

# **Workers' Compensation: Rx for Policy Reform**

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# Executive Summary

Workers' compensation is the oldest government-mandated employee benefit program in the United States. Each state has its own system. State systems vary, but when a worker is injured on the job or has a work-related illness they all provide coverage of medical costs, replacement of lost wages and payment for death or dismemberment.

Though workplaces became much safer in the 20th century, and job-related injuries declined, the soaring claim costs of state-mandated workers' compensation insurance has offset the decline in injuries. As a result, employers face increasingly higher insurance premiums and self-insurance costs, which reached nearly \$60 billion in 2000. Although the average cost of workers' compensation premiums nationwide is less than 3 percent of payroll, premiums vary widely by industry. In high-risk industries, workers' compensation costs are often greater than health insurance premiums or Social Security payroll taxes. Workers implicitly pay part of these costs through reduced wages.

Costs are increasing because state systems provide incentives for employers, employees and others to behave in ways that cause costs to be higher and workplaces to be less safe than they otherwise could be. Specifically:

- Insurance premiums, especially for small employers, are not fully experienced-rated; as a result, firms that improve workplace safety cannot reap the full rewards and others are not penalized for poor safety practices.
- Employers are not allowed to use their regular group health plan to cover workers' compensation injuries; as a result, employers and employees do not benefit from cost control mechanisms common under normal health insurance, and employees have no incentive to economize on their use of health care. (For example, on the average, it costs twice as much to treat the same injuries or conditions under workers' compensation as under group health plans.)
- Employers are also prevented from using ordinary disability insurance for workers' compensation; as a result, workers report injuries that may not be work-related, stay away from work when it is not medically necessary, and engage attorneys to pursue questionable claims. (Whereas disability insurance typically requires a worker to be unable to work for 30 to 90 days, workers' compensation benefits begin after a wait of as little as three days.)
- Workers' compensation premium rates are highly regulated in some states, and insurance markets are not as competitive as they could be; as a result, many small firms pay more than necessary for coverage. (For example, average premiums as a percentage of payroll are 50 percent higher for firms of less than 500 employees than for larger firms.)

- In general, individual employees do not reap the rewards or bear the full financial costs of their individual behavior; thus they have weakened incentives to prevent workplace injuries or to economize on the use of benefits if injured.
- Employees are typically overinsured for workplace injuries; they cannot trade less complete coverage for higher wages or other benefits.

Addressing these problems would increase the efficiency of the system by controlling costs and giving workers a greater choice of benefits. If state systems were properly reformed:

- Employers could lower their premiums by improving safety and reducing claims costs if premiums were fully adjusted for the firm's experience, rather than based upon occupational or industry risk ratings.
- Employers could integrate employee health plans and workers' compensation medical coverage so that employees could use the same provider networks and employers could pay the same negotiated fees — thus reducing costs and improving care.
- Employers could provide wage replacement benefits under an integrated disability plan — thus reducing perverse incentives to make false claims or to claim a disability as work-related when it is not.
- Deregulating insurance rate-setting and allowing alternative insurance arrangements would give firms more options to reduce their costs, especially if small firms were allowed to self insure or at least purchase high-deductible policies.
- Employers could establish Workers' Compensation Accounts (WCAs) for employees, funded by savings on premiums from selecting more limited conventional coverage; individually-owned WCAs would be a form of self-insurance that would give workers an alternative to third-party workers' compensation benefits.
- Employees could voluntarily agree to selectively relax the employer's strict liability (establishing liability by contract) in return for higher wages or other benefits.

These measures would lower employers' insurance costs and allow employees to make tradeoffs between overly-generous workers' compensation coverage and higher wages and other benefits they value more.

## Introduction

Workers' compensation is the oldest government-mandated employee benefit program in the United States. Each state has its own system. The features of the state systems vary, but they all provide three basic types of benefits when a worker is injured on the job or has a work-related illness: (a) coverage of medical costs, (b) replacement of lost wages and (c) payment for death or dismemberment. An injured worker typically receives medical treatments paid for by the employer or employer's insurance carrier; if the injury results in lost time from work (beyond a statutory waiting period) he or she receives wage replacement (indemnity) benefits; and in cases of permanent injury or death, the worker (or the worker's family) is compensated.

Each state sets employee benefit levels and regulates insurance arrangements and premiums that cover benefit costs. Employers are obligated by law either to purchase insurance or to self-insure and pay the claim costs. Employees as a group, however, implicitly pay part of the costs of these benefits in the form of lower wages. All states require employers and their insurers to cover the full cost of medical services without any employee copayments or deductible amounts.

This paper discusses how the levels of state mandated benefits and other features of state systems distort the incentives of employees, employers, medical service providers and attorneys in cost-increasing ways. After identifying the problems these perverse incentives create, it suggests solutions designed to align the incentives of all the players in the system in ways that will reduce claim costs and employers' costs and improve employee safety and benefits.

## How the System Works

Each state has designed its own workers' compensation system, and no two are exactly alike. The types and levels of benefits, the cost of claims and the structure of the system vary widely. The premiums paid by employers also vary widely by state, size of firm and industry. However, the rising cost of workers' compensation to employers — a cost implicitly borne in part by workers — is a common problem. In this section we will examine major features of state systems and the effects they have on claims and costs.

**Employers Are Required to Provide Benefits.** Employers are held strictly liable for workers' compensation benefits. [See the sidebar, "The Genesis and Evolution of Workers' Compensation Systems."] Specific state statutes generally replaced the tort liability system — but not completely or in every state:

*"Workers' compensation is the oldest government-mandated benefit in the United States."*

- Currently, Texas is the only state that routinely allows employers to opt out of the statutory system.<sup>1</sup> Employers that opt out, however, are still liable for workplace injuries under the negligence standard.
- In five states — North Dakota, Ohio, Washington, West Virginia and Wyoming — employers are obligated to either buy insurance coverage from a state-owned fund or obtain approval from the state agency to self-insure.

In a number of other jurisdictions, state or residual (assigned risk) funds provide insurance as a last resort to employers that are unable to obtain insurance from private carriers. Such risk pools are necessary because, when employers are required to have coverage, the state must make an alternative available.

### **Benefits to Replace Wages and Compensate Injured Workers.**

There are three main types of wage replacement (or indemnity) benefits. When the employee is recuperating and unable to work he can receive temporary total disability (TTD) payments. [See the “Glossary of Terms.”] When workers are permanently disabled and unable to work, the system provides permanent total disability (PTD) benefits. A third type of benefit is permanent partial disability (PPD), generally paid when an injured employee attains the maximum medical improvement expected for an injury but still has either a residual physical impairment or occupational disability that prevents the worker from continuing in his former occupation.

The maximum amount of wage replacement benefits and the length of time a worker can receive them varies considerably among the states. In 2005, for example:<sup>2</sup>

- The maximum weekly benefit for TTD ranged from a high of \$1,133 per week in Iowa to a low of \$351 in Mississippi, and in most states is equal to the state’s average weekly wage.
- The maximum duration of payments ranged from a high of 500 weeks (nearly 10 years) in Virginia to a low of 104 weeks (two years) in South Carolina and a number of other states.

PPD benefits also vary widely among the states:

- The weekly maximum payment for PPD ranged from a low of \$220 in Alabama to a high of \$1,070 in New Hampshire in 2005.<sup>3</sup>
- The maximum duration of weekly payments was shortest in New Hampshire (262 weeks) in 2005, but many states have no maximum, implying weekly benefits may be paid for as long as the disability lasts.<sup>4</sup>
- For workers’ compensation policies effective 2000 to 2001, the costs incurred for PPD benefits averaged \$61,327 and ranged from a high of \$184,257 in Michigan to a low of \$32,425 in Missouri.<sup>5</sup>

*“Benefits vary widely among the states.”*

## The Genesis and Evolution of Workers' Compensation Systems

Prior to the institution of state workers' compensation systems at the turn of the 20th century, workers insured themselves against the risk of workplace accidents by purchasing their own policy or maintaining precautionary savings, and their wages included an implicit risk premium. Under the common law tort system, employers were held liable for workplace injuries only if their negligence caused the injury.<sup>1</sup> Workers' compensation replaced the common law tort system and the negligence standard.<sup>2</sup> Under workers' compensation, employers became strictly liable for providing wage replacement benefits to injured workers on a no-fault basis — regardless of whether the employee or the employer caused or contributed to the injury. In return, workers gave up most of their rights to seek judicial redress for their losses through the tort system.

The problem with this standard, however, is that while it provides a complete incentive for the employer to prevent workplace accidents, it provides little or no financial incentive for an employee to avoid them, and to economize on the use of benefits when injured. Even if an employee's negligent behavior contributes to his injury, he is not financially penalized.

In 1913, New York enacted a workmen's compensation law that was upheld by the State Court of Appeals as a constitutionally sound exercise of state police powers. In 1917, three decisions handed down by the U.S. Supreme Court validated the New York act, establishing the lawful authority of states to enact both compulsory and elective workmen's compensation statutes.<sup>3</sup>

Workers' compensation laws effectively removed responsibility for adjudicating liability for employees' injuries and illnesses from the civil justice system, and delegated enforcement of the laws to state agencies. State agencies, also known as industrial commissions, were empowered to promulgate rules and regulations and to monitor and enforce these laws.

Following New York's reform, most states and territories enacted workers' compensation laws. Within a few decades, the scope of programs widened to cover almost all employers, industries and occupations,<sup>4</sup> and greatly expanded compensable injuries to include all work-related injuries and illnesses. By the mid-1920s only eight states remained without a statutory law. By 1949 each of the 48 states, the District of Columbia and the territories of Alaska and Hawaii had instituted statutory workers' compensation systems.

The basic structure of the New York law is still followed by the statutory systems used throughout the country. Employers are required to carry workers' compensation insurance, although in most states they have some flexibility in choosing the form of the insurance. Generally, the statutory indemnity benefits include automatic payment of up to two-thirds of an employee's before-tax wages, and in fatal cases, funeral expenses and compensation for the families.<sup>5</sup>

<sup>1</sup> Richard A. Posner, "A Theory of Negligence," *Journal of Legal Studies*, Vol. 1, January 1972, pages 28–89.

<sup>2</sup> Ibid.

<sup>3</sup> The three U.S. Supreme court decisions were *New York Central Railroad v. White*, 243 U.S. 188 (1917); *Hawkins v. Bleakly*, 243 U.S. 210 (1917); and *Mountain Timber Co. v. Washington*, 243 U.S. 219 (1917).

<sup>4</sup> Domestic and agricultural workers are excluded from coverage in most states. Also excluded in some states are small businesses with fewer than 10 employees and self-employed workers.

<sup>5</sup> The New York law did not include medical benefits and applied only to high-risk manufacturing establishments.

## Glossary of Terms

**Actuarially fair:** a premium equivalent to the expected value of insured losses.

**Assigned risk market (pool):** usually state-run system that provides workers' compensation policies for individual employers who cannot obtain private insurance, also known as "residual market."

**Claim costs:** incurred costs of a claim.

**Frequency of claims:** number of claims per covered employees in a policy year in a state.

**Impairment rating:** a value (in percentage) assigned to an injury that in most states determines an individual's permanent partial disability benefits.

