

The rationale for pre-funding ACC

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PensionCommentary 2009-2¹

Revised 20th November 2009

This commentary is based on a RPRC presentation to The ACC² Summit: *Reviewing New Zealand's Accident Compensation System*, held in Wellington 29-30th June 2009. Michael Littlewood first discussed the case for treating ACC on a pay as you go (PAYG) basis. Susan St John then discussed the lessons from history. While pure PAYG is a logical solution to the financing of ACC, history suggests that it may also be as misunderstood as actuarial full funding. Political agreement must be sought regarding a pragmatic level of reserves as originally envisaged by Sir Owen Woodhouse.

History matters



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

Owen Woodhouse, 1999

The proposal to return ACC's financial management to pay as you go (PAYG), discussed by Michael Littlewood, in [Why does the Accident Compensation Corporation have a fund?](#) is logical and persuasive. It is important however to locate the funding debate in a frame that reflects ACC's history over more than 35 years. This background reveals that there is nothing new under the sun with respect to the swings in thinking regarding funding and PAYG, and whether the state should be the monopoly provider, and whether competition should be allowed. Rather than be prisoners of our history, we could draw lessons from it for future policy development.

The funding debate is full of semantic ambiguities. For purposes here, "Full funding" or "full pre-funding" means funding in an insurance sense i.e. the actuarial requirement that current assets are sufficient to meet all accrued obligations. "Prefunding" is a more general term and implies a scheme has some assets but is not necessarily fully-funded. A PAYG scheme may have contingency reserves but the concept of a fund is not an essential part of PAYG.

¹ An RPRC *PensionCommentary* is an opinion piece designed to provoke discussion on an issue of public significance. The views expressed in this commentary remain the sole responsibility of the author. Comments and assistance from Michael Littlewood and M.Claire Dale RPRC are gratefully acknowledged.

² "ACC" has evolved from the short form of Accident Compensation Corporation to the generally recognised name for New Zealand's tax-funded, no-fault accident compensation scheme.

Workers' compensation origins

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

Woodhouse found this "interpolation" of private insurers into what was essentially mandatory social insurance inappropriate and "extremely expensive", with no corresponding advantages (Report of the Royal Commission of Enquiry, 1967, p. 90).

216. Private enterprise plays no part in obtaining the business. The system itself can offer no central impetus in the important areas of accident prevention and rehabilitation. It is operating in an area which ordinarily would be handled by the central Government as a social service. It is involved with all the adversary problems to which we have referred. And it is very expensive—not because the system is mismanaged, but because the system makes this inevitable.

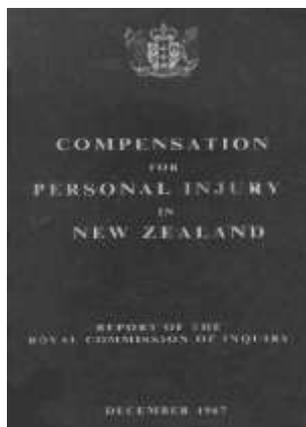
Operating under The Workers' Compensation Act 1956, the scheme was financed by a system of differential premiums that reflected industry risk. It was run on insurance principles, including being fully-funded and tightly circumscribed, with limited no-fault

benefits for 'workers' only, with the right to sue for damages in cases where it was believed that fault could be proven. Demarcation was a clear problem:

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

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

ACC was to be Social insurance



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

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

This clarity has been lost in the current debate in which full funding has become the tail that wags the dog. The whole point of having *social insurance* is to enable society to escape from the strictures of private insurance. The benefits under social insurance can be more *redistributive* and *comprehensive* than under private insurance. The coverage and scope does not have to be limited by the small print, and evolution or change of the scheme is

not only possible, it is desirable as new risks emerge. Weekly compensation for long-term accidents can be inflation and wage-growth adjusted - a near impossibility for private insurance; and, importantly the scheme does not have to meet the funding standards of private insurance.³

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

The funded basis of the 1972 ACC Act

In the 1967 Report, Woodhouse suggested a levy of 1 percent of all wages would approximately replace the existing insurance premiums (S 314). In the first years of ACC, the current outgoings for accidents would be greater than income. Although this surplus was to be invested in the short term, there was no suggestion that the scheme would operate on a full funding basis. Built-in inflation adjustments, wage indexation, and the subsequent expansion to meet new needs would make full funding entirely inappropriate. Furthermore, Woodhouse intended that the levy rates be pegged, with additional funds in the future if needed to come from general taxation (see S 481 Report of the Royal Commission of Inquiry, 1967, p. 176)

While it is possible and logical to fund social insurance by general taxation on a PAYG basis, Woodhouse argued that he had to take account of the premiums on industry that were already in place. To change to general taxation would unduly benefit industry. Accordingly, he said "logical argument is an insufficient reason for shifting these costs in such a fashion" (Woodhouse, 1967, p 171). However, he did recommend a flat rate levy with no risk or performance-based differentiation as a more appropriate way to finance ACC.

