

## *Chapter VIII*

# SIX STEPS TO IMPROVE WORKERS' COMPENSATION<sup>1</sup>

Workers' compensation is often neglected in discussions of state health care reform. That is unfortunate. Employers who think they have achieved real savings after a significant change in their group health insurance plan often discover their lower health insurance costs are partially offset by higher workers' compensation costs. The reason: Employees often exercise discretion (even if they are not supposed to do so) in choosing whether to file a claim for a medical condition under workers' compensation or under group health insurance. Thus, when employers make health insurance coverage less attractive, often their workers' compensation claims rise instead.

Although each state has its own workers' compensation system, when a worker is injured on the job or has a work-related illness, all states provide three basic types of benefits: (a) coverage of medical costs, (b) replacement of lost wages and (c) payment for death or dismemberment. 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 claim costs. Every state holds employers strictly liable for all the costs of medical treatment and lost wages, with few exceptions. (Some state courts have held employers responsible even when an employee was drunk or high on drugs when the accident occurred!)

Ironically, although workplaces have become much safer in the last several decades and job-related injuries have declined, the cost of state-mandated workers' compensation insurance has not experienced a parallel decline. Instead, costs have soared.<sup>2</sup> Costs are increasing because state systems provide incentives for employers, employees and others to behave in ways that cause costs to be higher than they otherwise would be. Although the goal of workers' compensation is to protect workers, the costs of the system are ultimately paid by employees in the form of lower wages. Conversely, cost-reducing improvements in the system will ultimately lead to higher wages.

In general, the current system has six underlying problems: 1) employers and employees are unable to choose more efficient health coverage; 2) employers and employees are unable to choose more efficient disability coverage; 3) employers face imperfect incentives to create safer workplaces; 4) there is an inefficient market for workers' compensation insurance; 5) there is a lack of portable insurance coverage; and 6) employers and employees are unable to modify strict employer liability by contract. The following is a discussion of how these problems might be solved.

### **Step No. 1: Expand Health Insurance Options.**

Group health plans frequently require employees to pay some of the costs of their health care spending directly through copayments and deductibles. This encourages employees to economize on their use of medical services and avoid wasteful overconsumption. By contrast, under work-

ers' compensation, employees typically face no copayments or deductibles. As a result, when they (and the doctors who treat them) obtain excessive tests, schedule excessive doctor visits and abuse the system in other ways, the costs of their overconsumption are borne by others. Unsurprisingly, treatment costs for similar injuries are higher when paid for by workers' compensation insurance compared to group health plans.<sup>3</sup>

Ideally, employers and employees should be able to cover workers' compensation claims under the employer's regular health plan. And, absent state and federal laws, fully integrating workers' compensation into group health plans would probably be the norm.<sup>4</sup>

The argument for using the employees' group health plan (or choice of plans) for workers' compensation is straightforward. Employee benefits are a substitute for wages. Employee health plans can always be made more generous, at the price of lower wages. They can be made less generous in return for higher wages. The trade-off between money spent on health insurance and money spent on wages is currently determined in the labor market.

Employers who find a more worker-pleasing way to spend the employees' total compensation cost will have an edge in the competition for labor. Workers presumably prefer compensation packages to which they voluntarily agree to benefits chosen by state legislatures. Thus, employers and employees should have the option to choose higher wages or other benefits instead of first-dollar coverage of treatment costs under workers' compensation.

Accordingly, any employer-provided health plan that has been agreed to as a part of a union contract or that has survived the market test in the competition for employees should be de facto adequate for workers' compensation as well. If employers do not have a group health plan, the legislature or department of insurance could designate a list of acceptable plans from among those common in the labor market. For example, any of the plans offered to state employees might be deemed reasonable per se.

Integrated health care plans would provide both group health and workers' compensation medical benefits to employees. They would have the following advantages:

- Employees could use the same provider networks for job-related injuries they use for regular health coverage, and in most cases they would have the option to change doctors or (for an additional fee) 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 — fees that are generally lower than those 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.
- Where workers are given a choice of health plans, they would be able to choose a single plan to cover both types of health needs.