**Incurred costs:** all payments on a claim plus reserves set to cover any future payments on open claims

**Indemnity benefits:** insurance coverage that provides financial compensation for injury or loss wages.

**Permanent partial disability (PPD):** a condition where the injured attains maximum medical improvement possible, but still has a residual physical impairment or occupational disability.

**Permanent total disability (PTD):** a condition where the injured loses the complete ability to work.

**Soft-tissue injury:** an injury involving tendons, muscles or ligaments, such as a sprain or strain.<sup>1</sup>

**Statutory benefits:** medical and wage replacement benefits that are mandated by law.

**Temporary total disability (TTD):** a condition where the injured loses the complete ability to work temporarily, but is expected to recover.

**Total benefit costs in the system:** cost of all benefits on all claims in a policy year in a state, excluding most administrative costs.

<sup>1</sup> "Soft-Tissue Injuries," University of Maryland Medicine, Web document, available at <http://www.umm.edu/orthopaedics/soft.htm>.

*"The cost of claims varies widely among the states."*

State statutes provide the greatest cash benefits for the most serious injuries, fatalities and permanent total disabilities where employees lose the ability to work. The definition of PTD depends on the state, but it generally includes, for example, the loss of eyesight or both hands. Overall, in 2000 to 2001:<sup>6</sup>

- The costs of fatal injuries averaged \$242,770 per case, with Missouri having the highest average cost (\$462,484) and California the lowest (\$149,370).
- The costs of PTD are higher than for fatal injuries and averaged \$381,909, with Nevada having the highest (\$2,496,678) and Utah the lowest (\$93,185).

**Decline in the Frequency of Claims.** Data on accidental fatalities indicate that workplaces are now arguably safer than workers' homes. Throughout the second half of the 20th century, as deadly home accidents increased, workplace injuries resulting in death declined steadily in the United States [see Figure I].

The frequency of workers' compensation claims has also declined over the last decade. As Table I shows, between 1992-93 and 2000-01:<sup>7</sup>

- The frequency, or number of claims filed per 100,000 covered employees, declined 29 percent.
- The nationwide decline occurred in virtually every claim category, including claims that resulted in lost time from work (35 percent) and claims requiring only medical intervention (28 percent).
- The declines were similar in magnitude for high- and low-risk occupations and industries; thus, we can rule out any explanation of the countrywide trend in frequency based on the mix of employment in U.S. industries.

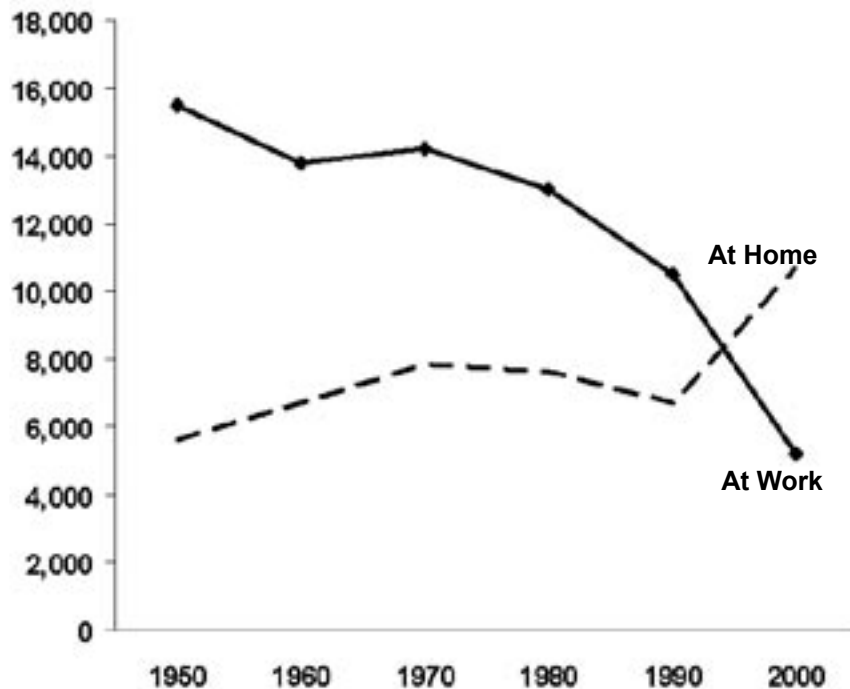
The decline in claim frequency, however, was not the same in every state. For example, in California the frequency of all claims declined 22 percent between 1992 and 2001, considerably less than the countrywide decline (29 percent), while permanent partial disability (PPD) cases actually increased 13 percent. This suggests that features of the California state system encourage more claims for PPD, relative to other types of claims and other states' systems.

**Rise in Premium Costs.** Even though workplace safety has increased dramatically and the frequency of claims has declined, workers' compensation

*"Workplaces are safer than homes."*

FIGURE 1

## Number of Fatal Accidents



Note: Home accidents exclude deaths from auto accidents.

Source: "Accident Facts," 1951, 1961, 1971, 1981, 1991, 2001; National Safety Council.



“The number of workers’ compensation claims has dropped by more than one-third.”

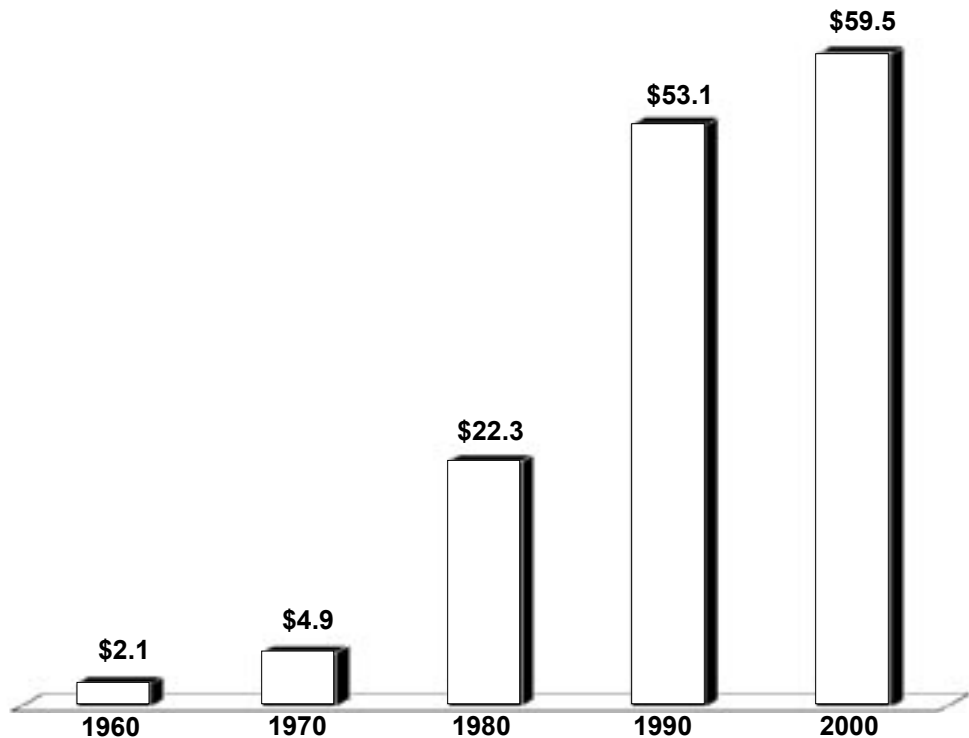
**TABLE I**  
**Frequency of Claims Reported**  
**by Private Insurers Countrywide\***  
 (per 100,000 workers)

	1992-93	2000-2001	Percent Change
All Claim Types	8,279	5,856	- 29.3%
Medical Only Claim	6,296	4,563	- 27.5%
Lost-Time Claims	1,983	1,293	- 34.8%

Source: *NCCI Annual Statistical Bulletin*, 1997 and 2004 Editions, National Council on Compensation Insurance, Exhibit XII.

\* Excludes data from Nevada, North Dakota, Ohio, Washington, West Virginia and Wyoming.

**FIGURE II**  
**Employer Costs of Workers’**  
**Compensation Insurance**  
 (billions of dollars)

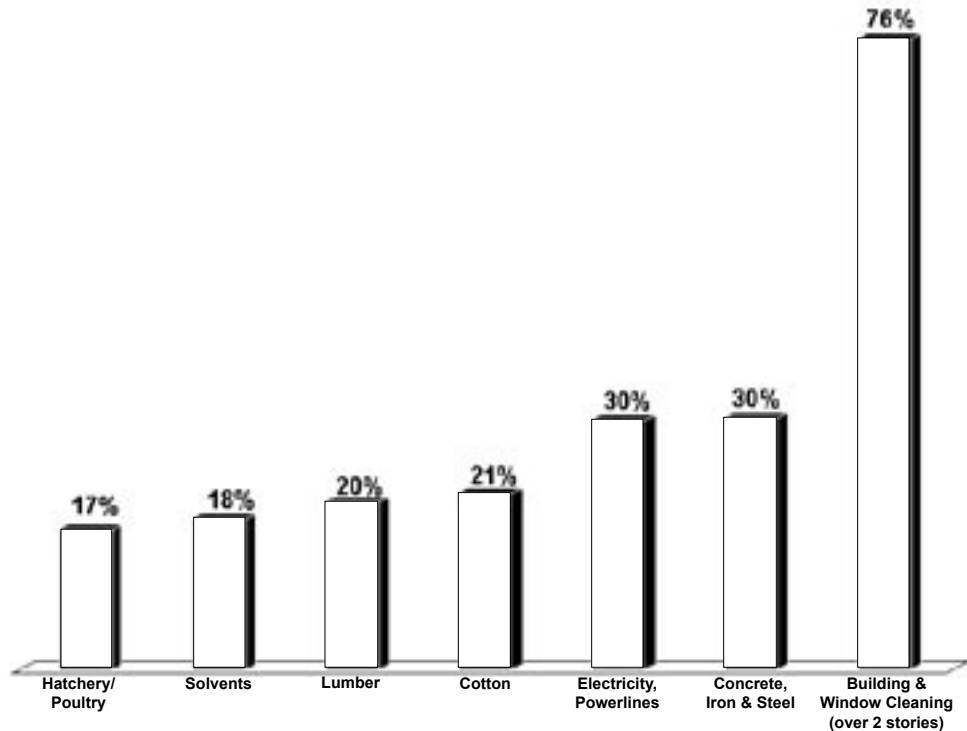


“Costs for workers’ compensation have soared.”

Source: John F. Burton Jr., “Workers’ Compensation Benefits and Costs in 2003,” *Workers’ Compensation Policy Review*, 2005, pages 15 - 25.

FIGURE III

## Texas Workers' Compensation Costs for High Risk Occupations as a Percentage of Payroll



Source: Texas Department of Insurance, "Basis of Rates (1/1/2006 Relativities)." Available at <http://www.tdi.state.tx.us/wc/regulation/wcrate06.html>.

*"Workers' compensation costs more than health insurance or payroll taxes in high-risk industries."*

costs have soared. As a result, employers face increasingly higher insurance premiums and self-insurance costs, which reached nearly \$60 billion in 2000 [see Figure II].<sup>8</sup>

Although the average cost of workers' compensation premiums nationwide is less than 3 percent of payroll, employers' premium costs vary widely by industry [see Figure III]. In high-risk industries, employers' workers' compensation premiums are often higher than health insurance costs or Social Security payroll taxes. For example, in Texas:

- Workers' compensation in the hatchery and poultry industry account for 17 percent of payroll costs.<sup>9</sup>
- However, workers' compensation in some building and window-cleaning occupations account for a staggering 76 percent of payroll costs!