Sir Owen has been clear that the purpose of ACC's reserves was NOT to prefund today's accidents in any sense, but for contingency reasons as for example an earthquake. His view has always been that reserves may be a useful by-product, but are not essential to PAYG.⁴

The Law Commission's report in 1988 notes how the unavoidable transitioning from Worker Compensation to ACC contributed to the subsequent misunderstandings:

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

In the event, influenced no doubt by the Workers' Compensation history, the 1972 Accident Compensation Corporation Act legislated an insurance-based approach, with differential levies set by Order in Council with possible penalties and rebates.

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

⁴ Personal communication: 16th November 2009.

(The Accident Compensation Act 1972, p. 7)

The scheme also paralleled its predecessor in being set up on an apparently fully-funded basis requiring actuarial reports at 5-yearly intervals to assess whether levies were "sufficient to meet the current and future liabilities of the Fund".

Sanford (1996) however questions whether these requirements as set out in the Act implied a clear obligation for a funded scheme "in the strict sense". It appeared not to have operated this way in the 1970s. Sir Owen Woodhouse is in no doubt that this piece of the Act was based on a misconception of the nature of the scheme. He for example stated in 1979 that his views and those of the Commission "had been on a collision course for some time".

(8) The Commission shall, in its annual report to the Minister, state whether in its opinion the levies being credited to the Earners' Compensation Fund and the Motor Vehicle Compensation Fund are in the case of each Fund (together with the income from the Fund) sufficient to meet the current and future liabilities of the Fund, including transfers to the General Fund.

(9) The Commission shall, within 5 years from the date of the commencement of this Part of this Act and thereafter at intervals not exceeding 5 years, arrange for the Government Actuary or another independent actuary approved by him to make a report to the Minister regarding the matters on which the Commission was required to make recommendations to the Minister under this section since the date of the commencement of this Part of this Act or the date of the last such report, whichever is the later. The actuary shall send to the Commission a copy of his report to the Minister. On receipt of any such copy of a report, the Commission shall, as soon as practicable, advise the Minister of any comments it may wish to make thereon.

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

In 1977, Sir Geoffrey Palmer noted that the fund was expected to plateau at \$200m (\$1.3 billion in 2009 dollars). He was sceptical that the idea of full funding made much sense.

This basis of funding is likely to prove no more successful than it did for general accident insurance under the old scheme. (Palmer, 1977, p. 201)

He pointed to the event of rapid inflation in the 1970s and the emergence of a long tail of claims which "... makes the estimate of contingent liabilities very much a matter of guesswork." But, he claimed:

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

Palmer described the end result as "a curious mixture that provides useful insulation and flexibility". Thus, the arrangements as they evolved in the 1970s were a pragmatic mix of PAYG and pre-funding.

Funding and the 1980s

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

The fact that the scheme had some years to run before it reached maturity was never discussed. Nor was it said that an upgraded workers' compensation scheme would have been far more costly. Instead, the early confusion about the nature of the reserves as a painless side advantage of a still maturing scheme led directly to

their remarkable political decision that they could now be eroded in order to supplement a reduction in the levies. It was rationalised on the basis that the scheme should now become a pay as you go operation- a method the system was already operating.(Woodhouse, 1995)

Nevertheless, the National government’s 1980 cabinet-caucus committee chaired by Hon Derek Quigley, under pressure from employers, recommended a PAYG basis, clearly failing to see the point made by Woodhouse. This PAYG approach was endorsed in the Accident Compensation Act 1982.

(4) All money held by the Corporation at the date of commencement of this Act in the accounts known as the Earners’ Compensation Fund, the Motor Vehicle Compensation Fund, the Accident Compensation Corporation’s General Fund, the Active Service Compensation Fund, and the Supplementary Fund shall be applied by the Corporation for the purposes of this Act.

