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Workers' Compensation under Alternative Insurance Arrangements

One of the most important differences among state workers' compensation programs concerns the insurance arrangements for providing workers' compensation coverage. State laws prescribe workers' compensation benefits, but these laws assign to employers the responsibility for providing benefits. The employers obtain workers' compensation coverage to provide these benefits by one of three mechanisms, depending upon the options available in their state. They may purchase insurance from 1) a private insurance carrier, 2) a competitive state workers' compensation fund, or 3) an exclusive (monopolistic) state workers' compensation fund. In addition, self-insurance is available in almost every state upon satisfying prescribed criteria. This commingling of private (insurance carrier) and public (state fund) approaches to providing workers' compensation benefits is a distinctive feature of workers' compensation in the United States.

Another important difference is the degree to which workers' compensation insurance pricing has been deregulated. The private provision of workers' compensation in the United States was highly regulated until recently. Carriers were subject to "pure administered pricing," under which maximum permissible rates were largely determined by state rating bureaus, and the rates charged by carriers were subject to prior approval by state insurance commissions. However, most states in recent years have dismantled (to varying degrees) their systems of regulation for workers' compensation insurance pricing. In fact, the deregulatory movement begun by just a few states in the early 1980s has become so widespread that now only a few jurisdictions continue to use the pure administered approach.

In our recent book, *Workers' Compensation: Benefits, Costs, and Safety under Alternative Insurance Arrangements* (2001, W.E. Upjohn Institute), we use a unique panel data set of state-level data for 48 jurisdictions between 1975 and 1995 to explore the effects of insurance arrangements on workplace safety, the structure of the workers' compensation insurance market, and the employers' costs of workers' compensation insurance. In addition, we examine the trade-off between the benefit adequacy and affordability objectives of state workers' compensation programs and estimate the impact that the imposition of federal standards for benefit adequacy would have on workers' compensation costs.

There is substantial debate about the relative merits of public versus private provision of workers' compensation insurance and about the regulation of private-carrier-provided workers' compensation insurance. This debate has, for the most part, centered on questions concerning the availability and affordability of compensation insurance, since these two variables are relatively easy to measure. However, questions have also been raised regarding the "quality" of services provided to the parties to workers' compensation. Labor advocates, for example, have been particularly concerned that the profit motive causes insurers to unjustly deny claims or otherwise

impede the delivery of benefits to workers, thus exacerbating the adverse consequences of workplace injuries or diseases.

Here, we focus on our results and conclusions with respect to only one of the research questions we addressed: the impact of the deregulation of the workers' compensation insurance market on employers' costs.

Deregulation and Employer Costs

Economic theory fails to offer unambiguous predictions about the impact of the regulation of rates in private insurance markets. In part this is because these effects depend on the behavior of the regulatory agency, which is driven by political rather than economic considerations. A regulatory body that aligns itself with employer-consumers of workers' compensation insurance will suppress rates below competitive levels (at least in the short run). On the other hand, regulators who are more responsive to the insurance industry may help cartelize the market, resulting in supracompetitive rates. Even those regulatory agencies that pursue the public interest can inadvertently engender price distortions, due to lags in the rate-making process that delay the price response to changes in market conditions.

Empirical study of property-casualty insurance (principally, automotive insurance) has usually found that rates increased following deregulation, a result consistent with the hypothesis that regulators respond to consumer interests by suppressing insurance prices. However, the results from those studies examining workers' compensation insurance rates have been decidedly mixed. The empirical study of rates and deregulation is very difficult, and it is likely that no empirical study will ever surmount all of the problems and completely dispose of the issue once and for all. Nevertheless, we believe that we improve on previous research in at least two important ways.

