability is not necessarily ensured as governments may be reluctant to allow immediate premium increases in the event of emerging costs. The result is that liabilities may accumulate over time necessitating subsequent dramatic increases in premiums to ensure scheme viability. This occurred under the WorkCare scheme.

• Ensures that licensed insurers compete for market share on the basis of service delivery rather than premium discounting.	• This assertion is not borne out by the comments obtained during consultations and available evidence on insurer turnover. Feedback received by the review panel consistently pointed to the lack of innovation in insurer service delivery with employers believing to be little or no differentiation between insurers. These observations are supported by empirical evidence suggesting that insurer turnover by employers is less than one per cent annually. In contrast, 10 to 15 per cent of small businesses change their main bank each year.
Costs	
• There are limited incentives for insurers to maximise the efficiency and effectiveness of managing claims because they do not bear the costs of the injury management process and do not benefit from any cost savings achieved.	• Because insurers do not bear full commercial risks, there are few incentives for them to adopt a total risk management approach incorporating prevention and injury management (ie. rehabilitation and return to work) and to develop strategies and policies appropriate for different workplaces.
• Since all risks are borne by the VWA, insurers have an incentive to lower premiums by mis-classifying employers' risk and workforce.	• While this represents a benefit for employers because it lowers their effective price for insurance, it mutes incentives for safety and therefore conflicts with the legislative objective of reducing the incidence of work injuries and diseases.
• The assumption of risk exposes the Government and taxpayers to financial losses.	• Public underwriting essentially means the Government guarantees the insurance fund so that any losses would need to be met by the Government and taxpayers (although, in practice, any losses are usually passed on to employers in the form of a levy as occurred under WorkCare). The appropriateness of this arrangement must be assessed in the context of Government policy that is seeking to divest the public sector of non-core activities and transfer risks to the private sector where appropriate.
Centralised premium setting	
Benefits	
• Premiums are set to reflect workplace risks (rather than unrelated factors such as investment returns) which provide appropriate incentives to prevent work-related injury and illness.	• Premiums based on workplace risks which provide incentives for safety and prevention are a necessary element of any workers' compensation scheme. While centralised premium setting can achieve this, other less regulated options may be available that encourage innovation while preserving strong safety incentives (this is discussed further in sections 6 and 7).
• Ensures the scheme is fully funded.	• The argument is that premiums can be set at levels that allow for all liabilities and other system costs to be funded. However, similar incentives exist in more decentralised markets as costs must be recouped in the long run if firms are to survive.

• Premium costs can be contained thereby conferring a competitive advantage on Victorian businesses.	• This is essentially an industry assistance argument and there are strong reasons for not manipulating premiums for this purpose. Perhaps the chief argument is that if premiums do not reflect true workers' compensation costs, employer safety incentives will be muted and products/services will not reflect their full costs of production/delivery. Moreover, costs need to be paid for by others and this will usually be injured workers through lower benefits, or taxpayers.
• Avoids 'excessive' premium volatility and therefore employers can accurately predict their workers' compensation insurance costs.	• The issue of premium volatility is a complex one as some element of premium variability in response to safety initiatives and performance is desirable. Moreover, depending on the mechanisms used, volatility suppression can have important implications for the incentives and behaviour of various parties. Nonetheless, stable premiums can also be realised under less regulated premium setting processes. These issues are expanded further in section 7.
Costs • In the absence of price competition there are few incentives for insurers to control administrative and management costs and generally pursue efficiencies that could be reflected in lower premiums.	• Centrally fixed premiums do not provide the type of discipline imposed by price competition which encourages and indeed necessitates the achievement of administrative and other efficiencies to maintain and increase market share.
• Without competitive pressures constraining premiums, there are limited incentives for insurers to develop risk management programs to assist employers in reducing workplace injuries and diseases.	• In the absence of price competition, scheme costs are simply passed on through higher premiums (or reduced benefits for injured workers). Conversely, with competition constraining premiums, insurers would be encouraged to develop tailored prevention and return to work strategies for employers to minimise their premium costs.
Centralised funds management	
Benefit • It is argued that centralised funds management achieves economies of scale.	• There appear to be no perceptible benefits of centralised funds management. The argument commonly propagated is that centralised funds administration allows economies of scale to be realised. However, many insurers are of sufficient size to be treated as institutional investors and, in any case, if the scale argument is accepted it is not obvious why economies could not be achieved in a decentralised system (by insurers pooling their funds for example).
Costs • Insurers may not fully recover premiums from employers.	• Given that premiums are fully ceded to the VWA, insurers' incentive to collect the full amount of premiums may be reduced. This perhaps explains, at least partially, the rigorous auditing requirements of the VWA.

• Reduces 'ownership' by a key stakeholder (insurers), further muting incentives for effective management of claims.	• By restricting insurers from managing their premium income, their role as simple claims processors is reinforced. Hence, this further reduces incentives for insurers to adopt total workplace risk management and return to work strategies.
Regulations	
Eligibility requirements for self-insurance	
Benefit	
• Limiting the number of employers self-insuring ensures the viability of the scheme by maintaining the 'pooling' effect of insurance.	• More extensive self-insurance arrangements will increase the average premium for remaining employers and, in the limit, the viability of the scheme would come under pressure if only a small number of high-risk employers remained in the 'pool'.
Costs	
• Restriction of self-insurance may result in systematic cross-subsidisation of high-risk employers.	• To the extent that some employers are unable to self-insure under current arrangements but would choose to do so under less stringent requirements, these employers are subsidising high-risk employers. Cross-subsidisation is undesirable because some employers do not bear their entire claims costs and therefore safety and prevention incentives are reduced.
• Improved workplace safety and return to work outcomes will be foregone.	• During consultations, the review panel consistently received comments about the benefits of self-insurance. It was argued that self-insurers invest more heavily in prevention, experience fewer workplace accidents and claims, have fewer disputes over claims, and focus on speedy rehabilitation and return to work. This is because self-insurers directly bear all risks and therefore have the clearest incentives for accident prevention and returning employees to work as earliest as practicable. These claims are further examined in section 5.4.1.
• To the extent that self-insurance is constrained, the degree of competition in the market may be reduced.	• Allowing greater scope for self-insurance increases the options available to employers and consequently enhances competition. Insurers would need to clearly demonstrate that they add value if employers have the choice of opting out.
Licensing of insurers	
Benefits	
• Ensures that insurers are able to meet liabilities resulting from claims.	• Given the long term nature of many of the liabilities, it is argued that solvency tests and other financial indicators need to form part of insurer licenses to ensure that liabilities are covered. The consequences of default by an insurer in the workers' compensation area are considered to be particularly severe as such failure would result in the loss of the only source of income for some workers.

• Provides pressures for insurers to maintain appropriate service quality standards.	• The argument for having quality standards form part of insurers' licensing requirements is a result of the nature of the insurance contract. That is, because the party paying for insurance coverage (employers) is different to the party being covered (employees), the usual competitive pressures for delivering quality services do not strictly apply.
• Allows for adequate data collection required for informed policy making.	• Information on workplace accidents and risks is important to inform the development of preventive strategies and policy making more generally. Insurers it is argued would underinvest in system-wide information collection and dissemination because competitors could reap the benefits. Hence, the argument for licenses incorporating some data and information requirements.
Costs	
• 'Excessive' regulatory requirements can tie up resources in fulfilling licensing and reporting conditions rather than channelling resources into the efficient and effective management of claims.	• Feedback received by the working panel was that the management of claims is heavily regulated and focused on processes as opposed to outcomes. Consequently, insurers spend an inordinate amount of time and resources fulfilling VWA requirements rather than focusing on risk and claims management. Innovation by insurers is also said to be stifled as there are few opportunities to vary product and/or service delivery.
• Compliance costs may unnecessarily raise the cost structure of insurers which is ultimately reflected in higher premiums and may also deter entry by other insurers.	• The licensing, reporting, and auditing requirements imposed on insurers may require significant resources for insurers to comply which leads to premiums that are higher than would otherwise be necessary. The review panel did not obtain data on the magnitude of compliance costs, but it is concerned that cumbersome regulations may act as a deterrent for other insurers to enter the market thereby reducing the level of competition.
Approval of occupational rehabilitation providers	
Benefit	
• Ensures an adequate level and quality of service delivery by approving providers with relevant qualifications and experience.	• Approval of rehabilitation providers (together with payment structures) seeks to address the incentive for overservicing and overuse given that workers do not pay for the service and the providers' income is guaranteed (subject to some conditions). Approval of providers also seeks to ensure that services are of an adequate standard.
Cost	
• Depending on the nature and stringency of the requirements, the entry of some providers may be unnecessarily precluded.	• Anecdotal evidence obtained suggests that the market for rehabilitation providers is competitive and service standards have improved under the WorkCover scheme. However, this is not an argument for retaining 'non-binding' regulations which might be irrelevant and may raise the cost structure of service providers.

