## March 3, 2003


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BY MAURA C. CICCARELLI
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**A Return to RTW** BY MADDY BOWLING
Workers' comp providers--as well as employers and injured workers--are best served by sustainable return-to-work practices, not premium price increases.

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**Getting Workers' Comp Costs Under Control**
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**Average workers' comp insurance costs vary widely from state to state. But while they certainly have a hand in why this is so, insurers aren't entirely to blame.**

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While the use of integrated risk financing has never been greater, implementing these programs clearly requires new thinking on the part of the risk manager and buy-in from senior management.

# For Benefits Managers:

## Getting Workers' Comp Costs Under Control

**By Peter Rousmaniere and Phil Denniston**

***Average workers' comp insurance costs among states vary widely. The insurers aren't the only ones to blame for this disparity.***

Comparable workers' compensation insurance costs vary by as much as a factor of two between many neighboring states. Between the five lowest- and five highest-cost states, the average difference is a factor of more than three. For the highest-cost states, the difference may be even higher.

The variances provide a laboratory in which to explore the forces that drive workers' comp costs. The lab results show that costs come from employer behavior and from the relative efficiency of a state's system of workers' comp laws and regulations.

But that's only half the story. Employers with good loss experience and discipline can avoid high insurance costs by self-insuring or by using high deductibles. Even in states with relatively high insurance costs, employer costs can be quite low.

Therein may lie the real trouble for insurers and regulators in the next few years. Employers have an increasing appetite for self-insurance. If employers with good workers' comp practices can cut insurance purchases, the insurance industry may be stuck with an adverse selection of risks. This gap can help fuel a spiral in workers' comp insurance.

These findings lead to three conclusions: States should devote more effort to improve employer practices; states saddled with high cost structures should reduce the inefficiencies generated by laws and regulations, and critics of interest groups, such as insurers, lawyers and doctors, should be wary of oversimplification.

### Placing the Blame

The data supporting these conclusions are not as current as one would want. But one statement is certain: The range of insurance costs among and within states is not due solely to insurers. Blaming insurers for high costs also requires praising them for low costs, yet insurer practices do not change much - if at all - among states and among insureds. It would be similar if we tried to explain the rise and variations in health care costs among households based just on the proficiency of hospital administrators.

Average insurance costs among states vary widely. Table A, column B, shows the ratio of insurance costs in each state and compares it to the national average for a hypothetical manufacturing firm. States are sorted in order of cost. These ratios reflect premiums in each state for the average firm - the *average insured* manufacturer with identical staffing. For example, if a manufacturing firm located entirely within Connecticut had insurance costs of $121,000 (21 percent above national average), and moved to Iowa, the manufacturer's costs would decline to $80,000, or 20 percent below the national average. In California, the insurance bill would jump to $227,000. In Arizona, it would be $36,000.

Actuarial & Technical Solutions of Ronkonkoma, N.Y., has over the past 10 years produced a comparative profile of insurance costs of most states. ATS creates a hypothetical company whose workforce mirrors the nation's manufacturing workforce. It then acquires insurance data from 45 states, leaving out states with monopolistic funds. For the report effective Jan. 1, 2002, ATS calculated net insurance costs per $100 in payroll for these 45 states. The firm's data can be correlated with OSHA injury data compiled by the Work Loss Data Institute, and compared with findings of the Workers Compensation Research Institute and the National Academy of Social Insurance. Other comparative rankings of workers' comp costs support ATS' findings of the most - and least - expensive states, as well as the huge variances among states.

Employers have for some time been shedding conventional workers' comp insurance for self-insurance or high-deductible plans. Between 1990 and 2000, the share of workers' comp benefits paid directly by employers rose from 20 percent to 30 percent of all benefits paid. With today's hard market, this percentage is certainly increasing.

The impetus for shedding conventional workers' comp is partly due to the success employers have had in controlling losses. Injury rates have been dropping for years. Work-site managers can jump on fresh injuries and employ early-return work policies. Without slighting the dedication of insurer loss-control staffs, these work-site-based improvements occurred mainly at the instigation of employers, not insurers. This productivity juggernaut continues, separating the better-managed employers from the pack. It is no longer useful to refer to the "average" employer. There are those that perform well, and those that do not. The better employers run such tight ships that any lost-time injury of more than 30 days can today be called a long-term injury.

## High-Cost States

Very high-cost states such as California may suffer a triple whammy in their workers' comp systems. First, the frequency of long-term injuries in California is higher than average. Employers can do a much better job at resolving injuries faster. Second, the laws and regulations are inefficient, making the long-term injuries even more expensive. Third, as more employers exit standard insurance contracts, the insurance sector may enter an adverse selection spiral.