Savings from the introduction of integrated health plans would be passed on to workers as higher wages or other types of benefits. Some employers allow employees to choose less expensive plans and “bank” the premium savings in Health Savings Accounts (HSAs), from which they can pay small medical bills. Employees could be given a similar choice for their workers' compensation coverage. Alternatively, employees could use the workers' compensation premium savings to purchase other benefits or make deposits into a disability account (described below).

## **Step No. 2: Expand Disability Insurance Options.**

Employers are also prevented from integrating workers' compensation wage replacement benefits with their regular disability insurance. This is

unfortunate. Compared to private disability policies, workers' compensation generally has a shorter waiting period before a claim can be filed and often has a lower wage replacement rate. Workers' compensation disability benefits typically replace only about half of a worker's lost wages, and employees who miss work for long periods earn lower wages afterward.<sup>5</sup>

As with 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 more of their compensation in the form of income-replacement insurance, when they might prefer higher wages or other benefits. There are significant premium savings from choosing longer waiting periods (for example, 30, 60 or 90 days) before insurance eligibility for income-replacement insurance. The choice of a longer waiting period requires a willingness to self-insure for a certain number of days, after which the employee relies on disability insurance. These same choices should be available under workers' comp. To remedy these problems:

- Employers should be able to self-insure and pay disability claims directly — reserving third-party insurance for catastrophic claims.
- Employers should be allowed to integrate workers' compensation wage replacement benefits with their regular disability plan so that employees face the same waiting periods and wage replacement rates whether an injury or illness is work-related or not.
- 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.

As with the health insurance reform discussed above, the costs savings from these reforms would be used to pay higher wages or applied to other benefits.

Also, employers should be allowed to offer, and employees to accept, options for employees to self-insure for some of their disability costs. For

example, in return for a worker accepting a disability plan with a 90-day waiting period, the employer should be able to put the premium savings in a disability savings account that belongs to that employee. The build-up in this account might roll over into a retirement account when the employee leaves the company or retires.<sup>6</sup>

### **Step No. 3: Free the Actuaries.**

In general, the insurance premiums employers pay cover benefit and claim management costs in each state. Rating bureaus collect claims data from private insurers and state funds and determine actuarial insurance rates by occupation. 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 histories. Employers that have lower-than-expected losses for their occupation or industry are rewarded with lower premiums. Those that have higher-than-expected losses are penalized with higher premiums.

Smaller firms are generally not experience-rated, however, and tend to pay state-regulated premiums based on occupational categories alone. Firms that are not individually rated do not reap the full rewards of safety improvements, nor do they bear the full cost if safety deteriorates. Thus they have less incentive to promote safety. To correct this problem, 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. Private insurers will naturally experience-rate employers in this way, if they are allowed to do so.

### **Step No. 4: Free the Employers.**

A number of inefficiencies exist in state workers' compensation insurance markets. These inefficiencies primarily arise because employers are not able to choose more cost-effective forms of insurance.

In a number of states, large employers have access to high-deductible policies under which they self-insure for smaller claims. These employers have added incentives to promote workplace safety because they pay workers' compensation costs directly and thus directly benefit from a reduction in claims costs. However, in many states, smaller firms are not allowed to self-insure. Texas is an exception.<sup>7</sup> Any Texas employer can self-insure, and 43 percent of the state's smallest employers (1 to 4 employees) do not participate in the state workers' compensation system, in contrast to 21 percent of firms with 500 or more employees.<sup>8</sup> [See the sidebar on Workers' Compensation in Texas.]

### Step No. 5: Free the Workers.

Workers' compensation premiums are based on the collective claims history of all a firm's employees rather than individual workers. Workers could be rewarded or penalized for their individual behavior, however, through workers' compensation coverage that is individually owned and portable, traveling with the employee from job to job. Workers who know they will be financially rewarded for a good safety record and low claims costs or penalized for a poor safety record and high claims costs have incentives to prevent workplace injuries or to economize on the use of benefits if injured.

