Chapter summary

Incapacity payments are economic loss compensation payments for the inability (or reduced ability) to work because of a service injury or illness. Incapacity payments are based on the difference between a person’s normal earnings (NE) and their actual earnings (AE). The full difference between NE and AE is paid for 45 weeks after discharge; after this time, payments are made as a percentage (at least 75 per cent) of the person’s NE and their AE (known as ‘stepping down’). Payments may continue for as long as a person’s AE are below their NE, or until they reach age 65.

The Review received a number of submissions relating to incapacity payments, all of which contended that the provisions should be made more beneficial. However, the Military Rehabilitation and Compensation Act 2004 (MRCA) has a very high income replacement ratio compared to other compensation schemes, which may adversely affect some members’ willingness to undergo vocational rehabilitation or desire to return to the civilian workforce.

Incapacity payments are based on pre-injury earnings adjusted over time. It is often argued that payments should be further adjusted over time to take account of career progression that would have been likely to occur if not for the injury (known as ‘reasonable expectations’). Adjusting payments for ‘reasonable expectations’ is likely to involve speculation, be difficult to quantify for legislation, create inequity and inconsistency, and unreasonably increase Australian Government responsibilities and costs.

Significant administrative difficulties are involved in determining NE over time, due to the complexity of Australian Defence Force pay scales and the more than 40 allowances that apply to incapacity payments. Determining incapacity payments is labour intensive and system support is inadequate. A more efficient method for calculating NE might be required; for example, consolidating allowances into one generic allowance or loading, or placing time limits on the application of allowances. Another option may be to convert long-term incapacity payment recipients to a statutory rate (either a flat rate, or taking account of rank) for the remainder of the time they are eligible.

The beneficial nature of the MRCA’s incapacity payments may act as a disincentive for some former members to undertake rehabilitation with a view to obtaining alternative employment. While benefits should make up for what the former member loses through their incapacity to the extent practicable, there is also a need to recognise the link between return-to-work incentives and the level of income replacement.

Many of the issues raised in relation to incapacity payments under the MRCA also relate to the administration of incapacity payments in other state, territory and Commonwealth jurisdictions, as well as whole-of-government superannuation issues. The Committee therefore recommends that a cross-agency working group investigate and advise the Military Rehabilitation and Compensation Commission on issues relating to incapacity payments.

Introduction

10.1 This chapter looks at incapacity payments as prescribed in the Military Rehabilitation and Compensation Act 2004 (MRCA) for members, former members and Reservists. Incapacity payments are payments for economic loss, also referred to as ‘income replacement’ or ‘income maintenance’.
10.2 In addition to addressing the submissions on incapacity payments, this chapter is concerned with identifying those aspects of the legislation that appear to provide scope for policy improvement and/or administrative efficiencies. The two key policy issues the Review seeks to examine here are:

- the complexity, confusion and labour intensity surrounding the administration of incapacity payments, particularly determining a former member’s normal earnings; and
- the relationship between incapacity payments and return-to-work outcomes, with particular reference to finding the right balance between the level of income replacement and the incentive to return to work.

Background

10.3 Incapacity payments are economic loss compensation payments due to the inability (or reduced ability) to work because of a service injury or disease.

10.4 Sections 85, 86, 87 and 118 of the MRCA provide the legislative authority for the Commonwealth to pay compensation to current and former serving, permanent and reserve Australian Defence Force (ADF) members, cadets, officers and instructors of cadets and declared members who are incapacitated for service or work. To be eligible, the member or former member must have liability accepted for the service injury or disease that results in the person’s incapacity for service or work.

10.5 Incapacity payments are essentially the difference between a person’s normal earnings (NE) before the injury and his or her actual earnings (AE) for a week. For serving members AE are what a person is actually earning from ADF service. For former members, AE are the earnings from work the person is doing, or is able to do, having regard to their age, experience, training, qualifications and other skills.

10.6 For serving members, incapacity payments make up the difference between NE and AE. However, different rules apply to the calculation of incapacity payments for former members.

10.7 While permanent members and Reservists on continuous full-time service (CFTS) are still serving, NE are generally based on the member’s ADF salary and allowances at the date of incapacity.

10.8 If a former permanent member is no longer serving, NE are based on the former member’s ADF salary and allowances at the date of discharge for his or her last period of service.

10.9 NE for Reservists depend on whether the Reservist was engaged in full-time or part-time service at the time of the incapacity. If a Reservist was rendering CFTS at the time of the injury or contraction of the disease his or her NE are generally based on a choice of the Reservist’s full-time ADF wage or full-time civilian income plus part-time reserve income. If a Reservist was performing part-time service at the time of the injury or contraction of the disease, his or her NE are generally based on a combination of civilian income and part-time reserve income.

10.10 Where NE are based on full-time ADF pay and allowances, a remuneration loading is added to compensate for the loss of the non-salary benefits a person received while serving in the ADF; for example, subsidised housing and medical treatment.
10.11 The earnings capacity and circumstances of cadets and declared members can vary widely and their incapacity payments are worked out on a case-by-case basis by reference to regulations 5–17 of the Military Rehabilitation and Compensation Regulations 2004.

