

The Law and Economics of Workers' Compensation

Executive Summary

Linda Darling-Hammond and
Thomas J. Kniesner

Policy Issues and Research Needs

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Foreword

This Executive Summary and the complete study upon which it is based (*The Law and Economics of Workers' Compensation*, R-2716-ICJ) describe the current national situation in the area of workers' compensation and identify critical issues about which research seems both necessary and possible. These reports do not advance policy recommendations. Their objective is to provide the informed, but not necessarily expert, reader with basic information about the overall status of the area discussed and the main avenues through which the research community may shed light on active policy issues.

These documents inaugurate a new series of Institute for Civil Justice studies sharing the subtitle "Status and Issues for Research." It is particularly fitting that the series begin with a study of workers' compensation. The most dramatic event in the twentieth century history of the American civil justice system was the relatively rapid extraction of the rules governing employers' responsibility for work-related injuries from the traditional law of torts. The unique "bargain" struck by workers' compensation laws remains an unusually clear example of compromise between the traditional rights of individuals and the practical necessities of industrialized economies. Under these laws, the injured employee surrenders his (or her) right to full compensation for nonmedical costs in turn for his employer's prompt payment of medical and subsistence expenses. This plan is meant to avoid a costly and time-consuming legal process to determine whether and to what degree the employer's or the employee's negligence contributed to the injury. The employer, on the other hand, gives up the immunity which he would gain by disproving negligence in return for the certainty that his liability will be limited to a schedule of finite benefits set by a public body according to injury classes which disregard individual circumstances (other than fraud or intentional harm).

The workers' compensation approach was adopted in virtually all American states within 20 years at the outset of the century. The speed of the change was the more remarkable in light of the fact that many state supreme courts first ruled the approach unconstitutional. The

view that it was unconstitutional for employers to pay without proof that they had been at fault, initially widespread among business and judicial leaders, was quickly routed by the consensus that an urbanized industrial economy required a quick, predictable way of dealing with workplace injuries. Such injuries were happening on a scale unknown to pre-industrial societies and were overwhelming the institutions established by such societies for determining rights and resolving disputes.

So sudden and complete was the transformation of opinion that today most Americans accept workers' compensation as a fixed feature of the civil justice scene—so essential and obvious as to be beyond policy debate. Only rarely does this pervasive instrument of social and economic policy emerge from its technical cocoon into the publicly visible portion of the policy arena. Except for those involved in its administration and the periodic struggles over its benefit schedules, few citizens—or legislators—have more than the haziest knowledge of how the system works or what policy issues it presents.

As this report shows, this placidity is misplaced. The same economic and social forces that have buffeted other social institutions have affected workers' compensation. First, modern medicine has identified new links between work and diseases. Many of these diseases, unknown at the time of exposure, may take years to develop. Second, modern judicial doctrine has altered some aspects of the workers' compensation "bargain," introducing such factors as employer negligence into the compensation calculus. Third, inflation makes maintaining the balance between prevailing wage rates and benefit schedules difficult. At the same time, pressures are generated for indexing benefits to be paid past beneficiaries whether or not the system's financial structure had provided for such indexing. Finally, the dividing line between workers' compensation and the tort system (which theoretically fully compensates for all costs of injuries in which negligence or strict liability is shown) seems to be more and more frequently crossed, so that the two parallel systems increasingly provide compensation for the same injury.

One might well inquire into the nature of these changes. How do they affect the fairness, the incentives, or the financial viability of workers' compensation? What are the basic economics of the system? Is the system in financial trouble? Are entire industries threatened by recent changes? What alternatives or major alterations to the system have been proposed?

Linda Darling-Hammond and Thomas J. Kniesner address these questions by reviewing the principal trends and issues in the current statutory, judicial, and professional literature on the law and economics of workers' compensation. They provide concise, factual, and analytic

material necessary to an informed view of the current policy scene. The reader who desires further information on any single topic will find the appropriate references in the footnotes.

We hope that this report will add to a broader, more incisive examination of the issues concerning workers' compensation.

Gustave Shubert
Director, The Institute for Civil Justice

Executive Summary

Workers' compensation laws, enacted by most American states in the early twentieth century, have received widespread national attention only during the past decade. The workers' compensation system was originally designed to provide prompt, certain relief to victims of industrial accidents by removing dispute resolution from the tort-based liability system. A bargain was struck between the rights of employers and employees: Employers became liable to payment without a finding of fault in return for a guarantee that their liability would be restricted to statutorily set benefit amounts; employees gave up the right to sue their employers for full damages in return for a guarantee of prompt, certain compensation for work-related injuries. In recent years, the nature and extent of the employer's liability have changed rapidly as coverage and benefits have expanded and recourse to the courts for resolving uncertainties has become more frequent. This report describes the current status of workers' compensation law, reviews the legal and economic bases for the system's design, and identifies emerging issues and areas of concern that may be illuminated by future research.