5.1 Public underwriting

78. The most compelling argument for continued public underwriting is that it ensures that workers' compensation liabilities are funded and therefore the entitlements of injured workers are protected. Moreover, this satisfies the legislative objective that all workers be provided with compensation in the event of work related injury or illness. However, in the opinion of the review panel, this protection of entitlements comes at the cost of more effective performance in the areas of prevention and injury management.

79. Public underwriting implies that insurers do not bear the risks or the costs of the workers' compensation scheme. Hence, there are few incentives for insurers to assist in the promotion of workplace safety and early return to work by devising appropriate risk management and rehabilitation products. Nor do they have the financial incentive to minimise legal and medical costs that are often argued to be important cost drivers in the system. Further, it creates the perverse incentive for insurers to classify incorrectly the workforce of employers in order to lower premiums and attract custom.

80. The assumption of risk by insurers would encourage competition and product/service delivery innovation as prevention and return to work strategies form an essential element of controlling accident risks and claims costs. The generally accepted superior performance of self-insurers on various dimensions of accident prevention and claims management is a clear demonstration of the benefits of assigning risk to parties that are better placed to control and manage the risk. Section 6 will examine alternatives that preserve the entitlements of workers while providing for enhanced incentives to achieve safe workplaces and more efficient claims management.

5.2 Centralised premium setting

5.2.1 Risk and cost reflective premiums

81. One of the objectives of workers' compensation legislation identified earlier in section 2 was that the scheme should reduce the incidence and duration of work related injury. Centralised premium setting can assist in the achievement of this objective by basing premiums on employers' past and likely safety experience. This has provided the rationale for the adoption of experience rated premiums under the WorkCover scheme. However,

current premium setting arrangements do not appear to allow much flexibility for premium and service innovation and do not appear to provide sufficient incentives to minimise administrative costs.

82. Price competition, on the other hand, can act to restrain premiums as insurers would be forced to strive for efficiencies to maintain or gain market share. In addition, with some element of price competition, one would expect innovations in the area of prevention and injury management as mechanisms for limiting and reducing premium costs for employers.

83. Moreover, while centralised premium fixing can ensure that premiums are reflective of workplace risks rather than being based on other unrelated factors, it does not follow that this will necessarily occur. Governments may be reluctant to pass on higher claims costs particularly if they wish to use lower premiums as a way of influencing firms' location decisions. A recent example where true claims costs were not reflected in premiums is provided by the New South Wales scheme on which the current Victorian system is predicated. Despite increasing underlying claims costs in that State, premiums were not adjusted to reflect these costs but were subsidised by the investment returns on the scheme's assets. The result was that safety incentives for employers were muted and substantial liabilities accumulated. The financial deterioration of the scheme necessitated sizeable premium increases and the scheme remains in a fragile state[19].

84. This is not to suggest that a similar experience awaits the Victorian scheme. It does highlight however that centralised premium setting of itself does not ensure premiums will always be based on workplace risks and claims costs.

5.3 Centralised funds management

85. As discussed in the table above there appear to be no conclusive benefits of maintaining central responsibility for the management of premium funds. More importantly, centralised funds management is not necessary for the achievement of the legislation's objectives. The only rationale for this arrangement appears to be that it represents the 'reinsurance premium' paid by insurers to the VWA for underwriting and therefore carrying the risks of the scheme.

[19] For more information the reader is directed to the *Inquiry into Workers' Compensation System in NSW, Final Report, 15 September 1997,* and in particular chapter 3.

However, even if it was considered desirable for this reason to maintain public ownership of the funds, it does not follow that the funds should not be managed by private insurers.

86. Centralised funds management should also be considered in the context of other elements of the scheme. Together with public underwriting, centralised premium setting, and regulations governing claims management procedures, this restriction significantly reduces ownership of the scheme by insurers. Arguably, without the ability of authorised insurers to undertake any of these functions, they essentially become claims *processors* rather than *managers*. In these circumstances there are few dimensions on which competitive processes can operate and it is difficult to create incentives that focus insurers' attention on total risk and injury management.

5.4 Regulations

5.4.1 Self-insurance

87. The argument for the restriction of the extension of self-insurance represents the fundamental conflict existing in workers' compensation systems. Given that they operate as insurance schemes they require the pooling of risks as discussed in Appendix 4 of this report, but the need to encourage workplace safety requires that premiums reflect specific workplace risks. The review panel however is not convinced that eligibility for self-insurance should be deliberately restricted for several reasons.

88. First, there is evidence from various jurisdictions that self-insurers provide safer workplaces and actively promote the rehabilitation and early return of injured workers. For example, VWA annual reports show that the incidence of long term claims (that is, those greater than 52 weeks) is substantially lower among self-insured employers. Moreover, an industry analyst has recently suggested that self-insurers both in Australia and overseas spend approximately 30 per cent more on safety programs and have better return to work experiences[20]. Clearly, some of this difference can be explained by 'selection bias' but on balance the evidence in favour of self-insurance is persuasive. The theoretical case for self-insurance is also strong in that such an arrangement removes the three party contract discussed earlier. This means that all costs are internalised to the firm and employers

[20] Marsden Jacob Associates, *Accident Compensation Market Structure: Preliminary Paper for National Competition Policy Review of (Workplace) Accident Compensation Legislation*, May 1997, p.17.

acquire ownership of the rehabilitation process. Hence, self-insurance would appear to be an essential element of any system that seeks to reduce the incidence and duration of work related injury or illness.

89. Second, allowing for self-insurance (and self-administration) enhances competition in the market by increasing the options available to employers. This can therefore act as an added discipline for improved claims management. If (large) employers have the choice of meeting their own workers' compensation costs, insurers will need to demonstrate that they can add value through the development and provision of innovative products and enhanced service levels. This has been recognised in Victoria through the recent expansion of the eligibility requirements for self-insurance.

90. Third, while theoretically possible, it is unlikely that more extensive self-insurance arrangements will place the viability of the scheme in jeopardy. In practice, it is only the very large employers that are willing and able to bear the full costs of workplace accidents. More importantly, if premiums closely match workplace risks and claims experience, they should not be greatly affected by allowing greater scope for self-insurance.

91. Before proceeding, it is worthwhile considering the reason for the low assumption of self-insurance among currently *eligible* employers. Given the generally superior return to work performance of self-insurers it would appear that employers able to self-insure would have a strong incentive to do so because it would reduce their 'down time' and possibly avoid additional costs in hiring and training new workers. Moreover, evidence suggests that self-insurers are able to manage claims at lower administration cost thereby providing a further incentive for self-insuring. This then raises the question of why only 23 out of a potential pool of 300 firms have chosen to self-insure. The review panel considers the following factors to be relevant:

- the experience rating system - the experience rate seeks to link employer premiums to the level of workplace risks. The proxy used for true risk is the firm's recent claims experience adjusted by a 'credibility factor'. This factor increases with firm size because claims experience is a more accurate estimation of true risk the larger the firm. It may be therefore that experience rating ensures larger employers are 'almost at' self-insurance in any case.

- the management of workers' compensation claims is not a core activity for non-insurer employers - claims management and administration is an ancillary function for employers and therefore does not represent their core interest and/or competency. This is particularly relevant in the context of contemporary business practice where employers are increasingly focusing on core activities and outsourcing or contracting-out non-core functions.
- the inability to use third party administrators - to become a self-insurer an employer must undertake every aspect of claims management. Hence, employers cannot bear the risks of workplace accidents while contracting-out the administration of claims to insurers or other third parties.
- the VWA assessment process - in granting licences for self-insurance, the VWA employs a rigorous process and hence some employers may conclude that applying for self-insurance is 'not worth the effort'. In addition, it may be that self-insurers are providing a 'subsidy' to the remaining pool as alluded to earlier in section 2 of the report[21].

5.4.2 Licensing of insurers

92. The arguments for retaining some form of licensing for insurers were outlined in the table above. The key considerations relate to prudential, quality and informational issues. The review panel accepts that these are legitimate concerns and all need to be addressed to ensure the objectives of the legislation are met. The justification for the panel's position is discussed below. However, while accepting that there may be some role for licensing conditions, the review panel believes current arrangements are cumbersome, inflexible, and ill-focused and therefore detract from the achievement of the objectives of the legislation. This issue is also discussed further below.

Prudential requirements

93. The argument for the imposition of some form of prudential requirements essentially arises from the need to ensure that liabilities resulting from claims can be met. It is desirable to

[21] *supra* n. 1.

avoid insurance company insolvencies primarily for two reasons. First, unless insurer losses are fully covered by a private underwriter or somehow confined to the individual insurer, the cost of unfunded liabilities will be borne by somebody else. Depending on the arrangements, this will usually be the Government (or public authority) or some form of 'nominal' insurance fund. If the liabilities are ultimately funded by employers through levies or higher premiums, safety and injury management incentives will be distorted as premiums will not be reflecting risks and costs. Inter-temporal and inter-firm cross subsidisation will also result, further acting to mute safety incentives.