Uniquely, Texas permits firms to "opt out" of workers' compensation insurance coverage.<sup>10</sup> But payroll costs in Texas are not unique. Even in states that require participation in the workers' compensation system, employ-

“Claims for wage benefits increased faster than claims for medical treatment in the 1990s.”

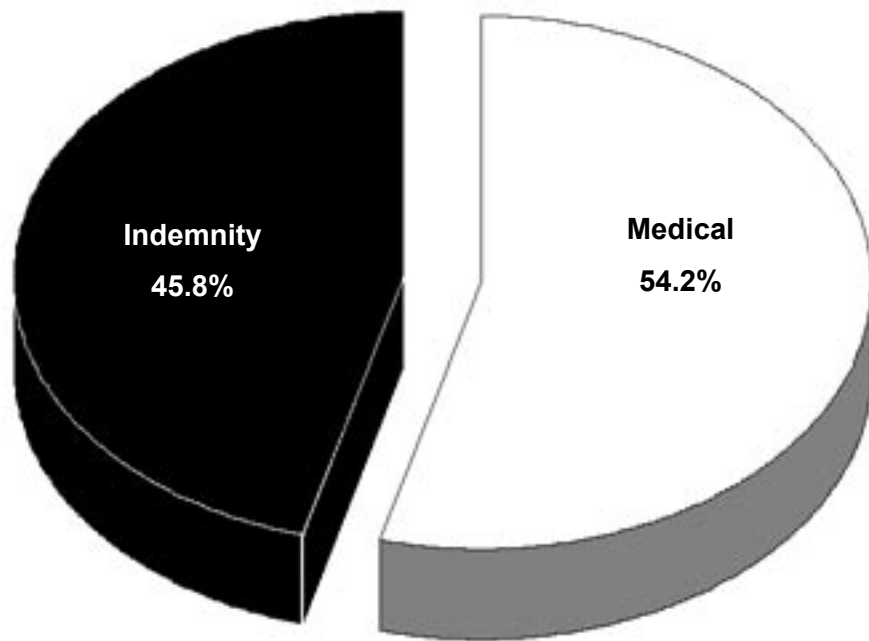
**TABLE II**  
**Average Claim Costs Reported by Private Insurers Countrywide\***

	1992-93	1999-2000	Percent Change
All Claim Types	\$ 4,850	\$ 7,440	+53.4%
Medical-Only Claims	\$375	\$572	+52.5%
Lost-Time Claims	\$19,060	\$31,684	+66.2%

\*Excludes data from Nevada, North Dakota, Ohio, Washington, West Virginia and Wyoming.

Source: *NCCI Annual Statistical Bulletin*, 1997 and 2004 Editions, National Council on Compensation Insurance, Exhibit XII.

**FIGURE IV**  
**Percentage of Costs for Medical Treatment and Wage Replacement, 2000-2001**



“Medical treatment accounts for more than 50 percent of costs.”

Source: *NCCI Annual Statistical Bulletin*, 2004 Edition, National Council on Compensation Insurance, Exhibit X.

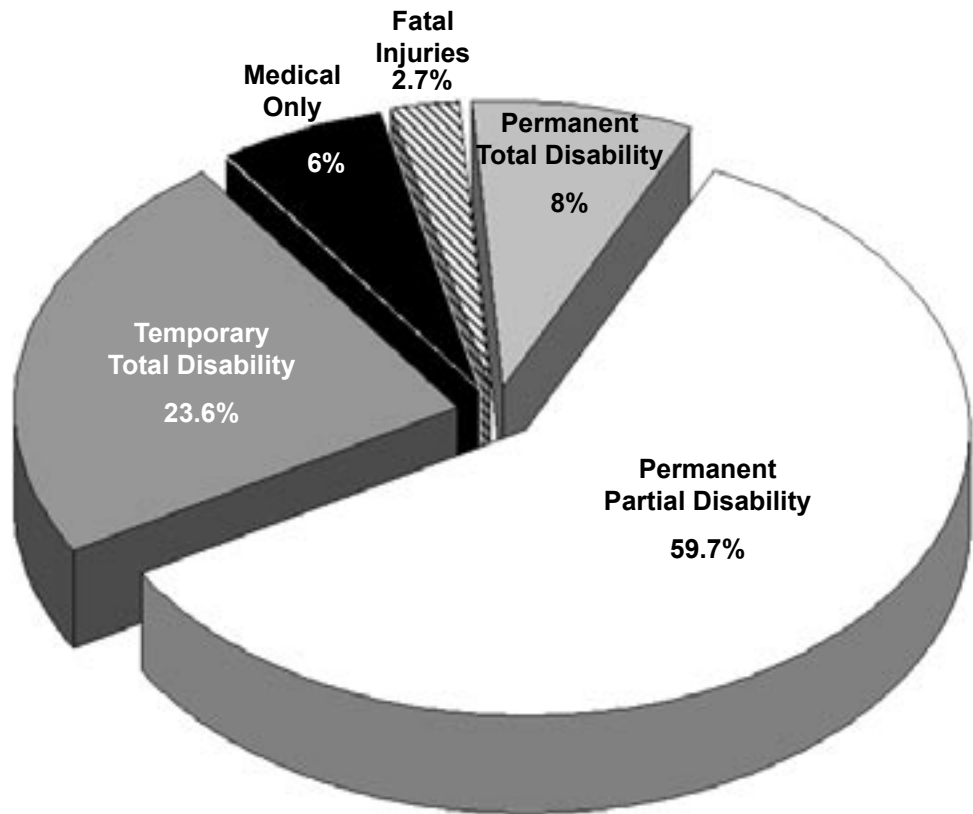
ers' costs of insurance as a percentage of payroll are steep. In Maine, for example, where workers' compensation insurance is mandatory:

- Workers' compensation in the local trucking industry accounts for almost 19 percent of payroll costs.<sup>11</sup>
- In the sawmill industry, it consumes about 20 percent of payroll costs.
- In logging and lumbering, premiums cost up to 30 percent of payroll.

**Increase in Claim Costs.** A sharp nationwide increase in claim costs at the same time claim frequency declined (from 1992-93 to 2000-01) offset any savings in total benefit costs in the system that would have resulted.<sup>12</sup> The nationwide average cost for all claim types (including medical-only claims and indemnity claims for lost time from work) increased 53 percent; the average cost for claims resulting in lost work time (beyond states' statutory

FIGURE V

### Cost of Workers' Compensation Claims by Type, 2000-2001 (percentage of total claims)



*“Permanent partial disability cases account for almost 60 percent of claims.”*

Source: *NCCI Annual Statistical Bulletin*, 2004 Edition, National Council on Compensation Insurance, Exhibit X.

waiting periods for receiving indemnity benefits) increased 66 percent, from \$19,060 in 1992-93 to \$31,684 in 2000-2001.<sup>13</sup> [See Table II.]

Following sharp increases in health care costs and utilization of medical services over the last two decades, medical services now account for 54 percent of total benefit costs incurred in workers' compensation systems. [See Figure IV.] Only a decade earlier, roughly half of total costs were for indemnity benefits and half were for medical benefits, and in previous decades a majority of costs were for indemnity benefits.

**Composition of Costs.** It is noteworthy that the most serious cases — fatal injuries and PTD — make up less than 11 percent of total benefit costs in the system, as Figure V shows. In contrast, PPD cases, which often involve more subjectivity in evaluating the disability and more discretion about treatment, account for a majority of system costs (nearly 60 percent). PPD cases average \$61,327 per claim and make up 33 percent of all lost-time cases.<sup>14</sup> Note also that these cases often involve disputes between the employees and employers, and result in negotiated settlements with a lump-sum payment. This phenomenon is discussed in greater detail below.<sup>15</sup>

A clear majority of diagnoses in lost time claims are back sprains and other soft-tissue injuries. Sprain of the lumbar region (back sprain) is the most common diagnosis and accounts for 36 percent of all cases that result in lost time from work, which are more serious than claims that require only medical intervention (medical-only claims). [See Figure VI.] The second most common diagnosis is carpal tunnel syndrome (16 percent), a type of soft-tissue injury. Other back-related problems account for an additional 18 percent of all lost time cases.<sup>16</sup>

Over a relatively short period, between 1980 and 1989, back sprains and soft-tissue injuries increased from 45 percent of all lost time claims to more than 50 percent in a 15-state claim sample.<sup>17</sup> In contrast, crushing and fracture injuries declined from 18 percent to 14 percent. Controlling for other factors that potentially could account for these injury trends, such as employment rates in high-risk industries, researchers have found that the increase in back sprains and soft-tissue injuries are related to increases in wage replacement benefits that result in shifting costs to the workers' compensation system.

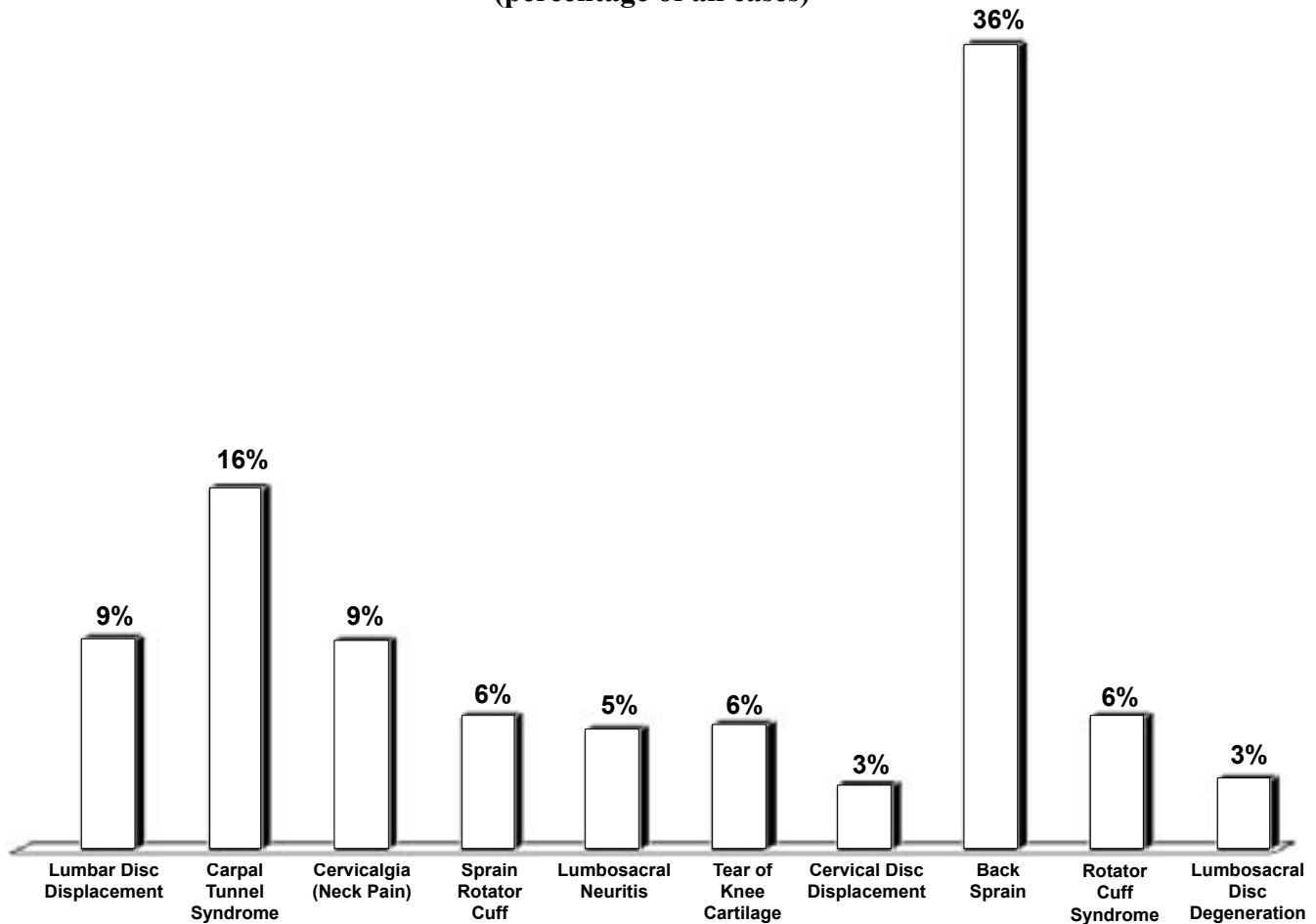
**Coverage When Employees Contribute to Their Injury.** More than 80 years of litigation and legislative changes have failed to definitively resolve the question: Which claims are compensable under workers' compensation?<sup>18</sup> For example:

- In 1918, a Connecticut court found that a worker who died of sunstroke shoveling coal on a hot day was entitled to compensation because of his increased risk of exposure.

