



Employment Cost Drivers in
Washington State:
The Case for Workers' Compensation and
Unemployment Insurance Reform

A joint research series from the Washington Roundtable and Washington Research Council

THE THRIVE WASHINGTON PROJECT

The Great Recession dramatically changed fiscal conditions in Washington state, possibly forever. The impact of falling revenues and structural budget deficits has elicited a near universal call for a transformative shift in state government. This research series—developed by the Washington Roundtable and Washington Research Council—will provide actionable state policy recommendations that, if enacted, will preserve essential services, lay a foundation for sustainable economic growth and create an environment in which Washingtonians can thrive.

Introduction

Job creation in Washington, as across the nation, remains an urgent priority. During the quarterly economic and revenue forecast on March 17, 2011, Washington state revenue forecaster and chief economist, Dr. Arun Raha, said employment in our state is still 175,000 jobs below the pre-recession peak. He indicated it will be at least another two years before Washington returns to pre-recession employment levels. Persistently high levels of unemployment sap consumer and investor confidence and prolong recovery. In an effort to improve business climate conditions, Gov. Chris Gregoire and a bipartisan group of state legislators have promoted smart workers' compensation and unemployment insurance (UI) reforms this year.

The logic is simple: When state policies inflate hiring costs, fewer jobs will be created. Uncompetitive workers' compensation and UI costs depress employment. And Washington employers have long endured some of the nation's highest workers' compensation and UI costs. The 2011 Competitiveness Redbook ranks Washington second highest among the 50 states in UI benefits paid, fifth in UI taxes per full-time employee, and second on workers' compensation benefits paid.

Recognizing the urgent need for reform, Gov. Gregoire, as part of her "Transforming Washington's Budget" effort, presented policy recommendations in January to more closely align the state with the national mainstream. Lawmakers acted swiftly to enact sensible UI reform. They have also made some gains in workers' compensation policy by allowing for medical provider networks, and they continue to consider a strong workers' compensation reform measure that addresses voluntary settlement agreements.

In this paper, we evaluate Washington's UI and workers' compensation systems and recommend policy reforms that will encourage job development, reduce unfunded liabilities and position Washington for recovery in the wake of the Great Recession.

Workers' Compensation

Workers' compensation systems provide for wage replacement, medical treatment and rehabilitation for injured workers. All states

RECOMMENDATIONS

Workers' Compensation

1. Allow voluntary settlement agreements.
2. Clarify the definition of occupational disease and statute of limitations.
3. Permit private insurers to offer workers' compensation policies.

Unemployment Insurance

1. Protect the trust fund.
2. Refrain from adding new benefits.

Washington's workers' compensation system is among the nation's most expensive and it continues to get even more costly.

Washington ranks 2nd in the nation in benefits per covered worker and 3rd in benefits paid as a percent of covered wages.

offer workers' compensation, in a variety of forms and with significant policy variations. Washington's system, managed by the state Department of Labor and Industries (L&I), is among the nation's most expensive and continues to get even more costly, with large employer premium increases in recent years.

A 2010 study by the National Academy of Social Insurance found that Washington state paid \$778.36 in benefits per covered worker in 2008 (the most recent year for which comparative data are available). This was the nation's second highest benefit level. Moreover, benefits per covered worker increased 11 percent over 2007, and total benefits paid increased 9.9 percent (to \$2.2 billion). By comparison, total benefits paid increased 2.6 percent in Oregon and 4.5 percent in all states from 2007 to 2008.

Washington ranks third in the nation in benefits paid as a percent of covered wages (1.69 percent in 2008, behind West Virginia and Montana). Total workers' compensation benefits paid in Washington grew from \$1.3 billion in 1998 to \$2.2 billion in 2008. That's an increase of 70.4 percent, compared to 34.2 percent growth for all states.

Generous and increasing benefit levels have led to high employer costs. Every two years, the Oregon Department of Consumer and Business Services publishes a study comparing workers' compensation premium rates, state by state. However, unique features of Washington's workers' compensation program frustrate attempts at interstate cost comparisons. For example, Washington calculates premium rates in dollars per payroll hour. Every other state quotes rates as a percent of payroll. (For more information on the Oregon study, see the Washington Research Council brief "The Time Has Come to Fix Workers' Compensation.")