94. Second, the consequences of insurer insolvency can also be severe for injured workers. The loss of perhaps the only source of long term income for workers having suffered a serious workplace injury or illness can impoverish the lives of both those individuals and their families. In other words, the consequences for peoples' lives following default by an insurer are considered to be greater in the area of workers' compensation than other branches of insurance.

95. The probability of unfunded liabilities is also considered to be higher in workers' compensation markets because of the nature of some liabilities. As discussed in section 2 of the report, one distinguishing feature of such markets is the existence of long tail claims. That is, the treatment of some injuries or illnesses, whose effects are not easily predicted and indeed might initially be unknown, can continue for extended periods of time. Such claims might entail substantial ongoing costs that had not been (and perhaps could not be) anticipated by the insurer. It is clear, therefore, that some level of prudential monitoring will be necessary to achieve the objectives of the legislation[22].

Quality standards

96. The discipline to deliver quality services is not as strong in the workers' compensation market because the party paying for insurance coverage (employers) is separate from that being covered (employees). This is particularly true in those aspects of service that directly

[22] The foregoing discussion applies equally to self-insuring employers and therefore prudential monitoring of such employers will also be needed to ensure that injured workers are not stranded.

affect workers such as prompt processing of claims, timely weekly payments and expeditious dispute resolution. Some of the stakeholders consulted were concerned that insurers concentrate predominantly, if not exclusively, on employers as their client. The incentive is therefore created to deny liability and 'unjustifiably' terminate claims as a way of reducing compensation costs for employers. This suggests there is some merit in having service standards forming part of insurer licenses.

Information and data collection

97. Most stakeholders argued that the collection and dissemination of meaningful information is imperative for the success of any workers' compensation scheme. The review panel concurs with this point of view. Information is required *inter alia* to educate employers and workers about the causes of workplace accidents and actions they can undertake to avoid them. While insurers will have an interest in collecting and disseminating information on workplace hazards, there are reasons to believe that insufficient information will be provided[23]. Much of the information, such as that relating to 'generic' problems like back strains and stress, is of a public good nature so that competitors can benefit from the research and safety awareness activities of other insurers. At a more practical level, the generally inadequate nature of existing information on workplace hazards and injuries as highlighted in a number of inquiries[24] suggests a continued government role in this area.

Existing licensing arrangements

98. Current licensing and reporting requirements concentrate on processes so that insurers spend a lot of time and resources focusing on the VWA rather than the needs of employers and injured workers. Moreover, there is little scope for innovation as most aspects of claims management are dictated by VWA guidelines resulting in an undifferentiated level of service delivery that simply meets the stipulated minimum standards. Discussions with authorised insurers and other stakeholders confirmed that claims management and service delivery processes are heavily regulated. While such regulations seek to ensure that minimum service levels for employers and workers are met, they lead to an inordinate focus on VWA as customer and stifle innovation given insurers' limited ability to vary the product

[23] It is also worth noting that representatives of both workers and employers can and should play a role in the creation and provision of information.
[24] See for example the *Report of the Committee of Enquiry into the Victorian Workers Compensation System* (the Cooney Report) and the Industry Commission, *Workers' Compensation in Australia*, Report No. 36, 4 February 1994.

and services they offer. As noted in the table above, the review panel is also concerned that the resources required in meeting licensing and other requirements can be deterring the entry of other insurers into the workers' compensation market. As a result, while licenses are addressing what the review panel considers to be legitimate concerns, they do not appear to be doing so in the most cost-effective manner.

5.4.3 Approval of occupational rehabilitation providers

99. The rationale for having approved providers of rehabilitation services arises from a concern about both the *level* (or quantity) and *standard* of service. Workers are not required to pay or contribute to the cost of rehabilitation services, so there is no incentive for them to assess and justify the potential benefits of such services relative to the costs involved. Providers also have weak incentives to confine services to those that are necessary particularly if their fees are reimbursed on a per service basis[25]. The result may therefore be overutilisation of occupational rehabilitation services.

100. Nonetheless, it is not clear how the approval of rehabilitation providers assists in overcoming excessive service levels. More effective means for tackling the problem would be to devise payment structures for providers that are geared toward outcomes and having effective fraud control mechanisms that can detect overservicing. It is worth noting that medical providers have similar incentives but there is no additional requirement for them to be approved by the VWA. The review panel therefore does not accept that the approval of rehabilitation providers is necessary for controlling the *level* or quantity of service.

101. As mentioned above, approval of occupational rehabilitation providers also endeavours to ensure adequate quality *standards* by approving providers with the 'necessary' qualifications and experience. However, in assessing the need for approval mechanisms the following ought to be considered:

- Rehabilitation centres presumably have the incentive to hire appropriately qualified staff;

[25] One would expect however that reputation would act as a strong discipline for rehabilitation providers to seek cost-effective and successful outcomes. One of the parties consulted stressed that successful return of injured employees to full-time work constitutes the best advertising for the provider's services.

- Performance indicators and quality audits are alternative and arguably more effective mechanisms for monitoring and ensuring the provision of quality services;
- Effective rehabilitation may require a combination of services and professionals embracing areas such as medical services, counselling and psychological services, and specialist training. It is difficult therefore for a regulator to determine what are 'adequate' qualifications or what combination of these disciplines is necessary for effective rehabilitation programs. Further, one would expect that the search for the right 'product mix' would form an important element of competition among occupational rehabilitation providers.

102. Irrespective of the necessity for approval processes, the current requirement that service providers have at least 20 WorkCover cases per annum appears to be unnecessary. Such a requirement would preclude the entry of providers currently specialising, for example, in the rehabilitation of injured sports people. At a more practical level, the requirement also appears to be redundant as rehabilitation providers tend to deal with a substantially greater number of workers. Hence, the review panel considers that approval processes for rehabilitation providers, at least in their current form, are not necessary for the achievement of the legislation's objectives.

5.5 Conclusions

103. As previously outlined, the broad objectives of the workers' compensation legislation are to:

- provide all Victorian workers with compensation in the event of work related injury or illness; and
- maintain affordability for employers by reducing the incidence and duration of work related injury or illness through prevention and rehabilitation.

104. The analysis above indicates that the identified restrictions, at best, support the objectives at the expense of enhanced incentives for safety and innovation through more competitive processes, or at worst, are irrelevant to the achievement of the objectives. In particular:

- public underwriting supports objectives but at the expense of more effective performance in the area of prevention and injury management;

- centralised premium setting possibly supports objectives but does not entail strong incentives for insurers to pursue administrative efficiencies and premium and service innovation;
- centralised funds management is not necessary for the achievement of objectives;
- stringent restriction of self-insurance runs contrary to the objectives as such arrangements have been demonstrated to result in reduced incidence and duration of work related injury or illness;
- licensing of insurers supports the objectives but currently there is 'excessive' regulation of processes which ties up many resources and stifles innovation among insurers; and
- the current approval processes for occupational rehabilitation providers do not appear to be necessary for meeting objectives.

6. Alternative means of achieving the legislation's objectives

105. In accordance with the terms of reference for the review, this section considers alternative arrangements for the achievement of the identified objectives of the legislation. In arriving at its preferred alternative, the review panel has been guided by the legislative principle that restrictions be retained only when the benefits outweigh the costs *and* when less restrictive means for achieving legislative objectives are not available.

106. The underlying position is that there will be sustainable and improved results from competition which focuses on generating greater efficiencies and/or better outcomes in the areas of prevention and safety, claims management, and rehabilitation and return to work. It is not envisaged that the affordability objective be satisfied through the erosion of benefits to workers. Hence, in considering alternatives, the following factors are taken as given:

- the legislative objectives outlined in earlier parts of the report continue to apply; and
- fundamental design features of the current scheme such as no-fault liability and existing benefit levels for injured workers will be maintained.

107. The framework of alternatives does not address all current scheme features. Issues such as the desirability of common law access, the appropriate level of worker benefits, and effective procedures for dispute resolution, are all important but beyond the scope of the current review. Consequently, they have not been considered by the panel and no position has been arrived at on these matters.

108. The remainder of this section briefly considers the case for maintaining the status quo and explores the merits of one possible alternative arrangement - a monopoly insurance fund. Following this, there is more detailed examination of the preferred alternative, while a final section contains the main conclusion of the discussion.

6.1 Maintaining the status quo

109. The existing WorkCover scheme is in a considerably better financial position than its predecessor WorkCare. The scheme as at 30 June 1997 remained fully funded while premium rates have been kept at levels substantially lower than those existing under WorkCare. However, many of the savings appear to have resulted from the elimination of

journey claims, the extension of employer excess, erosion of worker benefits, and some reduction in short-term liabilities. There is evidence that long tail claims representing a sizeable proportion of scheme costs have not been significantly reduced since the introduction of WorkCover. Moreover, there are indications that at current premium rates the scheme could soon be in deficit[26].

