

## Washington's High Benefit-High Cost Workers' Compensation System

### I. Workers' comp costs add to state's uncompetitive business climate, slow economic recovery

Workers' compensation costs in Washington add to the state's uncompetitive business climate. Proposed double-digit increases from the state's Department of Labor and Industries (L&I) in recent months have fueled frustration with a complicated, but critical area of business costs over which employers in the private, public and non-for-profit sectors have little control. According to Association of Washington Business President, Don Brunell, "every dollar that employers have to pay into the (workers' compensation) system unnecessarily is a dollar we don't have, either to keep workers employed or to get employees back to work."

The workers' compensation (industrial insurance) system combines with health and disability insurance to insulate workers and the economy against the medical expenses and loss of income that might result from a workplace injury or illness. But, while technology and a shifting economic base have contributed to safer workplaces and fewer workplace injuries and while employers and health care providers have begun to control employee health care costs total workers' compensation costs continue to escalate.

In 2003 L&I raised workers' comp premiums 29.5 percent for employers in the state fund (more than 99 percent of Washington employers). And, the department was proposing an additional 19.5 percent increase for 2004. Although L&I has since reduced its most recent rate proposal to a 9.8 percent increase, the conditions that prompted it to attempt another double-digit rate increase have not changed. These conditions and their implications for our state's workers' compensation system need to be better understood.

Changes in the system must assure the on-going solvency of the state fund, contribute to the state's economic recovery, and help strengthen its future economic competitiveness.

Washington's system of worker's compensation is one of only five such systems in the country. Here, the state is the sole or monopoly provider of insurance. About 370 employers, including some hospitals and local governments, are large enough to operate their own industrial insurance programs and are called self-insured employers. Estimated to represent less than 1/2 of one percent of the state's employers, these businesses employ 28 percent of the state's workforce and represent about 30 percent of the hours worked by employees covered by the workers' compensation system.

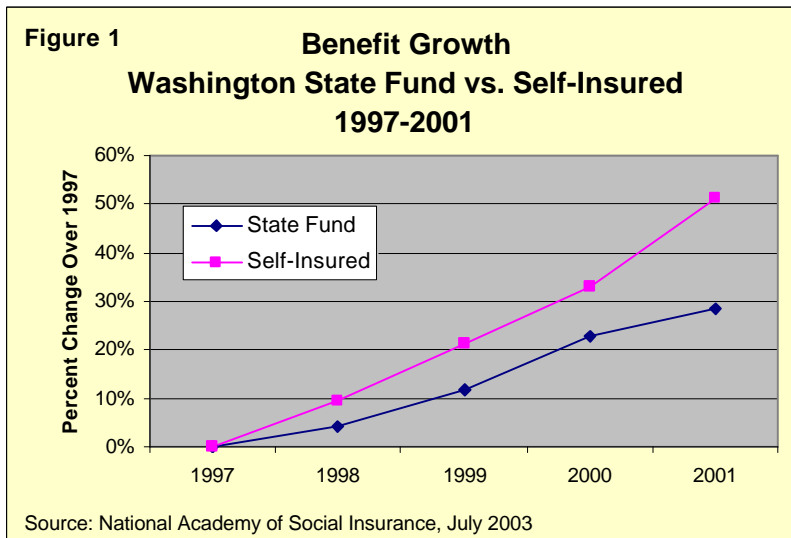
In the mid- and late-1990s, benefits required of all employers grew rapidly, due to two primary factors: First, Washington requires an automatic cost of living adjustment for certain areas of workers' compensation of benefits. This automatic adjustment to monthly benefits payments, together with medical inflation (which was significantly faster for the state fund than for the Seattle CPI for medical over the period), explains most of the benefit growth up until 2000.

While the state fund was flush with net investment earnings over this period that were temporarily sufficient to pay for increasing benefits without premium increases, self-insured employers felt the effect of benefit

increases relatively quickly. Figure 1 compares the growth in benefits payments paid out by the state fund compared with self-insured employers.<sup>1 2</sup>

But this scenario was not sustainable – state fund employers would not be insulated indefinitely by investment earnings.