Supporters of the workers' compensation status quo have used the Oregon study to argue that Washington's system provides high benefits at a low cost. Putting aside questions about the accuracy of the study in Washington's case, the most recent edition

shows that Washington's ranking has deteriorated. In 2010, Washington ranked 26th in the country, meaning its premiums were higher than 25 other states and the District of Columbia (Oregon ranked 41st, or 11th lowest in the country). In the 2008 report, Washington's premiums looked much better, at 38th in the nation (Oregon ranked 39th).

The change in ranking reflects recent steep increases in workers' compensation premiums in Washington. Those increases, however, still fail to cover the actual cost of the state's system. A December 2010 audit concluded the Accident Account is insolvent, and there is a 94.1 percent chance the Medical Aid Account will be insolvent within five years.

According to the audit, the insolvency of the Accident Account was due to the economic recession, the fact that loss and loss adjustment expense liabilities increased (to which "the growing duration of time loss claims and frequency of pension awards has contributed"), and "for the past three years premium rates have been insufficient to fund the system." L&I is artificially depressing premium rates below the

ACCIDENT ACCOUNT		
	Actuarial Firm's Best Estimate of the Break-even Rate Change	L&I's Actual Rate Change
2011	34.8%	29.8%
2010	33.0%	4.5%

MEDICAL AID ACCOUNT		
	Actuarial Firm's Best Estimate of the Break-even Rate Change	L&I's Actual Rate Change
2011	11.8%	-10.3%
2010	24.5%	8.4%

Sources: Department of Labor and Industries, Washington State Auditor's Office

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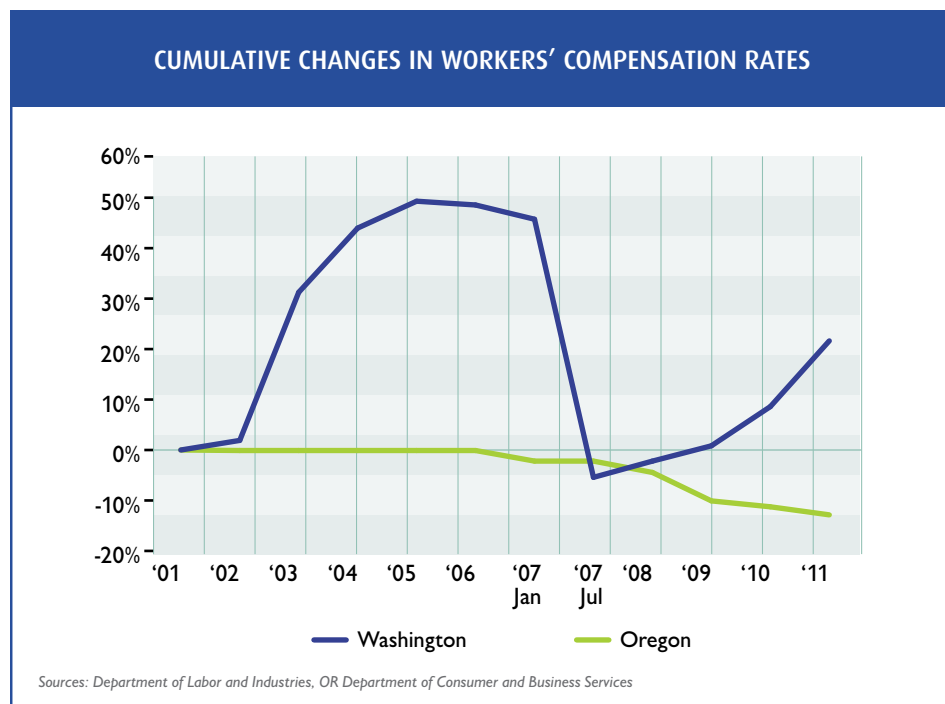
actuarially-recommended level. The agency is required by law (RCW 51.16.035) to make premium rates “the lowest necessary to maintain actuarial solvency of the accident and medical aid funds in accordance with recognized insurance principles.”

