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Is Workers' Compensation a Model for Unemployment Insurance?

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In the early 20th century, state governments and the District of Columbia set up Workers' Compensation (WC) systems to pay employees' lost income and medical expenses due to job-related accidents. In 1935, the federal government set up the state-administered Unemployment Insurance (UI) system to pay benefits to laid-off workers. Over the decades, WC has evolved as states have experimented with various structures and learned from the experience of others. The UI system, however, remains much as it was in 1935 because its structure is set by federal law.

The success of the 1996 federal welfare reform law highlights the value of state experiments. Prior to that law's enactment, a number of states secured federal waivers that allowed them to change their welfare programs. The most successful state experiments emphasized the "work first" approach later embodied in federal law. In short, the experience of various states helped the entire country find a better way to help those on welfare.

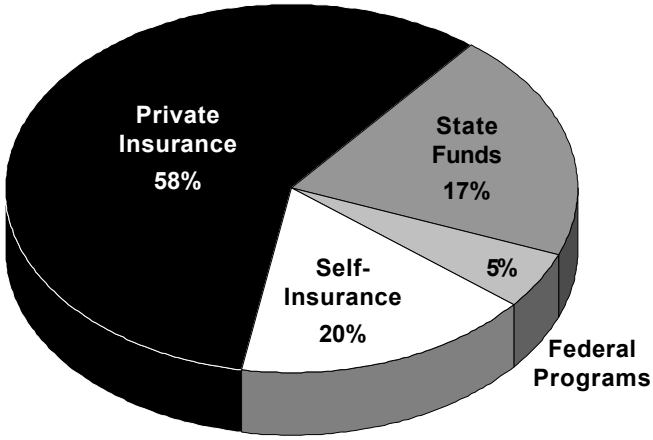
Similarly, if states could receive waivers from UI requirements, they could experiment with new ways to structure the program.

Why Change Unemployment Insurance? There are good reasons to reform the UI system:

- It gives unemployed workers an incentive to engage less intensively in job search activities, leading to longer durations of unemployment.
- Its extended benefits — and the longer periods of unemployment it encourages — do not necessarily enable workers to find higher-paying jobs.
- It increases layoffs by allowing some companies to shift the costs of layoffs to other businesses and workers.

Cost shifting occurs because employers in seasonal or cyclical businesses do not pay a tax rate that reflects their cost to the system. Although UI taxes are "experience rated," meaning that companies pay lower or higher tax rates based on their past employees' UI usage, there is a ceiling on the tax rate. For a highly unstable employer at that ceiling, further layoffs cost nothing. Between 5 percent and 30 percent of all layoffs are caused by the ceiling on UI tax rates, various researchers have found. A 1995 study from the W. E. Upjohn Institute for Employment Research suggests that the UI system may be responsible for 50 percent of all layoffs at the depths of recessions.

Sources of Workers' Comp Coverage (2000)



Source: U.S. Department of Labor.

Another compelling reason for UI reform is that tax rates for many businesses are higher than necessary because UI claims are "socialized." The largest number of socialized claims is from companies at the maximum tax rate that do not bear the full cost they create for the UI system. Other claims are not charged to an employer because workers shift from one job to another and a portion of their benefits are not charged to either. A third source of socialized costs is companies who do not pay their "share" of costs because they go out of business. In 1997, these excess benefits ranged from a low of 15 percent of total benefits (New Hampshire) to a high of 58 percent (Mississippi). Through reduced compensation, workers pay these socialized costs.

How Workers' Compensation Differs. Although federal law does not require them to do so,

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all 50 states have Workers' Compensation systems. Each state has designed its own system. Some are now experimenting with alternative structures, while others are copying successful programs in order to improve the system over time.

Depending on the state, an employer secures WC coverage through private insurance, a state WC fund or self-insurance. Private insurance accounts for the majority (58 percent), but self-insurance (20 percent) is the most rapidly growing option. [See the figure.] For the year 2000:

- In 26 states, employers could participate in a public fund or carry private insurance.
- Employers had to carry private WC insurance in 20 states, and five states required employers to pay into a public fund.
- Of 46 states that allowed private insurance, all but two allowed self-insurance or group self-insurance.
- In Texas alone, employers could opt out of the WC system, but those who did were exposed to tort law liability.

There has been a trend toward deregulation of the private WC insurance industry. Since 1980, the number of states where insurers are free to set their own rates, called "open competition," has increased from one to 37.

In states with private insurance, often a residual market operates like an assigned risk pool in automobile insurance. The size of the residual market indicates the extent to which insurers are prevented from pricing each employer's coverage according to that employer's risk. The residual market's share of total WC premiums shot up in the 1980s, peaking at 28 percent in 1992. Since then, the residual market has dropped sharply and represented only 4 percent of total premiums in 1998.

Benefits of State Workers' Comp Reforms. Recent statistics suggest WC changes have been successful:

- The rate at which workers are injured has been falling steadily over the last decade.
- The cost of workers' compensation coverage per $100 of payroll has declined in the last decade.

Lower accident rates are partially due to decreased regulation, since market insurance rates reflect the risk of injury for particular employers and thus provide strong incentives to improve workplace safety.

In contrast to WC, the UI system is basically a monopoly insurance fund. Employers are assessed taxes equal to a tax rate times their taxable payroll. Former employees receive UI benefits from the state fund. The entire schedule of tax rates shifts up or down, based on the adequacy of the entire fund to pay benefits.

A Model for Reform. UI would look more like the dynamic, adaptive WC system if the federal role were limited to oversight, with the details of providing coverage left to the states.

The states should allow employers to opt out of the present system, either through private insurance or self-insurance — guaranteeing UI payments by posting a bond or carrying third-party insurance. Companies should be allowed to administer claims themselves or contract for claims administration. Private UI insurance should be allowed, with free entry and exit and no rate regulation. States could continue to set minimum UI benefits, but employers and insurance companies could choose more generous benefits or bonuses for rapid reemployment.

Flexible State Systems Lead to Innovative Approaches. A private insurer or a self-insured employer might offer wage subsidies in lieu of UI benefits, similar to the JOBS Plus program Oregon has used for both welfare recipients and unemployed workers. UI programs might realize substantial savings through active case management to help unemployed persons find work.

Another possible reform is to put the UI tax revenues into individual accounts. Workers who are more diligent in finding work would build up balances that could be rolled into a retirement plan. This would eliminate the current disincentive to search for a new job. Interestingly, Chile has just initiated such a program, integrated into individual accounts for Social Security.

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