Questioning Conventional Wisdom...

Do Higher Workers' Compensation Costs Drive Companies Out of State?

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In 1910, Missouri's governor appointed a commission to investigate the feasibility of a workers' compensation law. So contentious was the issue, that it took 16 years for the state to enact legislation because of fears that a measure would drive business away.

Fast forward to the 21st century, and you'll find there are still fears in Missouri and other states that their workers' compensation programs spur businesses to relocate to less-costly states. Comprehensive reforms of the workers' compensation system have been on the table in almost every state in recent years. At least nine states undertook major reforms of their workers' compensation systems in 2004 alone, although few states enacted substantial reforms.

In most cases, the impetus for reform has been the perception that higher workers' compensation costs send businesses and jobs to less-expensive states. In his 2004 state of the state speech, California Governor Arnold Schwarzenegger asserted that "California employers are bleeding red ink from the workers' comp system. Our high costs are driving away jobs and businesses."

California went on to enact worker compensation reforms in April 2004. A bill to further reform the system was introduced in January 2005.

Despite nearly universal claims of job losses from escalating workers' compensation costs, little research exists to either support or deny these claims.

The U.S. system of workers' compensation is actually a set of 51 different systems representing each of the 50 states and the District of Columbia, and a federal system to cover federal employees, coal miners suffering from black lung disease, veterans injured on active duty, and longshore and harbor workers. In virtually all states participation is mandatory for all but the smallest employers, generally those with fewer than five workers. Compensable injuries and illnesses, benefit levels, and other administrative characteristics vary widely across the states.

According to the National Academy of Social Insurance, roughly 45 percent of workers' compensation benefits are for medical care, with the remainder going toward cash benefits. Cash benefits for total disability typically equal some fraction of the predisability average weekly wage (often two-thirds) up to a maximum benefit. Cash benefits for a partial disability typically conform to a schedule of benefits linked to specific impairments. Because workers' compensation benefits are excluded from income taxation and wage replacement rates are relatively high, the system can lead to after-tax wage replacement greater than the worker's actual wages.

> "The U.S. system of workers' compensation is actually a set of 51 different systems."

Efforts in the Tenth District

Echoing the fear that high costs drive away business, Oklahoma House Minority Leader Todd Hiett, a Republican, judged that the state's "expensive, lawyer-friendly workers' comp system is a leading cause of 'job flight' from Oklahoma, as employers move to states with more business-friendly environments."

Oklahoma's House approved a reform package in March that would encourage mediation between injured workers and their employers, take steps to reduce injured workers' medical costs, increase marketplace competition for workers compensation insurance and increase death and disfigurement benefits for injured workers.

And back in Missouri, the governor signed a bill in March that will allow employers to require workers to use sick time or paid time off to recover from a work-related injury. The measure also requires physicians to use only "objective" medical findings about a worker's injury, not "subjective" information about pain. Another section of the law requires that the workplace be the "prevailing" factor in a worker's injury, where it previously only had to be a "substantial" factor.

The legislation will only serve to delay injured workers from getting medical care, says a national labor leader.

"The bill in Missouri is frankly right out of the playbook that's been offered by insurance," says Robert McGarrah Jr., workers' compensation coordinator for the AFL-CIO. Requiring the workplace to be the "prevailing" cause of an injury is unfair, he says.

"Anyone can have a back problem, go to work and lift a box or slip, and the insurance company is going to say it's not the prevailing factor. The insurance company is looking for ways to avoid paying the claim. That's the distressing thing that's happening with the insurance drive to cut costs. It's going to hurt businesses in the long run."

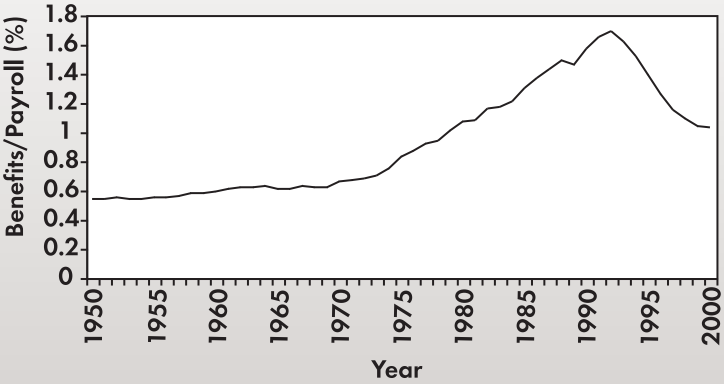
Reducing costs by restricting covered care will be counterproductive, he says, as workers resort to litigation to get their medical care compensated.

