Does much-maligned, oft-reformed workers' compensation offer a promising model for unemployment insurance restructuring?

Allowing the States to Innovate

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The very notion that unemployment insurance reformers should look to workers' compensation as a model for reform may sound absurd. Workers' compensation systems around the nation have been the subject of business criticism, "crisis" reports in the newspapers, blue ribbon study commissions, and major structural changes by the legislatures. Meanwhile, the unemployment insurance system appears to be running along quietly, much as it has since 1935. Why would anyone want to exchange the quiet system for the noisy system?

But look at the issue from another point of view. Do we prefer a system that changes or one that is stagnant? Do we prefer a system in which experiments in some states help policymakers in other states learn how to make a more effective system? Do we prefer a system in which results must be identified and compared to costs, or one in which costs are simply passed on without regard for effectiveness? In short, do we prefer a system that can adapt or one that is forever static?

The success of welfare reform highlights the value of state experiments. Before the federal welfare reform law was passed, a number of states had secured waivers to change their programs. The most successful state experiments emphasized the "work first" approach, and that strategy was later embodied in federal law. In short, the experience of varying state programs helped the entire country find a better way to help those on welfare.

The workers' compensation (WC) system has some very desirable features, notably flexibility for states to experiment with different industry and regulatory structures. As a result, WC has evolved over time, with growing self-insurance and a move toward less regulation of private insurance. At the same time, there has been substantial reduction in on-the-job injuries, suggesting that the WC system is providing employers with incentives to improve workplace safety. Further, the states that allow private insurance have lower injury rates than those whose WC systems are structured similar to their unemployment insurance (UI) systems: as exclusive state insurance pools.

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UNDESIRABLE INCENTIVES

There are several compelling reasons to consider restructuring the unemployment insurance system:

- The system provides an incentive for unemployed workers to have longer durations of unemployment.
- The longer durations of unemployment do not yield higher wages in the new jobs, contradicting one argument for benefit generosity.
- Some people enter the labor force only because of the prospect of collecting UI.
- UI also allows some companies to shift the costs of their layoffs to other businesses and workers, thus increasing the incidence of layoffs.

Worker incentives The effect of the UI benefit on duration of unemployment is most easily identified by comparing the experience of young people who are similar, except that some receive UI benefits and some do not. UI benefits are paid only to those with recent work experience; those not eligible either have no recent work experience, were fired for cause, or quit their previous job. One would expect that people collecting UI would be better job candidates than those not eligible for UI. However, the evidence shows that the UI recipients take longer to find work than those youth who do not receive UI benefits.

Numerous studies have compared unemployment durations across states, and those studies allow us to assess whether more generous benefits lead to longer durations of unemployment. The literature is quite consistent: More generous benefits lead to more weeks of unemployment.

One claim sometimes made for the UI system is that it allows the unemployed job seekers more time to find better jobs. Unfortunately, that claim does not stand up to the data. Longer job searches do not result in higher wages. When experiments were conducted in which the unemployed could receive bonuses for rapidly finding work, they did find work more rapidly, and those jobs paid just as much as the jobs that the control group eventually found.

The UI system even induces some people into the labor force for the prospect of collecting unemployment insurance. In some Canadian provinces, benefits are so generous that the system is called the "Lotto 10/40" because a mere 10 weeks of work can lead to 40 weeks of unemployment insurance for those lucky enough to be laid off at exactly the right time.

Employer incentives The UI system also changes, for the worse, the incentives companies face regarding layoffs. Prospective workers generally prefer more stable employment over less stable employment. If wages were equal, they would opt to work for stable employers. Some companies, however, have unstable needs for workers. Those include seasonal companies such as food processors and highly cyclical companies such as construction contractors. If wages were equal across all employers, the less stable employers would be shunned by job hunters. To hire workers, then, the less stable employers have to offer higher wages. Thus, those employers have an incentive to dampen their seasonality or cyclicality in order to reduce the wage premium that they must pay to workers.

The UI system reduces the need to pay higher wages for less stable work because workers will receive UI benefits when laid off. That reduces or eliminates the incentive for employers to minimize layoffs. However, the UI system does also add some incentive for stability, but only imperfectly. UI tax rates are "experience rated," meaning that companies with a history of more UI usage by their past employees pay higher tax rates. Companies with less UI usage by past employees pay lower tax rates. That provides the desired incentive to more stable employment. In fact, some of the early proponents of UI believed that this would be the major effect of the system.