EVOLUTION OF WORKERS' COMPENSATION LAW

Industrialization in the nineteenth century generated an unprecedented rate of employment-related injuries. The legal system made it very difficult for injured workers to receive compensation from employers. In Europe this led to reforms that made compensation compulsory and levied the cost partially or wholly upon employers. By 1908, these reforms had occurred in all Western industrialized countries except the United States. American adoption of the workers' compensation approach was greatly slowed by judicial resistance to forcing employers to pay without any finding of fault. Nevertheless, virtually all states enacted some form of workers' compensation between 1911 and 1920, although these plans were generally elective and applied mainly to

highly hazardous occupations. By 1949, programs of income maintenance for work-related injury were in effect in all states. Still, as recently as 1968, 23 states permitted elective coverage, 24 had size-of-firm restrictions, and 29 excluded farm workers.

In the late 1960s, the federal government became instrumental in extending coverage to workers traditionally not covered by state systems. The Coal Mine Health and Safety Act (1969) established a Black Lung Benefit Fund, and the Occupational Safety and Health Act of 1970 set up, in addition to an elaborate regulatory structure, a National Commission on State Workmen's Compensation Laws. This Commission reported in 1972, suggesting 19 reforms considered essential for a modern system. An Interdepartmental Workers' Compensation Task Force was established in 1974 to follow up on issues and recommendations raised by the National Commission. Although many state systems responded to the Commission's recommendations with substantial changes, there is continuing pressure to enact federal standards for enforcing the Commission's proposals. At this writing, however, such standards have not been enacted.

Nearly 90 percent of American workers are now covered by state and federal workers' compensation laws. Those not covered include some farm workers, self-employed persons, casual and domestic workers, and some state and local government employees. About 7.8 million workers' compensation awards were made in 1978, of which about six million (or 77 percent) were medical payments. Most awards were for temporary or partial disabilities. However, the one-tenth of 1 percent of benefits awarded for permanent disability or death accounted for three-quarters of the total benefits paid. Dollar totals for benefits paid amounted to \$7.6 billion in 1976, up from \$3 billion in 1970. Dollar costs to employers have also climbed from \$4.9 billion in 1970 and \$11 billion in 1976 to an estimated \$15.8 billion in 1978. The average premium for workers' compensation insurance has risen from \$1.11 per \$100 of payroll to an estimated \$1.80 in 1978.

During the last decade, selling workers' compensation insurance became substantially less profitable than in previous years. While the ratio of current benefits paid to current premiums received remained stable, the amounts required to be reserved for future payments to compensate current-year injuries rose sharply. As a result, stock insurance companies showed a net loss of 5.1 percent in 1976, while mutual companies showed a surplus of only 1.6 percent. Some signs indicate that these trends leveled off somewhat after 1976, but insurers continue to be concerned about their capacity to project program costs and to obtain the public approval necessary to charge the premium rates required to pay those costs. The changing economics of workers' compensation have combined with changes in law, medical technology, and

other factors to produce an unusual state of flux in most state systems. Courts and legislatures across the country are wrestling with these problems.

THE CURRENT STATUS OF WORKERS' COMPENSATION

The status of workers' compensation law across states can be summarized by type and degree of coverage, income protection, medical care and rehabilitation, safety incentives, and delivery systems.

Coverage

All but three states have compulsory laws (usually with exemptions). In 1976, 26 states and the District of Columbia covered more than 85 percent of their workforces; five states covered less than 70 percent of their workers. All states limit compensable injuries to those "arising out of or in the course of employment." In other words, the risk must be a condition of the task or work environments, and/or the employee must be engaged in a job-related activity at the time of injury. Many states exclude injuries resulting from willful misconduct, aggressive assault, and drunkenness; some states increase compensation when the employer has willfully misbehaved.

Originally excluded from workers' compensation laws, occupational disease is now covered in all states. However, the coverage has numerous limitations. Frequently, the disease must be shown to have resulted from an unexpected event or exposure. As a result of these limitations, only a tiny fraction of occupationally-related disease cases enters the workers' compensation system; those that do are typically resolved by "compromise and release" settlements. When doubt exists regarding the cause of an illness, courts tend to favor claimants, especially if the risk is demonstrably higher in the occupation in question than in other occupations.

Cumulative injury (harm resulting from long-term or repeated job-related causes) is an older category of compensable injury than occupational disease. Recently, however, courts have expanded the definition to include conditions of reduced health that may result from natural, non-job-related causes. This expansion is justified under the well-established doctrine that an employer must "take the employee as he finds him" and compensate him for any exacerbation of a latent problem. In determining causation, courts usually examine whether the job entails unusual strain or recognizable contributions to the health problem.

a slightly higher risk than that presented by off-the-job living and well under half the risk presented by time spent in a motor vehicle. In 1970, work-related injuries made up about 20 percent of all accidental injuries, and work-related deaths made up 12 percent of accidental deaths (down from more than 20 percent in 1929). By all measures, industrial safety has improved considerably, though not uniformly, over the last several decades.

