

ECONOMIC SCENE

Repairing workers' comp will be Schwarzenegger's next big challenge.

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AFTER winning authority to borrow to keep the state afloat, the next test of Gov. Arnold Schwarzenegger's ability to govern will not involve gay marriage or a constitutional amendment permitting immigrants to be president. Instead, it will be fixing the crisis in California's workers' compensation system, the program that provides cash benefits and medical services to millions of workers injured on the job.

"I call on the Legislature to deliver real workers' comp reform to my desk by March 1," Mr. Schwarzenegger said in his state of the state address in January. "Modest reform is not enough."

That deadline has come and gone. With the Legislature still deliberating and the governor drafting a ballot initiative, it is unclear what will happen next -- but it is clear that the state workers' compensation system needs surgery. The predicament highlights what can go wrong in workers' compensation, a program that generally works well in most states.

Workers' compensation was the nation's first social insurance program. Most states passed laws in the 1910's and 1920's that made companies liable for workplace injuries on a no-fault basis, but limited the amount they had to pay. Workers gave up the right to sue their employer. The conventional wisdom is that workers and employers gained because the prevailing court system had been unpredictable and inefficient. Workers had typically received little from filing a negligence suit, and legal costs were high.

After California passed workers' compensation legislation in 1911, legal disputes were all but eliminated: fewer than 2 percent of claims for permanent injuries were contested in 1924-25. The central problem in California now is that the costs paid by employers are the highest in the country, while the benefits received by workers are about average -- in part because many cases are disputed, which wastes resources.

Total costs for California employers increased to \$29 billion in 2003 -- eight times the gross domestic product of Haiti -- from \$11 billion in 1998. By one estimate, the average employer in California pays 5.2 percent of payroll for workers' compensation insurance, more than twice the average of other states. Rates are much higher in hazardous occupations: 43 percent for loggers, 33 percent for roofers, 22 percent for carpenters and 18 percent for truck drivers.

The governor maintains that these high costs are the main reason jobs are leaving the state. But this confuses who writes the check (employers) with who bears the burden of the program (employees). Research has found that most workers' compensation costs are shifted to workers in the form of lower wages over time, so the effect on jobs is probably minimal.

Nonetheless, reducing inefficiency and administrative costs is to everyone's benefit. The main problems with California's system are:

Thirty percent of claimants who miss more than a week of work hire a lawyer -- much higher than in the other states -- according to Robert Reville, director of the Rand Institute for Civil Justice. Lawyers are involved in three-quarters of permanent disability cases, and their legal fees averaged \$8,352 in 2002, or 20 percent of combined medical and cash

benefits. For a system intended to reduce litigation, these figures represent failure.

Prof. John Burton of the Rutgers School of Management and Labor Relations, widely considered the nation's leading workers' compensation scholar, traced many of California's problems to its complex system for rating permanent injuries that are only partly disabling. Such injuries account for almost 90 percent of benefit costs in California and 70 percent nationwide. Because the system gives much discretion, litigation is common for hard-to-measure medical conditions like back sprains. Furthermore, some injuries, like those to the shoulder, receive particularly low benefits compared with the wage loss workers experience.

The adversarial relationship that develops between workers and employers in contested claims causes California to have one of the lowest return-to-work rates of all states.

Medical costs are high, almost as high as the cash benefits that are meant to replace lost wages. Because workers' compensation insurance pays all the bills, doctors and patients have little incentive to restrain costs. Increasingly, in California and elsewhere, health care providers are shifting medical costs to workers' compensation by prescribing more services or charging more per service.

Medical costs are also high because workers and employers often hire dueling doctors to bolster their cases. Doctors selected by workers tend to rate a given injury as 34 percent more severe than doctors selected by employers or insurers; independent doctors tend to be between, but closer to employers' doctors. With this much difference of opinion, it is no wonder that so many cases are disputed.

While there is much agreement about the source of the problems, there is considerable disagreement about the solutions.

Professor Burton proposes using the American Medical Association's guidelines for rating the severity of disabilities. The guidelines are used in most states and provide a more objective and more clear basis for decisions, although he acknowledges that they are imperfect and should be adjusted to reflect earnings losses associated with various injuries.

He also proposes basing claimants' lawyers' fees on the difference between the amount employers offer and the award workers receive -- the lawyers' value added -- rather than the full amount of the award. And to foster cooperation, he suggests giving lawyers a bonus if workers return to work for a specified length of time.

A draft ballot initiative by Mr. Schwarzenegger would raise the burden of proof for workers to receive benefits; require physicians to use objective, observable medical evidence to assess injuries; restrict an employee's choice of doctor to those agreed to by his or her employer; deny compensation for impairments that result from cumulative activities, like back sprains, unless they are proved to be "predominantly caused by actual activities of employment"; and deny compensation for other impairments unless a single work-related incident caused at least 10 percent of the disability.

Although restricting choice of doctor is controversial in California, Professor Burton notes that other states have limited the access to doctors for years.

He warns, however, that not compensating employees for injuries that arise from work but cannot be pinpointed to a particular event could have a major unintended consequence: employers could possibly be sued for large damages outside the workers' compensation system.

This type of collateral damage would set workers' compensation insurance back a century.