However, the tax schedules have floors and ceilings. When a highly unstable employer finds itself at the ceiling tax rate, further layoffs do not cost the company anything; after all, its tax rate cannot rise above the ceiling rate. Similarly, a company paying the minimum rate may still be at the minimum even if it does a small layoff.

Econometric studies conclude that the imperfection of the experience rating system causes layoffs. Different studies have different estimates of the magnitude of the effect, ranging between five percent and 30 percent of all layoffs. One study concluded that the UI system may be responsible for 50 percent of all layoffs at the depths of recessions.

The evidence from the many academic studies shows conclusively that the UI system creates disincentives to desirable behavior. It discourages the unemployed from looking for work, and it encourages businesses to lay off employees. There is good reason to look for an alternative structure for providing income security to workers.

TABLE 1

WC at a Glance

Workers' compensation summary statistics, 2000

Covered workers	126.6 million
Covered wages	$4,474 billion
Benefits paid	$45.9 billion
Employer costs	$56.0 billion
Benefits as % of covered wages	1.03%
Employer costs as % of covered wages	1.25%
Benefits per covered worker	$363
Employer costs per covered worker	$442

Source: National Academy of Social Insurance, 2002.

WC'S STRUCTURE

All 50 states have workers' compensation systems, even though there is no federal requirement for workers' compensation aside from the system for federal employees. (The federal government also administers WC systems for coal miners and longshoremen.) Because each state has decided on its own to have a WC system, there is some variety in how they arrange for coverage.

Federal employees received workers' compensation coverage in 1908, and most states followed with coverage of private sector employees by 1921. Coverage generally is mandated for all employers. (In Texas, employers may opt out of the WC system, but in doing so they expose themselves to tort law. Sixteen states exempt companies with less than three, four, or five workers from mandatory coverage.)

The basic idea of WC is that employers will pay the cost of workplace injuries. They will pay the medical costs of injured workers, and they will pay workers for lost income. They may also provide compensation for permanent injuries separately from income loss.

The employee motivation for supporting WC was to guarantee compensation for medical costs and lost income when injured. The employer motivation for supporting WC legislation has been to reduce litigation costs and the uncertainty that results from a tort system of liability. In WC, there is no argument about whether the employer is at fault or negligent; if the accident occurs at the workplace, then the employer pays.

Differences between states An employer secures workers' compensation coverage in one of three ways: private insurance, a state WC fund, or through self-insurance. In 2000, some 58 percent of coverage was provided by private insurance, 20 percent by self-insurance, 17 percent by state funds, and five percent by federal programs.

The choices open to an employer vary from state to state (including the District of Columbia). In 2000, 26 states permitted a choice between public funds and private insurance, 20 states mandated private insurance, and five states required employers to participate in a publicly funded system. Self-insurance or group self-insurance is allowed in all but two of the states that allow private insurance.

Most states allow self-insurance for WC, and that is the fastest growing type of coverage. Most states also allow private insurance companies to provide WC coverage. The extent of regulation of private WC insurance varies, though there has been a trend toward deregulation of the WC insurance industry.

Recent workers' compensation statistics show the worker injury rate has been falling steadily over the past decade, while the cost of coverage has declined.

One indicator of the degree of regulation in the private insurance market is whether insurers are free to set the rates that they want — so called "open competition." Since 1980, the number of states with open competition has increased from one to 37.

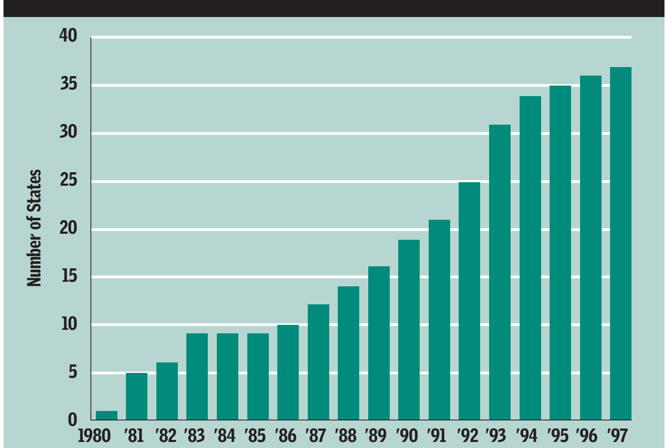
All states have a mechanism to assure coverage is available, even to employers with high risks. In the states with exclusive funds, those firms simply participate like any other firm. In states with private insurance, there often is a "residual market" that operates like the assigned risk pools in automobile insurance. The excess costs of the residual market are passed on to all other employers.