Although L&I has not increased rates as much as the actuarial firm recommends, rates have trended up sharply (in 2007, stock market returns subsidized premiums). Oregon, on the other hand, has steadily decreased its rates.

As presently operated, the Washington workers' compensation system has become

employers who provide light duty work for injured workers (versions of these reforms have been under consideration by the legislature throughout the 2011 session). The governor originally also proposed reducing total permanent disability (TPD) pension payments if a worker can do some work, capping pensions at federal retirement age, increasing permanent partial disability (PPD) benefits by 30 percent, and allowing the use of Medical Aid funds for safety and health investment projects.

The governor's support for these reforms has contributed to legislative momentum



insolvent and unsustainable. Significant system reforms are necessary to balance the books without further premium increases that will hinder job creation.

In January 2011, Gov. Gregoire proposed an extensive reform package that, if enacted, would establish a medical provider network, allow certain workers to choose a voluntary settlement, and provide wage subsidies for

this year. Passage of her proposal for medical provider networks represents positive reform. Medical provider networks, common nationally, have demonstrated success in controlling costs and improving patient outcomes.

More must be done. The governor's initial recommendation on voluntary settlements would have limited the option to workers above the age of 55. And she did not address

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serious problems in the state’s definition of occupational disease, the ambiguity of which exposes employers to long-term uncertainty and drives up system costs.

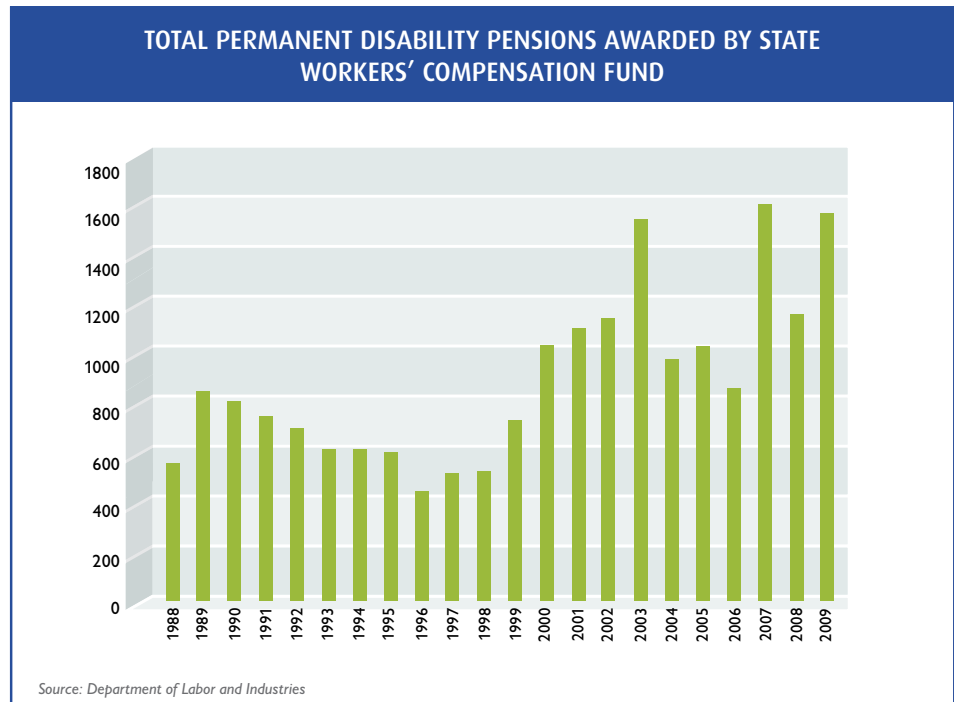
Voluntary Settlements

As Gov. Gregoire noted, “one of every 19 time-loss claims becomes a lifetime pension—a rate that has doubled in the past 10 years. And lifetime pension claims comprise half of all workers’ compensation costs.” L&I awarded 1,542 TPD pensions in FY2009, compared with 13 pensions awarded by Oregon in CY2009. In 2008, the Upjohn Institute (Washington Pension System Review, Nov. 12, 2008) found that Washington has “two to four times the TPD incidence of the highest other states.”