110. In other words, fundamental commercial risks associated with the scheme have still not been adequately addressed. Emerging problems are generally addressed through legislative amendments. This has undermined the search for more commercial and enduring reforms. The review panel believes that continual legislative change is inappropriate and ultimately infeasible for addressing problems with the scheme. In particular, frequent legislative change creates uncertainty, reduces cooperation among the various stakeholders and distorts incentives for prevention and return to work. Moreover, if fundamental causes are not addressed, legislative amendments are inherently unstable as stakeholders become familiar with the changes and search for ways to undermine them.

111. Many of the scheme's problems appear to be symptomatic of the restrictions identified and discussed in this report. As argued in the previous section, while current arrangements may contribute somewhat to the achievement of objectives, underlying incentives for safety and innovation (including strategies for prevention and return to work) are muted by the restriction of competition. This option is therefore not preferred.

6.2 Monopoly insurance fund

112. One possible alternative would be to have a single insurer responsible for all aspects of the scheme. Proponents of this arrangement argue that it yields economies of scale and scope, it leads to greater control over all aspects of workers' compensation insurance, and allows for better collection of data and enhanced fraud control.

113. The review panel did not obtain evidence on the significance of economies of scale. However, a study referenced in the Industry Commission inquiry into workers' compensation arrangements[27] found that such economies are confined to administration which accounts for a small proportion of premium costs. The Industry Commission

[26] At the time of writing it was announced that average premiums will be increased from 1.8 to 1.9 per cent which further suggests that under current arrangements the underlying costs of the scheme will soon outweigh revenues.

concluded that of themselves economies of scale do not justify sole provision (p. 209). Nonetheless, it is unlikely that sole provision is necessary to reap all economies of scale and the existence of a number of insurers could be consistent with the realisation of administrative economies. Moreover, if there is a natural tendency toward sole provision owing to economies of scale, such an arrangement would be dictated by market forces.

114. The second major argument for a single insurance fund is that a sole provider can take a holistic approach to workers' compensation insurance as it will have control over all aspects including prevention, compensation and injury management (ie. rehabilitation and return to work). However, greater *control* by a *single* provider does not necessarily translate into greater *incentives* for maximising the benefits of each component of workers' compensation insurance. Without competition constraining premiums, a monopoly provider can simply charge more to cover increased insurance costs rather than controlling costs through cost-effective risk and injury management.

115. Furthermore, in the absence of competition there will be limited incentives for improving efficiency. Competition creates continuous pressures to generate efficiencies as complacency can lead to loss of market share to other firms that are more efficient and/or provide better services. No similar disciplines are extant in the monopoly situation. Indeed, it is for this reason that the principle guiding legislative reviews contains a presumption in favour of competitive market structures.

116. A final argument for sole provision is that it allows for better information collection and more effective fraud control. There may be some argument for centralised data bases both for reasons of fraud control and for data collection to inform premium setting and policy making. However, this does not of itself provide an argument for the sole undertaking of the entire insurance function. If centralised data collection and fraud control is considered to be more effective, such an arrangement can be accommodated under competitive insurance. Hence, the review panel does not prefer the monopoly option.

6.3 Competitive insurance

117. The preferred option is to introduce competitive insurance entailing the underwriting of liabilities by private insurers and more flexible premium setting. The review panel

[27] Industry Commission, *Workers' Compensation in Australia*, Report No. 36, 4 February 1994.

recognises that this represents a fundamental change to the scheme. To implement it, the Government will need to comprehensively consider the design features of the new structure. This is beyond the scope of the current review. Hence, while the review panel believes that private underwriting would better achieve the legislation's objectives, it is not in a position to prescribe, for example, the necessary prudential requirements that must accompany such a system. This level of detail will need to be clarified once and if the Government accepts the 'threshold' issue of moving to a competitively underwritten system.

118. Nonetheless, the *broad* elements of a privately underwritten scheme as envisaged by the review panel are briefly outlined below, together with a statement of recommendations. This is followed in the next chapter by a discussion of possible concerns and objections about the preferred approach of the review panel.

6.3.1 Elements of competitive insurance

119. Under the proposed arrangements, the ultimate financial responsibility for workers' compensation liabilities will shift from the VWA to private insurers. In other words, authorised insurers will not be required to reinsure with the VWA - all underwriting risks will be borne by the private sector. To guard against insurer insolvency, underwriters and insurers (including self-insuring employers) will be required to satisfy prudential requirements. A 'nominal' insurance or 'guarantee' fund could be examined as a means to protect entitlements to compensation. Naturally, all premiums collected will be retained and managed by insurers.

120. Regarding the setting of premiums, greater flexibility and innovation should be allowed. Some regulation of premiums *may* be necessary to ensure that premiums are based on risks and provide incentives for safety and prevention, but the review panel believes there is still considerable scope for allowing some flexibility. A number of premium setting alternatives are available that would allow for greater innovation and enhanced incentives for pursuing efficiencies including prices oversight and a 'file and write' system[28]. The precise premium setting system to be adopted is another issue that should be the subject of further

[28] A 'file and write system' is a regulatory mechanism where insurers are required to file their proposed premium setting systems with the regulatory authority for approval before being able to issue insurance contracts.

investigation if the recommendations of this report are accepted[29]. The review panel would argue that, at a minimum, insurers should be able to compete on administrative costs and services such as risk and injury management.

121. It is further proposed that an independent regulator be established. The types of functions that would be undertaken by the regulator include:

- administration of the legislation including the prescription of benefits and other components of compensation;
- licensing of underwriters, insurers, and self-insurers able to satisfy 'appropriate' prudential requirements;
- monitoring of the quality of service delivery by insurers, self-insurers and service providers;
- facilitation in the collection of data and dissemination of information;
- supervision of premium setting (if premium regulation is considered necessary); and
- fraud control.

122. It is also important to note that the separation of commercial activities (reinsurance and funds management) from regulatory functions is consistent with the Government's commitment to structural reforms under the *Competition Principles Agreement*. Such separation provides greater focus on clearly specified objectives and improves accountabilities.

6.3.2 Recommendations

123. To reiterate, the review recommendations are premised on the assumption that essential scheme features such as universal coverage and no-fault liability will be maintained. They also seek to establish arrangements that will improve on current outcomes and better achieve the legislative objectives identified earlier. In light of this, the review panel recommends that:

[29] At the time of writing, access to common law within current scheme arrangements was abolished. The review group therefore believes that a further option that might be explored in implementing the recommendations of this report is the possibility of workers or employers paying for additional insurance that would allow for common law claims.

- the VWA cease to be a provider of reinsurance and all underwriting risks be borne by private insurers;
- premium setting should be more decentralised with insurers competing, at a minimum, on the basis of administrative costs and services such as risk and injury management;
- all premium funds be owned and managed by insurers;
- insurers, underwriters and self-insurers be licensed by an independent regulator subject to satisfying 'appropriate' prudential requirements;
- current approval criteria for occupational providers be removed;
- the quality of service delivery by insurers, self-insurers and occupational rehabilitation providers be monitored by the regulator but with greater focus on outcomes - current detailed regulation of processes is considered unnecessary; and
- the regulator facilitate the collection and dissemination of information with minimal burden on insurers and other parties.

124. The recommended changes should be implemented coherently and with adequate attention to scheme design. While the timing of implementation is beyond the scope of this review, it is important that a consistent overall approach be adopted. Clause 4 of the Competition Principles Agreement relating to the 'Structural Reform of Public Monopolies' outlines the scope of matters to be considered in undertaking reform. It is therefore recommended that -

- the Government approach implementation of the above recommendations through application of the structural reform principles of the Competition Principles Agreement. This will involve consideration of various factors including:
  - ⇒ the appropriate commercial objectives for participants;
  - ⇒ the most effective means for separating policy, regulatory and commercial functions; and
  - ⇒ the need for, and form of, price and service regulations.

These principles for the 'Structural Reform of Public Monopolies' have been applied successfully in the electricity and gas industries.

6.4 Conclusion

125. The terms of reference for this review required the consideration of alternatives for achieving the legislation's objectives. After examining the case for maintaining the status quo, the option of establishing a monopoly insurance fund, and the introduction of competitive insurance, it was decided that the latter would meet the legislation's objectives at least cost and generate the greatest benefits. Hence, the review panel urges that the recommendations just outlined in 6.3.2 be adopted by Government.

7. Addressing possible concerns

126. This chapter seeks to address some objections to the review recommendations that may be raised. Implementation of the preferred model should lead to better outcomes for both safety incentives and cost containment, while preserving scheme entitlements and its universal character. However, given the scope of the recommendations, it is important to consider aspects of the scheme that could be affected and which might cause concern. In particular, the following issues will be examined:

- protection of worker entitlements under private underwriting;
- implication of lump sum pay-outs;
- incentive for private insurers to reject some risks;
- decentralised pricing and risk-reflective premiums;
- decentralised price setting and small employers;
- decentralised pricing and premium volatility;
- obligations to workers under competitive insurance;
- the possibility of suppressed claims reporting by self-insurers;
- the pre-1985 experience with private insurance arrangements; and
- the potential for 'effective' competition with continued Government regulation.