First, while earlier studies typically used relatively simple measures of the regulatory environment (often states were categorized solely as "regulated" or "deregulated" jurisdictions), we use a more complex characterization of the regulatory environment in order to capture the actual practices of the regulatory agency as well as interstate differences in statutory regimes. We categorize state insurance market regulatory regimes as

- pure administered pricing, under which all insurers must use an identical set of manual rates that a) include an allowance for benefit payments ("loss costs") as well as for loadings for factors such as underwriting expenses, b) were developed by a rating bureau, and c) have been approved by the state regulatory agency;

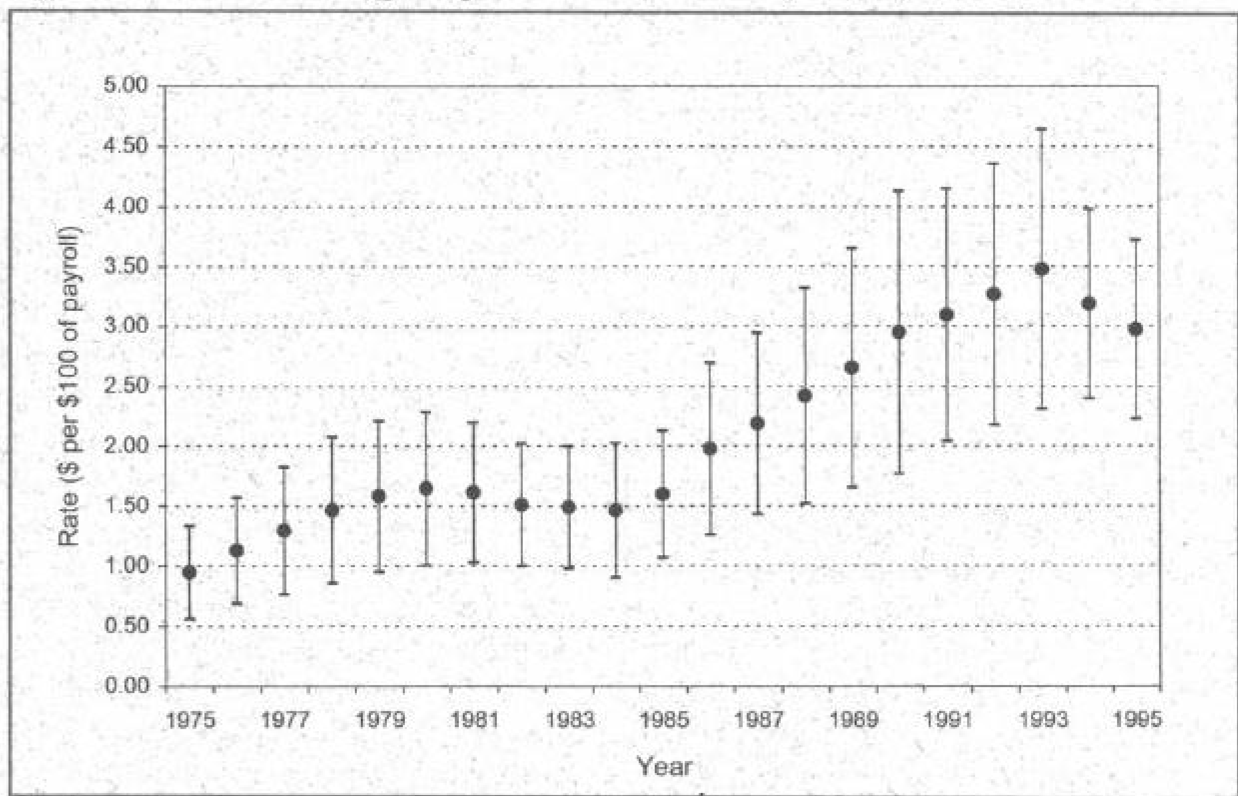
- comprehensive deregulation, under which rating bureaus only publish loss costs and insurers are permitted to set their own rates without first seeking approval of state regulators; or

- three forms of partial deregulation, where at least one of the elements of the pure administered pricing system has been dismantled.

Second, because workers' compensation insurance rates vary among employers both within and among jurisdictions, it is difficult to measure the costs of workers' compensation insurance actually paid by employers. Consequently, most previous research has relied on proxies such as the ratio of incurred losses to premiums written. We use measures that accurately reflect the workers' compensation insurance costs actually paid by the average employer in a particular state during a particular year.

