Policy Dialogue

Workers Compensation Reform: Finishing the Job in Massachusetts

On December 10, 1996, Pioneer Institute introduced its latest book, ***Toward a Safer Workplace: Reform and Deregulation of Workers Compensation****, by* ***James R. Chelius*** *and* ***Edward Moscovitch****. In 1991, Massachusetts addressed the growing crisis of its workers compensation system by enacting a set of reforms that tightened eligibility requirements, streamlined the adjudicator system, and reduced the amount and duration of benefits to injured workers. While most would agree that these reforms have been a success, there is more to be done. After examining workers compensation systems in other states, the authors posit that Massachusetts can finish the job it started in 1991 by deregulating insurance rates, creating incentives that make workplaces safer and encourage employees to return to work in a timely fashion.*
Our forum participants were:

> ***Gloria Larson*** *(moderator), Foley, Hoag, & Eliot*
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> ***James Chelius****, professor of human resources management, Rutgers University*
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> ***Edward Moscovitch****, president, Cape Ann Economics*
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> ***Howard Mahler****, vice president and actuary, Workers Compensation Rating and Inspection Bureau of Massachusetts*
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> ***Steven Bent****, executive director, Texas Association of Responsible Non-Subscribers (TXANS)*

In the following pages, Pioneer Institute has reproduced an edited transcript of the forum.

Larson: When Governor Weld brought me to Massachusetts in 1991 to be Secretary of Consumer Affairs and Business Regulation, one of my responsibilities was to set workers compensation rates in the state. No system of government-regulated cost was more out of control in 1991 than the runaway train that was workers compensation. Between 1985 and 1991, costs had tripled from $800 million to $2.5 billion and the adjudicator system had become a slow and costly process. Two thirds of the premiums had been dumped into an assigned risk pool by insurers who, despite double-digit increases for the past three years, could not adequately cover their cost of doing business. When I met with the insurance company executives, they told me that if they did not see a 46 percent increase in 1992, they were going to leave the state. If we had agreed to that kind of increase, we would have had a riot on our hands when Massachusetts employers got their 1992 workers compensation bills.
This crisis was the catalyst for the bipartisan reforms passed in 1991. We tightened eligibility requirements to target fraud and abuse, revamped the adjudicator system, and put the appropriate emphasis on workplace safety.
We have seen great results; a dramatic drop in claims, a clearance of the case backlog, and consecutive double-digit rate decreases. Our rates have gone from the top of the heap to the middle of the pack compared to other states. The assigned risk pool has been reduced to less than 50 percent of the premiums and is now actually running at a small profit.
In their new book Toward a Safer Workplace: Reform and Deregulation of Workers Compensation, Jim Chelius and Ed Moscovitch look at reforms enacted in other states in order to help us build on our success. The prescription includes increased workplace coverage for employees, more emphasis on safety and return to work, and deregulating premium pricing.
Chelius: Massachusetts passed the first workers compensation law in 1911. It is a system that benefits both employers and employees by relying on powerful yet subtle market incentives. If it had been invented in the 1930's, it would probably have been just another government program, but because of its early twentieth centuries origins it relies on the private sector to get the job done.

It is a great program that occasionally gets out of kilter, as happened in Massachusetts during the late 1980's. That crisis led to the 1991 reforms, which have been a remarkable success. But there is more to be done. There are two basic areas that we need to address: insurance market deregulation and the structure of benefits.

The current system basically treats the workers' compensation insurance industry like a regulated utility. Telecommunications, financial services, even the interstate bus systems have been deregulated and rely on the private market. There is no reason why the private market cannot be utilized in workers' compensation and insurance pricing. All the advantages of vigorous competition that we have seen in so many areas of our economy where the marketplace has been reintroduced could be achieved for workers' compensation.

The problem with government pricing is that it is very difficult for government to get the price right. The private sector doesn't always get the price exactly right either, but there are natural forces in the system that move it in the right direction. If prices get too high, more companies aggressively seek out the market share that will drive that price down. If prices get too low, there are forces to bring them up.

Insurance pricing is not just a supplement to the workers' compensation system. The power of the system is imbedded in the subtlety of its pricing. What causes employers to do a good job is in large part the rewards that they can achieve through the workers' compensation system.

We have a system of safety regulation in this country that is broad and diverse. Most people think of the Occupational Safety and Health Administration (OSHA) as the agency in charge of regulating safety, yet studies show that the workers' compensation system has had a much greater effect on workers' safety than OSHA. The billions of dollars flowing through the compensation system has had a powerful effect on employee safety. We want to introduce changes that will enhance that system so it better serves workers and employers.