10.12 Former members eligible to receive incapacity payments receive the full difference between NE and AE for a total period equal to 45 times his or her normal weekly hours. This is the maximum payment rate. If a former member is unable to work at all, this is the rate paid for 45 weeks. The 45-week period commences on discharge.

10.13 After this period, incapacity payments are the difference between a percentage of the former member’s NE and his or her AE. The percentage varies between 75 per cent and 100 per cent of NE, depending on the number of hours the former member is able to work in a week compared to his or her normal weekly hours (Table 10.1). For most people, normal weekly hours will be 37.5 hours per week, but it may be different for Reservists. This move from maximum rate to incapacity payments based on a percentage of NE is known as ‘stepping down’.

Table 10.1 Percentage of incapacity payments after a person’s maximum rate weeks run out

<table>
<thead>
<tr>
<th>Hours worked as a percentage of normal weekly hours (usually 37.5 hours)</th>
<th>Percentage applied to NE before AE is subtracted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nil</td>
<td>75%</td>
</tr>
<tr>
<td>25% or less</td>
<td>80%</td>
</tr>
<tr>
<td>More than 25% but not more than 50%</td>
<td>85%</td>
</tr>
<tr>
<td>More than 50% but not more than 75%</td>
<td>90%</td>
</tr>
<tr>
<td>More than 75% but not more than 100%</td>
<td>95%</td>
</tr>
<tr>
<td>100% or more</td>
<td>100%</td>
</tr>
</tbody>
</table>

AE = actual earnings; NE = normal earnings

10.14 Incapacity payments for former members are offset dollar-for-dollar by the Commonwealth-funded portion of superannuation pensions and/or lump sums. Offsetting for superannuation payments is covered in Chapter 12.

10.15 Incapacity payments may continue for as long as a person’s actual earnings are less than their normal earnings, due to their service injury or disease. However, payments cease at age 65. The exception to the age 65 rule is where the injury or disease causing an incapacity for service or work occurred between age 63 and age 65. In these cases, incapacity payments can be paid for a maximum of 104 weeks.

10.16 Incapacity payments are income-related payments and are, therefore, generally taxable. However, where the NE are calculated by reference to part-time reserve earnings and tax-free salary or allowances earned while on warlike service, that component of the incapacity payment is also non-taxable.

10.17 Section 138 of the MRCA provides for redemption (conversion to a lump sum) of small amounts of incapacity payments in certain circumstances. The intention of the redemption provisions is to reduce the cost to the Commonwealth of administering small weekly payments and to provide the injured member with the benefit of access to a lump sum rather than a relatively small weekly benefit.

10.18 A redemption is a lump sum payment made in lieu of future weekly compensation payments. It does not affect liability to pay any other compensation benefits (e.g. permanent impairment compensation and medical treatment).
Submissions

10.19 A number of submissions were received relating to incapacity payments, all of which contended, in various ways, that the provisions should be made more beneficial. The submissions covered the following topics:

- ‘reasonable expectations’;
- duration of pay-related allowances;
- superannuation offsetting;
- indexation;
- cessation at age 65;
- taxation;
- the step-down period;
- redeeming; and
- interrelationship between a Veterans’ Entitlements Act 1986 (VEA) disability pension and incapacity payments.

10.20 In addition to material in the submissions, most of what is addressed in this chapter is drawn from the experience of the Department of Veterans’ Affairs (DVA) in administering the legislation.

Beneficial nature of the Military Rehabilitation and Compensation Act’s incapacity payment provisions

10.21 The MRCA’s incapacity payment provisions could reasonably be described as the most beneficial of any Australian compensation scheme. The MRCA’s provisions are modelled on the Safety, Rehabilitation and Compensation Act 1988 (SRCA) — the incapacity payment provisions of which appear to be more beneficial than any other Australian jurisdiction — but were then enhanced by:

- including a remuneration loading, currently $135.46 per week, which is included in calculating NE, introduced to recognise the intangible benefits of military service that discharged members forgo;
- not starting calculation of the 45-week period during which the former member is entitled to receive full pay (if unable to perform any work) before being stepped-down to 75 per cent until the member has been discharged from the ADF — some former members incapacitated while serving may be unable to work for months before being medically discharged;
- a genuine 75 per cent step-down — the SRCA’s step-down to 75 per cent is reduced by a further 5 per cent to reflect a notional superannuation contribution;
- actual movements (rather than indexation) in ADF salaries and pay-related allowances being used to calculate normal earnings;
- not including a prescribed maximum payment — as is the case with all other schemes, including the SRCA, which sets the maximum amount payable at 150 per cent of Average Weekly Ordinary Time Earnings of Full-time Adults (AWOTEFA); and
• the MRCA’s minimum payment being 75 per cent of the federal minimum wage ($569.90 per week as at 1 July 2010), currently $427.43 per week (the SRCA’s minimum payment is currently $402.06 per week).

10.22 The MRCA’s incapacity payment provisions reflect the ADF’s remuneration package, which is competitive in order to attract and retain personnel. However, the relatively beneficial nature of the MRCA’s incapacity payments may be a disincentive for incapacitated former members to undergo vocational rehabilitation and eventually return to the civilian workforce. Generally, returning to the workforce would provide the best outcomes for a person, as well as reducing long-term scheme costs.