The market turned down in 2000 and with it went the extraordinary income on which the state fund had been relying to avoid premium increases. In addition, two important court decisions – Department of Labor & Industries vs. Avundes and Department of Labor & Industries vs. Cockle – preempted decades of accepted workers' compensation practices and threatened to cost the state's employers hundreds of millions of dollars. In response to the



decisions, state fund managers moved to increase premiums on the multitude of Washington employers that were already in the middle of a deep and prolonged recession, sounding immediate alarm throughout the employer community.

We asked Washington employers who have operations in other states to help us understand the issue of Washington’s relatively high premium by providing actual examples. One farm supply dealer from Eastern Washington said that he would have to pay

<b>Job Category and Number</b>	<b>Comparison with Oregon Washington is:</b>	<b>Comparison with Idaho Washington is:</b>
<b>Fertilizer Dealer (with farm supply business) #2106</b>	Nearly twice Oregon (1.93)	Nearly a third higher than Idaho (1.29)
<b>Clerical (with farm supply business) #4904</b>	More than five times Oregon (5.27)	More than three times Idaho (3.46)
<b>Temporary office help (with temporary employment agency) #7105</b>		More than three times Idaho (3.11)
<b>Hops Farm Worker #4811</b>	Nearly twice Oregon (1.88)	
<b>Clerical (with hops farm) #4904</b>	More than 3.5 times Oregon (3.57)	
<b>Chemical plant worker #7113</b>	Nearly twice Oregon (1.88)	

more than five times more in workers’ compensation premiums for a clerical worker at his Washington location than he would pay for the same worker in Oregon; more than three times higher than in Idaho.

These and other similar examples abound for employers throughout Washington. Several more are outlined in the table.

While these examples do not reflect a scientific sampling, they capture the experience of many Washington employers and, anecdotally, they appear to be widespread enough to suggest that this policy-driven system needs serious attention from elected and appointed leaders concerned about economic competitiveness and vitality

This paper explains what is happening with Washington’s workers’ compensation system today and examines the actions required of the Legislature and L&I to bring greater certainty, fairness and competition to the system and to support state competitiveness.

Workers’ compensation is one component of a larger system of state-mandated employer benefits. While reforms in the workers’ compensation system do not hold the whole answer to solving the state’s economic competitiveness problems, they are critical to overall economic health. As important, they will signal a new state commitment to work with employers to promote economic recovery and job creation in Washington.

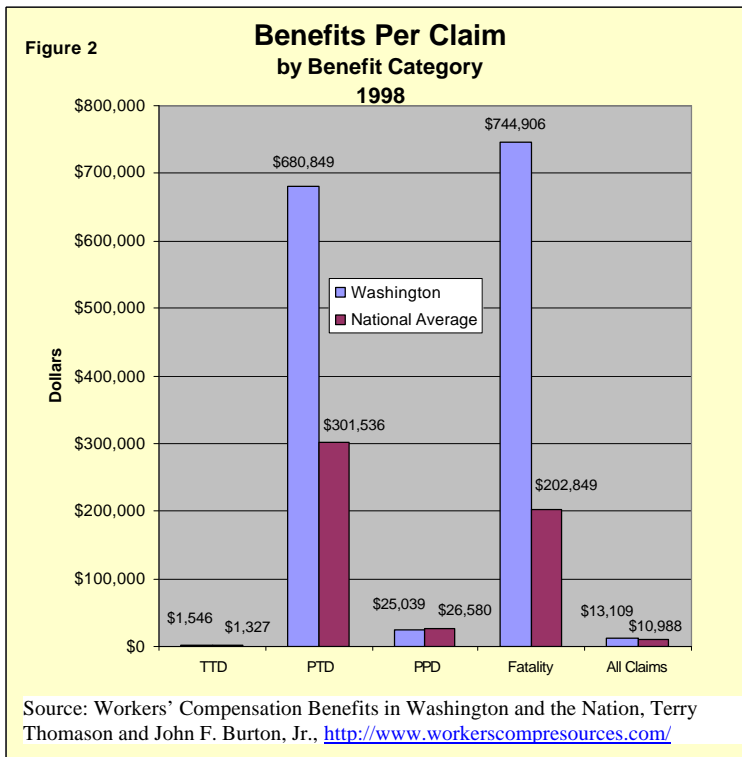
## II. Benefit Increases and Comparative Growth

Washington's workers' compensation system pays benefits for several types of workplace injuries, including:

- Temporary Total Disability or TTD
- Permanent Total Disability or PTD
- Permanent Partial Disability or PPD
- Fatal Injury

Terry Thomason and John Burton, two nationally recognized experts in workers' compensation analysis, recently completed a benefit study for Washington L&I.<sup>3</sup> Their findings compare Washington's benefits paid per claim with the average U.S. state in these various categories for 1998 (the most recent year for which comprehensive national data are available). Briefly, they found that:

- Total temporary disability benefits were about 17 percent higher in Washington than the U.S. average, \$1,546 per claim in 1998 in Washington compared with \$1,327 per claim on average across the



U.S. In Washington these benefits took a large jump in 1989 and have grown steadily in most years since, placing Washington's benefit per claim well above the 75th percentile (that is, 75 percent of states in the U.S. paid less per claim than Washington) in 1998.

- Washington's permanent total disability benefits were more than double the U.S. average – \$680,849 per claim in Washington compared with \$301,536. This can be traced to legislation passed in 1975 that escalates benefits automatically in conjunction with growth in the state's average wage. The auto-escalation policy sent Washington's benefit level shooting up in 1976, well above the 75th percentile state where we have remained ever since. There have been steady increases in benefits per claim for PTD since the mid-1990s.
- Permanent partial disability benefits in Washington were slightly below the national average in 1998 – \$25,039 per

claim in Washington compared with \$26,580 for the average state.

- Fatality benefits, like PTD benefits, escalate automatically in Washington, stemming from legislation passed in 1975. As a result, Washington's benefits per fatal injury claim are more than three times the national average – \$744,906 for Washington compared with \$202,849 for the average state.

**In total, benefits paid in Washington in 1998 were approximately 19 percent greater than the national average – \$13,109 per claim in Washington compared with \$10,988 per claim nationally – placing Washington above the 75th percentile.**

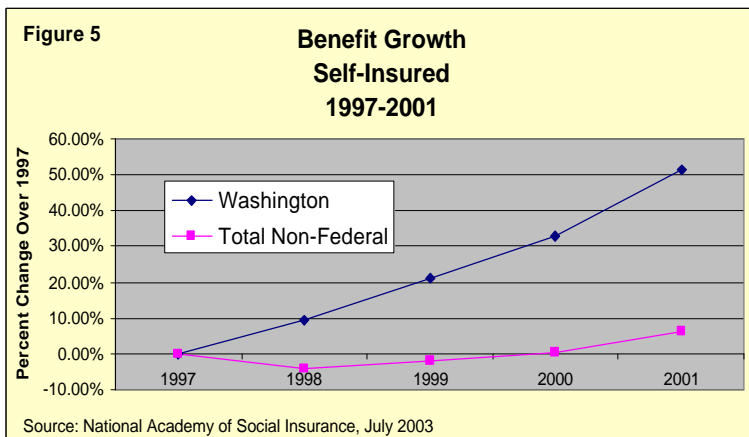
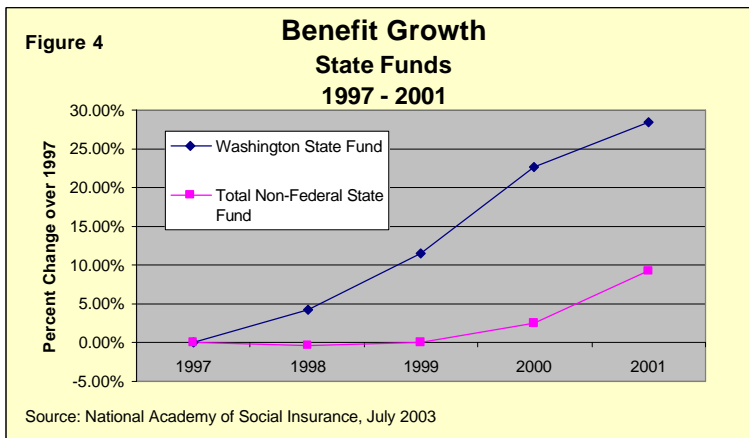
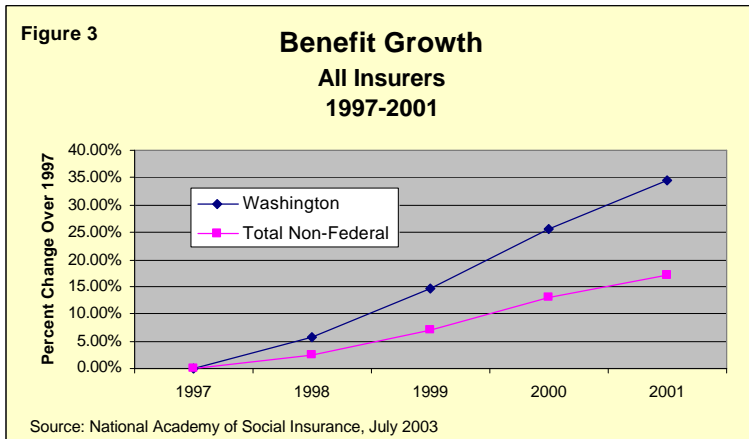
Data show more recent effects of Washington's generous benefits. According to the National Academy of Social Insurance,<sup>4</sup> Washington's growth in benefits between 1997 and 2001 was double that of the all states (referred to normally as "Non-Federal" the total of the fifty states excludes federal workers' compensation for both federal employees and special federally funded programs), 35 percent growth compared with 17 percent, respectively. (See Figure 3)