*“Back sprains and other soft tissue injuries account for the majority of claims for wages.”*

FIGURE VI

## Workers' Compensation Claims by Type of Injury, 1996-2000 (percentage of all cases)



Source: Harry Shuford, "Carpal Tunnel Claims Rank Second Among Major Lost Time Diagnoses," National Council on Compensation Insurance, NCCI Research Brief, Vol. 3, April 2005.

*"Back sprain is the most frequent injury involving lost time from work."*

- In 1935, a Massachusetts court found that a worker was not entitled to compensation for a foot that froze as he cleaned a street on an extremely cold day, since the risk was no greater for him than for anyone else outside.
- But a 1950s-era New York court decision expanded workers' compensation to cover a worker injured when a workshop collapsed due to an explosion next door, because his work put him at the particular location where he was imperiled.

Furthermore, courts and legislatures have taken a variety of stances on the extent to which workers' compensation should cover injuries when an employee's own behavior contributed to or caused the injury. For example:<sup>19</sup>

- Five states deny coverage for injury resulting from workplace horseplay.

*“Higher benefits raise the number of claims filed.”*

- Thirteen states deny compensation if an injury resulted from a safety rule violation (while various other states reduce indemnity benefits by 10, 15, 25 or 50 percent).
- And in the majority of states, when an intoxicated worker is injured, “the burden of proof is on the employer to demonstrate that the intoxication was the proximate cause of the workplace injury.” (In some states intoxication must be the sole cause, or the worker must be so drunk that he is unable to perform his job duties.)

The reluctance of courts and legislatures to limit benefits for workers whose behavior contributes to workplace injury indicates that the workers’ compensation system is more of an entitlement program than an insurance system. It is health insurance that supplements regular employer-provided health plans and disability insurance that replaces lost wages when an employee is unable to work. Commenting on the above-mentioned New York case, a Kentucky appeals court judge noted that it “...is a big step toward complete coverage of all injuries suffered by an employee during working hours without regard to whether the injury results from risk connected with the employment.”<sup>20</sup>

## **Do Economic Incentives Matter?**

How do workers respond to incentives of the workers’ compensation system? Researchers have found that benefit increases distort their behavior in ways that increase costs. These costs are paid by employers in the form of higher insurance premiums and by employees in the form of lower wages.

**The Effect of Higher Wage Replacement Rates.** The higher the wage replacement rate, the greater the potential economic reward for workers who file claims. Do workers respond to this economic incentive? The evidence suggests that they do. In general, if the financial rewards for making a claim increase, there will be more claims, particularly lost time claims. This is sometimes called “claiming behavior.”<sup>21</sup> Studies have found, for example, that a 10 percent increase in the wage replacement results in:

- a 2.5 percent to 5 percent rise in the total number of claims made,<sup>22</sup>
- a 6 percent increase in the relative frequency of lost time claims,<sup>23</sup> and
- a 7 percent rise in the number of people receiving benefits — due to both the increased number of claims and the longer receipt of benefits.<sup>24</sup>

Conversely, in the 1990s a number of states reduced some types of indemnity benefits. Partly as a result of these changes, the frequency of claims and injuries declined countrywide. The growth in employer costs for insurance also moderated.

The effect of benefit increases on claims is different for employees of larger firms than for employees of smaller firms, according to an analysis of longitudinal data on claims for manufacturing firms from 1979 to 1984.<sup>25</sup> The greatest increase in claims was for establishments with fewer than 100 employees, where each \$50 increase in weekly indemnity benefits raised claim rates by 18 percent. In establishments with 500 or more employees, the same increase in weekly benefits increased injury rates only 4 percent.

Why the difference in the behavior of workers at different size firms? Larger firms are more likely to offer short-term disability benefits apart from workers' compensation. Thus the smaller rise in claims among employees of large firms indicates that workers' compensation indemnity benefits substitute for disability insurance, and the benefits are less valuable to employees if they have alternative short-term disability coverage.

The wage replacement rate affects not only the number of claims filed, but also the type of claims filed. One study found that following an increase in the percentage of weekly wages replaced by indemnity benefits in Texas there was a sharp increase in the percentage of indemnity claims compared to medical-only claims.

Furthermore, a statutory increase in wage replacement benefits is also statistically associated with employees' remaining away from work longer than medically necessary to recover from their injuries. For example:

- A 5 percent increase in the minimum and maximum wage replacement benefits in Minnesota led to an 8 percent increase in the duration of disabilities for employees affected compared to those not affected.<sup>26</sup>
- A 10 percent increase in the maximum weekly benefits for temporary total disability that only affected some high-wage employees in Kentucky and Michigan increased the average duration of disability among the affected employees by 3 percent to 4 percent.<sup>27</sup>

In addition, since workers can receive both workers' compensation permanent total disability benefits and Social Security disability payments, they have a financial incentive to claim that a disability is work-related when their total benefits will be higher than if they receive only Social Security disability.<sup>28</sup>

**The Effect of Longer Required Waiting Periods.** The greatest effect on claiming behavior appears to come from increasing the number of days employees must be absent from work due to an injury before they are eligible for wage replacement benefits. For many workers, the number of days of required waiting equals the number of days of lost pay and hence represents a cost to the worker of filing a claim. Alan Krueger, for instance, found that increasing the statutory waiting period from three days to seven days results in a 39

*“Higher wage replacement increases injured employees’ time away from work.”*



percent reduction in the number of employees receiving workers' compensation benefits.<sup>29</sup>

**The Effect of Permanent Partial Disability Benefits.** Permanent partial disabilities are small but significant residual impairments that are thought to be permanent in nature, such as 10 percent permanent loss of the use of a hand, or 5 percent permanent loss of the use of an arm. Most states base PPD benefits on the impairment rating — they do not consider whether or not the employee with a partial disability returns to work at full or near-full wages, or if the disability affects the employee's future wage-earning capacity. So a worker can receive a lump-sum PPD payment but return to work either in the same job or another one that he is able to perform despite the disability. An increasing and large percentage of claimants with lost time from work now receive PPD benefits after receiving total temporary disability.<sup>30</sup> PPD compensation now accounts for about 60 percent of all system costs. In California and a number of other states, the average impairment rating is less than 15 percent loss of use.

The laws that determine the award associated with an impairment rating are often arbitrary. For example, Virginia's statute provides that a worker who loses a thumb gets a benefit equal to two-thirds of the worker's average weekly wage up to 60 weeks; however, if only the first joint is lost, the benefit is reduced to 30 weeks.<sup>31</sup> In some states, the percentage of wages an injured worker receives depends on whether the injured hand is the worker's dominant one.<sup>32</sup> State agencies publish compensation schedules for partial loss of part of the body and unscheduled permanent partial benefits when the loss of function is not confined to any particular part of the body.

The method used to determine permanent partial disability affects the cost of these claims, and varies considerably from state to state for similar injuries.<sup>33</sup> In a six-state study, California and Texas had the highest percentage of workers' compensation cases that involved lost-time claims (more than

*“An increasing percentage of workers receive benefits for permanent partial disabilities.”*

TABLE III

**Permanent Partial Disability  
as a Percentage of Claims  
(claims with greater than seven days of lost work time)**

	CA	CT	FL	GA	TX	WI
All Diagnoses	53.9%	43.1%	45.0%	43.5%	53.9%	29.1%
Back Sprains/Strains	58.3%	38.8%	49.1%	45.1%	59.2%	20.2%
Fractures	51.0%	58.8%	46.6%	46.1%	54.2%	40.9%

Source: Peter Barth, Mike Helvacian and Te-Chun Liu, “Who Obtains Permanent Partial Disability Benefits: A Six-State Analysis,” Workers Compensation Research Institute, 2002, Table A, page XVI.

50 percent). [See Table III.] These two states, however, have very different methods for compensating PPD claims.

- In California, PPD benefits are generally paid in lump sums and attorneys are involved in negotiating the amount; the wage component of PPD claim costs averaged \$42,624 in 2000.
- In Texas, PPD benefits are generally paid as weekly compensation for wage loss, and attorney involvement is rare; the indemnity component averaged \$19,180.

Fees for the plaintiff's (worker's) attorney are included in these costs, and they account for a significant component of the cost difference between the two states.<sup>34</sup>

**Other Factors Affecting Permanent Partial Disability Claims.** One way in which the workers' compensation system distorts employees' behavior is by encouraging longer disability in order to obtain permanent partial disability (PPD) benefits. Three factors related to features of the state systems affect the frequency of PPD cases. They are (1) the extent to which the state limits temporary total disability, (2) how the state treats back injuries and (3) the amount of the anticipated PPD award.

First, the likelihood of particular outcomes for PPD claims is related to the length of temporary total disability (TTD) claims — which is in turn influenced by state benefit levels and the state's mechanism for ending TTD benefits. States without adequate controls on the length of time a worker receives TTD also have high rates of PPD claims. For example, Texas is among the states with the longest average duration for receipt of TTD and it also has high PPD rates. Nearly all Texas claimants receiving weekly TTD benefits beyond three months go on to receive PPD benefits. There is no clear reason for this outcome, except that it may be more difficult to challenge claimants who file for PPD benefits once they are out of work for an extended period.

The second factor affecting the likelihood of PPD claims in a state is the proportion of back sprain and soft-tissue injury claimants who receive PPD benefits. The greater the percentage of back sprain cases awarded benefits, the greater the percentage of cases in the state that involve PPD claims. Connecticut, for example, has a low rate for back sprains and strains, but a relatively high rate for more objective fracture cases. The overall PPD rate in Connecticut is lower than in the other states compared in Table III, except for Wisconsin. The states that more readily award benefits for back sprains and soft-tissue injuries encourage employees to file for awards and have proportionately more PPD cases.