7.1 Possible concerns

♦ *Public underwriting ensures the protection of worker entitlements while the failure of a private insurer/underwriter can jeopardise such entitlements.*

127. Under the review panel's recommendations insurers and underwriters would be required to satisfy prudential requirements and would be monitored and supervised by the regulator. In addition, it is recommended that the establishment of a 'nominal' insurance or 'guarantee' fund financed by a levy either on insurers or employers be considered. This fund would serve the dual purpose of meeting liabilities in the event of insurer/underwriter insolvency, and provide insurance cover for workers of employers who have neglected or deliberately

avoided purchasing insurance. Consequently, worker entitlements will continue to be protected while the benefits of more competitive arrangements - greater administrative efficiency, total risk and injury management by insurers - can also be realised. It is also worth noting that similar prudential issues arise with self-insurers. Hence, if an effective prudential regime can be established for self-insurers - and the recent legislative changes expanding eligibility requirements suggest that this is believed to be the case - it is not obvious to the review panel why a similarly effective prudential framework cannot be developed for private or 'professional' insurers.

- *The incentives for insurers in a privately underwritten system will differ from those in the current publicly underwritten scheme. For example, insurers (and employers) will have an incentive to offer workers lump sum redemption of benefits which may result in costs being shifted to other government programs and reduce incentives for returning to work.*

128. Lump sum pay-outs have obvious benefits for insurers and employers. A single payment of entitlements removes the need for ongoing administration and allows claims to be cleared from books which reduces insurers' costs and ultimately the premiums paid by employers. Injured workers may also prefer to redeem weekly benefits as a lump sum to help finance any readjustment costs resulting from the injury and relieve any financial anxiety. However, lump sum redemption can result in cost shifting between government programs. It has also been argued that lump sum pay-outs reduce incentives for early return to work.

129. It is often argued that on receiving lump sum payments, some workers seek social security support - particularly if they mismanage the lump sum monies - and in some instances may become dependent on social security payments. It is inappropriate for workers to be supported by the social security system if their injury is the hindering factor in obtaining employment. The workers' compensation system should remain responsible for payment in this instance. Social security has been established for a different purpose - income support in defined circumstances - and therefore taxpayers and the general community should not be paying for the cost of work related injury.

130. Despite the above, the review panel is reluctant to recommend against lump sum redemptions if this is in the interests of all parties - workers, employers and insurers. Moreover, cost shifting could be minimised by employing better tracking systems that can

trace the history of workers' compensation recipients - this would target the source of the problem.

131. As mentioned above, there is some concern that incentives for rehabilitation and return to work may be muted with the receipt of large once off payments of benefits. If this is true, the payment of lump sums will conflict with the legislative objective of reducing the duration of work related injury. However, the review panel would argue that incentives go in the opposite direction. Once a lump sum payment is received, this becomes a 'sunk' benefit for workers and, therefore, if they wish to maximise their future income, there will be a strong incentive to return to work quickly. Weekly payments, on the other hand, may provide an incentive for workers to exaggerate their condition and delay their return to work particularly during times of high unemployment. We therefore conclude that redemption of weekly benefits should not be disallowed as they do not compromise, and indeed may assist in, the achievement of the legislation's objectives.

- *With private underwriting there will be increasing pressures for insurers to choose who they insure and an incentive to avoid issuing policies to some employers.*

132. Insurers may choose to not issue policies to certain employers for at least two reasons. First, an employer may be considered too risky for the insurer's preferred customer profile and, second, the degree of riskiness associated with particular employers may be too uncertain. There are two fundamental options the Government may pursue given its objective of universal coverage. The first would be to require insurers to issue policies for all employers irrespective of their risk profile. This would avoid the creation of a single pool of bad and/or uncertain risks. However, it would detract from insurers' commercial focus and if cross-subsidisation is to be avoided it may be necessary to identify the policies 'imposed' on insurers and some subsidy provided. This would add to the complexity of the scheme and provide incentives for insurers to maximise the subsidy received from Government.

133. The other option is to have a Government insurer of last resort for those employers that are 'rejected' by insurance firms. This, theoretically, has the advantage of revealing that portion of the market which is not considered to be 'commercial' and thereby making explicit the social policy element of the Government's objectives. However, it exposes the Government

to considerable financial risks[30] and there is a danger that the pool of employers that the Government is called upon to insure may progressively increase.

134. This is a further scheme design issue for which the current review panel cannot provide the required answers but it would need to be resolved if the shift to private underwriting is accepted. However, it should be highlighted that this problem is not 'created' by private underwriting. Under current arrangements the distinction between risks that can be insured on a commercial basis and those that cannot is hidden. Private underwriting could provide the opportunity for the social policy objective of Government to be codified and made transparent.

- *Under more decentralised price setting arrangements, insurers can base premiums on factors other than risk therefore distorting incentives for safety.*

135. The argument is that insurers have an incentive for a number of reasons to base premiums on factors totally unrelated to workplace risks. For example, insurers might discount premiums simply to gain or maintain market share or they may use windfall gains from investment activities to reduce premium charges to customers[31]. While these are perfectly legitimate business practices, the concern here is that incentives to improve safety performance would be muted. This issue again arises from the significance of premiums in workers' compensation insurance which serve as an incentive device for promoting workplace health and safety.

136. While the above arguments may be sound, the review panel does not believe that premiums need to be regulated to the extent they are currently. Some regulation of premium structures *may* be required to ensure that premiums reflect costs and risks but price competition can and should be introduced. As mentioned above, the precise price setting arrangements to be adopted need to be considered further if the recommendations of this report are accepted. However, at a minimum, the review panel believes that competition on service should be allowed. This could be achieved by clearly separating the various components of the premium. For example, that part of the premium representing the employers' experience rate can be separated from the insurer 'loadings' for claims administration costs, risk and

[30] It should be noted that current Government policy requires that, wherever possible, the Government should not be in the business of managing risks.

[31] As noted earlier, government bodies are not immune from the temptation to reduce premiums through the application of investment returns.

injury management services and return on capital. The latter component would be set competitively by insurers thereby offering the choice of differentiated service for employers and workers.

137. Nevertheless, the review panel wishes to submit it is not convinced that in a privatised system with fully decentralised pricing, insurers would in the *long run* price on the basis of factors unrelated to workplace risks. If private insurers are fully bearing the risks of the scheme, systematic ignorance of workplace accident risks in price setting would place insurers in a vulnerable position and jeopardise their viability. While premium discounting may be used as a strategy for gaining market share, premiums will ultimately need to cover for all liabilities and reflect the risks of particular employers if the insurer desires to maintain a long term position in the market.

- *Decentralised price setting will result in substantial increases in premiums for small employers driving many of them out of business.*

138. This argument implies that current centralised premium setting entails systematic cross-subsidisation of small employers by larger employers. As discussed elsewhere, cross-subsidies are not desirable because it means some employers are not paying premiums that reflect workplace risks and this will have implications for prevention. Hence, even if the above concern is real, it is not appropriate to retain centralised premium setting to contain premium levels for small employers through cross-subsidisation. If it is considered necessary to constrain premiums for this group of employers at some specified level, it is best that this be achieved through more transparent means such as separate funding of explicit subsidies.

- *Without centralised control, premiums will be excessively volatile as evidenced by other jurisdictions in the areas of both workers' compensation and compulsory third party insurance.*

139. Premium stability is considered to be important to allow employers to accurately predict and plan for workers' compensation insurance costs. Under privatised schemes it is argued that premiums are excessively volatile owing to the competitive pressures faced by insurers and incorrect assessment of risks. Typical cases of price volatility are said to occur in the

Tasmanian workers' compensation system and the New South Wales compulsory third party insurance market.

140. The review panel does not believe its recommendations will result in 'excessive' premium volatility. As mentioned above, some element of price regulation such as simple prices oversight or a 'file and write' system can be retained if considered necessary. The regulation of premium structures through these mechanisms could then be used to ensure that premiums are not set artificially low by insurers therefore avoiding subsequent 'wild upswings' to meet liabilities. However, if insurers are bearing the risks of the scheme, as they would under the review panel's recommendations, it is not clear why they would not have the incentive in the long run to make an accurate assessment of risks or would be less capable than the regulator. Indeed, the fact that insurers operate in other insurance markets would suggest that they are better able to determine the correct premiums given their experience in assessing risks in various settings.

141. The other thing to note is that some element of premium variability, where this represents consistent changes to premiums in accordance with the claims experience and safety initiatives of employers, is desirable. It is these variations in premiums which transmit information to employers about their safety performance and provide incentives for the introduction of more effective preventive strategies. Deliberate volatility suppression will mute these signals and incentives and probably lead to worse performance in workplace safety.