A spiral is more likely today as more employers exit standard contracts. In addition, they are the very employers that have accumulated the skills used to control costs. Insurers as a whole have not made anywhere near the investment in this know-how that self-insured employers have. Follow this spiral out for a decade, and the insured market as we know it in high-cost states may turn into an "assigned risk" pool for employers insured due to their small size, their lack of good practices or plain bad luck.

This dismal scenario underscores a poorly appreciated fact that a state's workers' comp costs are actually the sum of the successes and failures of two systems joined at the hip. One is the employer community's work in safety and health. The other system is one of laws and regulations designed to address long-term injuries. Insurers, third party claims firms that service self-insured employers, medical specialists and attorneys run this system. Think of the employer-centric system as a busy but low-cost wellness center, and think of the insurer-centric system as a high-cost hospital with a large intensive care unit.

The employer-centric system focuses on safety, fast response and early return to work. Knowledge of the intricate details of fast response, medical care, return to work and safety remedies is deep and wide. For injuries lasting longer than a few weeks, the system of laws and regulations takes over. The employer's system strives to reduce the frequency of injuries, which migrate into the domain of the insurer. The accompanying table (column C) reports the relative frequency of long-term injuries.

Arizona, for example, has 37 percent fewer long-term injuries per 100 workers than the national average.

The insurer-centric system of laws and regulations primarily works to resolve long-term claims and ensure availability of insurance. Insurers and TPAs are largely responsible for making the system work. Their knowledge of claims resolution details is usually vastly greater than that of employers'. But their ability to manage fresh injuries and to prevent them from deteriorating is spotty and lags several years behind best practices.

These two systems, each in their own way, drive workers' comp costs up or down. The frequency of long-term injuries has a huge impact on workers' comp costs. When the injured worker is able to stay at work, or when the worker returns within a few weeks, the average cost of an injury is less than $1,000. But injuries that extend beyond 30 days have an enormous capacity to increase costs. They average about $50,000 and consume a vast share of money spent on injured workers. There is even a costly quasi-medical condition, which afflicts injuries extending beyond 30 days: chronic pain.

## The Friction Factor

Each year, one worker out of 50 suffers an accident and loses at least a day of work. One worker out of 250 loses at least a month. In the top 10 most costly workers' comp states, the frequency of long-term injuries increased in the 1990s, but decreased in the 10 least costly states.

"Friction" is the accumulation of rules, procedures, disputes, delays, discretionary charges and patterns of practice that press upon the resolution of claims. It occurs in every insurance or business enterprise. An adverse friction factor adds insurance costs. A favorable factor means that the claims resolution process is more efficient and economical than a claims process with an average friction factor.

In our analysis, Oregon's system is the most efficient. California's and Florida's are hugely inefficient. The accompanying table includes an estimate of the relative efficiency (friction factor) of laws and regulations. The table (column D) shows that while Massachusetts has a higher-than-average frequency of long-term injuries, its system is efficient (favorable), resulting in lower-than-average insurance costs. (Massachusetts along with New Mexico earned the "most improved" prize for reductions in workers' comp costs since the early 1990s.)

Ironically, Massachusetts offers an example of an inefficient regulatory feature. It has long had a surgical fee schedule well below prevailing group health plan rates. Since few surgeons will accept the formal fees, surgeries are routinely preceded by negotiations. That raises the surgical fee and tacks on weeks of delays for indemnity payments to the claim. That this nuttiness has persisted shows how inefficiencies can be entrenched.

California, as noted above, suffers from a large number of expensive injuries made even more expensive through contention and inefficiencies. Other states with high volumes of long-term injuries, New York and Texas, also have relatively inefficient laws. Florida's misery is unique. It produces a below-average rate of long-term injuries but has an inefficient set of laws and regulations.

One out of every three long-term injuries in the nation is incurred in one of these four states: California, New York, Florida and Texas. The Workers Compensation Research Institute calculated that legal and medical review expenses in California and Florida are two to three times higher per claim than in Wisconsin. This means that a larger share of higher costs goes out as fees to third parties.

Texas allows employers to opt out of its system of laws and regulations, and to treat worker injuries under common law. The so-called "nonsubscribers" - those who opt out - cover one-fifth of Texas workers. The data we have obtained show that the long-term injury rate of nonsubscribers is about half that of Texas as a whole. Advocates of opting out contend that the claims resolution process is simpler compared to the state's formal system. They say they are better able to manage cases, enforce modified duty, avoid state red tape, and choose the most appropriate and qualified providers.