A third factor is the anticipated size of the PPD award, which is often paid in a lump-sum amount, in conjunction with the degree of litigiousness and attorney involvement in the state systems. The states where attorneys are

*“Workers' compensation benefits encourage employees to remain away from work.”*

frequently used to resolve disputes and to close claims generally have higher PPD rates. A state's litigation rate in workers' compensation cases is affected by many factors, including the anticipated size of the award, the uncertainty associated with receiving it and whether the award will be paid as a lump sum. In many states, the size of the anticipated award is the central issue in litigating claims and in subsequent negotiations between the attorneys representing the employees and employers/insurers. Attorneys representing workers are paid on a contingency fee basis and receive 20 percent to 25 percent of the award, which is generally paid in a lump sum. Plaintiffs' attorneys have a financial incentive to litigate cases if they are relatively certain of a successful outcome and of the size of the anticipated award. Attorney involvement in workers' compensation claims raises both PPD rates and claim costs.<sup>35</sup> The proliferation of lump-sum payments or award of benefits to settle or close claims over the last two decades has caused a surge in the frequency of such cases.<sup>36</sup>

## **Problems Caused by the Current System**

In general, the current system gives rise to six underlying problems: 1) imperfect incentives to create safer workplaces, 2) inability to choose more efficient health coverage, 3) inability to choose more efficient disability coverage, 4) inefficient markets for workers' compensation insurance, 5) lack of portability of insurance coverage, and 6) inability to modify strict employer liability.

These problems result from state laws that prohibit employers and employees from choosing workers' compensation arrangements other than those mandated by the state, and from state controls over the insurance markets.

### **Problem 1: Imperfect Incentives to Create Safer Workplaces.**

In general, the insurance premiums employers pay are actuarially determined to cover benefit and claim management costs in each state. Rating bureaus collect data from private insurers and state funds, and actuarially determine insurance rates by occupation in each state. These rates — quoted as a premium per \$100 of payroll per occupation class — apply when policies are renewed and require approval by state insurance departments.

However, not every employer in the insurance pool has the same incentive to promote safety. Large employers are generally experience-rated — their premiums vary according to employee claims history — relative to losses in the industry or occupation. Employers that have lower than expected losses for their occupation or industry are rewarded with lower premiums than the average for their occupational class when their policies are renewed, and those with greater than expected losses are punished with higher premiums. Employers with large deductible policies and self-insurance have added incen-

*“Employers who self-insure have better incentives to promote safety.”*

tives to promote workplace safety because increases in workers' compensation costs tend to be paid by the employer directly.

Smaller firms, by contrast, pay state-regulated premiums based on occupation; because they are not individually rated, the connection between their workplace safety practices and the premiums they pay is very imperfect. Thus they have less incentive to promote safety. They are also more likely to be in the assigned risk pools because they are unable to obtain private insurance coverage, and pay a substantial assigned-risk premium. Imperfect experience-rating means that these firms do not reap the full rewards of safety improvements; nor do they bear the full cost if safety deteriorates.

### **Problem 2: Inability to Choose More Efficient Health Coverage.**

The workers' compensation system does not allow insurers and employers the flexibility to use cost-control mechanisms that are common in employer-sponsored group health plans. For instance, employer-sponsored group health plans frequently require employees to pay some of the costs through copayments and deductibles. This encourages employees to economize on the use of services. But employees treated under workers' compensation receive medical services at no cost to them.

As a result, treatment costs for similar injuries are higher when paid for by workers' compensation insurance compared to group health plans. A 1996 study that compared medical costs in workers' compensation with employers' group health insurance in Florida, Illinois, Oregon and Pennsylvania found that the average cost of treating the same injuries or conditions was twice as much under workers' compensation as under group health plans.<sup>37</sup> The medical services in workers' compensation were provided under fee-for-service arrangements, while services in group health plans were under a mix of fee-for-service and managed care arrangements. The study found, for example, that back injury cases received treatments over an average of 241 days under workers' compensation compared to 68 days under group health plans, and average payments for treatment were 2.25 times greater (\$2,629 vs. \$1,166) under workers' compensation.<sup>38</sup> The higher costs were entirely due to more service use and a different (more expensive) mix of services in workers' compensation. The researchers attributed the higher costs largely to perverse incentives to maximize the use of medical benefits [see Figures VII and VIII].

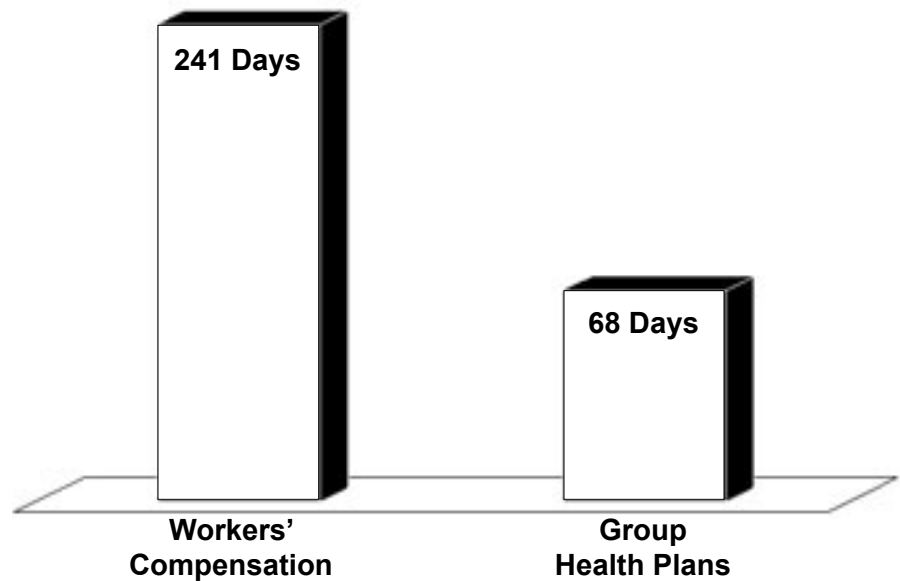
Some of these cost differences may arise from the fact that managed care was not available in workers' compensation until the mid-1990s.<sup>39</sup> Historically, workers' compensation paid medical providers on a fee-for-service basis, which is still the only payment method in 26 states. However, since the 1990s a number of states have allowed managed care networks that reimburse medical providers a fixed amount per covered employee — known as capitation — rather than on a fee-for-service basis.<sup>40</sup> Managed care programs use in-network physicians who receive payment based on the number of employ-

*“Workers’ compensation pays more than group health plans to treat similar injuries.”*

*“Back injuries covered by workers’ compensation take three times longer to treat than under group health insurance.”*

FIGURE VII

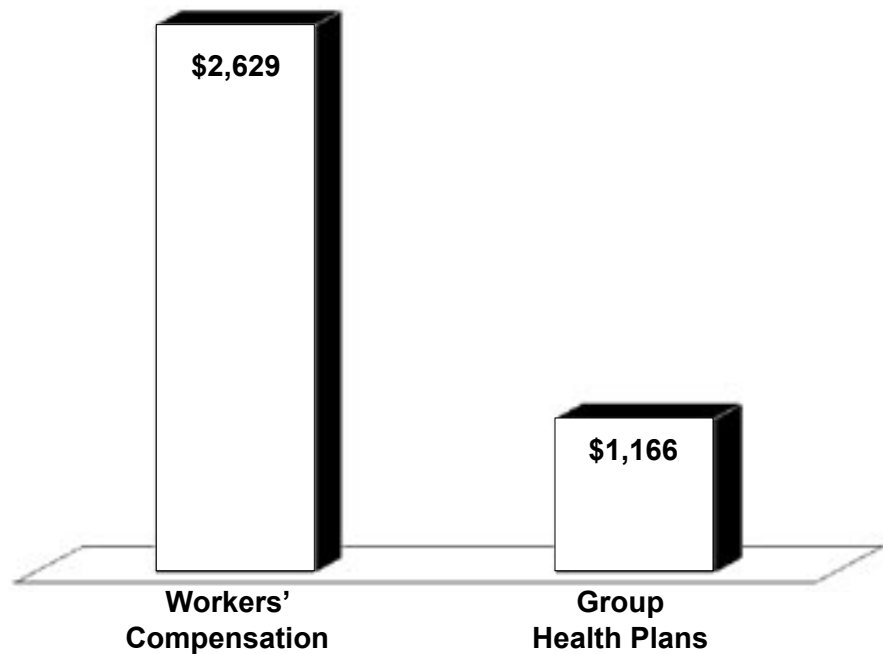
### Number of Treatment Days for Back Injury by Type of Payer



Source: David Durbin, D. Corro and N. Helvacian, “Workers’ Compensation Medical Expenditures: Price vs. Quantity,” *The Journal of Risk and Insurance*, Vol. 63, No. 1, March 1996, pages 13-23.

FIGURE VIII

### Cost of Treatment for Back Injury by Type of Payer



*“Back injuries covered by workers’ compensation cost more than twice as much to treat as under group health insurance.”*

Source: David Durbin, D. Corro and N. Helvacian, “Workers’ Compensation Medical Expenditures: Price vs. Quantity,” *The Journal of Risk and Insurance*, Vol. 63, No.1, March 1996, pages 13-23.

ees covered under the program — called capitated fees — in addition to the number of procedures and types of procedures performed.

Incentives for physicians are different when they are paid on a fee-for-service basis by workers' compensation but receive fixed capitated payments under group health plans. Further, a 1997 study found significant cost shifting by managed care providers to workers' compensation when their services were provided on a fee-for-service basis. The reason: managed care physicians have financial incentives to misclassify claims as compensable under workers' compensation in order to maximize their income.<sup>41</sup>

Instead of using managed care techniques, state workers' compensation agencies attempt to control medical costs through various administrative measures. In the 1990s, state agencies implemented fee schedules for treatment providers. These generally lower the unit cost of services, but providers often respond to the lower fees by increasing the use of services (such as scheduling more office visits) and changing the mix of services (such as ordering more diagnostic tests), with unpredictable results on costs.

However, there is still a wide variation in medical claim costs for treating similar injuries in different areas within a typical state. Costs vary from area to area because the number of services per case vary, and because the number of treatments for similar injuries varies. For similar claims and diagnoses in Texas, for example, workers' compensation medical claim costs were 58 percent higher in Houston than in Austin, with excessive use of services accounting for 76 percent of the differences.<sup>42</sup>

A number of states allow employers to choose the medical providers who treat injured workers, and some of these states allow employees to choose another provider if they are dissatisfied with the employer's initial choice. In employer-choice states, average medical claim costs are lower than in states that do not allow employers to choose.<sup>43</sup> This is because employers have an incentive to choose lower-cost health care providers and to avoid those who shift costs for treating nonwork-related conditions to workers' compensation claims.

**Problem 3: Employers and employees are not allowed to realize gains by choosing more efficient disability coverage.**

Workers' compensation laws prevent employers from offering the same type of coverage that is common in disability insurance markets. Disability insurance could provide direct financial incentives and disincentives to workers for safe behavior and impose financial penalties for unsafe behavior. Such incentives would discourage excessive claim filings, and when a worker is injured, encourage prompt return to work. (Some of these incentives are discussed in greater detail below.) By contrast, the mandatory benefit provisions of the current system (discussed previously) give rise to excessive claims for lost time that are longer than medically necessary to recover from injuries.