- *A privatised system will place obligations to employees in jeopardy. Given the nature of the contractual relationship in the workers' compensation market, insurers and employers will have the incentive to group together to deny liability and get workers off the scheme quickly.*

142. The possibility of reduced service levels for injured workers has been discussed elsewhere in this report (see section 5.4.2). The review panel recognises this is a problem within current scheme arrangements and will persist under a privately underwritten scheme. It is for this reason that it has recommended that the newly established regulator monitor service levels. The separation of commercial from regulatory functions should also lead to a clearer focus for the regulator and therefore improved mechanisms for monitoring and evaluating the quality of service received by workers from insurers. One would expect that the regulator will develop performance indicators and quality standards and it may be necessary

to levy fines and penalties against insurers not meeting specified standards, especially if there is evidence of coercion of workers to terminate claims. Consideration could also be given to revoking an insurer's licence as the ultimate sanction for not satisfying predetermined standards of service. Finally, the regulator could publish the results of quality audits which would assist workers and employers in choosing an insurer.

- *Increased access for self-insurance ignores the fact that employers may be in a position to suppress claims reporting.*

143. The review panel accepts that in certain limited circumstances some self-insuring employers may choose to suppress claims. For example, following an injury it might become evident that significant investment is required to improve workplace safety. The employer may not be willing (or able) to make such an investment and therefore might choose to suppress the claim to avoid alerting the regulator to the safety problem. The injured worker may be looked after financially for the duration of the injury but the claim will remain unreported resulting in inaccurate claims data necessary for informed policy making. It must be noted, however, that such a strategy will only be worthwhile if the cost of the new investment outweighs the costs of potentially more accidents with current production design plus the risk of being 'caught' by the regulator. Under the review panel's recommendations the regulator will endeavour to ensure accurate claims reporting and protect workers' entitlements through its data collection and monitoring roles.

- *A privately underwritten system existed in Victoria prior to 1985 and was shown to be unsuccessful; why return to the uncertainty and instability of the mid 1970s and early 1980s?*

144. In the opinion of the review panel the volatility experienced in the mid 1970s and early 1980s was the result of a number of factors and cannot be attributed solely to the existence of private underwriting. The problems arose just as much from bad scheme design, inappropriate legislative and structural frameworks, and the absence of a culture of care and return to work. For example, there was inadequate prudential supervision of insurers and underwriters; the pre-1985 system arguably emphasised compensation rather than prevention of accidents and the rehabilitation of injured workers; the size of compensation awards by the courts were often uncertain making correct premium setting difficult; there were endemic delays in settling disputed claims coming before the then Workers'

Compensation Board; employers paid inadequate attention to claims development and risk management; and managers and workers alike did not exercise a culture of care that encouraged commitment to workplace health and safety.

145. This is not to deny that insurers should bear some of the responsibility for the system's failure during this period. However, it is difficult to attribute blame to any single factor including the existence of private underwriting. It is interesting in this respect that the Cooney Committee which reviewed the workers' compensation system at that time recommended, albeit with a slim majority of 3-2, that private insurance and underwriting be continued. Further, the Cooney report listed numerous factors which it considered to have contributed to the deterioration of the system including many of those listed above. Some specific comments in the report regarding the causes of instability include the following:

> "Applications for [insurer] licences, have been subjected to limited financial analysis." (Ch.6, p.34).
>
> "...the annual renewal of licences has involved limited investigation and analysis." (Ch.6, p.34).
>
> "There is no State inspectorial or policing mechanism, to ensure the proper provision of reliable data as to insurer operations in the workers' compensation area." (Ch.6, p.34).
>
> "Many legislative amendments to Acts have retroactive effects. Recent changes....increased the time in which common law actions can be initiated from three to six years. Insurers were again at risk for costly common law actions on claims which had earlier run out of time and which they presumed no longer had common law potential." (Ch.6, p.26).
>
> "The cost of claims is open ended. The insurer does not know the maximum liability on a claim. Nor does the insurer know when the claims incurred in a given year have been received. One large insurer reported receiving a claim during 1982/83 which had allegedly been incurred in 1936." (Ch.6, p.27).

146. Regarding the volatility of premiums the Cooney Committee was particularly critical of private insurers. It was argued that between the years 1977 and 1980 insurers discounted premiums for short term cash flow gains and increased market share but inevitably increased them dramatically to cover long tail liabilities. The Cooney Committee concluded that "a responsible insurer who seriously desires a long term place in the workers' compensation market carries a heavy obligation to avoid discounting at all costs" (Ch.6, p.19)[32]. However, the Committee also identified other reasons for the premium "shocks" including the following:

> "a) A sharp increase in claims for damages at common law as an alternative to compensation, partly the result of an apparently more liberal attitude by the Courts.

[32] As noted earlier, the review group believes that insurers will have that incentive in the long run anyway particularly given their "heavy obligation" to shareholders.

> b) The settlement and legal costs for common law claims tend to be far greater than for compensation and some insurance companies report that such claims increased by as much as 50 per cent last year.
>
> c) A discount rate for the present value of future loss of 3% has been set by the High Court, resulting in increases of up to 150 per cent.
>
> d) Another High Court decision which, for a limited period, greatly increased the cost of settlement of common law claims for fatal injuries in many cases." (Ch.6, p.19).

147. Finally, the current workers' compensation environment is vastly different to that described above. Today there is greater appreciation of prevention and rehabilitation issues and more emphasis is placed on returning injured workers to productive employment. Indeed, under the review panel's recommendations, the independent regulator will continue to promote a culture of care and educate employers and workers about workplace hazards and other occupational health and safety issues through its information collection and dissemination role. Moreover, the development of adequate prudential arrangements and possibly light regulation of premium structures, which also form part of the review panel's recommendations, will further act to ensure the stability of the system. Hence, with careful and effective scheme design there is no reason to believe that private underwriting will result in the type of instability experienced in the earlier period.

- *Even if the review panel's recommendations are accepted there will still be substantial government and regulator involvement. In these circumstances, can we expect insurers to be attracted into the new workers' compensation market or will the risk of 're-regulation' undermine the development of effective competition?*

148. The review panel has examined arrangements in various jurisdictions around the world and as there are existing systems with similar arrangements to those proposed here, we are convinced that effective competition will develop[33]. Moreover, discussion with insurers during the consultation phase suggested that they would be willing to actively participate in a privately underwritten system with continued Government regulation.

149. Nevertheless, it is important that Government carefully consider scheme parameters in the beginning and avoid subsequent *ad hoc* changes and interventions. This would serve to create a certain operating environment and maximise the benefits of competition. The risk of 're-regulation' increases the operating costs of insurers - because it adds a premium on the required rate of return to account for the uncertainty created by possible future

Government action - and therefore employer premiums. More importantly, unpredictable Government changes to scheme parameters can deter insurers from participating, in which case the possibility of effective competition developing may indeed be undermined.

7.2 Conclusions

150. The foregoing analysis tests the preferred model against possible concerns. It does not purport to cover all issues that may be raised. Nor does it attempt to detail resolution of scheme design issues. This analysis of concerns points to two conclusions:

- the preferred model recommendations appear to be robust; and
- successful implementation will rely on a systematic approach to undertaking the reform recommendations.

[33] Appendix 5 briefly outlines arrangements in Wisconsin (United States) where competitive insurers operate and the scheme is widely regarded as 'world's best practice'.

Appendix 1: Workers' compensation insurance in Australia

151. In Australia, there are ten distinct workers' compensation schemes, one in each jurisdiction - except for the Commonwealth, which has two schemes, one for public servants and one for merchant marines. Workers' compensation schemes in Australia are generally *compulsory* in nature and are based on the concept of *no fault* compensation, in which employers are held liable for work related injury and illness suffered by employees.

152. That said, there are significant differences between schemes, particularly in relation to their insurance/reinsurance arrangements, benefit levels and structures, dispute resolution procedures and rehabilitation strategies.

153. Workers' compensation schemes in Australia generally require employers to insure against their statutory and, where applicable, common law liability to compensate employees for work-related injury or illness. In Victoria, all employees are covered including those in self-insured workplaces. However, in other jurisdictions, coverage of workers does not usually extend to unincorporated businesses, partnerships or the self-employed.

154. In Victoria, journey claims cannot be made under WorkCover[34] and common law claims until recently were restricted to seriously injured workers, that is, those generally deemed to be at least 30 per cent incapacitated[35]. Journey claims are available under workers' compensation in Queensland, South Australia, ACT, Tasmania and the Commonwealth. In the Northern Territory and South Australia, employers are not obliged to insure for common law liability (see table 1).

[34] Journey claims are covered by the *Transport Accident Act* if a worker is injured in a transport accident.
[35] Access to common law has now been removed and once new legislation becomes effective workers injured prior to the changes will have three years to bring common law proceedings against negligent employers.