Figure 1 depicts summary statistics of rate estimates for 48 U.S. jurisdictions in the period 1975-1995. On average, the employers' costs of workers' compensation insurance rose markedly over the study period, from 0.95 percent of payroll in 1975 to 2.97 percent in 1995. The cyclical nature of insurance pricing is also evident from the figure. Finally, the data reveal that interstate variation in adjusted manual rates increased considerably between 1985 and 1990; thereafter, the variation generally declined.

Figure 1 National Average Adjusted Manual Rates (±1 S.D.) 1975-95



Since workers compensation insurance costs are affected by a variety of factors in addition to the regulatory environment, a simple comparison of costs under different regulatory regimes is inappropriate. Consequently, we estimated multiple regression equations predicting employers' workers' compensation costs as a function of the regulatory regime variables as well as a variety of controls. These controls included the levels of cash and medical benefits, the injury rate, and

the proportion of the workforce covered by the state workers' compensation program, as well as state and year dummies to control for unobserved state- and time-invariant factors affecting employer costs. In addition, we also attempted to examine the interaction among the regulatory regime, the state of the insurance market, and the behavior of the regulatory agency prior to regulation.

Empirical Results

Most forms of partial deregulation are, on average, associated with higher employer costs for workers' compensation. On the other hand, the most comprehensive form of deregulation—loss cost systems that do not require prior approval—is, on average, associated with lower employer costs. In addition, the impact of deregulation on costs depends not only on the statutory form of deregulation, but also on the behavior of the regulatory agency prior to deregulation; where the regulatory agency has suppressed rates, deregulation is more likely to lead to increased costs. The behavior of the regulatory agency is apparently related to the state of the insurance market; regulatory agencies are more likely to suppress rates during a hard market (when insurance demand exceeds supply and prices are increasing) than during a soft one. Consequently, the impact of deregulation varies over the insurance cycle.

What may we conclude from these results? Given the contradictory findings for partial and comprehensive deregulation, it is difficult to draw clear inferences concerning the nature of regulation, i.e., whether regulatory agencies are more likely to respond to employers and suppress rates or whether they are more likely to help the insurance industry cartelize the market. Our inability to do so leads us to conclude that regulators do neither, at least not consistently. Lags inherent in the regulatory process may be responsible for the inconsistent findings. However, it may also be due to the ebb and flow of political pressure over the course of the insurance cycle. As the market hardens, political pressures from employers may force regulators to become more concerned with the impact of insurance rates on the state's business climate, and as a result, rates are suppressed. When the market softens once again, the political pressures ease and, concomitantly, regulators' concerns over the effect of workers' compensation rates vanish and rates are allowed to rise to competitive (and, perhaps, supracompetitive) levels.

Insurers respond to this pattern of regulatory behavior by increasing prices during the soft phase of the insurance cycle, which is easier to accomplish where the market has been partially deregulated. Anticipating rate suppression when the market hardens again, insurers in partially deregulated systems are likely to keep market rates higher than the competitive level during the soft phase of the cycle. In a partially deregulated environment, this is facilitated by the rating organization, which promulgates rates that serve as a pricing point for insurance carriers. This accounts for the asymmetry between comprehensive and partial deregulation. comprehensive deregulation results in lower prices during both phases of the insurance cycle, while insurers take advantage of regulatory indifference to increase rates, during the soft phase, in anticipation of the coming crunch when the market hardens once again.

This interpretation of our results leads us to conclude that a completely deregulated market is a more efficient delivery system and is, therefore, preferable to either partial

deregulation or administered pricing. The latter two alternatives seem to be associated with the inefficiencies resulting from insurer uncertainty over their ability to respond to market changes. Furthermore, anecdotal evidence from states such as Rhode Island and Maine suggest that insurance rate regulation can sometimes have near-catastrophic consequences for all the stakeholders in the workers' compensation program.

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