*"In Texas, medical costs for treating the same injuries were 58 percent higher in Houston than in Austin, mostly due to excessive use of services."*

Long disability periods also impose substantial financial costs on the workers who make the claims, because statutory benefits do not replace all wage losses — due to statutory waiting periods before employees can start receiving benefits and because a lower percentage of higher-wage workers’ wages are replaced. As a result, benefits typically replace only about half of a worker’s lost wages. Additionally, research indicates that employees who miss work for long periods have lower future wages than others in their cohorts.<sup>44</sup>

**Problem 4: The Market for Workers’ Compensation Insurance Is Inefficient.**

There are a number of inefficiencies in state workers’ compensation insurance markets. As noted, premiums are not fully adjusted for the claim experience of individual firms, particularly smaller ones. This means that small firms with good safety records pay higher premiums than they would otherwise, while firms with poor safety records can pay less than their risk warrants.

In addition, premium rates are regulated by the states, and the time lag created by the rate-approval process destabilizes insurance markets because insurers’ premium revenues do not match their claim losses. At the margin, this encourages insurers to stop writing policies, making the market less competitive.

Smaller firms are more likely to be in a state-assigned risk pool because they cannot find a private insurer willing to sell them a policy, and their cost of insurance is higher than for larger firms. A study by James Chelius and Robert Smith found that workers’ compensation premiums as a percentage of payroll were 53 to 58 percent higher for small firms of less than 500 employees, compared to larger firms.<sup>45</sup> In Texas, where workers’ compensation insurance is voluntary, almost half of the state’s smallest employers (1 to 4 employees) do not participate in the system, versus 20 percent of firms with 500 or more employees. The cost of premiums is a major reason why many of these employers do not participate.<sup>46</sup>

**Problem 5: Workers’ Insurance Lacks Portability.**

If we experience-rate firms, shouldn’t we to some degree experience-rate employees? Today, workers’ compensation premiums are based on the collective claims history of all the firm’s employees rather than individual workers, but it might be possible to reward and penalize workers for their individual behavior.

How? Through individually owned and portable workers’ compensation coverage. Insurance portability refers to the ability of a worker to carry coverage from job to job. Like group health insurance, workers’ compensation coverage is not portable. Today, most health insurance is provided by employers, and the incentive of workers is to consume as much medical care as

*“Small firms aren’t rewarded enough for good safety records.”*

possible — since they have a use-it-or-lose-it benefit. Similarly, in the workers' compensation system, employees have an incentive to consume as many benefits as they can. They have weakened incentives to prevent workplace injuries or to economize on the use of benefits if injured.

### **Problem 6: Inability to Modify Liability.**

Under the current system, employers are strictly liable for workers' injuries, whether or not the worker is at fault. Therefore, workers' compensation pays 100 percent of a worker's medical costs and replaces wages after a short period away from work. The incentive for injured workers is to prolong the period away from work in order to receive cash benefits. But what if workers were willing to trade less complete coverage for higher wages — or other benefits? For instance, they might be willing to agree to pay a deductible toward their medical costs or receive wage replacement only after 90 days away from work if they shared in the resulting premium savings. Since each individual has a different tolerance for risk, workers would make different trade-offs. Under the current system, they cannot do so.

*“Employers are strictly liable for workers' injuries, regardless of fault.”*

## **Making Workers' Compensation Work Better**

Why have workers' compensation at all? If there were no externalities — costs imposed on society as a whole — employers and employees could exercise freedom of contract. Presumably, the willingness to trade off higher wages for a greater risk of injury differs from worker to worker and occupation to occupation. People pursuing their own interests in the private sector made these trade-offs prior to the enactment of workers' compensation laws and they could do so again. They also currently make these trade-offs with wages and other types of benefits and types of occupation. However, workers' compensation arrangements may have external effects on the rest of society. Injured workers without health insurance and disability coverage potentially will rely on Medicaid, Social Security disability insurance and other government programs.<sup>47</sup> When they do so, taxpayers will have to pay the costs of decisions to which they were not a party.

However, we can protect employees' and employers' rights to choose the arrangements that best meet their needs, and society's interest in avoiding additional costs for social programs, without imposing an inefficient system with perverse incentives. If employees and employers have the flexibility to make efficiency-improving changes in workers' compensation coverage, just as they routinely make trade-offs between wages and other benefits in the labor market, the system can be greatly improved. The following recommendations are proposed to achieve that goal. Short of these fundamental reforms, there are some more modest steps that states could take to improve their systems. [See the sidebar, “Some Modest Steps.”]



## Some Modest Steps

Short of fundamental reform, states could make changes that would improve incentives under the current workers' compensation system. Permanent partial disability claims (PPD) are the most contentious cases in workers' compensation. As we have seen, three major factors affect the frequency of PPD cases in a state: the duration of temporary total disabilities (TTD); the percentage of back sprains and soft-tissue injuries that receive payments; and the anticipated size and certainty of the awards. A number of policy reforms may lower the frequency of PPD claims, including better rules and controls to limit the duration of TTD, allowing employers and insurance companies to more rigorously contest soft-tissue injuries and back cases, and changing the rules for compensating attorneys.

In addition, the frequency of PPD could be reduced by the following three measures.

- *Allow periodic rather than lump-sum payments.* In most states, PPD claims are closed with the payment of a lump-sum settlement. The size and certainty of lump-sum payments encourage attorney involvement and litigation, and encourage employees to seek PPD benefits.
- *Use AMA Guidelines to rate impairment.* Despite the fact that a number of states stipulate use of American Medical Association Guides to evaluate physical impairments, the final impairment rating used for such awards is often negotiated with little semblance to the initial evaluation of the impairment. Adhering to the AMA Guides for the final rating of permanent disability would cap the size of the anticipated award, and therefore lower the frequency of claims.
- *Limit attorneys' fees.* Attorneys' contingency fees currently range from 20 to 25 percent of the lump-sum PPD awards. Reducing attorneys' financial incentives would reduce litigation and case frequency. The contingency fee could be based instead on the increment of indemnity benefits attorneys obtain for their clients, rather than on the full amount of the lump-sum award. The increment, in turn, could be based on the employer's initial offer. This would provide the claimants' attorneys with the incentive to obtain the maximum possible benefit for their clients, but also reduce their incentives to litigate claims when the expected gains from litigation are minimal.

### **1. Workers' compensation premiums should reflect real risks on a company-by-company basis, so that employers and employees can realize the full rewards of risk-reducing behavior.**

Small employers and their employees should have the opportunity to fully realize gains from improving safety and reducing claims costs. In most states, self-insurance is a common alternative to private insurance for the largest employers. A number of states also allow group self-insurance. Under this arrangement, mostly smaller employers in the same line of business (for example, restaurants) pool funds to provide self-insurance for their members. A third alternative, large-deductible insurance policies, is also available only

*"Workers' compensation premiums should reflect the risks of individual firms."*

to relatively large employers in a number of states. Similar in concept to self-insurance, employers with large-deductible policies are directly responsible for making claim benefit payments up to an amount (for example, \$250,000) stipulated by the policy. Claim costs in excess of the predetermined amount are covered by the employer's insurance policy.

In many states, smaller firms are not allowed to purchase group coverage or high-deductible policies under which they self-insure for smaller claims. Since the premiums in these cases should better reflect the firms' actual risks, the ability to self-insure is a step in the right direction. These types of insurance arrangements should be allowed in all states.

More should be done, however. Private insurers and state systems should re-rate companies that take steps to reduce injuries and charge them lower premiums. Conversely, higher premiums should be charged when a firm's safety record deteriorates.

## **2. Employers and employees should be able to realize gains from choosing more efficient health coverage.**

Most employer-sponsored health plans do not have first-dollar coverage or allow a completely free choice of physicians and facilities. The reason: there are significant savings from other types of plans. Presumably, these savings are passed along to workers in the form of higher wages and other benefits because employees prefer extra wages and other benefits to a more expensive health plan.

For companies that have employer-provided insurance, we can assume that the health plan reflects the employees' implicit trade-off between wages and health insurance. The reason: employers have to compete for labor by making their overall compensation package as attractive as possible. Therefore there should be no barrier to using the same health plans for workers' compensation claims. The failure to give people this option forces them to take too much worker's compensation coverage and too little in wages and other benefits.<sup>48</sup>

For employers who have no health plan, the law could stipulate what kinds of plans represent a reasonable trade-off between wages and health insurance coverage. For example, any of the plans offered to state employees might be deemed reasonable per se.

State laws and some federal regulations prevent employers (including those that self-insure) from fully integrating workers' compensation with their group health plan.<sup>49</sup> However, so-called 24-hour medical coverage has been tried as a pilot program in a number of states and has a number of advantages. An integrated health care plan would provide both group health and workers' compensation health benefits to employees:

*"Employers should be able to use their regular group health plan to cover injured workers."*

- Employees could use the same provider networks they use for regular health coverage, and they would still have the option to change doctors or go out of network if not satisfied with the services provided.
- Employers and insurers could use the same negotiated fee schedules for work-related injuries and illnesses as under regular health plans, which are generally lower than fees paid by workers' compensation.
- Since employees would pay the same deductibles and copayments as in their regular health plan, there would no longer be any incentive to claim that a nonwork injury or illness is work-related or vice versa.

Savings from the introduction of copayments and deductibles could be passed on to workers as higher wages or other types of benefits.<sup>50</sup> Some employers give workers choices among health plans, allowing those who choose less expensive plans to “bank” the premium savings in Health Savings Accounts (HSAs) from which they can pay small medical bills, or to use the savings to obtain other, nontaxed benefits. Employees could be given a similar choice for their workers' compensation coverage. Employees could “bank” the workers' compensation premium savings in the same HSA as their regular health plan, or purchase other benefits. The premium savings also could go into a disability account (described below).<sup>51</sup>

### **3. Employers and employees should be able to realize gains by choosing more efficient disability coverage.**

As in the case of medical benefits, the current system keeps employers and employees from choosing more efficient ways of delivering income-replacement benefits. It also forces employees to accept too much of their compensation in the form of income-replacement insurance as opposed to higher wages or other forms of compensation. To remedy these problems, the following reforms are needed:

- Employers should be able to create a self-insurance pool and pay claims directly — reserving third-party insurance for catastrophic disability claims — where there are cost savings from doing so.
- Employers should be allowed to offer indemnity benefits with the same waiting periods as their regular disability plans. Allowing companies to offer workers' compensation indemnity benefits under an integrated disability plan would reduce the employers' insurance costs.
- Small employers without disability plans should be allowed to provide a benefit that resembles standard disability policies sold in the state or one that replicates disability benefits available to state employees.

*“Employers should be able to use their regular disability plan to cover injured workers.”*

- Employers should be allowed to offer employees the opportunity to gain from self-insurance on an individual basis. Specifically, employers should be able to offer, and employees should be able to accept or deny, indemnity benefits that deviate from the statutory benefits with regard to waiting period, wage replacement rate, maximum and minimum benefit levels and duration of temporary disability.

For example, in return for an employee accepting a 90-day waiting period, the employer should be able to put the premium savings in an employee-specific disability savings account. The build-up in this account might roll over into a retirement account when an employee is terminated or retires.<sup>52</sup>

In addition to benefiting the employers and employees who take advantage of these opportunities, there are other social benefits. Small-size establishments — particularly in high-risk occupations such as construction — currently rely on self-employed subcontractors who are not covered under the workers' compensation system. Many of these subcontractors carry either no workers' compensation insurance or have inadequate coverage. Their injured workers impose costs on society by utilizing the social safety net, such as Medicaid and Supplemental Security Income. Allowing employers the flexibility to offer disability benefits that deviate from the statutory workers' compensation benefits would entice some subcontract workers back to regular employment.