Table 1: Fund structure and insurance coverage by jurisdiction

Jurisdiction	**Fund Structure**	**Liability Cover**
New South Wales	Managed fund	Full statutory liability/limited common law
Victoria	Central fund	Full statutory liability
Queensland	Central fund	Full liability/unlimited common law
Western Australia	Approved insurers/private fund	Full statutory liability/limited common law
South Australia	Central fund	Full statutory liability
Tasmania	Approved insurers/private fund	Full liability/unlimited common law
Australian Capital Territory	Approved insurers/private fund	Full liability/unlimited common law
Northern Territory	Approved insurers/private fund	Full statutory liability
Commonwealth -public servants -seafarers	 Central fund Approved insurers/private fund	 Full statutory liability/limited common law Full liability/unlimited common law

Source: *Comparison of Workers' Compensation Arrangements in Australian Jurisdictions*, VWA, January 1997

155. The Victorian WorkCover Scheme is a centrally funded scheme. All authorised insurers must cede all premiums collected to their respective accounts within the WorkCover fund. There is no provision for private underwriting as all liabilities are reinsured with the WorkCover Authority which bears the ultimate risk[36]. Other centrally funded schemes are operated by the Commonwealth, Queensland and South Australia. In NSW, employers are required to insure their liabilities through authorised insurers. Authorised insurers must cede all premiums collected into statutory accounts within a *managed* fund. Unlike the WorkCover scheme in Victoria, however, insurers can invest funds and retain proceeds such as interest from those investments.

156. All jurisdictions provide for-self insurance except the Commonwealth seafarers scheme. Eligibility requirements to become a self-insurer vary across jurisdictions, ranging from basic 'suitability requirements' to bank guarantees of liabilities, minimum employee numbers and minimum asset bases.

157. Compensation for lost earnings is generally based on some proxy for the worker's pre-injury earnings. Initially, benefits are usually equivalent to 100 percent of such an approximation - in Victoria, benefits begin at 95 per cent of pre-injury earnings to a maximum of $664 per week. Benefits usually reduce over time, and cease upon reaching dollar or time limits. These limits vary considerably across jurisdictions. In Victoria, benefits cease after 104 weeks of payments unless the injured worker is seriously injured or totally and permanently incapacitated.

158. Most jurisdictions provide compensation for non-economic loss including pain and suffering. Compensation is based on 'Tables of Maims or Disabilities'. These tables specify compensation for particular types of injury or estimated extent of disability. In cases of work related death, schemes pay a prescribed lump sum. In Victoria, the maximum payment for non economic loss is $102,460. The maximum amount payable for pain and suffering is $55,040.

159. Dispute resolution procedures differ across jurisdictions in terms of the emphasis on arbitration and conciliation, and on the form of appeals process more generally. In Victoria, disputes over premiums or the employer levy go straight to an external review. Other matters, such as disputes relating to rehabilitation and medical services go to conciliation first, and then to external review by the Administrative Appeals Tribunal and Magistrates Court.

160. The table in Attachment 3 contains a comprehensive summary of the different workers' compensation insurance schemes which operate in Australia.

[36] Although the Act stipulates that the initial liability rests with the insurer and employer, it is the VWA that is the insurer/reinsurer of last resort (see section 9(2)(a),(b), (3) and (4) of the *Accident Compensation (WorkCover Insurance) Act 1993* and sections 156, 159 and 163 of the *Accident Compensation Act 1985*).

Appendix 2: Historical background

161. The workers' compensation market in Victoria has developed in four broad stages, consistent with the periodic introduction of legislation establishing government institutions and an evolving regulatory framework for the market.

162. Prior to the introduction of compulsory insurance, a range of institutional mechanisms to support injured workers were developed, including friendly societies and trade union funds. *Compensation could only be claimed under a common law action where an employer was found to be negligent*.

1914-1975: Compulsory scheme comprising private insurers/underwriters with statutory benefits and common law remedies

163. In Victoria, *compulsory workers' compensation insurance* was first introduced by the *Workers' Compensation Act 1914*. This Act established a system of private insurers, with certain enterprises permitted to self-insure. The legislation also established a government insurer that functioned as an insurer of last resort. This compulsory private insurer model was characterised by *statutory benefits* and *common law remedies*.

164. In 1937, the Workers' Compensation Board was established under legislation to determine contested claims with the aim of reducing reliance on the general court system.

1975-1985 Market volatility

165. From 1975-76 to 1983, the workers' compensation insurance market experienced substantial premium volatility. There was considerable competition for market share amongst insurers, and this in combination with a number of other factors (discussed in section 7.1) led to heavy discounting and 'mispricing' of premiums. Insurers suffered large losses and this resulted in considerable premium surcharges and restrictions on benefit pay-outs in the early 1980s. From 1981-83, annual average increases in premiums were around 50 per cent. This volatility was not a result of volatile underlying insurance risks, but unrelated factors such as the investment performance and market share ambitions of insurers over the period.

166. The volatility in premiums from 1975-1983 created a degree of uncertainty amongst employers, particularly in relation to their expected future payroll liability. In addition, employees were dissatisfied with scheme arrangements, especially in respect of the nature and delivery of benefits[37]. The loss in confidence expressed by market participants in the scheme was a significant catalyst for the establishment of the WorkCare scheme.

1985 -1992: WorkCare as government insurer/underwriter with private insurers/claims agents

167. The *Accident Compensation Act 1985* established the workers' compensation scheme 'WorkCare'. This scheme *ended private underwriting, eliminated common law claims in relation to income loss, directed substantial resources into rehabilitation*[38] and included the cross-subsidisation of the manufacturing industry. Insurers operated as claims agents but employers were not free to switch insurers. The scheme also placed an emphasis on weekly, no fault benefits rather than lump-sum payments.

168. Over time, it became apparent that a major problem with the WorkCare system was its inability to control costs. For instance, under WorkCare, claimants could sue at common law for non-pecuniary loss, and WorkCare would bear all costs regardless of the outcome. This created an incentive for claimants to take claims actions to court for relatively small amounts. In addition, the high number (and cost) of long term claims was perceived to result from having a separate organisation administering rehabilitation and the lack of employer involvement. These problems resulted in a deteriorating funding position - the scheme was only 40 per cent funded as at July 1992.

1992: The current WorkCover scheme

[37] In the early 1980s premium surcharges were accompanied by practices to reduce benefit pay-outs.
[38] The Cooney Report (1984) stressed the need to combine workers' compensation arrangements and occupational health and safety requirements (ie. prevention and rehabilitation).

169. In 1992, the WorkCover scheme was introduced to avoid a number of outcomes generated by the market under the previous scheme, with the *Accident Compensation Act 1985* (as amended), the *Accident Compensation (WorkCover) Act 1992* and the *Accident Compensation (WorkCover Insurance) Act 1993* providing the legislative framework for the new workers' compensation scheme.

170. The *Accident Compensation Act 1985* (as amended by the WorkCover Act 1992 and subsequent amendments) imposes a mandatory liability on employers to pay compensation to injured workers and specifies the Governments' objectives, the scope of compensation, the circumstances under which it arises (Part 4, Divisions 1 - 9), dispute resolution processes (Part 3, Divisions 1, 2, 3), and *the powers and functions of the Victorian WorkCover Authority, the sole administrator of WorkCover* (Part 2, Divisions 1, 2 and 3).

171. The *Accident Compensation (WorkCover Insurance) Act 1993*:

- requires employers to hold WorkCover insurance policies against their contingent liability (section 7);
- provides for the licensing of authorised insurers for the purpose of issuing and renewing WorkCover insurance policies (Part 3);
- provides for the levying and collection of premiums (Part 2); and
- requires authorised insurers to reinsure against their liability with the Authority (section 34).

172. Under these Acts, an employer who in any financial year employs a worker within the meaning of section 5(1) of the *Accident Compensation Act 1985* (as amended) must obtain and keep in force a WorkCover insurance policy with an authorised insurer in respect of all the employer's liability under the Act (*Accident Compensation (WorkCover Insurance) Act 1993*, section 7).

173. As indicated above, authorised insurers collect premiums paid by employers, issue insurance policies, and undertake claims management. Insurers do not perform insurance functions retained by the VWA which include underwriting and pricing, nor do they manage and invest premium funds. Authorised insurers must place all premiums collected from employers within statutory accounts under WorkCover. The authorised insurer effectively

cedes all premium revenue to an account within the WorkCover fund. These funds are then managed and invested by the VWA - not the insurer. Insurers must also reinsure all liabilities with the VWA[39].

174. Under the WorkCover scheme, employers may self-insure where they employ at least 500 employees. In addition, employers must have a minimum net asset base of $200m[40]. At present, 23 employers in Victoria self-insure.

[39] The legislation refers to 'authorised insurers', although it is the VWA which retains what are typically the main insurer functions (ie. insurance and underwriting). The residual insurer functions of premium collection and claims management reside with authorised insurers, whose functions, as specified in the legislation, suggest that authorised insurers operate as claims agents.

[40] These requirements have now been removed and replaced with a set of commercial criteria which must be met before self-insurance is permitted.