The size of the residual market is an indicator of the extent that the market is prevented from pricing each employer according to that employer's risk. With a perfect matching of rate and risk, there would be no employer turned down for coverage. Some researchers have used the residual market as a proxy for regulation. The residual market's share of total workers' compensation premiums shot up sharply in the 1980s, reaching a peak of 28 percent in 1992. Since then, however, the residual market has dropped sharply, and represented only four percent of the total premiums in 1998.

FIGURE 1

Freer Markets

The number of states with open competition in workers' compensation.



Positive effects The workers' compensation system has two success stories in recent statistics. First, the rate at which workers are injured has been falling steadily over the last decade. Second, the cost of workers' compensation coverage per $100 of payroll has also declined in the last decade. Lower accident rates are likely to be a result of decreased regulation in the workers' compensation market. When insurance rates are more heavily regulated, insurance costs are a less accurate reflection of the risk of injury for a particular employer. For example, an employer in the residual market may be having accidents costing $5 per $100 of wages. However, the ceiling on insurance rates might limit the employer's cost to $4 per $100 of wages. The employer would see no benefit from a 20 percent reduction of accident costs because such a reduction leaves the insurance rate at $4 per $100 of wages. It would not make economic sense for the employer to spend money on safety improvements in that situation. If workers' compensation insurance rates were not regulated, the employer would be paying the actual cost of $5 per $100 of wages, and thus have a strong incentive to provide a safer workplace.

Two studies, one in 1997 by Anthony Barkume and John Ruser and the other in 1998 by Patricia Danzon and Scott Harrington, found connections between the degree of regulation and accident rates or costs. Another study, by Terry Thomason, Timothy Schmidle, and John Burton, Jr., found higher accident rates in the states that have exclusive state funds (the same structure used in the unemployment insurance system). Those studies are not without statistical problems, and other studies have found little connection between regulation and accident rates in cross-sectional data. However, two facts are clearly evident in the time series data:

- There is now less regulation in the workers' compensation insurance market than there was in 1990.
- The rate of injuries in the workplace has declined since 1990.

Evidence suggests that many states — but not all — have used deregulation to improve incentives for workplace safety. That makes the workers' compensation system a particularly interesting model for unemployment insurance. The workers' compensation problem has been to improve incentives for

FIGURE 2

Fewer Injuries

The annual rate of workplace injuries that resulted in lost time

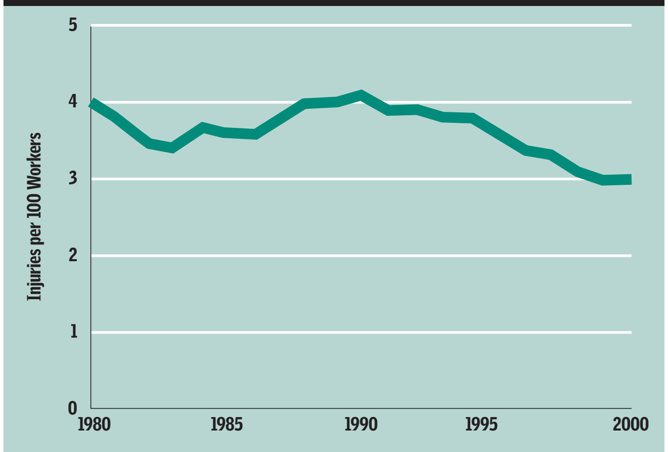
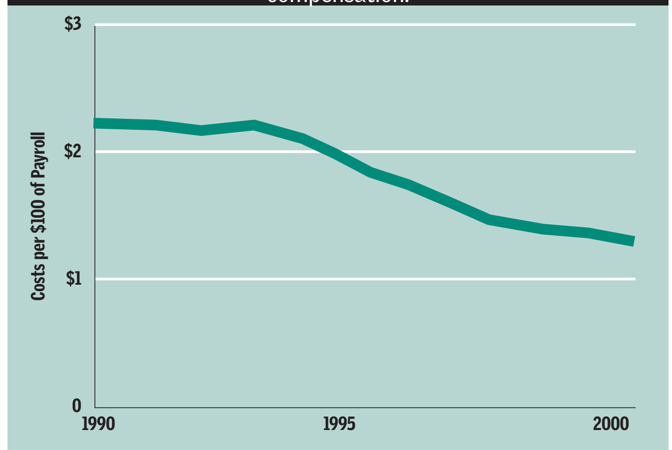


FIGURE 3

Declining Costs

The annual employer costs per $100 of payroll for workers' compensation.



workplace safety by reducing cross subsidies. As we will see, the unemployment insurance system has both an incentive problem and a cross subsidy problem.