**Incapacity payments based on pre-injury earnings**

10.23 A universal feature of workers’ compensation legislation is that a worker will receive payment for economic loss based on his or her pre-injury earnings as adjusted over time. The premise is that a worker’s past earnings are considered to be the most reliable way of predicting his or her future earnings.

10.24 The introduction of an economic loss payment based on pre-injury earnings is substantially different from the situation under the VEA, which prescribes statutory pension rates without reference to a person’s normal earnings. That said, veterans have been entitled to incapacity compensation under SRCA for service since 1994.

10.25 In the event an injured member or former member is unable to work and receives incapacity payments under the MRCA, the payment will continue to be calculated on the basis of his or her pre-injury earnings, regardless of how long he or she receives payment. In the ADF environment, determining NE is not always straightforward. In administering incapacity payments for former ADF members it is necessary to determine:

• the former member’s rank level and pay grade at the time the injury occurred, as well as the manner in which he or she left the ADF;

• what the former member’s salary rate would have been during the period for which payment is being made, as if the person was still an ADF member and was not incapacitated for service;

• whether the former member would have been eligible to receive any pay-related allowances during the period for which payment is being made. In doing so, it is necessary to make a judgment (or rely on someone else’s judgment) about whether the former member would have been posted to a particular unit or ship, or would have continued to be posted to a particular unit or ship, but for the injury;

• what the former member’s pay-related allowance(s) would have been during the period for which payment is being made; and

• the difference (if any) between the former member’s NE and AE.

**Implications of the ongoing nature of payments**

10.26 The ongoing nature of incapacity payments — potentially in excess of 40 years — can lead to confusion and dispute about the level of pay over time. It is not unusual for arguments to be made by former members and/or ex-service organisations (ESOs) that incapacitated former ADF members should have their payments increased for
reasons other than periodic adjustments to their pre-injury rate reflecting movements in base rates through indexation increases.

10.27 Former members who are injured at relatively low rank levels frequently contend that they would have been promoted to a higher rank level but for injury disrupting their career. Hence, the argument is made that the level of incapacity payments should be adjusted over time to take account of career progression, a concept referred to as ‘reasonable expectations’.

10.28 Such an argument may attract some sympathy in considering cases where members have left the ADF, and are subsequently incapacitated some years later by virtue of their military service. Any incapacity payment will be based on their ADF pre-injury earnings, notwithstanding that they may have achieved higher remuneration in their civilian employment than in their earlier career in the ADF.

10.29 The opposite situation can, and frequently does, arise. A member who is injured during recruit or initial employment training and is medically discharged will receive incapacity payments as if he or she had achieved the pay level of a private (or equivalent) pay group 3. The salary for this rank level is currently $43,870 per year, plus Defence Service Allowance of $11,355 per year. When the MRCA’s remuneration loading of $7,044 per year is added to this it totals $62,269 per year.

10.30 Even after being stepped-down (75 per cent of $62,269 per year), such a member would receive ongoing payments of $46,702 per year. As a comparison, the current federal minimum wage is $569.90 per week or $29,635 per year.

10.31 In many cases, young former ADF members, who generally lack skills, qualifications and experience at this stage of their life, are unable to obtain employment at this remuneration level. In such circumstances, they will be eligible for top-up payments under the MRCA, possibly for some years, should they obtain employment.

Policy issues surrounding the argument for abandoning the notion of pre-injury earnings

10.32 The question of moving away from the practice of determining NE based on pre-injury remuneration raises a number of vexed policy issues. First, it is universally the case that Australian workers’ compensation legislation is predicated on pre-injury earnings.1 There is no statutory scheme that provides for an employee’s incapacity payments to be increased on the supposition that he or she would have been promoted with the passage of time.

10.33 While the Committee acknowledges that the MRCA should be distinguished from civilian workers’ compensation schemes, its incapacity payment provisions are largely consistent with civilian workers’ compensation legislation.

10.34 Decisions by courts dealing with common law claims for compensation may take account of a person’s earning potential. But in such cases the court is required to determine the total amount of compensation for the remainder of the person’s life for both economic and non-economic loss, as well as the cost of medical treatment.

---

1 The VEA is not included in this statement because it is a totally different type of compensation scheme that provides flat rate, lifetime pensions, with no reference to what claimants would have received had they remained in the ADF.
Comparing such cases with statutory compensation benefits is erroneous; it is not comparing like with like.

10.35 Second, it is difficult to see how an arrangement premised on ‘reasonable expectations’ could be justified from a public policy viewpoint, as it would involve speculation and subjectivity. The present test is an objective one that depends entirely on the claimant’s position at the date of injury; that is, what is actually known. Subject to the step-down, the overriding principle is that the injured employee should be neither better nor worse off as a result of being incapacitated.

10.36 Third, it is by no means clear how such an arrangement could be quantified and included in legislation. How many potential promotions should it seek to encompass, and on what basis? Those arguing for such an arrangement imply that time is the sole criterion by which an ADF member is promoted, which is not the case. While time is a factor, there are other tests to be met, including gaining particular skills, knowledge and experience, obtaining relevant qualifications and competing successfully against one’s peers.