Appendix 3: Comparisons in cross jurisdictional workers compensation schemes as at May 1997

	VIC	NSW	SA	QLD	TAS	WA	NT	ACT	Commonwealth
Scheme Name	WorkCover	WorkCover NSW	WorkCover	WorkCover Queensland	Workplace Safety Tasmania	WorkCover Western Australia	WorkHealth	WorkCover	Comcare Australia
Fund Type	Central Fund	Managed fund	Central Fund	Central Fund	Approved Insurers (No set rates - essentially a private system)	Approved insurers (essentially private insurance; loading of 50% on set premium allowed; full discounting allowed)	Approved insurers (no set rates - essentially a private system)	Approved insurers (no set rates - essentially a private system)	Central Fund
Role of Regulator	VWA regulates licensed insurers and is a re-insurer	Regulates licensed insurers	Govt insures; claims mgt outsourced to private insurers	Government insures	WorkPlace Safety Board has a licensing & monitoring role	Government approves insurers & sets rates	Govt approves insurers	Minister approves insurers	Public Monopoly
Funding position at 30 June 1996 **Funding ratio** **Assets** **Liabilities**	 101.9% $2,931M $2,876M	 90.94% $4,559M $5,013M	 74.7% $625M $832M	 80.38% $1,303M $1,623M	Not applicable	Not applicable	Not applicable	Not applicable	 99.92% $1,251M $1,252M
Premium Rate (Average) *	96/97 1.8% 95/96 1.98%	96/97 2.8% 95/96 2.5%	96/97 2.86% 95/96 2.86%	96/97 2.145% 95/96 2.145%	96/97 3.2% 95/96 3.02%	96/97 2.67% 95/96 2.61%.	96/97 Not applicable 95/96 1.8%	Not applicable	96/97 5.00%(1) 1.6% (2) 95/96 5.2%(1) 1.7%(2) (1) ACT Govt (2) Fed. agencies
Operating Profit/loss **Before tax** **After Tax**	 (90.775M) loss before abnormals (16.955M) net loss	Not applicable	$76.028M profit before abnormals $72,836M profit after abnormals	 ($205.55M) net loss	Not applicable	Not applicable	Not applicable	Not applicable	Accumulated deficit of $5.4M
Employer Excess	First 10 days of incapacity and first $416 of medical costs	First $500 of weekly payments	First two weeks of incapacity per worker per calendar year; no medical costs	First 5 working days including day of injury	No excess - scheme coverage from first day of incapacity	First 5 working days of each injury and first $200 of other benefits	Day of injury only; no medical costs	No excess - scheme coverage from first day of incapacity; no medical costs	No excess - scheme coverage from first day of incapacity
Statutory (weekly) benefits	There is great variation in the allowable weekly benefits across jurisdictions. In Victoria, weekly benefits cease after two years unless workers are classified as *seriously injured* or *totally and permanently incapacitated*, while in Western Australia, Queensland and Tasmania there is a cap on the total amount payable for weekly benefits irrespective of injury classification. In the remaining jurisdictions it appears that weekly benefits continue to be paid indefinitely (presumably if certain requirements are being met).								
Lump sum payments	Again, there is wide variation among jurisdictions in the level of entitlements, but in all cases payments depend on the type and extent of injury and most benefits are capped. In Western Australia, Queensland, Tasmania and the ACT there is no threshold for *permanent incapacity*.								

Appendix 4: The economics of insurance markets

175. Insurance is a response to risk. Individuals or firms insure themselves against the likelihood of a particular risky event actually occurring. For example, persons may insure against the risk of their car being stolen or their house burning down. While the risk of such events occurring may be low, the personal costs are substantial. Insurance helps defray the costs of such catastrophic events.

176. Insurance *markets* base their operation on notions of pooling and risk sharing. By pooling contributions from individuals (premiums) and spreading risk across a large number of individuals, the insurance company is able to provide coverage to those individuals who experience the insured event. The insurer effectively averages out the risk faced by different individuals and these people are able to pool resources for unlikely contingencies and to avoid the high costs which may need to be met if the uncertain event occurs[41]. Premiums therefore tend to reflect the average risk of the pool.

177. These features exist in all insurance markets. The behavioural features of insurance arrangements are classified as 'adverse selection' and 'moral hazard' (discussed below). An issue for consideration is whether these behavioural consequences can be managed by the insurance provider in a way that ensures stability of the scheme, or whether these require a particular regulatory response to ensure the availability of a viable insurance market.

Adverse selection

178. Insurers may not be able to accurately determine the 'riskiness' of all those that they insure. Although there may be factors which alter riskiness and are discernible, a person's exposure to risk is generally 'private information'. Because the true risk of insuring an individual is not directly observable, the insurer may not be able to effectively separate high risk from low risk individuals. Premiums are therefore set on the basis of average risk within the pool of those insured rather than tailoring premiums for each member of the pool.

[41] Productivity Commission, "Private Health Insurance", *Report No. 57*, February 1997, p.168.

179. If the insurer is unable to differentiate between risky individuals, this may lead to low risk persons deciding not to purchase the product because the pooled price is too high compared to their estimation of their own risk exposure. As a result, the insurer will be insuring a greater proportion of risky types which will result in higher premiums and in turn further discourage more low risk consumers from purchasing insurance. Self selection of low risk types out of the pooled market creates an adverse outcome for the insurer and establishes a vicious cycle of growing premiums (as the average pool risk increases) which encourages remaining low risk consumers to leave the scheme. Hence, the term 'adverse selection'.

180. Problems of adverse selection can be mitigated by insurers better targeting premiums to low and high risk groups (hence reducing the cross subsidy). Proxies for risk (geographic location for household insurance, driver's vision or car engine capacity in the case of motor vehicle insurance) are often used to discriminate between consumers. Where adverse selection poses a serious risk to the stability of an insurance scheme (because it increases costs and decreases premium revenue), it may be eliminated by making insurance compulsory. Compulsory purchasing prevents movement out of the market and creates an effective average premium. This is essentially the case in the compulsory workers' compensation insurance market[42].

Moral hazard

181. Purchasing insurance may alter the behaviour of the insured and insurers cannot always effectively observe the change in behaviour of risky individuals. Once insured, an individual may engage in actions which increase the insurer's risk exposure. For example, persons attaching some positive value on speeding will be tempted to drive faster and take more risks when wearing a seat belt or driving a car designed to withstand accidents; some may also be less likely to take costly precautions to protect their home from burglary once insured. The operation of the insurance market could suffer as a result because insurers may systematically underestimate the true risk, which in turn would place the premium pool under pressure (in a similar way to adverse selection). In extreme cases, this problem can lead to the scheme

[42] In reality, workers' compensation schemes are not this simplified. Although purchase of the 'product' is compulsory, industry and experienced based rates (as opposed to a 'community' or average rate) are typically used to better apportion premium costs to workplace risks.

becoming unstable with insurers unable to effectively manage their liability. In the worst case, a scheme may collapse.

182. A response to moral hazard is to provide incentives for the insured to 'share' the costs of loss such as including 'excess' in the policy. Another response is to limit the amount of benefits payable and the circumstances under which they may be paid, providing an effective ceiling on the risk exposure for any particular individual. Such a response is often coupled with the establishment of eligibility thresholds for certain benefits.

Appendix 5: The example of Wisconsin

183. The Wisconsin state workers' compensation scheme is generally regarded as successful and is often used as a role model by other US states when considering reform. Wisconsin has higher than average benefits and it delivers these at low cost with employer premiums being in the bottom third of all US states. This ability to pay benefits equivalent or higher to those available in other US states while operating at low cost is due to a number of factors, including system features that promote return to work and minimise dispute resolution costs. However, it is interesting that the market structure existing in Wisconsin is similar to that advocated in this report.

184. The Wisconsin scheme is underwritten by private insurers within a regulated framework. Insurance coverage is compulsory and self-insurance is permitted. Employer premiums are regulated under what can be described as a 'file and write' system and 'base' premiums, which vary according to which of the 700 classifications employers are grouped under, are adjusted for experience. Larger employers can be retrospectively rated while the private insurers have developed 'dividend plans' for smaller employers. In addition to the benefits previously outlined, this structure has proven to be stable for a number of years in contrast to the concerns that are often raised for private insurance.

Appendix 6: Consulted parties

185. The following external parties were *sent* the interim report consisting of preliminary drafts of parts 1-4 of this report. The level and detail of feedback received varied among parties with some choosing not to respond. The review panel acknowledges the assistance given by those who provided feedback.

1. Employer associations

Australian Chamber of Manufacturers
Business Council of Australia
Metal Trades Industry Association of Australia
Victorian Employers' Chamber of Commerce and Industry

2. Labour organisation

Victorian Trades Hall Council

3. Insurers

FAI Workers' Compensation (Vic) Pty Ltd
MMI Workers' Compensation (Victoria) Limited
VACC Insurance WorkSafe Pty Ltd

Insurance Council of Australia

4. Rehabilitation Providers

Workplace Ergonomics and Rehabilitation Pty Ltd
Work Solutions

5. Self-insurers

Mobil Oil Australia Limited
Unilever Australia (Holdings) Pty Ltd

6. Victorian WorkCover Authority