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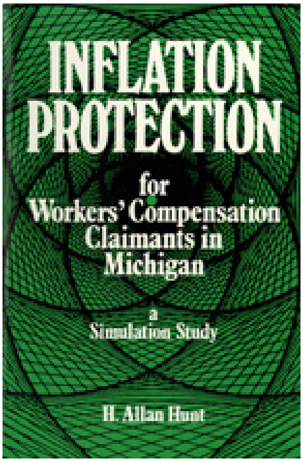
Introduction



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CHAPTER 1
Introduction

One of the serious shortcomings of workers' compensation as an income maintenance system for the long term disabled is the lack of protection from inflation. The weekly compensation rate in most states is set at two-thirds of the weekly wage as of the time of the injury. There is debate about the adequacy of this ratio, taking into account such factors as the historical maximum at two-thirds of the state average weekly wage, the loss of some or all fringe benefits, the tax free status of workers' compensation benefits, etc. But there is no room for debate on the adequacy of a benefit linked to a wage level 10, 20, or 30 years ago.

During inflationary times like the present, the passage of just a few years with double-digit inflation can have a devastating impact on the standard of living of a disabled worker. This concern is reflected in the following statement by William Marshall, President of the Michigan AFL-CIO, concerning the Michigan workers' compensation system:

> Perhaps the most inequitable part of our present law insofar as benefits is concerned, is the lack of a cost-of-living provision for injured workers. In this age where inflation is a fact of life, our current law fixes benefits as of the date of injury and condemns the disabled to an erosion of their purchasing power and in the final result to welfare.[1]

1. *LABORegister* 3 (June 1979), p. 173.

But it is not just labor interests that have endorsed the principle of inflation adjustment for workers' compensation beneficiaries.

The National Commission on State Workmen's Compensation Laws in 1972 recommended benefit adjustment for permanent total disability and fatality cases:

> We recommend that beneficiaries in permanent total disability cases have their benefits increased through time in the same proportion as increases in the State's average weekly wage.[2]

In May of 1974, a federal interdepartmental study group on workers' compensation published a "White Paper on Workers' Compensation." This report represented the Republican administration's reaction to the recommendations of the National Commission on State Workmen's Compensation Laws. It too endorsed the principle of benefit adjustment:

> *Cost of Living Adjustment.* Beyond the recommendations of the National Commission, we are concerned by the erosion of the value of workers' compensation benefits due to the long-term impact of inflation. Benefits which may have been adequate at the time they were granted, have, over the years, become seriously inadequate.
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> The States, therefore, should enact an annual cost of living adjustment in benefits paid regularly to employees' survivors and to persons with long-term disabilities. This adjustment should be automatic and compensate for changes in the purchasing power of benefits. On a prospective basis, this should be im-

2. Recommendation 3.14. See also Recommendation 3.22 (fatalities). *The Report of the National Commission on State Workmen's Compensation Laws* (Washington, DC: USGPO), July 1972, p. 64 and p. 71.

> plemented immediately. The complexity of retroactive adjustments for those disabled in the past requires further study, including consideration of a gradual phase-in of benefit adjustments.[3]

More recently, the Policy Group of the Federal Interdepartmental Workers' Compensation Task Force, in a follow-up to the White Paper, noted: "An annual cost-of-living adjustment for benefit levels, as recommended in the *White Paper,* is provided in only fifteen states. These vary widely as to the types of benefits adjusted and the formulas used in computing the adjustments."[4] Further, this group added its weight to the now familiar refrain:

> We recommend that long-term wage replacement benefits to disabled workers or survivors be increased annually in proportion to the increase in the State's average weekly wage, and that the pre-injury wage be similarly escalated in all calculations. We urge that State insurance regulatory authorities carefully review and control proposed trend or projection factors in respect to such escalation provisions and that alternative methods of funding increments be explored. This recommendation would apply to all new cases entering the workers' compensation system.
>
> Cases already receiving long-term benefits should also be adjusted to current wage levels. It is difficult to know how the cost of such payments should be allocated, however. States which decide to enact such adjustments, may wish to provide part or all of the funding.[5]

Lastly, on September 10, 1980, the International Association of Industrial Accident Boards and Commissions

3. *White Paper on Workers' Compensation: A Report on the Need for Reform of State Workers' Compensation* (Washington, DC: USGPO), May 1974, pp. 4-5.