However, labor leaders are not against workers' compensation reforms. Nearly all parties involved agree that it's worthwhile to look at updating these programs to reflect changes in health care and occupational trends.

In Nebraska, a coalition that includes business and labor leaders will be reviewing its program this summer.

"We're equally concerned about safety, and the care and service of the injured," says Terry Moore of the Omaha Federation of Labor. "But it has to be a fair process for both labor

FIGURE ONE: **Benefits as a Percentage of Covered Payroll**
United States, 1950-2000



and business, and the only way to accomplish that is for business and labor to work together with government."

Trends in workers' comp

Given the importance of the workers' compensation system in providing injured workers with sufficient, timely and certain benefits, and the role of workers' compensation insurance in limiting employers' liabilities, a proper analysis of the relationship between workers' compensation and employment is critical to developing sound policy options. Results from an analysis conducted at the Federal Reserve Bank of Kansas City reveal that higher workers' compensation costs relative to other states or time periods do indeed lead to lower employment levels, but the impact is small and not likely a significant factor in explaining cross-state variation in employment over time.

Workers' compensation benefits as a share of covered payroll increased at moderate rates from 1950 to 1970, rising less than 10 percent over each decade (Figure 1). The 1970s and 1980s saw much more dramatic growth in benefits, with 10-year increases of roughly 60 percent and 45 percent, respectively. The 1990s ushered in a remarkable turnaround, however, as benefits as a percentage of covered payroll declined 38 percent.

Although numerous states undertook major workers' compensation reforms in the 1990s, recent research suggests that other factors were the major force in the decline in benefits payments. The decline was due largely to reductions in injury-induced days-away-from work and restricted workdays, but economists from Boston University and the Bureau of Economic Analysis recently found that workers' compensation reforms in the 1990s were responsible for only 7 percent to 9.4 percent of the substantial nationwide decline. Other likely factors, according to research from the Department of Labor, include a shift in employment away from injury-prone sectors, increases in underreporting of workplace injuries and illnesses, cost-containment measures on the part of employers and insurers, elimination of workplace hazards, and improved Occupational Safety and Health Administration enforcement.

In 2002, the latest year for which complete data are available, the average benefits per $100 of covered payroll was $1.17 nationwide, but values ranged from $0.41 in the District of Columbia to $4.49 in West Virginia. West Virginia was a substantial outlier; the high cost of benefits can probably be attributed to the fact that mining, perhaps the most injury-prone sector of the economy, is an important industry in that state.

In the Tenth District, states averaged $1.23 in workers' compensation benefits per $100 of covered payroll in 2002, slightly higher than the U.S. average (Figure 2). New Mexico paid the fewest benefits relative to covered payroll in the Tenth District with $0.98, while Wyoming paid the most at $1.59. The Tenth District states roughly followed national trends in workers' compensation benefits over the 1976-2000 study period.

Workers' compensation costs and employment

If states are seeking to reform their workers' compensation laws with the sole intent of lowering costs to attract or keep businesses, they might be disappointed.

The analysis evaluates the claim that high workers' compensation costs drive jobs to lower-cost states by estimating the relationship between workers' compensation costs and state employment from 1976 to 2000. The goal of the analysis was to isolate the role that workers' compensation costs play in the determination of state employment from other likely factors.

Results of the analysis suggest that workers' compensation costs have a negative effect on both employment and wages, but the magnitude of the effect is quite small: a 10 percent increase in workers' compensation benefits would be expected to yield only a 0.11 percent decline in employment and 0.10 percent decline in real wages. To put these results in perspective, consider the effect of motor fuel prices on wages, which also was estimated in the model. A 10 percent increase in motor fuel prices would lead to a 0.5 percent decline in wages, fully five times the effect on wages of an increase in workers' compensation costs of similar magnitude. A 10 percent increase in wages would be expected to lead to a 2.1 percent decline in employment, according to model results, roughly 20 times the effect of a 20 percent increase in workers' compensation costs.