10.37 Were the level of incapacity payments to be adjusted on the basis of ‘reasonable expectations’, it would create inequity among members joining the ADF at the same time, where one member becomes incapacitated and another does not, but fails to be promoted.

10.38 Fourth, the MRCA already provides what is unquestionably the highest level of income replacement of any statutory compensation scheme. Arguments for increasing the amount of income replacement are difficult to justify.

10.39 An employer is responsible for compensating the employee on the basis of the employee’s position and associated remuneration at the time the employee was injured, not on what the employee’s remuneration may have become in the future with this or another employer. Compensating members and former members on a basis other than their pre-injury earnings would increase the Commonwealth’s responsibility and costs beyond that which is reasonable. It would also increase complexity in the administration of the legislation, and would be likely to create confusion and affect consistency of outcomes. Pre-injury earnings are a fixed, and readily understood, reference point.

Comprehensive and complex nature of Australian Defence Force remuneration

10.40 As already noted, there are significant administrative difficulties in determining and administering a former member’s NE over what may be considerable periods of time. In part, this comes about because the ADF has comprehensive and complex pay structures, which attempt to take account of the diverse and difficult nature of the work involved in military service. It is compounded by the fact the legislation adjusts incapacity payments in accordance with movements in ADF salary and allowances. The administration of NE is complex and inefficient.

10.41 One of the predominant features of the ADF’s remuneration arrangements is the large number of salary-related allowances. These allowances are designed to compensate for disabilities that go beyond Defence Service Allowance or to recognise certain qualifications and skills.
10.42 The determination of NE is complicated by changes to the ADF’s salary structure, such as has occurred and continues through the Graded Other Ranks Pay Structure and the Graded Officer Pay Structure. The Graded Other Ranks Pay Structure reduced the number of pay groups from 16 to 10. More detailed changes are now taking place encompassing the member’s corps, employment category and pay group.

10.43 In addition to the creation of new pay-related allowances from time to time, changes have also occurred, and will continue to occur, in the pay-related allowance structure. For example, the qualification and skills elements from some allowances were removed in order to include them in the new salary structure.

10.44 In 2009 the Australian Defence Organisation (Defence) commenced a Strategic Allowance Review, the purpose of which is to:

• examine what pay-related allowances and retention/completion bonuses are and what they are paid for;
• examine the relationship between salary, pay-related allowances and retention/completion bonuses; and
• rationalise and restructure the current pay-related allowances.\(^2\)

10.45 This suggests that Defence itself may be dissatisfied with, or uncertain about, the eligibility criteria and application of some allowances.

10.46 Some pay-related allowances are adjusted in line with the ADF Workplace Remuneration Arrangement. This is the means by which ADF members receive across-the-board increases over a specified period in return for improvements in productivity and efficiency (akin to a civilian collective agreement). Other allowances relevant to the MRCA move separately.

10.47 In addition, each allowance is subject to periodic review by the Defence Force Remuneration Tribunal. This usually leads to changes in the quantum and, not infrequently, to changes in the structure and eligibility criteria of the allowance.

10.48 It is clear that determining the level of income replacement for former ADF members receiving incapacity payments is highly labour intensive under the MRCA. This brings with it substantial administrative costs. It also results in high levels of dispute and appeals and, ultimately, administrative review.

**A multitude of pay-related allowances applies to incapacity pay**

10.49 The inclusion of the ADF’s pay-related allowances in the calculation of NE increases the administrative burden as these will, in some cases, need to be included for years.

10.50 *Kennedy v. Military Rehabilitation and Compensation Commission* \(^3\) is worth commenting on here. It involved an appeal against the cessation of the payment of Special Action Forces Allowance (SAFA) to a former Australian Army member.

10.51 The Administrative Appeals Tribunal (AAT) was required to determine whether, had the applicant continued to be employed as a member of the Army, he

---


\(^3\) [2007] 93 ALD 700 (15 January 2007).
would have continued to receive the SAFA and would have still been receiving the allowance at the time the case was determined (January 2007). In short, whether he would still have been posted to the Special Air Services Regiment after some 15 years.

10.52 The AAT found in the applicant’s favour, deciding he would have still been receiving SAFA in January 2007, having been in receipt of the allowance, during periods of incapacity, since 1992.

10.53 This case is a good illustration of the premise on which incapacity payments are based: the requirement to effectively decide what might have happened if some incident had not changed the course of history for a particular individual.

10.54 In determining whether an allowance will still be applicable to a former member’s NE, DVA relies on the career management agencies within the three services for advice. This advice can be confusing and sometimes conflicts with other advice provided. It can come down to an individual decision-maker’s judgment about whether a former member would have continued in a particular posting and, if so, for how long.

10.55 There are over 40 ADF pay-related allowances for the purposes of the MRCA’s incapacity payment provisions. Some of these allowances are paid infrequently while others are more typical in determining NE.

10.56 Allowances such as Special Action Forces Disability Allowance, Seagoing Allowance and Submarine Service Allowance are among some of the more common ones that may be payable for lengthy periods. These allowances provide substantial additional remuneration.