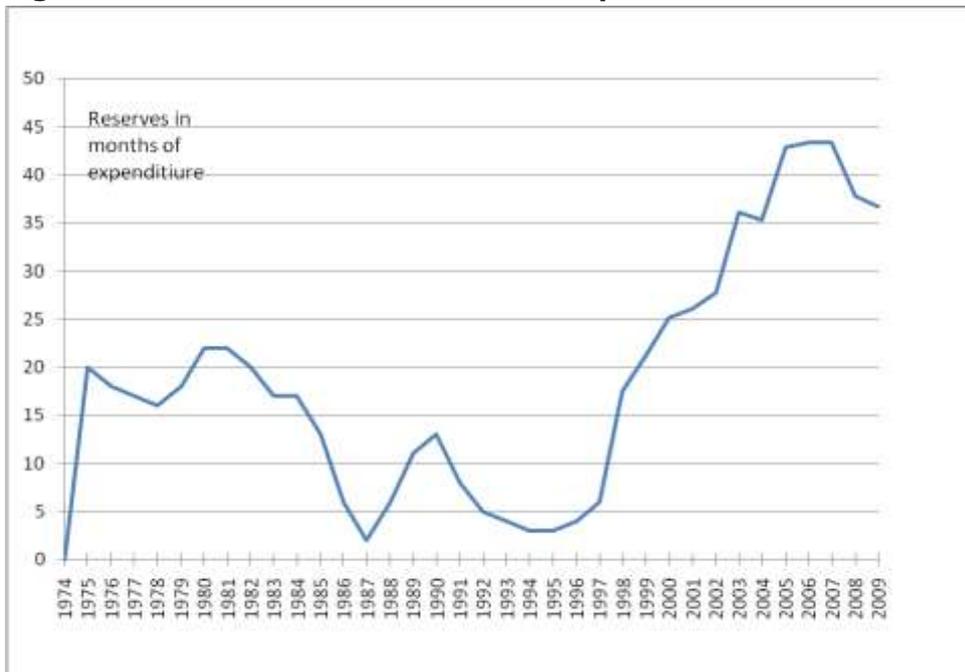
(Accident Compensation Act 1982, s. 19)

By 1985, levies had been reduced by 30% and by March 1986 the reserves had fallen to less than was considered necessary to support a PAYG scheme (Rennie, 2003, p. 340). The

Quigley decision was widely derided as ill-fated, for example Rennie (2003, p 348) refers to it as “disastrous”, producing a “short-term reduction in levies but a subsequent ‘blow out’ in levy rates and the obliteration of reserves”. Chapman (2009) however locates the real problem in the non-stipulation of a minimum level of reserves that should have been maintained under PAYG.

By 1987, reserves were down to only 2 months worth of expenditure (Figure 1) with claims of a cost blow-out, and angry demands for review and cutbacks. In response, levies were increased sharply, 238% on average. There was recognition that the PAYG scheme had to have sufficient emergency reserves for an unforeseen event such as a major earthquake, in addition to 6 months of estimated expenditure, but this was never enacted (Chapman, 2009). By 1990 the reserves were back to 13 months amid strident demand for review of this ‘costly’ scheme.

Figure 1: ACC Reserves in months of expenditure



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

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

1. *In estimating its income needs for any financial year, the Corporation shall set aside a sum amounting to not less than half its estimated expenditure for that financial year as a reserve fund.*
2. *The Corporation may draw on that reserve fund as a source of working capital and to meet any unforeseen contingency. (S102 New Zealand Law Commission, 1988, p. 154)*

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

Funding and the 1990s

In 1990, National repeated the cycle by once again bowing to employer pressure and reducing levies.

The result was another serious rundown in reserves over the next five years (see Figure 1) creating the conditions once again for claims of a blow-out in costs, possible insolvency, and thus the need for sharp levy increases in the future. (St John, 1999, p. 160)

Employers had been resentful of the tail of long-term claimants and their obligation to fund non-work accidents. The Hon Bill Birch (National) had fomented this resentment by claiming costs had mushroomed out of control between 1985 and 1990, and calling for cutbacks and more individual responsibility. The result was the Accident Rehabilitation and Compensation Insurance Act 1992. This was supposed to make ACC 'fairer' by scaling back benefits and reintroducing more of an insurance basis, for example by removing non-work accidents from the earner's account, and by renaming levies as premiums (St John, 1999, p. 163). The ACC was however kept on a PAYG basis in the meantime. By 1995, reserves were again down to only 3 months of expenditure (Figure 1).