*“Employees should be able to share premium savings through Workers' Compensation Accounts (WCAs).”*

#### **4. There should be less state regulation of workers' compensation rates.**

Greater deregulation of workers' compensation rates and allowing the alternative insurance arrangements discussed above could also lower employers' premiums for workers' compensation insurance. In the 1990s, a number of states introduced these alternative arrangements, giving some employers a greater choice of insurance coverage.<sup>53</sup> Large deductible policies and group self-insurance made self-insurance more accessible to some businesses. In other states the rate-making process was deregulated, allowing greater leeway to the private carriers in pricing workers' compensation insurance. One state, Nevada, changed its laws and moved from a monopolistic state fund to an open competition state, reducing employers' insurance costs over 25 percent in just a few years. These changes generally moderated increases in employers' insurance costs, and lowered some employers' insurance premiums.

#### **5. The system should evolve so that workers' compensation insurance is individually owned by workers, traveling with them from job to job and selected by them rather than their employers.**

Ideally, every worker should be allowed to make his or her own trade-offs between third-party health insurance and individual self-insurance. Similarly, employees should be able to make their own individual choices between

third-party disability insurance, individual self-insurance and perhaps other choices as well. Moreover, each worker should be able to choose from among plans available in the entire market, rather than a plan selected by an employer. However, employees should have to choose some form of insurance. They should not be able to go bare.

Since the cost of workers' compensation insurance would differ from job to job, employees would be better able to evaluate the trade-off between wages and safety in the job market. Employees with good safety records would benefit financially from lower premium costs and higher wages.

A new type of health benefit, called a Health Savings Account (HSA), is portable.<sup>54</sup> Typically, employers make periodic deposits of pretax funds to the HSAs, which the employees own and control. HSAs are a form of self insurance that gives individuals an alternative to third-party payment of medical expenses. Workers can use the funds in the HSA to pay small medical bills, health insurance deductibles and copayments. Unused funds earn interest and can accumulate until the worker reaches retirement. HSAs give workers a financial incentive to economize on the use of medical services. The HSA is accompanied by high-deductible health insurance that provides coverage for major medical expenses.

Similarly, employers should be allowed to establish Workers' Compensation Accounts (WCAs). The accounts could be funded by savings on premiums from selecting more limited conventional coverage. Individually-owned WCAs are a form of self-insurance that would give workers an alternative to third-party workers' compensation benefits; for example, a worker might self-insure for the first three months of disability.

Any unused balance in the WCA would move with the employee to a different job or could be paid out in cash upon retirement. WCAs would serve two functions: First, they would provide a direct incentive to workers to avoid unsafe behavior and injuries, and to economize on the use of disability benefits when injured. Second, they would allow employees to accumulate funds that can be used to supplement their savings upon retirement. Employers should be allowed the flexibility to explore such alternative insurance arrangements.

## **6. Employers and employees should be able to take advantage of liability by contract.**

Employers and insurers should be allowed to propose, and insurance commissioners should be allowed to approve, arrangements under which employers and employees voluntarily agree to selectively relax strict liability rules in return for lower premiums or higher wages or other benefits; for example, they could agree to a 90-day waiting period instead of the current waiting periods. As long as overriding social concerns are met (we don't want taxpayers to get stuck with the bill), employers and employees should be able to change their liability relationship by contract.

*"Workers' Compensation Accounts could be individually owned and portable."*

Another example of the agreement might state that the employer's liability is strict only if employees follow certain safety rules, and if not, the employee bears some of the costs of the injury. In return for agreeing to such changes, there must be a showing that employees have materially gained.

If a union represents the workforce, such agreements might be deemed reasonable per se. If not, we may want to impose constraints. For example, if employers want workers to accept \$1,000 of exposure, we may have a rule that says they have to deposit at least \$200 in a WCA each year.

## Conclusion

The proposed changes in workers' compensation are designed to promote greater efficiency and improve workers' welfare under workers' compensation systems. Efficiency is promoted when public policy allows employers and employees to write simple and enforceable contracts for workers' compensation benefits as they currently do for wages and other employee benefits. Begun in an era when employee benefits were a rarity, current workers' compensation laws and regulations impede such contractual arrangements. These proposals would also deregulate insurance rates and products so that employers and employees could realize full gains from promoting efficiency. Rewards of efficiency would accrue to employers as lower insurance costs, and to employees as higher wages and choice of benefits that they value most.

*"Employers and employees should be able to write simple and enforceable contracts for benefits."*

NOTE: Nothing written here should be construed as necessarily reflecting the views of the National Center for Policy Analysis or as an attempt to aid or hinder the passage of any bill before Congress.

## Notes

- <sup>1</sup> “Survey of Employer Participation in the Texas Workers’ Compensation System,” Public Policy Research Institute at Texas A&M University and the Texas Department of Insurance Workers’ Compensation Research Group. Available online at <http://www.tdi.state.tx.us/wc/regulation/roc/wcresearchpres.html>. In Texas, in 2004, a significant percentage of employers — 38 percent, covering about 24 percent of the workforce — chose not to subscribe to the statutory system.
- <sup>2</sup> U.S. Department of Labor, “State Workers Compensation Laws: Table 6. Benefits for Temporary Total Disability Provided by Workers Compensation Statutes in the U.S.” Available online at <http://www.dol.gov/esa/regs/statutes/owcp/stwclaw/tables-pdf/table6.pdf>; accessed on March 16, 2006.
- <sup>3</sup> Ibid.
- <sup>4</sup> Ibid.
- <sup>5</sup> Figures on average claim costs by state in this and following bullets, as well as those in the tables, are from the *NCCI Annual Statistical Bulletin, 2004 Edition*, Exhibit XI, page 331.
- <sup>6</sup> Ibid.
- <sup>7</sup> For the latest figures and more detailed analysis on claim frequency see Tony DiDonato and D. Brown, “Workers Compensation Claim Frequency Down Again,” *NCCI Research Brief*, Vol. 1, 2005.
- <sup>8</sup> John F. Burton Jr., “Workers’ Compensation Benefits and Costs in 2003,” *Workers’ Compensation Policy Review*, September/October 2005, pages 15-25.
- <sup>9</sup> “Basis of Rates (1/1/2006 Relatives)” Texas Department of Insurance, Division of Workers’ Compensation; available online at <http://www.tdi.state.tx.us/wc/regulation/wcrate06.html>; accessed on March 22, 2006.
- <sup>10</sup> For detailed information on workers’ compensation systems by state, see “Workers Compensation,” Insurance Information Institute, March 2006; available online at <http://www.iii.org/media/hottopics/insurance/workerscomp/>.
- <sup>11</sup> “High and Low Manual Rates for Selected Classifications,” The Maine Bureau of Insurance; available at <http://www.maine.gov/pfr/ins/workcomp.htm>; accessed on March 27, 2006.
- <sup>12</sup> Total benefit costs in the system primarily determine the employers’ premium, and are made up of frequency of claims (number of claims per covered employee) times average claim costs times the number of covered workers (see sidebar “Glossary of Terms”).
- <sup>13</sup> These are incurred costs, which include payments for medical benefits, wage replacement or indemnity benefits, and permanent disability, as well as claim reserve amounts for open cases.
- <sup>14</sup> Exhibits X, XI and XII, in the *NCCI Annual Statistical Bulletin, 2004 Edition*.
- <sup>15</sup> The negotiations are often conducted between attorneys representing the employees and insurers, and in the case of self-insurance, employers.
- <sup>16</sup> Harry Shuford, “Carpal Tunnel Claims Rank Second Among Major Lost Time Diagnoses,” *NCCI Research Brief*, Vol. 3, April 2005.
- <sup>17</sup> Richard Butler, D. Durbin and N. Helvacian, “Increasing Claims for Soft-Tissue Injuries in Workers’ Compensation: Cost Shifting and Moral Hazard,” *Journal of Risk and Uncertainty*, Vol. 12, 1996, pages 379-93.
- <sup>18</sup> “Legislative Guide to Determining Compensability in Workers’ Compensation: Report and Public Policy Recommendations,” National Federation of Independent Business Research Foundation, September 2005.
- <sup>19</sup> Ibid.
- <sup>20</sup> Ibid.
- <sup>21</sup> Benefit increases may also affect employees’ behavior with respect to workplace safety. Butler and Worrall argue that employees may respond to benefit increases by taking greater risks in the course of performing their jobs, which would result in greater injuries. Richard Butler and J. Worrall, “Claims Reporting and Risk Bearing Moral Hazard in Workers’ Compensation,” *Journal of Risk and Insurance*, Vol. LVIII, 1991, pages 191-204. This real effect, however, may be offset by change in the employers’ behavior to avoid injuries and even greater future increases in the insurance premiums.
- <sup>22</sup> Butler and Worrall also found that a 10 percent increase (or decrease) in weekly indemnity benefits is associated with a cor-

responding 6.8 percent increase (or decrease) in the number of claims filed. Richard J. Butler and John D. Worrall, "Claims Reporting and Risk-Bearing Moral Hazard in Workers' Compensation," *Journal of Risk and Insurance*, Vol. 58, No. 2, June 1991, pp. 191-204.

<sup>23</sup> John D. Worrall and David Appel, "The Wage Replacement Rate and Benefit Utilization in Workers' Compensation Insurance," *Journal of Risk and Insurance*, Vol. 49, No. 3, September 1982, pages 361-71.

<sup>24</sup> Alan B. Krueger, "Incentive Effects of Workers' Compensation Insurance," *Journal of Public Economics*, Vol. 41, No. 1, February 1990, pages 73-99.

<sup>25</sup> John W. Ruser, "Workers' Compensation and Occupational Injuries and Illnesses," *Journal of Labor Economics*, Vol. 9, No. 4, October 1991, pages 325-50.

<sup>26</sup> Alan B. Krueger, "Workers' Compensation Insurance and the Duration of Workplace Injuries," National Bureau of Economic Research, Working Paper No. 3253, 1990.

<sup>27</sup> Bruce D. Meyer, W. Kip Viscusi and David L. Durbin, "Workers' Compensation and Injury Duration: Evidence from a Natural Experiment," *American Economic Review*, Vol. 85 No. 3, May 1995, pages 322-340.

<sup>28</sup> If a worker receives permanent total disability benefits from workers' compensation and qualifies for Social Security disability, Social Security benefits will be limited so that the total does not exceed 80 percent of the worker's current average wages. See "How Workers' Compensation And Other Disability Payments May Affect Your Social Security Benefit," Social Security Administration, SSA Publication No. 05-10018, January 2004. Available at <http://www.ssa.gov/pubs/10018.html#how>.

<sup>29</sup> Alan B. Krueger, "Incentive Effects of Workers' Compensation Insurance," page 95.

<sup>30</sup> States often use the achievement of maximum medical improvement (MMI) as a criterion for ending temporary total disability payments. Workers with residual impairments may then be awarded PPD benefits.

<sup>31</sup> Virginia Code Annotated 65.2-503.