The greatest strength of the WC system is the diversity allowed to the states. Fair payments to injured workers, reasonable insurance costs, and low accident rates are the goals of each state. Some states are experimenting with alternative structures, and all other states are watching those experiments. States are copying successful experiments performed in other states, so the system improves over time.

THE UNEMPLOYMENT INSURANCE SYSTEM

The UI system is really two systems. The best-known system applies to for-profit employers and some non-profits, but there is another system for government employers and certain non-profits that are known as "reimbursing employers." (There are minor variations in the UI system state to state. Here we describe typical rules that apply in most states.)

The basic UI system that applies to for-profit companies is a monopoly insurance fund. Employers are assessed taxes equal to a tax rate times their taxable payroll. In all states, the taxable payroll is limited to a certain amount per employee. In Oregon, for example, the tax only applies to the first $25,000 of wages paid to each employee.

Employers pay taxes into the state fund. When their former employees receive UI benefits, those payments come out of the state fund. The state employment department keeps track of claims attributable to each employer. Tax rates are adjusted up or down over time to reflect each employer's claims history. This is called "experience rating." Employers with histories of low claims by former employees pay low tax rates, and employers with histories of high claims pay high tax rates. The floors and ceilings on tax rates, however, may prevent the system from accurately charging each employer in proportion to the costs imposed on the system by the employer.

The entire schedule of tax rates will be shifted up or down based on the adequacy of the entire fund to pay benefits. After a recession, tax rates generally shift upward to replenish the fund. After several years of boom times, tax rates generally shift downward because the fund is fairly strong.

Socialized cost The taxes that are collected from employers can be divided into two parts: a portion reflecting an individual employer's claims and a portion reflecting "socialized" claims that are spread over all employers. The largest source of socialized claims is due to companies at the maximum tax rate. For instance, a seasonal employer in Oregon may be paying the maximum tax rate of 5.4 percent of wages, even though UI benefits paid to its former employers equal seven percent of the wages paid. The difference between the actual claims experience and the company's tax is spread across all other employers.

Another source of socialized costs is claims that are not charged to an employer. Suppose that Jane has a long history of working at company X, but then quits voluntarily to take a job at company Y. Then company Y lays her off. The system begins by charging Jane's UI benefits to the two former employers in proportion to how much she earned in the past year at the two companies.

TABLE 2

UI at a Glance

Unemployment insurance summary statistics, 2000

Covered employment	126.8 million
Covered wages	$4,347 billion
Benefits paid	$20.5 billion
Employer costs (state programs)	$20.8 billion
Benefits as % of covered wages	0.47%
Employer costs as % of covered wages	0.48%
Benefits per covered worker	$159
Employer costs per covered worker	$161

Source: U.S. Department of Labor

But company X can ask that the claim not be charged to its account because X did not lay her off. Company X's share of Jane's payments is not then added to company Y's charges because Y did not pay all the wages that figure into the calculation of Jane's benefits. So a portion of Jane's benefits are not charged to either employer, which means that they are spread over all employers in the state.

The other source of socialized costs is companies going out of business. They no longer are making tax payments, but their former employees are collecting benefits. The cost of those benefits is spread among all remaining employers.

The amount of non-charged benefits varies from state to state. In 1997, non-charged benefits ranged from a low of 15 percent of total benefits (New Hampshire) to a high of 58 percent (Mississippi).

Reimbursing employers The second UI system is for "reimbursing employers" — governments and some non-profit organizations. Specific rules for non-profits to be reimbursing employers vary from state to state. Basically, reimbursing employers must reimburse the state for any benefits paid to their former employees instead of making payments into the fund over time. Unemployed people use the UI system without regard to whether their past employer is a regular UI taxpayer or a reimbursing employer.

In many cases, the reimbursing employer's activities look very much like paying the UI tax. One difference is that the UI tax system tends to smooth out payments over time, whereas reimbursing employers who have a major layoff in one year take a major hit in UI payments that year.

There are differences in treatment of socialized costs in the reimbursing system. In general, no socialized costs are charged to reimbursing employers. That is good for them, but there are a number of countervailing features that partially offset the benefit. First, non-profit employers may be required to post a bond to ensure that they will be able to reimburse the state for claims should they cease operations. Second, there is no maximum tax rate to limit their exposure to high claims costs. Third, they may not seek relief of charges, as tax-paying employers do. Thus, they would have to reimburse the state for UI benefits paid to Jane in our earlier example, even though they did not lay her off.