By 1997, reserves had improved to equal 6 months of expenditure and the then Chair of ACC suggested levy reductions were possible amid lobbying by business interests. In the 1996 Budget however, large tax cuts had been announced by the Minister of Finance. In December 1997 while the average employers' premium was reduced by 10%, the earner's premium was increased from 70c to \$1.20, perhaps to partly to offset the 'inadvisable' tax cuts of 1997-1998 (St John, 1999). Under the new GAAP whole of government accounting, the increase in funding of ACC would have had favourable consequences for the operating surplus and balance sheet.

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

The levy increases and the move to full funding were hotly debated with the Leader of the Opposition asking the Minister for Accident Rehabilitation, Compensation Insurance, Jenny Shipley, to explain the sudden conversion to full funding:

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

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

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

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

The sorts of things that have influenced me are when I visit, for example, a motorway development in Auckland where the employer and the workers tell me how proud they are of their non-accident record even though they are a major construction company, then in the next breath they tell me how they resent the fact that they are lumped together with other employers who have lousy work records. Those workers and those employers are entitled to have the experience-rewarding mechanism reward them for their performance. The only way we can do that is to go to the full funding of the scheme. (Shipley, Hansard, 2nd Dec 1999)

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

The curious 2000s

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

Surprisingly, Labour kept full actuarial funding by 2014 for the scheme as a whole, including the non-earners account in the IPRC Act 2001. Did it not just pave the way for the new government in 2008 to claim that ACC was insolvent? Was it the influence of Treasury? Was it to enable higher levies to produce more favourable operating surpluses under the GAAP accounting rules? A possible scenario is that Labour wanted to prevent the Quigley/Birch scenario ever again threatening the security of the scheme. But, perversely, the stick of full funding as threatened the scheme anyway even when reserves have actually been at a historic high in the last decade (see Figure 1).

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

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

.. I do remember that the National Government that held office before 1984 ran down the reserves of the corporation dramatically and put it on the point of insolvency, but of course that is not possible under the full funding model formula. (Cullen, Hansard, 4th March 2000)

During this debate in Parliament, Gerry Brownlee then asked Dr Cullen if he was “confident that he will not have to come to this House at any point in the future to give similar information in relation to the solvency of the ACC?” Cullen replied: “Yes, because I am not a member of a National Government determined to run down the accident compensation system” (Hansard 14th March 2000).

Another explanation might lie in the fiscal conservatism of the Labour Government. Caygill for example argued that while full-funding was a precursor to competition, it could be justified on its own merits. Quite clearly, the consolidation of ACC into the Crown accounts involving the accrual of future liabilities pointed to requiring levies to meet more than current needs.

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

From 2000 to 2007 (see Figure 1), the value of ACC’s reserves increased significantly. Most of the growth was due to retained investment income and strong returns in equity markets, but the economy was also strong and levy revenue was higher than forecast. ACC used the extra funds from the surplus to grow the investment portfolio in order to accumulate sufficient funds to cover the claims liability. The stated aim in the ACC Annual Report 2007 was for ACC to be “fully funded” (ACC, 2007, p. 49).

While Labour clearly failed to adequately appreciate the connection between the goal of actuarial full funding and the end game of privatisation, Hansard reveals that from time to time there had been glimpses of insight:

There is no question in my mind that Ruth Dyson was absolutely spot on when she said that the reason the Government is doing this right now is to get that scheme ready for privatisation. Just as the employers’ account has been privatised, the motor vehicle account is the next on the block. But in order to get it into shape for privatisation, the Government has to bring it into the fully funded scheme. (Dalziel, 20th May 1999, Hansard)

2008-9: ACC under attack

Labour bought into the concept of full funding, at least in part, because of the extreme pressure that it witnessed on ACC under the PAYG approach in the 1980s and 1990s, with each period leading to huge levy rises and accusations of insolvency and entitlement cuts. Although the 2000s produced a large increase in reserves, it was not large enough in light of the requirement for full funding by 2014. The scheme was therefore vulnerable to attempts by National after the 2008 election to once again announce that the scheme was in crisis, and use the slippery concept of “unfunded liabilities” to claim it was “technically insolvent”.

In 2009, the ACC Minister Nick Smith used the full funding requirement as a justification for sharply increased levies and reduced ACC entitlements, all the while masquerading as the saviour of the scheme. In Parliament the Hon David Parker (Opposition ACC minister) asked:

“When will the Minister come clean and say that the reason he is delaying legislation to extend the date for full funding of the earners account, which would, of itself, reduce levies? Is it because he wants to include cuts to accident compensation entitlements in the same legislation?”