10.57 DVA staff involved in determining a former member’s NE would need to be well versed in understanding the intricacies and nuances of the ADF pay and allowances system.

10.58 Systems support for incapacity payment processing is presently inadequate. The systems require delegates to determine the method of calculating NE and then to manually calculate this amount before entering data into incapacity payment calculators. Incapacity payment delegates in DVA currently process their work in six different systems, including PMKeys, which is owned by Defence.

**A simpler and more efficient approach might be considered**

10.59 The current definition of NE is based on the level of remuneration the claimant was regularly earning at the point he or she was injured. It is then necessary to make a judgment as to whether the claimant would have continued to receive the same or some other amount throughout the time he or she is incapacitated.

10.60 Given there are so many ADF pay-related allowances to be taken into account in calculating NE, one option may be to consolidate them into one generic allowance or loading for the purpose of administering NE.

10.61 This is the same logic that led to the introduction of site allowances (generic or consolidated allowances that encompassed all other allowances paid on building sites) in the building and construction industry some years ago. This reform provided administrative efficiencies for the employer and, importantly, greater stability of earnings for the employee.
10.62 Another option may be to place time limits on the application of allowances. It seems curious that a former member should continue to receive income replacement based on an allowance for performing specific tasks that, had the former member remained in the ADF, he or she may not have been performing for years. It is conceivable that the MRCA’s current incapacity payment system results in some former members being better off financially as a consequence of being injured.

10.63 More rational and efficient methods of compensating for lost allowances under the MRCA might be considered and the Committee recommends that the practicality and implications of these options be further examined.

**What is a reasonable period for the employer to administer incapacity payments?**

10.64 The incapacity payment provisions of the MRCA — some 93 pages in total — are probably some of the most complex to be found in any compensation legislation in Australia.

10.65 The complexity and beneficial nature of the legislation is compounded by the environment in which it operates. The ADF is one of the most diverse, atypical and risk-prone employment groups in Australia, with one of the most comprehensive and complex remuneration structures of any Australian enterprise or industry.

10.66 It may be that the remedial nature of the legislative provisions, when combined with the environment in which they operate, means it is not sustainable to administer as the number of claimants increases over the years.

10.67 While it is acknowledged that incapacity payments are a feature of other compensation schemes, they are, in a number of cases, subject to time restrictions (e.g. in Queensland and Victoria).

10.68 Furthermore, the employment categories performing the work covered by those schemes are quite different to military employment categories. The MRCA is likely to have a much higher proportion of the population it covers with a propensity to be incapacitated for longer periods on average. Any increased operational tempo leading to more service-related injuries among ADF members would place the system under additional pressure.

10.69 Arguably, it is unreasonable for any employer to be required to undertake the work that is necessary in administering NE under the MRCA for the length of time that potentially could be involved. One option may be to cease making incapacity payments after a certain period and pay recipients a statutory rate for the remainder of the time they are eligible to receive incapacity pay.

10.70 In the majority of cases, after a certain period long-term incapacity claimants are unlikely to return to work. Thus, the rationale for administering income replacement in the manner required by the MRCA could be considered to be largely academic. It may be more appropriate at that time for incapacity payments to be converted to a statutory amount until age 65 or retirement age — effectively, a final step-down.

10.71 The statutory rate could be a flat rate or set so as to take account of the member’s rank level if that was considered appropriate. This option could also include increasing the redemption limit to enable more claimants to take a lump sum in lieu of weekly incapacity payments.
10.72 Again, the Committee recommends that the practicality and implications of these options be further examined.

**Benefit structure may act as impediment to return to work**

10.73 The Committee spoke to injured serving members who were very determined to rehabilitate and either return to duty or engage in other careers post-discharge. The personal and family rewards of wellness and functioning as an independent person in society are important motivations to return to work.

10.74 Nevertheless, the beneficial nature of the MRCA’s incapacity payments — what in compensation terms could be described as a high income replacement ratio — may act as a disincentive for some former members to undertake rehabilitation with a view to obtaining alternative employment.

10.75 Former members are eligible to receive, as a minimum, 75 per cent of their pre-injury earnings, including Defence Service Allowance — an all-purpose disability allowance designed to take account of the exigencies of military service. In addition, in many cases they will be eligible for 75 per cent of what are substantial allowances, depending on their employment category.

10.76 As noted earlier, a private or equivalent on pay grade 3, once stepped-down would receive $46,702 per year; still well above the present federal minimum wage of $569.90 per week or $29,635 per year. Marginal tax rates would reduce this amount to $38,720 per year. Former members of the Permanent Forces of a higher rank or pay grade would receive more than this.

10.77 Indeed, claimants at a higher rank level than private or equivalent pay grade 3, and in receipt of one of the major pay-related allowances, would be above AWOTEFA, currently $1,256.30 per week or $65,327.60 per year, even when stepped-down. By comparison, the untaxed Special Rate of pension under the VEA is currently $546.45 per week or $28,415.40 per year.