Another troubled state is West Virginia, a monopolistic state for which ATS does not estimate insurance costs. The workers' comp fund has an unfunded claims liability of three to four times the annual premium revenue. The state's rate of long-term injuries is more than twice the national average, much higher than any other state's. Each year, one worker in 100 is disabled for at least 30 days, compared with the national average of one worker in 250. Proportional to population, West Virginia's unfunded claims liability is three times higher than California's.

Still, in almost every state, employers can largely control their costs through tight management, self-insurance or a high-deductible plan. An employer in a high-cost state can enjoy lower workers' comp costs compared with a peer employer in a low-cost state. This can serve as a magnet for individual employers. But it is also a signal to regulators who need to maintain a healthy market for workers' comp insurance.

States need to decide if they can afford grossly higher costs in workers' comp. They should be dogged in offering incentives to employers to control injuries. States also need to reduce the inefficiencies generated by laws and regulations. Wisconsin is an example of a state, which pays relatively high benefits to injured workers, but also has a low rate of long-term injuries. When they occur, claims are resolved efficiently. Oregon is an example of a highly efficient system of laws and regulations. If our analysis is correct, these states are not threatened by a spiraling of insurance costs as may happen in highly inefficient systems.

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# Backup Table

| A | B | C | D |
|---|---|---|---|
| State | cost of insurance | Long term rate | Efficiency |
| | | | |
| **CA** | 127% | 35% | very adverse |
| **FL** | 67% | -28% | very adverse |
| **TX** | 50% | 18% | adverse |
| **DE** | 49% | average | very adverse |
| **OK** | 34% | average | adverse |
| **RI** | 34% | 45% | mildly favorable |
| **VT** | 34% | -13% | very adverse |
| **NY** | 28% | 15% | mildly adverse |
| **AL** | 23% | -20% | very adverse |
| **CT** | 21% | -17% | adverse |
| **ME** | 20% | 21% | average |
| **NH** | 19% | * | * |
| **CO** | 15% | * | * |
| **HI** | 15% | 39% | favorable |
| **AK** | 12% | 26% | mildly favorable |
| **LA** | 11% | -11% | adverse |
| **TN** | 8% | -5% | mildly adverse |
| **MO** | 6% | -15% | adverse |
| **PA** | 5% | * | * |
| **MI** | 3% | 4% | average |
| **IL** | 1% | average | average |
| **Nation** | average | average | * |
| **MT** | 0% | 18% | mildly favorable |
| **GA** | -2% | -19% | mildly adverse |
| **KS** | -2% | -24% | adverse |
| **NJ** | -2% | -15% | mildly adverse |
| **NV** | -4% | -28% | adverse |
| **MN** | -12% | -40% | adverse |
| **NE** | -13% | -23% | mildly adverse |
| **KY** | -14% | 5% | mildly favorable |
| **MS** | -15% | * | * |
| **IA** | -20% | -43% | adverse |
| **MA** | -21% | 16% | favorable |
| **MD** | -21% | -15% | average |
| **ID** | -23% | * | * |
| **NC** | -23% | -34% | mildly adverse |
| **ND** | -23% | * | * |

| **SD** | -23% | * | * |
|---|---|---|---|
| **WI** | -24% | -8% | mildly favorable |
| **AR** | -29% | -19% | mildly favorable |
| **SC** | -34% | -19% | mildly favorable |
| **IN** | -40% | -24% | mildly favorable |
| **VA** | -42% | -42% | average |
| **NM** | -43% | -45% | average |
| **OR** | -55% | -15% | very favorable |
| **UT** | -60% | -37% | favorable |
| **AZ** | -64% | -37% | favorable |
| | | | |
| **OH** | ** | * | NA |
| **WA** | ** | 16% | NA |
| **WY** | ** | * | NA |
| **WV** | ** | 177% | NA |

A = States, ranks in descending order of relative insurance costs.
B = Relative insurance costs, 1/1/2002, per Actuarial and Technical Solutions
C = Departure of long term injury frequency from the national average, 2000, per Work Loss Data Institute
D = relative efficiency of system of laws and regulations

* Does not participate in OSHA data collection program
** Not analyzed by Actuarial and Technical Solutions.

Methodology: Long term injury rates were compared with relative insurance costs. The balance of the difference in insurance costs not explained by long term injury rates was attributed to relative level of efficiency (friction factor). Example: Michigan's insurance costs are close to average. However, it has a long term injury rate 15% above average. The state's system of laws and regulations are therefore estimated to be relatively more efficient than the average.