A step in the direction of portability would be to allow employers to establish Workers' Compensation Accounts (WCAs) for each employee who agrees to select more limited, conventional coverage (see below). The WCA could be funded by the employer's savings on insurance premiums. 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. A model for WCAs can be found in Chile, which has successfully combined three major

## Opting Out of Workers' Compensation in Texas

Texas is the only state that freely allows employers to opt out of the workers' compensation system.<sup>1</sup> Employers in the system must purchase a workers' compensation policy from a licensed insurance company, be certified to self-insure by the Texas Department of Insurance or be a member of an approved self-insurance group.<sup>2</sup> Firms that do not participate in the system, called "nonsubscribers," can make a variety of alternative arrangements, including integrating treatment of injured workers with their regular health plans and wage replacement benefits with their disability plans.

Nonsubscribing firms can also "go bare." That is, they make no alternative arrangements and take the chance that they will not be held liable in court for a worker's injury. The liability of nonsubscribers is unlimited under the traditional tort liability system, if an injured employee can prove in court that the employer was negligent. On the other hand, firms that participate in workers' compensation are held strictly liable for injured workers' medical expenses and lost wages, regardless of fault, but there are limits on the compensation workers receive.

Whereas the workers' compensation system pays the cost of legal representation for participating employees, attorneys for workers who sue nonsubscribing employers receive compensation only if their litigation is successful. Thus the workers' compensation system encourages attorney involvement, while the tort liability system discourages the pursuit of weak cases. Only 3 percent of nonsubscribers report being sued over a work-related injury in a five-year period.<sup>3</sup>

The most common reasons Texas employers cite for opting out is the increasing cost of workers' compensation insurance. According to the most recent data from the Texas Department of Insurance:

- About 37 percent of Texas businesses, employing 23 percent of Texas workers, opted out of the workers' compensation system in 2006.



- In the past, nonsubscribing employers were mostly smaller-size firms, but in more recent years the largest employers — firms with more than 500 employees — are increasingly opting out, rising from 14 percent in 2001 to 26 percent in 2006.

What difference does nonsubscription make? One study found that the nonsubscriber option helps Texas employers control workers' compensation costs.<sup>3</sup>

- Accident frequency was slightly greater among nonsubscribing firms than subscribing firms.
- However, subscribing firms had 10 percent to 50 percent more lost days from work (per occurrence) than nonsubscribing firms.
- In about half of industries examined in the study, payments for lost time (indemnity costs) were less for nonsubscribing firms than subscribing firms, ranging from 0.5 percent lower in the personal services industry to 169 percent less in food stores.

Finally, the study concluded that litigation costs per employee (combined employer and claimant legal expenses) were similar, though slightly higher for nonsubscribing firms than subscribing firms (\$9.20 and \$9.02, respectively). Thus, although the Workers' Compensation system is supposed to be an alternative to the tort liability system for subscribing firms, they still incurred significant legal expenses.

<sup>1</sup> N. Michael Helvacian, "Workers' Compensation: Rx for Policy Reform," National Center for Policy Analysis, Policy Report No. 287, September 2006. Available at <http://www.ncpa.org/pub/st/st287/>.

<sup>2</sup> See "Information for Workers' Compensation Nonsubscribers," Texas Department of Insurance, revised March 2006, available at <http://www.tdi.state.tx.us/consumer/cb007.html>.

<sup>4</sup> Joseph Shields and D.C. Campbell, "A Study of Nonsubscription to the Workers' Compensation System: 2001 Estimates," Research and Oversight Council on Workers' Compensation, February 2002.

<sup>5</sup> Richard Butler, "Lost Injury Days: Moral Hazard Differences Between Tort and Workers' Compensation," *Journal of Risk and Insurance*, Sept. 1996, Vol. 63, No. 4, pages 405-433.

employee benefits into one integrated system that covers unemployment, disability and retirement benefits. [See the sidebar on disability insurance in Chile.]

### **Step No. 6: Allow Liability by Contract.**

Today, 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, workers might be willing 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, different employees would likely make different trade-offs. Under the current system, they cannot do so.