Comparison of benefit growth in Washington's state fund with other state funds shows even more dramatic differences: Washington's state fund grew more than 28 percent over the period, while non-federal growth was only nine percent. (See Figure 4)

Washington self-insured employers shouldered a 51 percent increase in benefits between 1997 and 2001, compared with all states self-insured growth of only six

percent. (See Figure 5)

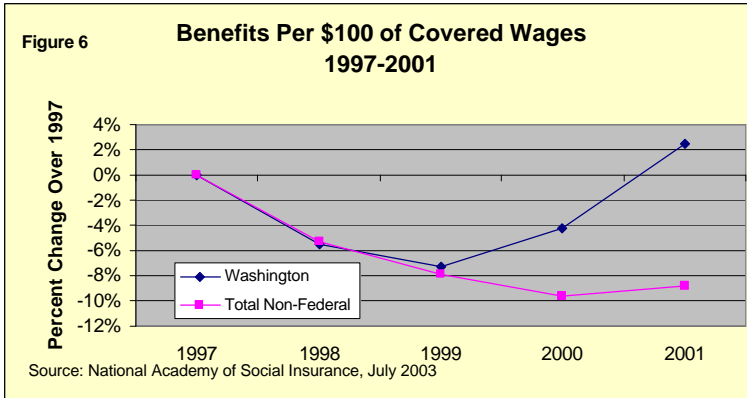
This comparatively rapid growth is not only a function of Washington's relative economic growth over the period. If we



compare benefits paid per \$100 of covered wages, Washington grew more than 10 times faster than the national average,

increasing by more than two percent, while all states declined by nearly nine percent. (See Figure 6)

The big divergence in benefits per \$100 of covered wages begins in 2000 and reflects, in part, two important Supreme Court decisions that added significantly to the benefits of Washington's workers' compensation system – and to the financial burden for both its state fund and self-insured employers.



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The first of these in April 2000 was the *Department of Labor & Industries v. Avundes*<sup>5</sup> in which the State Supreme Court found that workers' compensation benefits for seasonal and intermittent workers cannot be adjusted to reflect their work history, where the "intent" of the worker was to work year-round. The Court's decision resulted in many seasonal workers being eligible to receive more in workers' compensation benefits than they earned in wages while working.

In 2001 the Supreme Court ruled on the *Department of Labor & Industries v. Cackle*<sup>6</sup>, finding that employer contributions to health care benefits must be included in the wage calculation for workers' compensation benefits. These decisions reversed decades of established practice in Washington and, together, represented hundreds of millions of dollars in impact on employers. In its subsequent rulemaking on the Avundes decision, in particular, "the department has written rules that are far more complex than necessary and, therefore, more costly for employers," according to Clif Finch of the Washington Food Industry.