Moscovitch: I would like to make three basic points: One, that the 1991 reforms were a success; two, that the most important goal of workers' compensation is to improve safety; and three, that there is more we can do to improve our benefit system.

One of the reasons we know that Massachusetts can do better comes from the comparison with what happened in other states. Oregon and Texas reformed their systems around the same time we did. Premiums were reduced by about the same amount in all three, but Oregon and Texas raised benefits to those workers who had the most serious injuries. We cut them.

To address the problems with workers' compensation in his state, Oregon's Governor summoned representatives from labor and management, locked them together in the basement of the Executive Mansion, and said, "You're not getting out of here until you have come to an agreement. I will back whatever you agree on."

The deal they came up with is a very instructive one. Labor's main concern was workplace safety. They wanted on-site safety committees and more safety inspectors. Management agreed, and in return got an objective definition of what constitutes an injury and the right to use managed care. It has worked to everyone's advantage. The message is that the system is for workers and management. Doctors, lawyers and others are important, but their role is to serve.

The best way to reduce costs is to have fewer accidents, and doing that is surprisingly easy. First, there is a tendency to think of it as the insurance carrier's job. But the employer is in the position to make the most difference. Let me give you a couple of examples.

Most of the injuries reported to the Department of Mental Retardation are back injuries, staff working with patients who cannot move themselves. To reduce the number of claims, they bought raised platforms so that people changing diapers or washing patients no longer have to lean over to do their work. Their costs are down by 60 to 70 percent.

A common category of injury comes from people carrying sacks on their back. The softer and larger the sack, the more likely the injury. The supermarket industry has started urging suppliers to package their goods in rigid cardboard containers and limit the weight of each package. This inexpensive solution has caused an enormous decrease in the number of accidents.

Better management of back-to-work is another way to control costs. Employers who do the "right" thing on a personal and moral basis also tend to have lower costs. If you're the sort of employer who pays no attention to the injured employee, and upon her return makes it clear that you want her to get lost, you should not be surprised if she seeks to prolong her absence. On the other hand, if you take her to the doctor, make sure she is cared for, assure her that she will continue to receive an income, and that you will bring her back to work as quickly as possible within the constraints of her injury, there is no opportunity for that kind of bitterness to develop. In addition to treating her right, it will probably cost less.

Medical rates in Massachusetts are artificially low. Forcing people to have second-rate care is not the right way to save money. One of the things that was wrong with regulating rates was that we artificially held rates down for the most dangerous employers and forced the safest employers to subsidize them. One of the strongest reasons to deregulate is to ensure that employers pay the full consequence of not investing in safety, and that safe employers can reap the benefits.

The wage replacement system in Massachusetts is simple. The longer you stay out of work, the longer you receive benefits. The way to demonstrate that you are seriously hurt is to make sure that you do not go back to work. This clearly sets up a perverse incentive.

In Oregon and Texas, once you have reached your maximum recovery, an objective diagnosis is made of the seriousness of your impairment. Based on the degree of impairment, a determination is made about the duration of benefits, regardless of when the employee returns to work. The biggest advantage of the approach is that it provides an incentive to the worker to put the incident behind him. If you go right back to work, you can build up a little nest egg, but there is no advantage to prolonging the absence.

There are disputes in those states about how seriously impaired people are, but not about whether the recovery period has ended. In Massachusetts, we argue about whether a worker is recovered and can go back to work. We need a system that provides an incentive for returning to work.

Mahler: There is currently rate competition for workers' compensation in Massachusetts. While there is a single set of manual rates that serve as the starting point, what employers actually pay depends, to some extent, on which insurer he chooses. Deviations are allowed, but only downward. They must be filed with and approved by the Division of Insurance. If an employer is on a dividend program, his actual experience will be considered and he can get a dividend at the end of the year. Those on a retrospective rating program can pay more or less, depending on what their experience has been.

There are many ways in which insurance carriers are competing for business based on price. This is especially true for larger employers or larger insurers. There is competition, with a common starting point. Many smaller employers, and employers in the residual market pay the manual rate.

In moving to rate deregulation in workers' compensation, there are lessons to be learned from what happened in commercial auto insurance in Massachusetts during the 1980s. In 1981 competitive rating was introduced for commercial automobile insurance, which meant that individual insurers could file their own rates, have them approved by the Division of Insurance, and use them. The Commissioner left a lot of lead time so people knew during the previous autumn that competitive rating would take effect in July. All effected parties had time to prepare, and we implemented some transitional rules.