Lawmakers should allow voluntary settlement agreements for all workers. Washington is one of only six states that do not. Such settlements generally include a lump sum payment (or structured settlement) and involve a

release from further liability. Allowing these final settlement agreements for all workers would yield savings and bring Washington into the mainstream nationally. It would give workers and employers the option of a claims closure approach; provide both parties with financial certainty; allow for equitable settlements that can be cost-effectively assured by oversight, review, and approval by an appeals board judge; reduce legal costs and simplify administration; and reduce litigation, long-term claims costs, and need for future rate increases.

Oregon reformed its workers’ compensation program in 1990. The reforms included allowing voluntary settlements. The number of TPD awards fell 95 percent from 1988 to 1998, and the number of voluntary settlements went from zero to about 3,000 annually. The Workers’ Compensation Research Institute, according to the Upjohn report, studied the reforms and found that “the share of lost-time claims that received



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PPD or lump-sum payments dropped from 44 percent in 1989 to 38 percent in 1991, and with less litigation, attorney costs were reduced as well.”

Occupational Disease

Diseases arising from a worker’s exposure in the workplace are covered by workers’ compensation insurance. It is important, however, to distinguish between illnesses that are ordinary diseases of life and those particularly related to an occupation. Failure to make clear distinctions introduces costly ambiguity and uncertainty. As it stands, workers’ compensation insurance in Washington is very likely to be paying for injuries and illnesses unrelated to the workplace. Ambiguity

results in additional indirect costs when the need for clarification triggers more administrative and legal expenses.

Other states handle occupational disease definitions with more precision. For example, Virginia sets out specific circumstances under which a disease arises out of employment and excludes common illnesses.

Competition and Choice

Finally, the state should permit market competition. Washington is one of only four states in the nation to have a state-run workers’ compensation monopoly. L&I administers a state fund in which all employers must participate (unless they are large enough to self-insure). Private insurance

OCCUPATIONAL DISEASE DEFINITIONS

Washington (RCW 51.08.140): Such disease or infection as arises naturally and proximately out of employment under the mandatory or elective adoption provisions of this title.

Virginia (Code of VA 65.2-400): A disease arising out of and in the course of employment, but not an ordinary disease of life to which the general public is exposed outside of the employment. A disease shall be deemed to arise out of the employment only if there is apparent to the rational mind, upon consideration of all the circumstances:

1. A direct causal connection between the conditions under which work is performed and the occupational disease;
2. It can be seen to have followed as a natural incident of the work as a result of the exposure occasioned by the nature of the employment;
3. It can be fairly traced to the employment as the proximate cause;
4. It is neither a disease to which an employee may have had substantial exposure outside of the employment, nor any condition of the neck, back or spinal column;
5. It is incidental to the character of the business and not independent of the relation of employer and employee; and

6. It had its origin in a risk connected with the employment and flowed from that source as a natural consequence, though it need not have been foreseen or expected before its contraction.

Hearing loss and the condition of carpal tunnel syndrome are not occupational diseases but are ordinary diseases of life.

Oregon (2009 ORS 656.802): Any disease or infection arising out of and in the course of employment caused by substances or activities to which an employee is not ordinarily subjected or exposed other than during a period of regular actual employment therein, and which requires medical services or results in disability or death, including:

1. Any disease or infection caused by ingestion of, absorption of, inhalation of or contact with dust, fumes, vapors, gases, radiation or other substances.
2. Any mental disorder, whether sudden or gradual in onset, which requires medical services or results in physical or mental disability or death.
3. Any series of traumatic events or occurrences which requires medical services or results in physical disability or death.

The worker must prove that employment conditions were the major contributing cause of the disease. If the occupational disease claim is based on the worsening of a preexisting disease or condition, the worker must prove that employment conditions were the major contributing cause of the combined condition and pathological worsening of the disease. Existence of an occupational disease or worsening of a preexisting disease must be established by medical evidence supported by objective findings.

Illinois (820 IL Code 310): A disease arising out of and in the course of the employment or which has become aggravated and rendered disabling as a result of the exposure of the employment. Such aggravation shall arise out of a risk peculiar to or increased by the employment and not common to the general public.