4. "Workers' Compensation: Is There a Better Way" (Washington, DC: mimeo), January 19, 1977, p. 21.

5. Ibid., pp. 42-43.

(IAIABC) adopted a new set of standards at their 66th Annual Convention. This represents an attempt by these administrators of workers' compensation programs in the United States and Canada to define the parameters of an ideal workers' compensation system. New *Standard Number Ten* endorses the principle of inflation adjustment:

> (10) BENEFIT ADJUSTMENTS—Compensation payable for total disability or survivor benefits should be adjusted annually to reflect percentage changes in the average weekly wage of the jurisdiction.[6]

Thus there would appear to be widespread agreement that inflation protection for long term workers' compensation beneficiaries is desirable.

While Michigan is one of the states that does provide some inflation adjustment, there is still substantial need for inflation protection. Michigan statute specifies that permanently and totally disabled claimants shall not receive lesser compensation (in weeks or in amounts per week) than is currently provided by law. This amounts to a limited inflation adjustment program, since the benefit is still conditioned by the claimant's wage (so long as the minimum benefit does not come into play). But even this limited adjustment is only paid to those permanently and totally disabled, which is very narrowly defined in Michigan.[7] The result is that a total of less than 1,500 of the roughly 25,000 cases in active payment status were receiving such inflation adjustment payments as of late 1979. This is a start, but it is hardly sufficient to come into compliance with the recommendations recited above.

Since there is little or no disagreement with the premise that inflation protection for some or all long term workers'

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6. Report of the Legislation Committee of the IAIABC, September 8, 1980 (mimeo), p. 7.

7. Under Michigan statute, the totally and permanently disabled are the blind, the incurably insane, double amputees, and those who have lost the industrial use of both arms, both legs or one of each.

compensation beneficiaries would be a good thing, the problem of implementation clearly is the cost. In the words of the IAIABC Legislation Committee report:

> It is understood there are cost implications to this proposal perhaps greater than those which attach to any of the other recommendations we make to the Association. We understand that the legislative response to such recommendations will vary from jurisdiction to jurisdiction. The Committee recommends, and believes the Association will endorse, the explicit statement of principle here that a disabled employee's wage replacement ought to in some manner be assured of retaining its purchasing power. That this might not be an immediately attainable goal should not detract from the fact that *it is a desirable goal.*[8]

When the subject of inflation protection was considered by the Workers' Compensation Reform Task Force in Michigan in August of 1979, the National Council on Compensation Insurance (NCCI) reported that the addition of inflation adjustment would increase benefit costs in Michigan by an estimated 41.6 percent, and this was for a plan with a 6 percent annual cap on the adjustment. Even worse, when inflation adjustment was imposed over the anticipated increase in the maximum benefit to 100 percent of the state average weekly wage, the result would be an estimated 69 percent increase in benefit costs.

It would not be an overstatement to say that these figures shocked some of the Task Force members. Further, it made a compromise reform package difficult, if not impossible, to negotiate. The major business objective was to reduce workers' compensation costs, in the future if not immediately. This translated into specific proposals for coordination of workers' compensation with other income maintenance

8. Report of Legislation Committee, p. 7.

systems, changes in the definition of disability and the statute of limitations, new presumptions on retiree claims and heart or mental disability claims, and others. But if the major labor objectives of increasing the maximum benefit and securing inflation protection for all beneficiaries would raise costs by 69 percent, there was no chance that both sides could secure their objectives.

This paper addresses the issue of the cost of inflation protection from a different perspective. One of the ideas that emerged from the Workers' Compensation Reform Task Force discussions in Michigan was to create a state fund for the purpose of providing inflation protection for workers' compensation beneficiaries. Presumably, the pattern for this suggestion was the current program of differential benefit payments to Michigan's permanently and totally disabled workers' compensation population mentioned above.