Although the estimated impact of workers' compensation costs on employment and wages is small in relative terms, large changes in workers' compensation costs could still lead to substantial changes in employment. If workers' compensation benefits in Wyoming (highest in the Tenth District) were to drop to the level in New Mexico (lowest in the Tenth District), for example, a drop of nearly 40 percent, employment in Wyoming would be expected to be higher by roughly 1,100 jobs, or 0.4 percent, about equal to the number of jobs created in the Wyoming economy in the first quarter of 2005.

Of course, states such as Oklahoma and Missouri are hoping this will be the case with their reforms. Federal Reserve Bank of Kansas City Board of Directors Chairman Robert Funk of Oklahoma City has worked on a reform bill crafted by the Oklahoma House with the intent to reduce legal fees but increase death benefits for workers. He holds a monthly business forum with 15 randomly selected companies to gauge the business climate.

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"Fourteen of the 15 businesses said their major concern was workers' compensation costs," said Funk, who is also the chief executive of Express Personnel Services International.

"One said they only had 20 employees; if they moved 20 miles down the road to Kansas, they would save $87,000 in workers' compensation costs. That's quite a lot of money for a small employer," said Funk.

In another case, representatives of a larger national employer told Funk that their company, operating in three states—Indiana,

FIGURE TWO: **Workers' Compensation Benefits per $100 Payroll**
Tenth District, 2000

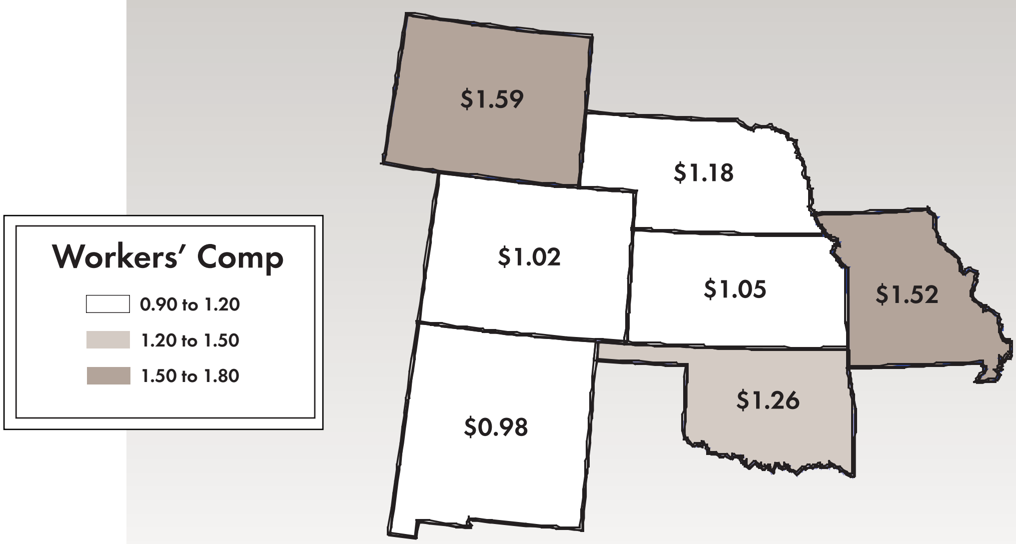
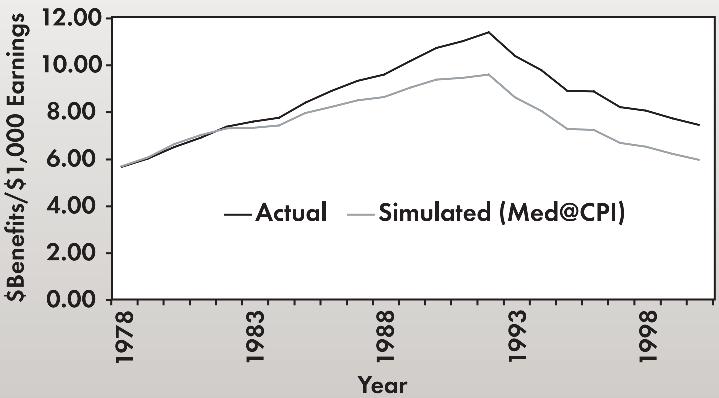


FIGURE THREE: Simulated Workers' Compensation Benefits
Medical Cost Index=CPI, 1978-2000



An analysis shows workers' comp costs would have been 80% of what they were in 2000 if medical costs had kept pace with the Consumer Price Index.

Tennessee and Oklahoma—found workers' compensation costs in Oklahoma to be three times higher than in the other states. Should the employer decide to expand, it will likely choose to do so in the other states rather than Oklahoma, said Funk.