A disease shall be deemed to arise out of the employment if there is apparent to the rational mind, upon consideration of all the circumstances, a causal connection between the conditions under which the work is performed and the occupational disease. The disease need not to have been foreseen or expected but after its contraction it must appear to have had its origin or aggravation in a risk connected with the employment and to have flowed from that source as a rational consequence.

Allowing private companies alongside L&I would create incentives for L&I to reduce costs and improve service.

companies cannot offer workers' compensation coverage.

Other states have opened their industrial insurance markets to private insurers with promising results. West Virginia enacted legislation in 2005 that allowed private insurers to sell industrial insurance and privatized the state workers' compensation system. Since then, premiums have decreased 43.7 percent, and the unfunded liability on old state fund claims has been cut in half, reduced from \$3.1 billion to \$1.5 billion.

Washington need not go as far as West Virginia. Allowing private companies alongside L&I would create incentives for L&I to reduce costs and improve service. Twenty-one states have both a state fund and private insurers, while 25 states have only private insurers.

UNEMPLOYMENT INSURANCE (UI)

Washington provides among the nation's most generous unemployment insurance benefits and imposes among the highest UI tax burdens. The uncommonly high taxes

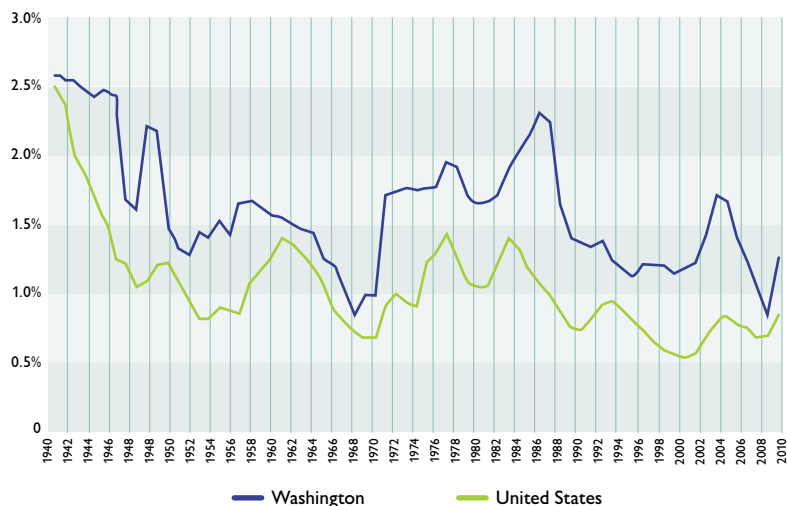
have allowed the state to build a healthy trust fund reserve that has remained robust through the Great Recession and a sustained period of high unemployment. Acknowledging the health of the fund and the potential economic damage of another round of large employer rate increases, the Washington Legislature enacted a sound reform package in 2011 that caps certain UI rates and invests in worker retraining. Before discussing the reform legislation in depth, we briefly review Washington's comparative UI costs and benefits and examine the trust fund.

Taxes and Benefits

As compared to the 50 states and the national average, Washington's UI taxes are high and benefits are generous.

- Washington's UI taxes were the fifth highest in the nation in 2010, at \$491 on average per full-time employee. The most costly state was Rhode Island, at \$628. The U.S. average was \$159.