One final distinction exists between the two types of employers. For-profit employers pay a federal UI tax in addition to their state taxes. The federal tax pays for administrative expenses and certain other parts of the federal program. Reimbursing employers do not pay the federal tax.

REFORMING UNEMPLOYMENT INSURANCE

The basic structure of the UI system has been set in law since 1935. The amounts paid out in benefits have changed, as have the tax rates, the maximum wage on which the tax is levied, and the number of occupations covered. The structure of the system, though, has not been tinkered with nor experimented upon.

Unemployment insurance can be made into a system that adapts. The system can be made to experiment and to react to experiments. The system can be designed to change when the underlying employment market changes. But it cannot do so if the federal government continues to set all structural aspects of the program, leaving no room for state decisions.

This section describes how we might alter the UI system to look more like the dynamic, adaptive WC system. We take as given a federal role in oversight of the states to ensure that workers receive adequate UI coverage. The details of providing that coverage can be left to the states. As a result, federal law would be broadly permissive regarding the details of the state UI system. The focus of the federal law would be ensuring the rights of employees to fair determination of their eligibility for benefits, and ensuring employers fairness in how they are treated as taxpayers.

The states could use their newfound discretion in a number of ways. Here is a set of guidelines that would allow a state to make a moderate transition to a competitive unemployment insurance system.

- **Every employer should be able to continue under the present system.** This is actually supported by a recent trend in WC, where more states are offering a state-run fund as an option in addition to private insurance or self-insurance.

- **Employers should be allowed to opt out of the present system, either through private insurance or self-insurance.** If they do so, they should be required to guarantee UI payments. This could be done by posting a bond, as some non-profits now do to become reimbursing employers. It could also be accomplished by a third-party, such as an insurance company, guaranteeing payment.

- **Employers should be able to choose a self-insurance option, either individually or in groups.** However, employers choosing this option would have to pay all claims from their past employees, even if they would be eligible for relief of the charge as a taxpaying employer. If employers are not willing to pay such claims, they should continue under the present system. This is how the reimbursing employers now operate.

- **All employees should have access to an adjudication system run by the government.** This could be either as a primary system or as an appellate system supplementing an arbitration system. Employers should provide the funding for the system.

- **Employers should have the option of administering claims themselves or contracting for claims administration.** The claims administration service should meet performance standards to ensure that employees have access to a fair system. The minimum performance standards should be based on results, not effort, and should correspond to the performance standards of the existing state system. Employers who choose to have the state employment department administer their claims should pay a fee reflecting those costs.

- **Private UI insurance should be allowed, with free entry and exit and no rate regulation.** However, the state's insurance commissioner may regulate the capital standards of insurance companies providing UI insurance in the state to ensure that they are capable of paying claims. Private insurance companies should be required to abide by the same rules described above for self-insurers to ensure fair treatment of the unemployed.

■ **The state would continue to set a minimum schedule of UI benefits based on the employee's past earnings.** Employers and insurance companies could choose more generous benefits, benefits paid as a wage subsidy (discussed in more detail below), or bonuses for rapid reemployment.

then only to the extent that the state chooses to follow up with those people. (Some companies do "claims management," which verifies the claims being charged to the employer's account. That is a different activity than helping the unemployed person find work.) An insurer or self-insured employer may choose to have more active case management, such as weekly follow-up calls to encourage and support job seekers, and to identify people who are not looking for work.

■ **Individual accounts:** Several economists, notably Martin Feldstein, have suggested using individual accounts for UI. Workers who are more diligent in finding work would build up balances in their accounts,

The unemployment insurance system can adapt, experiment, and change to meet the underlying employment market changes.

■ **Employers and insurers should be required to coordinate benefits.** A terminated employee may have had multiple employers. To relieve him of the burden of applying for benefits from each employer (or employer's agent), the administrative agent of the last employer should coordinate with other past employers to pay their share of the benefits. The presumption, barring some other agreement among employers, should be that employers pay UI benefits in proportion to their share of wages paid in the base period (a 12-month period used to calculate benefits). That is the current standard for both taxpaying and reimbursing employers.

WHAT VARIATIONS MIGHT WE SEE FROM THE STATES?