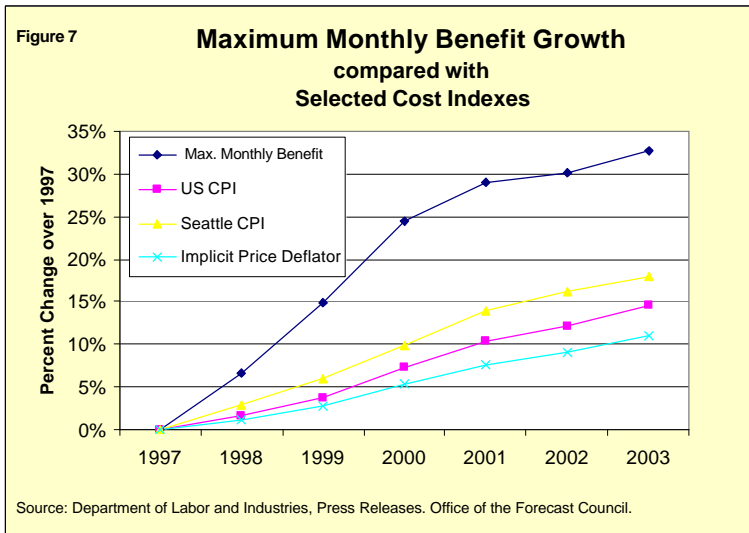
The maximum monthly benefit amount contributes significantly to the increase in benefits per claim. Indexed to 120 percent of the average wage for Washington, it grew nearly 33 percent from 1997 to 2003. This figure was tremendously affected by stock options taken by technology workers during the late 1990s. Workers injured after June 30, 1996, can currently receive more than \$45,500 annually. According to a recent study by Actuarial and Technical Solutions, Inc., Washington state ranks 3<sup>rd</sup> highest of all states in statutory wage replacement benefit provisions.<sup>7</sup> Growth in maximum monthly benefits for Washington is shown in Figure 7 and compared with several alternative cost-of-living indexes. The

most generous of these indexes, the Seattle Consumer Price Index, grew by only 18 percent – nearly half– the growth of the state’s average wage from 1997 to 2003. The US CPI and the Implicit Price Deflator both grew slower yet at 15 and 11 percent growth over 1997.

### III. Rate Studies and Comparisons

#### Washington’s rates cannot be compared reliably with other states.

Washington’s workers’ compensation premiums are calculated on the basis of the number of hours worked by an employee. This method is unique to Washington; all other states calculate premiums based on dollars of payroll. As a result, analysts have spent the last several decades arguing about the numbers. Most national rankings comparing premium rates simply exclude Washington, since the issues of data comparability are too great to allow responsible analysis.

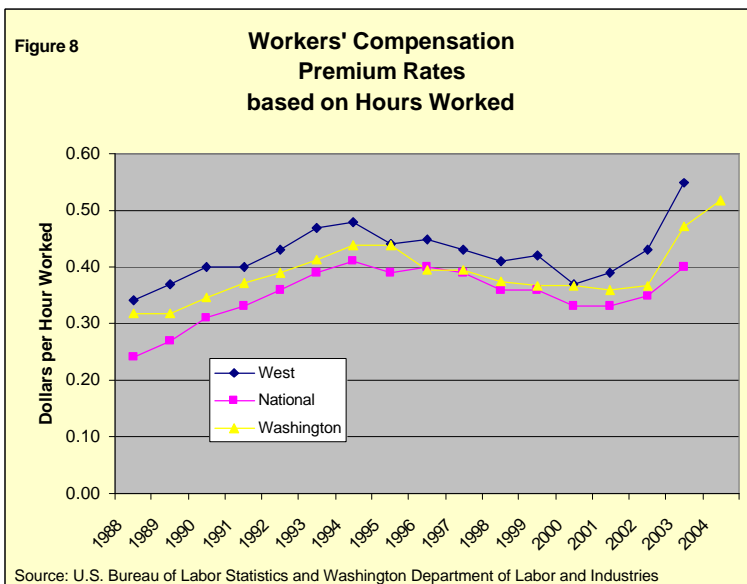


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Nonetheless, the state of Oregon produces a study every few years in which it attempts to compare its rates with other states, including Washington. Washington’s Department of L&I converts state data for use in Oregon’s study. In addition to using unadjusted manual rates (premium rates that do not reflect an employer’s experience rating, premium discounts, reductions associated with deductibles, retrospective rating, insurer deviations, schedule rating plans and other modifications), the Oregon study’s four-page methodology contains 14 “notes” in which cautions are offered on limitations of the data. Several significant cautions from the Oregon report are relevant when questioning Washington’s comparability:

1. “Since not all premium classes were included in the study, the actual average premium rate for a state may differ from the weighted premium rate index, which is based on Oregon’s economy.” [Note: The Oregon study does not include workers employed by self-insured employers, which make up nearly a third of Washington’s workforce.]