UNEMPLOYMENT INSURANCE TAXES AS A PERCENT OF TAXABLE WAGES

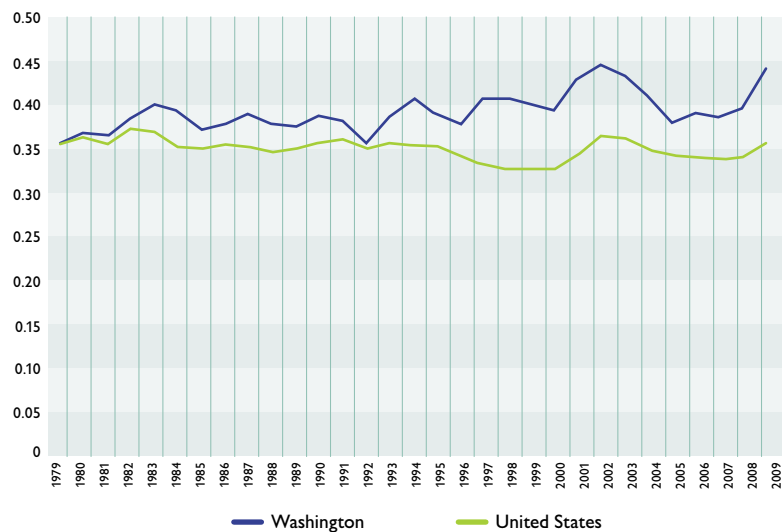


Source: US Department of Labor

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AVERAGE UNEMPLOYMENT INSURANCE BENEFIT AS A SHARE OF AVERAGE WAGE



Source: US Department of Labor

- The average weekly benefit amount in Washington was second highest in the country, at \$401.95. Hawaii had the highest, at \$419.27. The U.S. average was \$307.06.
- The duration of benefits in Washington was 16th highest, at 20.4 weeks. Alaska had the longest duration, with 23.8 weeks, compared to a national average of 20.1 weeks.

Employers pay UI taxes based on an experience rated factor, a social cost factor, and a surcharge based on the solvency of the UI trust fund. UI tax rates are set to maintain an adequate balance in the state's trust fund, from which benefits are paid.

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As noted above, UI taxes in Washington are among the nation's highest, placing employers at a comparative disadvantage in labor costs. UI taxes are paid by employers for their workers on wages up to a specified level. Rates and taxable wages vary among the states.

In Washington, taxes are capped at 80 percent of the average annual wage. State law prevents increases in the taxable wage base of more than 15 percent per year. That comes to \$36,800 in 2010, the highest taxable wage base in the nation. By comparison, the current federal UI taxable wage base is \$7,000. Because

Washington's taxable wage base is so high, even low tax rates yield considerable revenues for the trust fund.

THE CALCULATION OF UI TAXES

1. Experience rated factor. An employer's rates go up if he or she has laid off workers.

- Employers are placed in a rate class (1-40), with those who have not laid off workers in the first class. (In 2011, 46 percent of qualified employers are in the first class.)
- Employers are placed in the remaining rate classes depending on their benefit ratio, which is calculated by dividing the total amount of benefits charged to the employer in the previous two years by the

employer's taxable payroll in the same two years. The more benefits charged to an employer, the higher the rate class.

- Tax rates in the different classes vary from zero percent in the first class to 5.4 percent in the 40th.

2. Social cost factor. Costs that cannot be attributed to a particular employer are borne by the entire employer community. This social cost factor is derived by dividing the total social cost by the total taxable

payroll. The rate is then apportioned among all employers using a multiplier based on their rate class.

- In 2011, the social rate is 1.22 percent.
- The social rates multipliers vary from 78 percent for those in rate class one to 120 percent for those in rate classes 12 through 40.

3. Surcharge based on the solvency of the trust fund.

High taxes have produced a trust fund reserve that has remained robust even during the current recession.

A Very Healthy Trust Fund

Washington's healthy UI trust fund is a national outlier. Currently, more than 30 states are borrowing from the federal government to pay unemployment benefits, for a total of more than \$45 billion.

The state trust fund balance decreases as benefits are paid out. Should the trust fund balance fall to a level that would pay less than seven months of benefits, a solvency surcharge is automatically imposed and employer rates increase. In recent years, tax increases were greater than necessary to maintain the balance. In fact, as of Sept. 30, 2010, the trust fund had enough money to pay 14.2 months of benefits.

Despite having one of the nation's healthiest UI trust funds and uncompetitively high tax rates, Washington was on course to raise unemployment insurance taxes again this year, had the legislature not intervened in February.

Last December, the state Employment Security Department announced an average rate increase of 36 percent for 2011 (if enacted, the increase would have much higher for

many employers). Because of recent persistently high unemployment, even employers who had no layoffs faced a substantial tax hike because of a projected 40 percent increase in the social rate this year.