10.78 The minimum rate of incapacity pay under the MRCA — 75 per cent of the federal minimum wage — would, in reality, be paid to very few former members, and certainly no former members of the Permanent Forces. It would probably only be applicable to a small number of Reservists or perhaps to a cadet.

10.79 The MRCA has no maximum payment and no maximum time period applying to income replacement. In other words, no other scheme pays incapacitated workers 75 per cent of their normal earnings, irrespective of the level of those earnings, for any period up to age 65.

10.80 An important benefit of having a high income replacement ratio can be to make the cost of workers’ compensation so high that the employer will be acutely aware of the need to observe stringent occupational health and safety practices. (A high premium should achieve the same effect in a premium-based workers’ compensation scheme.)

10.81 In view of the risk-prone nature of military service, however, coupled with the attenuated relationship between ADF occupational health and safety and military compensation outcomes (as discussed in Chapter 3), it is difficult to see how the

---

4 The Australian Bureau of Statistics website indicates that the seasonally adjusted Average Weekly Ordinary Time Earnings for Full-time Adults is $1,256.30 with effect from August 2010.
MRCA’s high income replacement ratio could be expected to have any effect on the ADF’s occupational health and safety practices.

10.82 It is clearly necessary to balance the competing considerations. From an equity perspective the benefit structure should make up for what the former member loses through his or her service-related injury or illness to the extent practicable. Against this must be balanced the need to recognise the link between return-to-work incentives and the level of income replacement.5

**Numbers in the incapacity payment system: concerns and implications**

10.83 For 2008–09, there were 925 MRCA incapacity payees.6 For 2009–10 there were 1,247 incapacity payees — reflecting the growth of the scheme.

10.84 The Australian Government Actuary has advised that in July 2007 there were 1,905 long-term (in excess of 12 months) incapacity payees in the SRCA/MRCA system — mostly SRCA7 at that time. (In order to try to understand what will happen under the MRCA in the future, it is necessary to look at what has happened, and continues to happen, under the SRCA.)

10.85 Of this population, the average age was 46 years and the average length of time in the system was eight years. Of the 1,905 recipients, 450 recorded a date of injury as 1980 or earlier and 1,000 recorded a date of injury as 1995 or earlier.

10.86 The Actuary also advised that for every 1,000 incapacity payees who commence long-term incapacity payments, it is estimated that about 280 would still be in the system 10 years later.

10.87 The Actuary stated that the reduction or dropout rate in the first year (in effect, the second year on incapacity pay) was about 25 per cent. The dropout rate was about 22 per cent in the second and third years, reducing to 10 per cent after eight years and down to 4–5 per cent after 10 years.

10.88 Given the average age of the population, a reasonable proportion could be expected to drop out of the system before they reach the age of 65 (or have died). It is unclear whether any recipients leave the system as a result of their incapacity payments ceasing because it is determined they are capable of participating in rehabilitation programs but are not prepared to do so.

10.89 These figures illustrate the propensity of a significant proportion of incapacity payees to receive incapacity payments for a lengthy period. Of course, there will always be a certain proportion of former members with severe physical and/or psychological injuries receiving incapacity payments who have little real prospect of returning to the workforce.

10.90 The increasing incidence of mental health cases among younger veterans from conflicts such as East Timor and Iraq is relevant. A critical issue for the future is the nature and incidence of the MRCA’s claims and the extent to which the legislation will

---

5 For a discussion on this, see Review of South Australian Workers’ Compensation System Report by Alan Clayton and John Walsh, PricewaterhouseCoopers, Adelaide, December 2007, p. 98.

6 This figure represents the total number of claimants who received incapacity payments, either on a continuing or one-off basis, during the subject period.

7 The SRCA referred to here is the SRCA for ADF members and former members up to 30 June 2004.
deal with large numbers of late-onset claims (predominantly psychological) along the lines of those made under the VEA relating to service during the Vietnam War.

10.91 The Actuary’s figures appear to show, subject to more detailed research being conducted, that there is a point where diminishing returns set in; that is, where virtually no recipient is going to leave the system as a consequence of obtaining employment following rehabilitation.

10.92 If it can be shown that such a point exists, it could be argued there is nothing to be achieved in maintaining incapacity payments as they currently are — the structured nature of which is designed to encourage former members to return to the workforce — beyond that point. It would be more efficient and less costly to provide income support through an indexed statutory amount.

10.93 Related to this is the question of whether it will be feasible to cease incapacity payments at age 65 in the future. Apart from the fact the Australian Government has announced it will increase the qualifying age for age pension from 65 to 67 by 2023 (starting from 2017), there is the issue of whether it will be sustainable to cease incapacity payments at any age, because it could be argued it is a form of age discrimination. The ADF’s compulsory retirement age is now 60. A counterargument could be made to stop incapacity payments at that age. The impact on the MRCA of the increase to qualifying age for age pension to 67 years needs to be considered.

Wage Price Indexation versus actual movements in salary and allowance rates

10.94 Normal earnings of former employees under the SRCA are adjusted in accordance with Wage Price Index (WPI) and this makes administration easier than under the MRCA, which is based on actual movements in ADF salary rates.