2. “If different classes were selected or payroll from another state was used to weight the rates by class, the results might be substantially different.”
3. “Several states use different classification systems and the conversion to the NCCI (National Council on Compensation Insurance) system is not perfect.” [Note: This is true of Washington.]
4. “This study is based on payroll rates. In Washington hourly rates had to be converted to payroll rates. **The Washington payroll data included overtime pay which may overstate the average wage for purposes of premium computation, and thus understate the effective average payroll rate.**” [Emphasis added. Note: L&I agrees with this.]
5. “Payroll base exclusions (e.g., exclusion of vacation pay) exist in Oregon and South Dakota. Manual rates in these states have been reduced to reflect NCCI’s estimate of the effect of these payroll exclusions on premium rates. Additionally, some states assess overtime at the full overtime wage, but most states use the normal hourly wage as the payroll basis for overtime hours. This study does not account for these differences in treatment of overtime.” (See also #4.)
6. “These data exclude self-insurers’ experience.” [See #1.]



**Other comparisons exist.** Other comparisons exist that are helpful in putting Washington in perspective. The U.S. Bureau of Labor Statistics produces one of the few data series that compares premium rates based on the number of hours worked. It only compares regions of the country, however. In this data series the West, which includes Washington, California and 11 other western states, has been consistently higher than the national average since 1988. In 2000 the rates were as similar as they have been over this period at \$.37 per hour worked in the West and \$.33 per hour worked nationally. Since 2000, the gap has widened, as premium rates in the



West, led by California's notorious workers' compensation system problems, have grown more than twice as fast as rates nationally. Figure 8 illustrates this relationship.

Figure 8 also shows Washington's premium rate for workers covered by the state fund.<sup>8</sup> Although none of the data have been adjusted for industrial mix or system changes over the period, they illustrate the general trends and relationships of Washington, the West and the nation. As with all figures comparing rates, these figures have limitations. They generally understate Washington's rates in two ways: First, Washington composite rate includes state and local government workers, whereas the figures for the nation and the West are for private industry only. Since private industry premium rates are generally slightly higher than state and local government, Washington's composite premium for private industry, if it were calculable, would be a bit higher. Offsetting this understatement slightly is the fact that self-insured employers are included in the numbers for the nation and the West, but not in those for Washington. Self-insured employers are larger and have more flexibility in returning injured workers to work and would normally place a downward pressure on total rates.

*Although self-insured employers were already feeling the pinch of increased benefits (system costs), the vast majority of employers participating in the state fund had not yet had to bear the financial brunt (through increased premiums) of the higher benefit levels.*

**Washington's system can incur substantial debt without fear of bankruptcy.** When reviewing premium rates it is important to understand that, unlike most systems throughout the country, Washington's government monopoly system can spend reserves without fear of bankruptcy. Private providers, which predominate in other state systems, cannot undercharge (keep rates lower than actuarial standards would dictate) for any extended period of time. Workers' compensation expert and Rutgers University professor, John Burton analyzed Washington state's system for L&I. He explains "... *it is important to note that these cost estimates [adjusted manual premiums] do not adjust for deficits in accident reserve funds. Unlike private insurers, who are unable to sustain a deficit over a long period, exclusive state funds, such as Washington, are able to incur substantial debt without fear of bankruptcy. To the extent that this has occurred, our cost estimates may under-value the true costs of workers' compensation in Washington, relative to those states where private insurers operate.*"<sup>9</sup>

Accident and contingency reserve funds at L&I have been the subject of much controversy in recent months with Pricewaterhouse Coopers analysts alleging problems that are refuted by L&I's actuarial firm, Milliman USA. Without getting

bogged down in their actuarial debate, the issue is: L&I sets aside money in the event claims are more costly than anticipated. It invests and earns interest on that money . The investment income can then be used to cushion against premium rate increases. Because Washington is a government-run system, its state fund can spend more money than it has available – artificially masking system costs that would otherwise require premium rate increases. Private insurers cannot do this, so when we try to compare rates from state to state, we may be comparing rates fully funded by employer premiums with rates that are partially subsidized, either by extraordinary investment returns or by system indebtedness.