Recognizing the recovery-dampening impacts of another round of rate increases, lawmakers took action to enact permanent tax relief. They capped the social rate for 2011 at the 2010 level for all rate classes. Going forward, the legislation caps the social rate at a level dependent on the trust fund balance for all rate classes (at 1.22 percent if there are more than 10 months of benefits in the trust fund). For rate classes one through 20, the social rates multipliers are reduced (to a range of 40 percent to 116 percent). For rate classes 21 through 40, the multipliers are unchanged (they would remain at 120 percent).

The legislation reduces employer costs, while preserving benefits for unemployed workers and protecting the integrity of the trust fund. As the reform moved through the legislature, some lawmakers advocated using trust fund money to increase benefits, a prescription for rapidly depleting reserves and higher taxes in the future. The governor and legislature struck the right balance. The timely passage of the essential reforms represents a significant legislative and executive accomplishment.

Despite having one of the nation's healthiest UI trust funds, last December, the state Employment Security Department announced an average rate increase of 36 percent for 2011.

Conclusion

To encourage job creation, Washington should implement state policies that help, rather than hinder, employment growth. Currently, the workers' compensation and unemployment insurance systems combine to push payroll costs in Washington out of the mainstream, discouraging hiring.

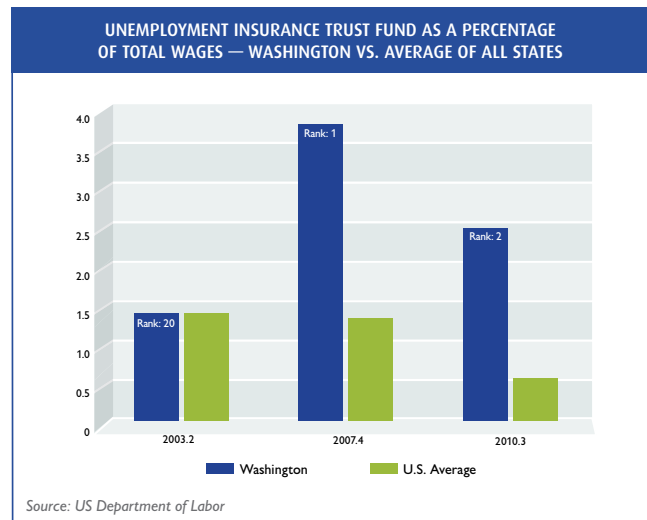
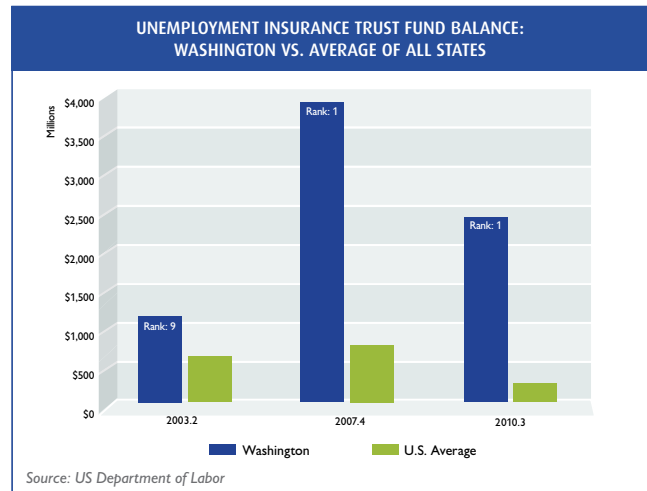
To stem the continuing rise of state imposed payroll costs, a number of reforms should be enacted.

Currently, the workers' compensation and unemployment insurance systems combine to push payroll costs in Washington out of the mainstream, discouraging hiring.

Significant workers' compensation reforms are needed this year. Costs are going up, yet injured worker claims are down and the workers' compensation system is on the verge of collapse. The state should allow voluntary settlement agreements, clarify the definition of occupational disease and statute of limitations, and permit private insurers to offer workers' compensation policies.

Essential UI reforms must be retained. The state has made significant headway in stemming the rise of unemployment

insurance rates. Lawmakers must uphold the reforms made already and avoid any actions that would undermine the health of the trust fund; such as adding or expanding benefits.



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