10.95 A comparison of ADF pay increases with WPI since 2001, when this form of indexation was introduced under the SRCA, shows that ADF pay increases rose by 33 per cent whereas the WPI used by SRCA increased by 30.6 per cent over the same period.

10.96 Given the relatively small differential in outcome, and in view of the extensive workload involved in adjusting NE in line with movements in ADF salary and allowances, consideration should be given to extending the WPI method used by SRCA to the MRCA. Alternatively, the method that is used to index the MRCA’s remuneration loading in line with the percentage increases applied to the ADF’s Workplace Remuneration Arrangements could be adopted.8

Income replacement for self-employed continuous full-time service Reservists

10.97 Before concluding this chapter, which has dealt primarily with the incapacity payment issues relating to former members of the Permanent Forces, it is necessary to address the policy issue surrounding income replacement for self-employed health professionals injured on CFTS. The Tanzer Review commented on this matter:

In circumstances where self employed, high income earning members of the Reserve are employed by the ADF on CFTS, and, as a result of such employment

---

8 Regulation 20 of the Military Rehabilitation and Compensation Regulations 2004.
the member’s private insurance cover is affected, the current disability income support arrangements of the MCS [Military Compensation Scheme] are unsatisfactory. 9

10.98 When the MRCA was introduced, it addressed this problem by enhancing the incapacity payment provisions in two ways. First, by providing for a CFTS member’s NE to be based on a choice between the member’s military or civilian earnings, with the latter to include earnings from part-time Reserve service, if regularly performed.

10.99 Second, it dispensed with a cap on incapacity payments. As noted earlier, the MRCA is the only compensation legislation to not impose a cap on incapacity payments. Aside from dissatisfaction with the existing arrangements under both the SRCA and the VEA, these reforms were an attempt to address the implications for military capability arising from health professional Reservists being reluctant to be deployed — these particular skills being in short supply within the Permanent Forces — because of the potential impact on their income.

10.100 It would be accurate to say that the MRCA has the most beneficial income replacement provisions of any compensation scheme in Australia. Indeed, one of the submissions dealing with this issue describes it as ‘probably the most generous income protection policy available on the Australian market.’10

10.101 Notwithstanding this, the MRCA may not necessarily replace a CFTS member’s income fully in circumstances where he or she was self employed before being injured. It has been commonplace for a number of years for professionals to create incorporated companies in order to obtain taxation, superannuation, the protection of a limited liability company structure and other advantages.

10.102 However, in the event that the member has established a corporate structure with monies earned going to a company, income replacement will simply be the salary or wage the member regularly draws from the company. This amount is usually calculated by reference to the member’s taxable income. Another way of determining the level of income replacement is to ascertain what it would cost to employ someone to do the work the member was doing in conducting his or her business.

10.103 In the same submission quoted above, the example is given of a health professional being personally responsible for bringing $10,000 per week into his or her business while only drawing an amount of $3,000 per week as ‘salary’.11 Normal earnings for the purposes of the MRCA would be the latter amount. The shortfall in income is or has been seen as something to be addressed through the income protection provisions offered through life and accident insurance policies, rather than through compensation legislation.

10.104 The problem with this approach is the potential for the income protection afforded by insurance policies to be negated through war exclusion clauses. Clearly, it would be preferable for those concerned to have their entitlements prescribed by statute, rather than being subject to the vagaries of the insurance industry. But, is it appropriate for the MRCA to go further in addressing this problem than it did upon its introduction? Would this be an appropriate role for a statutory military compensation scheme?

10.105 In answering this question, it is worth recalling that the MRCA is a highly unusual, perhaps even unique Act; an amalgam of workers’ compensation and some

10 BRIG Brian Pezzutti CSC RFD.
11 Ibid.
elements of the former repatriation system (as reflected in the VEA). While modelled primarily on workers’ compensation legislation, the MRCA’s incapacity payment provisions include some features that are unique to military service.\textsuperscript{12}

10.106 Nevertheless, it would be taking a large policy step to extend the MRCA’s incapacity payment provisions to take into account the entire income derived from the injured self-employed Reservist’s personal exertion.

10.107 Central to the MRCA’s incapacity payment provisions is the need to establish what is the real or actual level of economic loss that the member or former member has suffered as a consequence of being incapacitated. For the claimant to receive only a proportion of the income he or she would bring into the business through their own labour seems at odds with the notion of compensating for economic loss.

10.108 It is difficult to see how an objection could be made that providing income replacement to this extent is too high. As the MRCA’s incapacity payments are not capped, there is an ongoing potential for senior military officers to receive income replacement based on their full salary level. In other words, the MRCA already provides a higher level of compensation for economic loss in the form of income replacement than any other compensation legislation.

10.109 One of the primary factors influencing certain professionals (and some tradesmen) to become incorporated is to reduce their rate of taxation. Another important reason may be to obtain superannuation concessions. Employees (including ADF members) are able to reduce their marginal taxation rates through salary sacrifice arrangements in the form of concessional deductions to a superannuation fund.

10.110 Salary sacrificing provides employees with the opportunity to reduce their taxable income. Employees who choose to reduce their taxable income in this manner, and who become incapacitated, are not disadvantaged in terms of the calculation of NE for compensation purposes. That is, their NE are based on their pre-salary sacrifice remuneration.