### **Reserve balances cushion state fund employer premiums. System windfalls confused with success.**

During the economic boom of the mid- to late-1990s, an overheated economy produced abnormally large investment income on reserves. L&I was subsequently forced to return an estimated \$400 million<sup>10</sup> to employers and suppress employees' medical aid contributions by \$650 million in order to recalibrate its finances, even as benefits (TTD and PTD, especially) were growing well in excess of national norms. When the stock market slumped in 2000, increased benefits required more money than was anticipated to be available from employer premium income and investment earnings on reserves. Although self-insured employers were already feeling the pinch of increased benefits, the vast majority of employers participating in the state fund had not yet begun to bear the financial brunt (through increased premiums) of the higher benefit levels. To shore up the state fund, the resulting rate increase proposals were double-digit – 40.5 percent, eventually lowered to 29.5 percent in 2003 with a subsequent 19.4 percent increase proposed for 2004 that was reduced to 9.8 percent – and now had everyone's attention.

*...if the benefits of Washington's workers' compensation system are among the highest in nation (as everyone, including L&I agrees is true), then system costs are also among the highest in the nation.*

## **IV. Discussion, Observations, and Conclusions**

- 1. System benefits are also system costs.** The 'benefits' of the workers' compensation system – the cash and medical payments paid to or for injured workers – are also the 'costs' of the system. The 'high benefit-low cost model' for workers' compensation touted by the department is a myth. If the benefits of Washington's system are among the highest in nation (as everyone,

including L&I, agrees is true), then system costs are also among the highest in the nation.

- 2. The main *sources of income* for Washington's state fund are the premiums paid by employers, together with investment returns on system reserves.** Washington's system is structured to include reserve funds, earnings from which bolster employer premium income. During the technology boom of the 1990s, the state fund was swimming in cash as a result of extraordinary investment earnings on reserves. Thus, the department was able to cover its system cost increases (cash benefits per claim paid out to injured workers and to cover relatively rapid medical inflation), return \$400 million to state fund employers, hold down employee medical aid contributions by \$650 million, and avoid increases in state fund employer premiums.

But the extraordinary investment returns of the 1990s were not sustainable. Just as one-time or short-term windfall gains cannot support permanent increases in on-going operations, the workers' compensation system was immediately strapped when the market fell and investment earnings plunged. Cash benefits, which are indexed to increase with the state's average wage, together with higher-than-normal medical inflation, and the effects of the Cockle and Avundes court decisions were immediately unaffordable without more on-going income. The state fund turned to its primary funding source – increased premiums on employers.

- 3. Common sense helps untangle the complexity of Washington rate comparison.** Washington's inability to compare its premiums with other states is a continuing source of frustration to those attempting to understand its system. Because of the unique way Washington has elected to operate and the resulting difficulty in establishing comparative ranking, energy is spent debating the integrity of the data, instead of the merit of various policies and processes.

The department frequently cites Oregon's study rankings, which have shown Washington's employer premiums to be lower than Oregon's and the national averages. However,

for all the reasons enumerated by the Oregon analysts themselves and given the preponderance of experiential evidence to the contrary, these rankings cannot be accepted as the final word on Washington's rank.

In this report we have shown figures from the federal government comparing Washington with the nation and the West. Although, the BLS data do not adjust for changes in industrial mix, nor changes in workers' compensation programs over time, and although they differ in their inclusion of self-insured workers, they offer a reasonable guide to Washington's relative ranking and trend, providing a general indication of how the state compares.

This paper also offers comparisons from several multi-state employers operating in Washington and one or more other states. These examples have shown Washington's premium rates in specific job categories to range from nearly twice to more than five times more than the other state in question.

When comparative data are weak, it is important to rely on what data are available and what seems reasonable.

- We know comparisons from the BLS show the West to have higher rates than the nation as a whole. Given California's recent fiscal problems, especially with workers' compensation programs, this seems reasonable.
- Washington appears to be higher than the national average, but lower than the average for the West. Again, given what we know about Washington's generous system of worker benefits, and California's relative dominance of the 13 western states, this also seems reasonable.