During the transition to competitive rating, it is important to keep a long range eye on the residual market, clients assigned to an insurance company as opposed to voluntary insurance contracts. At the time of the commercial auto reform, the rates were more or less adequate, which provided a good starting point for deregulation. But not enough thought was given to the long term health of the residual market. Insurance companies were charging drivers in the residual market the same rates as their voluntary insureds, even though insureds in the residual market had worse safety records and more claims. As a result, the market ran a deficit. This made no sense and was not fair to the drivers or the insurers. The same is true for workers' compensation.

The money to subsidize unsafe employers came from insurance companies, who were forced to charge the safer insureds higher premiums in order to pay the higher costs of unsafe employers. The residual market got bigger, the deficit got bigger, and we got into a Òdeath spiral.Ó Eventually, the residual market was two thirds or more of the premium.

The solution was for the Division of Insurance to stop micro-managing the rates for voluntary insureds. They allowed the residual market to have its own rate that, to some extent, reflected the safety record of the people in that market. As a result, the residual market is now much closer to paying its own way.

Over the long term, competitive rating requires a self-sustaining residual market. As long as there is a source of money that can be raided to subsidize the residual market, there is immense political pressure to keep rates "affordable." One way to keep rates affordable is to stress safety and limit losses. Politically, the easier way is to get someone else to pay part of the freight. This is happening with workers' compensation even today. The residual market rate is the same as the voluntary market rate, and is not intended to pay for the actual losses in the residual market. There will come a time when the residual market will lose money and the voluntary market will have subsidize it. The basic problem of regulated rates is the inherent pressure of subsidizing unsafe employers with safe employers. The authors' suggestions for the introduction of competitive rating are sensible. Competition by itself does not necessarily lower costs, so we cannot assume that it will immediately mean lower rates. What it will do is move rates to their proper level.

Bent: I think the subtitle of the book should be " Step in the Right Direction," because bringing the free market into the highly regulated workers' compensation system is a great idea. I also think that having employers compete to keep workplaces safe is a tremendous idea. But reforming workers' compensation is like putting new tires on an Edsel, the thing might run a little bit better but it's still going to be ugly. Workers' compensation is an inherently failed system.

My comments are based on my experience dealing with a group of employers in Texas who have opted out of workers' compensation. In Texas we have an elective system. About 40 percent, or about 150,000 employers, do not carry workers' compensation insurance coverage. Marriott Corporation, McDonald's, Wendy's, Home Depot, and a number of smaller employers are among those who opted out. They developed their own injury benefits programs. There are both advantages and disadvantages to opting out, but examining the Texas experience can help teach us how to allow the free market to operate in workers' compensation reform across the country.

Workers' compensation has some perverse incentives that actually encourage an unsafe workplace. Some of the issues around opting out of the system demonstrate that disturbing trend. It is too complex. We have been patching workers' compensation in this nation ever since it started, but it still does not work right.

We should augment it with free market solutions that provide better benefits for injured employees and allow employers and employees to work together toward safer workplaces. In every state, workers' compensation only provides partial benefits to injured workers. When a worker is truly injured on the job, he or she should get 100 percent benefits. In some cases, the exclusive remedy provision of workers' compensation actually discourages employers from maintaining a safe workplace.

For example, a Houston printing company in the workers' compensation system did a risk management analysis to find out where injuries occurred, why they occurred, and their relative cost. This employer discovered that a specific piece of equipment caused a number of hand, finger, and arm injuries. When employees shut down the equipment to pull out old paper, the machine would engage on people's hands. The employer told me confidentially that because workers' comp rates were high, it was not cost-effective to replace the equipment and continue to pay the same rate. This employer then opted out of the system and immediately replaced the equipment because of the potential exposure to liability it faced outside the workers' compensation system.

Some things that we might look at for the future include medical savings accounts in the context of workers' compensation, and providing employees with financial incentives to avoid workplace injuries. This would control medical costs and help create safer workplaces, because the incentives would be there for both the employer and the employee.

Workers' compensation was never intended to be a workplace safety program. I think it is noble that the Commonwealth and the authors are concerned with safety, but we are not going to truly clean up the system until we allow the free market to get involved. Workers' compensation is a $70 billion a year industry. It's more than we spend on food stamps and Aid for Families with Dependent Children. It is time that we, the business leaders of this country, stop trying to protect our own interest in this industry and realize that the system is beyond reform. At the very least, alternatives should be allowed. Perhaps the whole system should be replaced.