The above reforms would give the states latitude either to allow experimentation or to retain the status quo. Here are a few examples that states might allow:

■ **JOBS Plus:** A private insurer or a self-insured employer might offer wage subsidies in lieu of UI benefits. The insurer finds employers looking to add to their staff, who are willing to provide on-the-job training and mentoring in exchange for a wage subsidy. The employee works for a wage instead of collecting UI. That is particularly helpful for disadvantaged workers with minimal skills and experience. A version of this approach has been used in Oregon for both welfare and unemployment insurance.

■ **Active case management:** Currently there is no real case management in the UI system, except in a few cases of people profiled as likely to exhaust their benefits, and

which at retirement could be rolled into an IRA or other retirement plan. This approach would eliminate the disincentive to job search that the present system creates. Interestingly, Chile has just initiated such a program, which is integrated into that country's individual accounts for Social Security. Each quarter, workers receive a combined statement showing balances in both their retirement account and their unemployment account.

■ **Bonuses for rapid reemployment:** An insurer might choose to pay a bonus for rapid reemployment. Experiments have suggested that bonuses speed up reemployment, but not by enough to be cost effective. However, it is possible that a bonus program could be cost-effective if targeted at a certain group of workers most likely to be influenced by the bonus offer, and least likely to "game" the system.

DEALING WITH HIGH-COST EMPLOYERS

One challenge in any compulsory insurance scheme is how to handle customers that the insurance companies do not want. Those are customers who pose a risk higher than the insurance companies can charge for.

In automobile insurance, that leads to the assigned risk pool; drivers with poor records are insured through the pool, and insurance companies are typically required to share in the cost of providing coverage to the pool. That constitutes a tax on the insurance industry (passed on to other customers) to subsidize the risky drivers.

In workers' compensation, states with private insurance have a similar pool, called the residual market. Again, the insurers are required to share in the cost of providing coverage to the companies that pose high risk to insurers. In states with government-run insurance, the state pool may provide coverage for high-risk employers.

Self-insurance has traditionally been a way for companies to avoid the cost of the residual market. Although the insurance companies are forced to provide coverage for high-risk employers, the cost is naturally passed on to the insurance customers through higher rates. Thus, a typical WC insurance customer is paying for the cost of its own work-related accidents and illnesses plus a portion of the costs of high-risk companies. Self-insured companies, in contrast, pay only their own costs. Self-insurance is therefore attractive to companies that have low workers' compensation claims. As those companies leave the insurance system and self-insure, the insurance companies are left with fewer low-risk companies. The high-risk companies now constitute a larger share of the total insurance market, increasing the burden on the low-risk companies who still use insurance. That drives even more good companies to self-insure. This vicious spiral can lead to very high WC insurance costs for those employers not large enough to self-insure.

One solution to this problem is to raise the insurance rates for high-risk employers high enough to cover their actual costs. Then there would be no need for the residual market. However, there is political pressure from the high-risk industries to place a limit on workers' compensation insurance rates. The construction, mining, logging, and fishing industries, for example, would in many cases pay higher WC costs if they were not subsidized by the rest of the economy.

Similarly in unemployment insurance, there are significant socialized costs that are passed on to other employers. The costs are due to companies perennially at the maximum tax rate, claims not charged to any employer, and companies going out of business. Self-insurers would avoid paying any of those costs, as reimbursing employers do today.

In UI, there are several possible approaches to this problem. A starting point is simply to raise the UI tax rate ceiling high enough to fully cover the costs of seasonal and cyclical employers. In addition, self-insured employers should have to post a bond or buy secondary coverage of an amount that insures payment of all potential UI claims, even if the company goes bankrupt. The UI system could also use a tactic that has been adopted by some states in workers' compensation: levying a charge against all employers, whether insured or self-insured, to cover the high risk pool.

The problem of employers who are not paying their own costs needs to be addressed when reforming the UI system. However, solutions are available, so this issue should not be a deal-killer with respect to changing the UI system.

CONCLUSION

The nature of a market economy is that entrepreneurs experiment; successful experiments are broadened and copied; and then another round of experiments is conducted. The businesses may not even be thinking of their activities as experiments. An entrepreneur starting a new venture may believe that he is implementing a new concept. But looked at from a distance, the activity is experimentation. The goal of market structure should be to allow a variety of ideas to be tried, and then to spread the use of ideas that have proved successful. Shifting UI to a WC-like system achieves those goals.

Humans are learning creatures, but to learn, we must try new ideas. The present UI system has been locked down from change since 1935. It is time to bring it into the twenty-first century, following the workers' compensation model. R

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