These data offer a more realistic picture of our relative rank than the Oregon study results.

More complete and reliable data are always preferable. No one wins when the costs of a government program cannot be readily compared. Employers making location decisions look at all these factors – comparable or not – and they draw conclusions, regardless of how easy it is to do or whether or not the state cooperates with them. A competitive state welcomes new employers. It is easy to work with and eager to provide reliable and verifiable comparative information.

#### **4. Superior Court appeal adds to expense of dispute resolution and delays claims closure.**

This report was not intended to address administrative procedures related to workers' compensation, however, one issue has been continually singled out in reports and audits of the department over the years: Washington's dispute resolution system.

It is widely accepted and reported in the 1998 JLARC audit that "*Washington has more levels of appeal than most jurisdictions.*"<sup>11</sup> JLARC goes on to say that, "*The extra levels present in Washington necessarily take up more time and more resources. There is no evidence that they produce better outcomes.*" The audit points out that Washington is among only a few states that allow a dispute to be appealed to Superior Court. In addition to the obvious additional delay and expense of this discrete step, it also adds to the burden and expense of all other steps in the dispute resolution process as "*every step must be taken in a manner that meets the evidentiary and procedural standards of the civil courts.*"<sup>12</sup> JLARC Recommendation 17 states that, "*Superior Court review of decisions by the Board of Industrial Insurance Appeals should be eliminated.*"

### **V. Recommendations**

Washington stands out among the states as a high benefit, high cost system. The fact that employers participating in the state fund did not have to bear the full burden of these increased costs through their insurance premiums until the last couple of years has obscured important issues associated with the system. The following action is needed:

#### **1. Reduce the long-term growth in system costs:**

Re-index the monthly maximum benefit amount using a cost-of-living index more representative of actual changes in the cost of living.

Adopt legislation that amends and/or clarifies the laws under which the Avundes and Cockle court rulings were made.

Eliminate superior court appeal from the dispute resolution process.

#### **2. Restructure Washington's system to allow comparison with other states:**

Pass legislation directing the department to transition to a payroll-based premium rating system similar to those used in most other states.

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<sup>1</sup> Workers' Compensation: Benefits, Coverage, and Costs, 2001. National Academy of Social Insurance, July 2003.

<sup>2</sup> Note: Figure 1 should compare benefit growth per claim for state fund and self-insured employers. L&I indicates, however, that these data are not reliably maintained by the department for self-insured employers claims and benefits.

<sup>3</sup> *Workers' Compensation Benefits in Washington and the Nation*, Terry Thomason and John F. Burton, Jr., available at: [http://www.workerscompresources.com/Data\\_and\\_Articles/DataArticles.htm](http://www.workerscompresources.com/Data_and_Articles/DataArticles.htm)

<sup>4</sup> Workers' Compensation: Benefits, Coverage, and Costs, 2001. National Academy of Social Insurance, July 2003.

<sup>5</sup> 140 Wn.2d 282 (2000).

<sup>6</sup> 142 Wn. 2d 801 (2001).

<sup>7</sup> Workers' Compensation State Rankings, Manufacturing Industry Costs, and Statutory Benefits Provisions, 2003 Edition, Actuarial & Technical Solutions, Inc.

<sup>8</sup> Washington composite rate is for all workers covered by the state fund. The figures for the national average and the West are for private industry workers. In telephone discussions with L&I, the department concurred that the difference between composite premium rate for all workers versus private workers was minimal. It is likely that the composite figure for state and local government is slightly lower, since these government jobs are less hazardous than private sector jobs on average. Inclusion of state and local government workers, therefore, serves to understate the composite premium rate for Washington in the years shown.

<sup>9</sup> *The Cost of Workers' Compensation in Washington and North America*, Terry Thomason and John F. Burton, Jr., [http://www.workerscompresources.com/Data\\_and\\_Articles/DataArticles.htm](http://www.workerscompresources.com/Data_and_Articles/DataArticles.htm)

<sup>10</sup> *Declining financial markets and rising claim costs force 40.5 percent boost in workers' comp rates in 2003*, L&I News, September 25, 2002.

<sup>11</sup> Ibid.

<sup>12</sup> Ibid.