The proposal was that insurers would add inflation supplements, in amounts to be specified by the plan, to regular weekly benefit checks as they were distributed through normal channels.[9] Then, at regular intervals (the Second Injury Fund uses six months), the state benefit adjustment fund would reimburse the insurers for the total inflation supplements paid. This plan has the advantage of making maximum use of current administrative machinery, and therefore would entail minimum additional distribution expenses for the workers' compensation system as a whole.

The revenue to make the reimbursement payments could plausibly come from a number of sources, but the specific proposal was that it should be raised by assessment against total indemnity payments by each employer. It could also be raised with some kind of earmarked tax, or even from general revenues, although in neither case would the additional benefit costs be internalized in the production cost of

9. The term insurer refers to both insurance carriers and the self-insured.

the products generating the original injuries—one of the basic principles of the workers' compensation system. The interest earnings of such a state benefit adjustment fund would, of course, not be subject to income taxation. Therefore, a greater proportion of the revenues collected could be translated into benefits for claimants than under a similar benefit adjustment plan in the private sector. This might be particularly significant for a benefit adjustment plan since it will be necessary to accumulate substantial reserves against the lifetime payments that will be required to protect current beneficiaries from future increases in the cost of living.

This paper explores the costs of a state benefit adjustment fund for workers' compensation claimants in Michigan.[10] To facilitate the process, a new methodology was developed. This benefit adjustment model is presented in chapter 2. It grew out of the need to organize the factors in the Michigan workers' compensation system that would impact on the cost of benefit adjustment. It was designed also to utilize the specific data available from the Michigan Bureau of Workers' Disability Compensation, namely, tabulations of active workers' compensation cases by year of injury. Two such tabulations were used to estimate marginal case retention rates and a retention function.

The retention function represents the proportion of cases from a given injury year that will still be drawing weekly income maintenance benefits during each year following the injury year. Thus it describes the persistence of disability cases through time—their retention by the workers' compensation system. Unfortunately, the limited experience (only since 1965) with lifetime benefits for general disability cases in Michigan makes it impossible to observe the tail of the

10. The paper concentrates on prospective benefit adjustment, that is, inflation adjustment for future disability cases. The Appendix demonstrates the application of the methodology developed here to costing retrospective benefit adjustment plans as well.

disability duration distribution. Therefore, the retention function is estimated partly by extrapolation and assumption. This retention function is specific to Michigan, but it should be possible to estimate such a function for any workers' compensation system; thus the methodology should be adaptable to other states.

The model of benefit adjustment is very simple, once the notation is mastered, and it is offered with the expectation that it will prove to be intelligible to policymakers. It is presented not as a finished product, but for further discussion and development. Hopefully, the discussion will lead to improvements that will make the model useful in other applications.

After the development of the conceptual framework for analysis of the benefit adjustment cost problem, chapter 3 presents a simulation of the operation, under stated assumptions, of a benefit adjustment fund for Michigan workers' compensation beneficiaries from the 1978 injury cohort. These results are termed simulations because of the very great level of uncertainty about the number of cases that will be eligible for inflation adjustment payments. This is due primarily to the deficient empirical base for the retention function described earlier. Rather than waiting for years until the actual retention experience is accumulated, it seemed preferable to proceed with a representative, hypothetical retention function and term the results simulations as opposed to projections.

The simulation tracks the fund operation over a 50-year period, representing the expected lifetime of claimants injured in 1978. The simulation results are presented in tables showing the transactions for each year as projected by the benefit adjustment model. This does not imply that it is possible to foresee these events with any clarity, but rather represents an attempt to convey the dynamics of the fund operation in a way that the present value of a 50-year stream of benefit adjustment payments could never do. Nevertheless, it is the present value of this stream, identified in chapter 3 as the forward funding level, which most effectively represents the cost of benefit adjustment.

Chapter 4 probes the sensitivity of this required forward funding level to assumptions about future inflation rates and the number of cases to be adjusted. Since there is no way to accurately forecast these critical parameters, a range of possible values is considered. Then their effect on the required prefunding level of a benefit adjustment fund is determined. In this way, a plausible range for the necessary fund assessment rate is developed despite considerable uncertainty about the future values of the critical parameters.