To what degree workers' compensation costs will motivate a company in its decision to relocate is unclear. Funk concedes that other factors will play into that decision—quality of life, cost of living and ease of transportation, for instance. In Oklahoma's case, the state boasts a highly productive work force, Funk says.

> "Higher medical costs lead to substantially higher workers' compensation costs."

Anecdotal evidence suggests that workers' compensation costs are no doubt a heavy burden for some companies, and these companies may well seek relief in another state with lower costs. But the more systematic evidence suggests that these cases are isolated, and that workers' compensation cost disadvantages do not lead to widespread shifts in employment to lower-cost states.

The reason for rising costs

A secondary objective of the analysis was to estimate the determinants of workers' compensation costs.

The most salient result from the model is that higher medical costs lead to substantially higher workers' compensation costs. Specifically, medical cost inflation of 10 percent leads to workers' compensation cost inflation of 4.7 percent. Over the time period of this analysis, medical costs increased approximately 356 percent, suggesting that workers' compensation costs would be much lower today had medical costs kept pace with consumer prices, which advanced only 177 percent over the period. In fact, the results suggest that workers' compensation costs would have been roughly 80 percent of what they were in 2000, all else equal. Figure 3 compares actual workers' compensation benefits for the average state over the period 1978-2000 to simulated workers' compensation benefits if medical costs were to have risen at the same rate as consumer prices. The large difference in workers' compensation costs would not have made much of a difference in national employment, however. Total U.S. nonfarm employment would likely have been only 0.1 percent higher in 2000 had medical costs merely kept up with consumer prices, yielding 158,000 additional jobs.

Other results indicate areas with higher union density tend to have lower workers' compensation costs, likely reflecting more regulated working conditions imposed by unions. Other

key determinants of workers' compensation costs include wage levels (greater pay increases costs), higher poverty rates (increases costs), older workforce (increases costs) and education levels (surprisingly, the higher the proportion of uneducated workers, the lower the costs).

Data from the National Academy of Social Insurance indicates that 75 percent to 80 percent of employers' costs are benefits; the remaining portion covers administration and legal costs.

What impact?

The study by the Federal Reserve Bank of Kansas City evaluates the impact of workers' compensation costs on total employment and average wages across states over time. The main finding is that higher workers' compensation costs lead to lower wages and employment levels, but that the effects are relatively small. The study also evaluates the determinants of differences in workers' compensation costs and suggests that medical costs are a substantial factor. Although workers' compensation costs have declined overall since the 1990s, all else the same, benefits, and therefore costs, would have been much lower had medical costs merely grown at the same rate as consumer prices.

There has been and continues to be a loud and consistent clamoring for workers' compensation reform across the states. The results here suggest that efforts to reform workers' compensation systems, to the extent the reforms reduce costs, are likely to have a positive modest impact on employment and wages and may be worth undertaking. However, workers' compensation reforms are unlikely to be the great boon to employment that policy makers would like to see. Policy makers may instead want to turn their efforts to addressing the skyrocketing costs of medical care.

TONI LAPP, senior writer, also contributed to this article.

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.

Other research available

from The Federal Reserve Bank of Kansas City

The Supervisory Framework Surrounding Non-Bank Participation in the U.S. Retail Payments System: An Overview

http://www.kc.frb.org/FRFS/PSR/Sullivan_Supervision_nonbank_pmt_providers_WP0403.pdf

Do Only Big Cities Innovate? Technological Maturity and the Location of Innovation

http://www.kansascityfed.org/PUBLICAT/ECONREV/ermain.htm

Credit Union Growth in the Tenth Federal Reserve District: How Legal and Regulatory Changes Have Affected Credit Union Expansion

http://www.kansascityfed.org/PUBLICAT/FIP/Fipmain.htm#2005

Consumption Taxes: Macroeconomic Effects and Policy Issues

http://www.kansascityfed.org/PUBLICAT/ECONREV/ermain.htm

A Puzzle of Card Payment Pricing: Why Are Merchants Still Accepting Card Payments?

http://www.kc.frb.org/FRFS/PSR/WP04MerchCardAcceptance12-28-04.pdf

What Do Expected Changes in U.S. Job Structure Mean for States and Workers in the Tenth District?

http://www.kansascityfed.org/PUBLICAT/ECONREV/ermain.htm