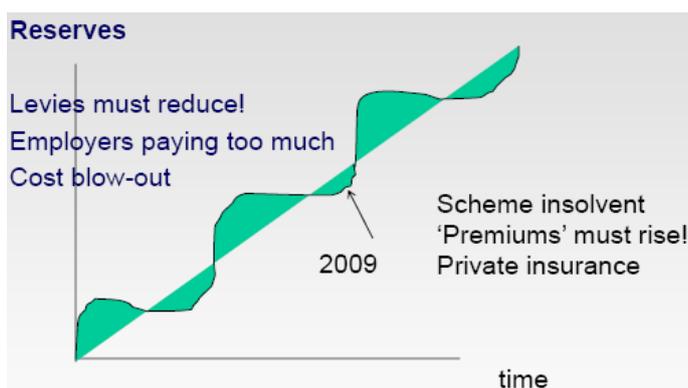
The Hon Dr Nick Smith replied:

The first point I make is that Labour had 9 years to address the time frame. It had 9 long years to address the issue of the timetable for full funding, and it did nothing..... If we are to secure the sustainability of accident compensation, it is absolutely plain that other changes will also be required. (Smith, Hansard, 22 June 2009)

The clamour is astonishing given that in 2009, even after sharemarket losses in 2008, reserves were still at about 37 months of expenditure (Figure 1). The justification for full funding has been the GAAP accounting requirements, even though these have applied selectively and should be no more applicable to ACC than to New Zealand Superannuation or health costs (Littlewood, 2009). The driver of full funding is arguably a political and ideological agenda.

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

Lessons to be learned



What can be learned? There are clear patterns from our past.

Perhaps the lesson for New Zealand is that both pure PAYG and full funding are potentially flawed and unsatisfactory goals. Both have been used by the National Government in power to attack ACC. Labour in turn failed to see the dangers of full funding and failed to question the flawed basis

of using GAAP rules for a social insurance scheme when it had the opportunity (Littlewood, 2009).

The experience of PAYG is that reserves can be quickly dissipated in an evolving scheme, leading to panic about cost blowouts and financial failure. Destabilising increases in levies follow. The more recent experience is a variation on that theme. This time, instead of reserves disappearing under PAYG, reserves have been growing strongly for some years with economic growth and favourable asset markets. The benchmark, however, has become some mythical fully-funded nirvana that allows the Minister Nick Smith to describe ACC's unfunded liability as "the biggest corporate loss in New Zealand's history" despite the reserves picture shown in Figure 1. The stability of the scheme is now determined by actuarial projections that are notoriously difficult to make.

[Actuarial projections] as a scientific exercise are almost as pointless as the debate in mediaeval scholasticisms as to the number of angels that can dance on the head of a pin. (Clayton, 2003, p. 460)

If the nirvana of full funding is actually achieved at any point, share markets may still crash again, or the discount rate may fall, or the ACC may have to accommodate

unforeseen expenditures or new risks in an uncertain world. Is full funding therefore a chimera as well as an inappropriate goal?

The reintroduction of insurer providers competing on price and, possibly on service is the likely next step, along with experience rating and more insurance principles. Thus, full funding is the Trojan horse of the competitive insurance model. The current full funding 'crisis' may be seen as being fabricated to force the privatisation of ACC, when what is required is a dispassionate investigation of what design of ACC is in society's best interests, including financing arrangements.

There is a way to prevent these destabilising attacks. First, acknowledge that ACC is social insurance with clear advantages over private insurance. Second, give careful thought to the purpose of the reserves and their size. The reserves could be, say 1.5 to 2.5 years of expenditure, or other agreed range, or set in relation to levy income as the Law Commission (1988) suggested. The idea of a contingency fund to meet a large disaster is the most obvious rationale for such reserves, along with practical day to day management.

Also, levies should never be adjusted in a discontinuous way to meet some reserve objective, rather the level of reserves should be allowed to fluctuate in line with the economy and markets. This would give employers, individuals and markets a degree of certainty about levy levels over the short to medium term. The entitlements and design of ACC should be reviewed, independently of any actuarial projections, to ensure New Zealand has the best possible scheme. Unfortunately, it is not presently clear how to achieve the multi-party political agreement and the economic understanding that this solution requires.

Those who cannot remember the past are condemned to repeat it.

George Santayana

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