Such an agreement might state that the employer's liability is strict only if the employee follows 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, some constraints could be imposed. For example, if employers want workers to accept \$1,000 of exposure, the rules could say the employer has to deposit at least \$200 in a WCA each year.

Disability insurance also could provide direct financial incentives 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 a prompt return to work.

## Private Disability Insurance in Chile

Twenty-five years ago, when Chile replaced its traditional social security retirement system with one in which workers contribute to investment accounts they individually own, it also reformed its disability insurance system.<sup>1</sup> Like the old age system, the new disability system is prefunded, so each generation covers its own disability costs. Workers make additional contributions to their retirement accounts to cover the contingency of disability, and they pay fees for group disability policies for any portion of their wages that can't be replaced from their accounts (up to 70 percent of their average wage).

Since workers partially fund their own disability benefits from their accounts, they have less incentive than American workers to claim disability. The private pension funds that handle their investment accounts and the insurance companies that provide group coverage participate in the process of assessing workers' disabilities, and they financially benefit from controlling costs. Workers also benefit from this private-sector participation through lower premiums for the disability insurance. This has led to lower disability rates and costs in Chile than in other countries or under the old system. For example, the disability rate among middle-aged workers in Chile is less than half that of U.S. workers and less than one-third that of western Europeans. Insurance costs for disability in Chile would be four times greater without investment accounts.

More recently, Chile introduced a new unemployment benefit system, which also combines group insurance with investment accounts in which workers save for spells out of the workforce. As with the disability accounts, any unused funds roll over into workers' retirement accounts.

Although Chile currently uses a different system for workers' compensation, the same principles of prefunding and individual savings apply. Wage replacement benefits under workers' compensation, disability, unemployment and early retirement are close substitutes. If workers fund their own benefits, they have greater incentives to stay in the workforce and do not have perverse incentives to claim benefits unnecessarily.

<sup>1</sup> Estelle James and Augusto Iglesias, "Integrated Retirement and Disability Systems in Chile," National Center for Policy Analysis, Policy Report No. 302, September 2007.

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### Notes

- 1 Adapted from N. Michael Helvacian, “Workers’ Compensation: Rx for Policy Reform,” National Center for Policy Analysis, Policy Report No. 287, September 2006. Available at <http://www.ncpa.org/pub/st/st287/>.
- 2 “Basis of Rates (1/1/2006 Relatives),” Texas Department of Insurance, Division of Workers’ Compensation; available at <http://www.tdi.state.tx.us/wc/regulation/wcrate06.html>. Accessed March 22, 2006.
- 3 David Durbin, D. Corro and N. Michael Helvacian, “Workers’ Compensation Medical Expenditures: Price vs. Quantity,” *Journal of Risk and Insurance*, Vol. 63, No. 1, March 1996, pages 13-33.
- 4 See N. Michael Helvacian, “Workers’ Compensation: Rx for Policy Reform.” 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.
- 5 A RAND Corporation study concludes that permanent partial disability (PPD) benefits to employees who lose significant time from work replace 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. 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.
- 6 In Chile, workers who contribute to personal retirement accounts also self-insure for about half of their disability benefits, on the average, although compensation for work-related illnesses and injuries are handled differently. See Estelle James and Augusto Iglesias, “Integrated Retirement and Disability Systems in Chile,” National Center for Policy Analysis, Policy Report No. 302, September 2007. Also, a worker’s compensation account could 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 at <http://www.ncpa.org/pub/ba/ba424/>.
- 7 “Workers’ Compensation,” Insurance Information Institute, August 2007.
- 8 “Survey of Employer Participation in the Texas Workers’ Compensation System: 2006 Estimates,” Texas A&M University and the Texas Department of Insurance Workers’ Compensation Research Group, October 2006. Available at [http://www.tdi.state.tx.us/reports/wcreg/documents/Employer\\_Participati.ppt](http://www.tdi.state.tx.us/reports/wcreg/documents/Employer_Participati.ppt). Nonparticipating, or nonsubscribing, firms are by definition self-insured. However, in Texas they are not required to have reserves to pay losses.