10.111 There are, it must be acknowledged, likely to be administrative difficulties associated with defining precisely the level of the earnings or income to be replaced where the member’s earnings are paid into a corporate structure.

10.112 But this in itself is not an obstacle, particularly given that determining NE for ADF members or former members is already complex because of the application of some pay-related allowances. Moreover, of the total number of claimants, there is likely to be a relatively small number of cases involving self-employed Reservists who are incapacitated while performing CFTS in an operational area and choose civilian earnings to determine NE.

10.113 This matter is the subject of a University of New South Wales Law Journal article which notes:\textsuperscript{13}

\begin{quote}
... the immediate problem is to determine which post-injury payments eliminate the economic loss flowing from physical incapacity for work and which do not. On the one hand, everyone is agreed that wages paid by an employer in return for work prevent economic loss. On the other hand, everyone would probably also agree that post-injury income which the worker would have received in any event
\end{quote}

\textsuperscript{12} An example of this is the step-down arrangement that is effected after 45 weeks have elapsed from the point of discharge; another example is the remuneration loading, which increases the level of incapacity pay for former members.

... — for example, income for investments — is irrelevant to the economic loss suffered. In between these two extremes there is no doubt room for debate about many types of post-injury income. The solution to any such debate is, with respect, to be found ... in the distinction between income which is produced by personal exertion and that which is not. It is where post-injury income is ‘personal-exertion income’ that it ought to be relevant as preventing economic loss.

10.114 The Committee notes that issues have also been raised in relation to life insurance for members of the ADF. These are discussed in Chapter 28.

10.115 The Committee considers that the calculation of the NE of a self-employed Reservist, incapacitated as a result of operational service performed during a period of CFTS, needs to be examined in more detail, taking into account any measures that might be taken by Defence to address issues relating to private insurance arrangements generally. The aim would be to determine whether it would be practicable and appropriate to redefine NE for this particular category of members or former members to encompass the income they bring into their business through their own personal exertion, or at least go further than is presently the case.

10.116 Should it be practicable to do so, the revised NE would need to be subject to the legislation’s normal step-down arrangements. Any revised arrangements would also need to be subject to the principle that claimants could not receive more income than they would have earned but for being injured.

Conclusions

10.117 In this chapter some of the key aspects of the MRCA’s incapacity payment provisions with respect to former members of the Permanent Forces were discussed.

10.118 The Committee concluded that the MRCA’s incapacity payment provisions are beneficial, reflecting the ADF’s competitive remuneration package. As the MRCA has a high level of income replacement ratio in comparison with other schemes, it would be difficult to justify increasing the overall level of incapacity payments.

10.119 Incapacity payments are based on adjusted pre-injury earnings. It has been suggested that payments should be further adjusted over time to take into account expected career progression. The Committee does not agree with this proposal.

10.120 Administration of the incapacity provisions is very complex, largely as a result of incapacity payments taking into account changes in the ADF’s remuneration levels and the multitude of pay-related allowances. This complexity is likely to increase over time as remuneration structures change. A simpler and more efficient approach to administering incapacity payments might be considered.

10.121 Incapacity payments to an individual may be required for many years. As research suggests that there is little prospect of long-term claimants returning to the workforce, there may be merit in considering a statutory rate to be paid to claimants after a certain period of time, and increasing the redemption limit to enable more claimants to take a lump sum in lieu of weekly payments.

10.122 The relatively beneficial incapacity payment provisions may also act as a disincentive for some former members to undertake rehabilitation and subsequently re-enter the workforce. This is an issue that should be examined in more detail.
10.123 Income replacement for self-employed professionals who are injured on CFTS in an operational area is also an issue that should be further examined.

10.124 The issues identified for further examination relate to the administration of incapacity payments in other state, territory and Commonwealth jurisdictions and whole-of-government superannuation issues.

10.125 The Committee believes there is a compelling case for a cross-agency working group to conduct a thorough examination of how the existing arrangements for determining and administering NE, together with the linkages with rehabilitation, could be made more effective and efficient. A cross-agency working group could also examine the payment of employee and employers’ contributions to superannuation schemes in relation to incapacity payments, discussed in Chapter 12.

**Recommendations**

The Committee recommends that:

10.1 no change be made to the current approach used to calculate normal earnings (NE) under the *Military Rehabilitation and Compensation Act 2004* (MRCA) to account for career progression; and

10.2 because many of the issues raised in relation to incapacity payments under the MRCA also relate to the administration of incapacity payments in other state, territory and Commonwealth jurisdictions, as well as whole-of-government superannuation issues, a cross-agency working group should be established to conduct more detailed analysis of existing incapacity payment provisions under the MRCA and provide advice to the Military Rehabilitation and Compensation Commission on:

- the relationship between the current incapacity payments structure and effective vocational and psychosocial rehabilitation;
- options for implementing more efficient methods of determining NE in respect of Australian Defence Force pay and pay-related allowances;
- options for simplifying payments to long-term incapacity payees, who have little prospect of returning to the workforce; and
- the practicality and implications of redefining NE for self-employed Reservists deployed on continuous full-time service.