<sup>32</sup> For a more thorough discussion of PPD benefits, see P. S. Barth and M. Niss, "Permanent Partial Disability Benefits: Interstate Differences," Workers Compensation Research Institute, 1999.

<sup>33</sup> This issue received considerable attention in California following enactment in 2002 of a workers' compensation law that sharply raised PPD benefits. California statute AB 749 significantly increased maximum and minimum wage replacement for PPD benefits, and also the number of weeks of PPD payments for each percentage point of permanent impairment. This enactment became a central issue in the gubernatorial recall election, and a new law (SB 899) was approved following the election of Gov. Arnold Schwarzenegger. The new law did not reverse the benefit increases in AB 749, but revised the methods for computing the degree of permanent impairment. This is also the central issue addressed in P. S. Barth, M. Helvacian and T. Liu, "Who Obtains Permanent Partial Disability Benefits: A Six-State Analysis," Workers Compensation Research Institute, 2002. For a more extensive analysis of interstate differences in PPD costs, see N. Michael Helvacian, "Permanent Partial Disability Claims: Policy Recommendations to Reduce Frequency and Costs," *Journal of Workers Compensation*, Vol. 15, No. 2, 2006.

<sup>34</sup> Average cost of a PPD claim with both medical and indemnity components included is \$84,735 in California and \$54,569 in Texas for 2000 policies in the *NCCI Annual Statistical Bulletin*, 2004, Exhibit XI.

<sup>35</sup> N. Mike Helvacian and K. Shim, "Attorney Involvement in Lost-Time Claims," *Journal of Workers Compensation*, Vol. 8 No. 2, 1999.

<sup>36</sup> In these cases, the claimant generally signs an agreement with the insurer/employer whereby he or she releases the insurer/employer from any future liability for indemnity and medical benefit payments related to the case in exchange for a lump-sum payment. The degree of PPD impairment, along with the PPD wage replacement rate, generally determines the lump sum awarded, often negotiated between the claimants' attorney and the insurer/employers. The amount of payment may be subject to approval by the state agency. Some states, among them Texas, do not encourage lump-sum payment of PPD benefits.

<sup>37</sup> David Durbin, D. Corro and N. Helvacian, "Workers' Compensation Medical Expenditures: Price vs. Quantity," *Journal of Risk and Insurance*, Vol. 63, No. 1, March 1996, pages 13 -33.

<sup>38</sup> *Ibid.*, page 17.

<sup>39</sup> Twenty-four states changed their statutes to allow managed care programs. Among these states are California, Florida and New York. But notable exceptions remain, including Illinois and Texas, where payment for medical services is still only on a fee-for-service basis.

<sup>40</sup> In addition to the usual medical services associated with treating work-related injuries, such as physical therapy and chiropractic manipulation for palliative care, many states cover treatments for such work-related (but not necessarily work-caused) illnesses



as mental stress and carpal tunnel syndrome.

<sup>41</sup> Richard J. Butler, Robert P. Hartwig and Harold Gardner, "HMOs, Moral Hazard and Cost Shifting in Workers' Compensation," *Journal of Health Economics*, Vol. 16, No. 2, April 1997, pages 191-206.

<sup>42</sup> Richard Victor and M. Helvacian, "Targeting More Costly Care: Area Variation in Texas Medical Costs and Utilization," Workers Compensation Research Institute, 2002.

<sup>43</sup> These states give employers either the choice or initial choice of physician: Alabama, Arkansas, California, Colorado, Florida, Idaho, Indiana, Iowa, Kansas, Maine, Michigan, Missouri, New Jersey, New Mexico, North Carolina, Oklahoma, South Carolina, Utah and Vermont. For 1999-2000 policies, average incurred medical claim costs were 8.6 percent less in the employer-choice states than in the employee choice states (\$3,865 vs. \$4,230). These figures do not control for types of injury and other state features that can affect medical claim costs.

<sup>44</sup> A large body of recent economic literature published by researchers at the RAND Corporation and their associates explores the percentage of wage loss replaced by PPD benefits over the PPD recipients' work life. This research concludes that PPD benefits to employees who lose significant time from work replaces about 50 percent of the employees' wage loss over a 10-year period. The analysis is based on a comparison of the income of employees who received PPD benefits with their cohorts who were not injured and lost no time from work. For a representative study, see R. T. Reville, L. Boden, J. Biddle and C. Mardesich, "An Evaluation of New Mexico Workers' Compensation Permanent Partial Disability and Return to Work," RAND Corporation, 2004.

<sup>45</sup> James R. Chelsius and Robert S. Smith, "Firm Size and Regulatory Compliance Costs: The Case of Workers' Compensation Insurance," *Journal of Policy Analysis and Management*, Vol. 6, No. 2, Winter 1987, pages 193-206.

<sup>46</sup> "Survey of Employer Participation in the Texas Workers' Compensation System," Public Policy Research Institute at Texas A&M University and the Texas Department of Insurance Workers' Compensation Research Group. Nonparticipating, or non-subscribing, firms are by definition self-insured. However, in Texas they are not required to have reserves to pay losses.

<sup>47</sup> Richard J. Butler, "Lost Injury Days: Moral Hazard Differences Between Tort and Workers' Compensation," *Journal of Risk and Insurance*, Vol. 63, No. 3, September 1996, pages 405-33.

<sup>48</sup> A number of econometric studies have measured the workers' valuation of wages compared to workers' compensation benefits. For example, see W. Kip Viscusi and Michael J. Moore, "Workers' Compensation: Wage Effects, Benefit Inadequacies and the Value of Health Losses," *Review of Economics and Statistics*, Vol. 69, No. 2, May 1987, pages 249- 61.

<sup>49</sup> Currently, in 24 states employers can use the same managed care plan that covers their employees' regular health care, but they are not allowed to charge employees copayments or deductibles. (Fee-for-service coverage is required in 26 states.) Managed care plans lower medical costs and claims frequency in states where they are now used.

<sup>50</sup> Currently, Florida requires a \$10 copayment for all medical services after the claimant achieves maximum medical improvement, and Montana has a \$25 copayment for each subsequent hospital emergency room visit.

<sup>51</sup> HSAs and "cafeteria plans" are gaining wider acceptance and use in group health plans and offer employees a real choice in selecting a health plan that best fits their needs.

<sup>52</sup> The account could also be integrated with an individual unemployment insurance account. See William B. Conerly, "Chile Leads the Way with Individual Unemployment Accounts," National Center for Policy Analysis, Brief Analysis No. 424, November 12, 2002. Available online at <http://www.ncpa.org/pub/ba/ba424/>.

<sup>53</sup> Joseph Shields, Xiaohua Lu and Gaylon Oswald, "Workers' Compensation Deductibles and Employers' Costs," *Journal of Risk and Insurance*, Vol. 66, No. 2, June 1999, pages 207-18.

<sup>54</sup> HSAs are potentially available to every nonelderly American due to provisions of the Medicare Modernization Act of 2003.

## **About the Author**

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From 1993 to 2000, he was on the staff of the National Council on Compensation Insurance (NCCI), Inc., where he served successively as Senior Economist, Director of Claims Research, Director of Research and Chief Economist. Prior to that, he served in economics positions at International Business Machines Corporation, American Telephone & Telegraph Corporation and the National Bureau of Economic Research.

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## About the NCPA

The NCPA was established in 1983 as a nonprofit, nonpartisan public policy research institute. Its mission is to seek innovative private sector solutions to public policy problems.

The center is probably best known for developing the concept of Medical Savings Accounts (MSAs), now known as Health Savings Accounts (HSAs). The *Wall Street Journal* and *National Journal* called NCPA President John C. Goodman “the father of Medical Savings Accounts.” Sen. Phil Gramm said MSAs are “the only original idea in health policy in more than a decade.” Congress approved a pilot MSA program for small businesses and the self-employed in 1996 and voted in 1997 to allow Medicare beneficiaries to have MSAs. A June 2002 IRS ruling frees the private sector to have flexible MSAs and even personal and portable insurance. A series of NCPA publications and briefings for members of Congress and the White House staff helped lead to this important ruling. In 2003, as part of Medicare reform, Congress and the president made HSAs available to all non-seniors, potentially revolutionizing the entire health care industry.

The NCPA also outlined the concept of using tax credits to encourage private health insurance. The NCPA helped formulate a bipartisan proposal in both the Senate and the House, and Dr. Goodman testified before the House Ways and Means Committee on its benefits. Dr. Goodman also helped develop a similar plan for then presidential candidate George W. Bush.

The NCPA shaped the pro-growth approach to tax policy during the 1990s. A package of tax cuts, designed by the NCPA and the U.S. Chamber of Commerce in 1991, became the core of the Contract With America in 1994. Three of the five proposals (capital gains tax cut, Roth IRA and eliminating the Social Security earnings penalty) became law. A fourth proposal — rolling back the tax on Social Security benefits — passed the House of Representatives in summer 2002.

The NCPA’s proposal for an across-the-board tax cut became the focal point of the pro-growth approach to tax cuts and the centerpiece of President George W. Bush’s tax cut proposal. The repeal by Congress of the death tax and marriage penalty in the 2001 tax cut bill reflects the continued work of the NCPA.

Entitlement reform is another important area. With a grant from the NCPA, economists at Texas A&M University developed a model to evaluate the future of Social Security and Medicare. This work is under the direction of Texas A&M Professor Thomas R. Saving, who was appointed a Social Security and Medicare Trustee. Our online Social Security calculator, found on the NCPA’s Social Security reform Internet site ([www.TeamNCPA.org](http://www.TeamNCPA.org)), allows visitors to discover their expected taxes and benefits and how much they would have accumulated had their taxes been invested privately.

Team NCPA is an innovative national volunteer network to educate average Americans about the problems with the current Social Security system and the benefits of personal retirement accounts.

In the 1980s, the NCPA was the first public policy institute to publish a report card on public schools, based on results of student achievement exams. We also measured the efficiency of Texas school districts. Subsequently, the NCPA pioneered the concept of education tax credits to promote competition and choice through the tax system. To bring the best ideas on school choice to the forefront, the NCPA

and Children First America published an *Education Agenda* for the George W. Bush administration, policymakers, congressional staffs and the media. This book provides policymakers with a road map for comprehensive reform. And a June 2002 Supreme Court ruling upheld a school voucher program in Cleveland, an idea the NCPA has endorsed and promoted for years.

The NCPA's E-Team program on energy and environmental issues works closely with other think tanks to respond to misinformation and promote common-sense alternatives that promote sound science, sound economics and private property rights. A pathbreaking 2001 NCPA study showed that the costs of the Kyoto agreement to halt global warming would far exceed any benefits. The NCPA's work helped the administration realize that the treaty would be bad for America, and the United States has withdrawn from the treaty.

NCPA studies, ideas and experts are quoted frequently in news stories nationwide. Columns written by NCPA scholars appear regularly in national publications such as the *Wall Street Journal*, the *Washington Times*, *USA Today* and many other major-market daily newspapers. NCPA scholars also appear on radio talk shows and television public affairs programs. According to media figures from Burrelle's, nearly 3 million people daily read or hear about NCPA ideas and activities somewhere in the United States.

The NCPA home page ([www.ncpa.org](http://www.ncpa.org)) links visitors to the best available information, including studies produced by think tanks all over the world. Britannica.com named the [ncpa.org](http://ncpa.org) Web site one of the best on the Internet when reviewed for quality, accuracy of content, presentation and usability.

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