Workers' compensation demands that each manufacturer enjoying the profit of a product should assume the costs of unavoidable injuries. Each producer is consequently motivated to lower accident costs to

As general liberalizing trends continue, definitions of the scope of workers' compensation coverage are in flux. Linkages between jobs and cancer, heart disease, emotional disorders, and other health problems are difficult to prove or disprove. Growing tendencies to grant such claims have led to reevaluation of the goals of the system. Those who emphasize its social objectives favor more liberalizing and easier stan-

achieve a competitive advantage. Whether universal insurance availability reduces or expands these incentives is debatable. However, insurers generally do seek to encourage safety by providing accident-prevention engineering services and by using a two-tiered rating system which, after grouping firms by industry type, alters rates for larger companies according to their loss experience. In 1972, about 20 percent of all firms were experience-rated; these firms employed about 80 percent of all employees covered by the workers' compensation system. The number of experience-rated firms is higher today.

Complicating factors make unclear the effect of workers' compensation safety incentives on job-related disability rates. It might be useful to evaluate the licensing requirement, adopted in Texas, Oregon, and Florida, that workers' compensation insurance carriers provide loss prevention services to all their clients. Studies comparing the effectiveness of government-enforced safety standards with that of standards administered by insurance companies would also be helpful.

Delivery Systems

The dream of a self-administering system has not been realized because (a) determinations of compensability and extent of disability are controversial; (b) state agencies have not sufficiently participated in clarifying statutes and settling disputes; and (c) societal values have, over time, expanded the purview of the system and obscured the differences between its goals and those of other social insurance mechanisms. Litigation is often a technique for rearguing the social policy underlying the system. According to one estimate, in 1975, about 20 percent of all claims were contested, with a much higher rate for occupational disease claims. By 1977, the cost of adjudicating claims may have amounted to as much as 17 percent of the cost of benefits paid. The adversarial atmosphere surrounding the workers' compensation system may explain why many workers choose not to submit injury and occupational disease claims to the system but to a variety of other social insurance programs instead.

The volume of litigation varies significantly between states, as do promptness of settlement and administrative mechanisms for handling claims. Administrative responsibility is centered usually in a single agency. The agency may or may not also have adjudicatory powers and may or may not take an active posture toward its duties. Organizational efficiency varies greatly—in 1972 half the states could not even estimate the percentage of contested cases. A majority of states require agreement between employer and employee before payments can commence. This requirement may explain why many injured workers hire

lawyers in uncontested cases. Other states begin immediate payments; the state agency becomes involved only if a dispute arises over liability. However, once employer liability is established, the duration of that liability must be settled. Some states resolve this question through compromise and release settlements that award a lump sum, generally in an amount between the employee's claim and the employer's offer. Despite much criticism, this practice is nevertheless strongly defended by many of the states that permit it.

Private insurers pay about two-thirds of all benefits, and state compensation funds about 20 to 25 percent; self-insured companies pay the remainder. Six states ban private insurance, and 18 states operate state funds. Four states do not permit self-insurance. There are long-standing disputes about whether the state fund or the private insurance approach is cheaper, but it does seem clear that private insurers provide more accident prevention services and are better adapted to multi-state employers.

ALTERNATIVES TO WORKERS' COMPENSATION

Unlike the law of torts from which it was extracted early in the century, workers' compensation is not designed to compensate all non-medical injury-related costs. Rather, workers' compensation is designed to provide enough support to sustain the injured worker during recuperation without dulling his incentive to return to the labor force. Because the tort system—which does seek to provide full compensation for all losses suffered because of compensable injury—operates in parallel with the workers' compensation system, the extent of the employer's exclusive liability has been subjected to constant legislative and judicial modification and debate. Other possible avenues of compensation are summarized below.

Tort Suits Against the Employer

A worker may sue his employer in tort for full compensation if his injury is not compensable under workers' compensation and if he can prove that his injury was caused by employer negligence. However, in some states a worker can win such a suit even when workers' compensation is applicable if he can show that the employer deliberately caused the injury. By federal law, railroad and maritime workers can collect compensation benefits as well as sue their employers for negligence. In some cases, the worker may sue the employer in the latter's capacity as manufacturer of the injury-causing product, while collecting com-

pensation from him in his capacity as employer. Many states immunize fellow employees of the same employer from personal suit by injured workers, and in some states (but not all) the immunity extends to the employer's insurer and/or to his contractors and subcontractors. In general, however, the "fellow employee" immunity does not extend to employees of such other companies.

Suits Against Third Parties

An injured worker may sue any party connected with an accident who is not granted immunity by the workers' compensation law. It is estimated that in 1974, 31,500 of 1.5 million compensation claims (or about 2 percent) led to suits against third parties, generating \$1.5 billion in payments beyond the \$5.5 billion paid in compensation benefits resulting from these claims. Most third party suits are product liability actions; these actions often raise questions about the relative negligence of manufacturers, employers, and even employees in cases of work injury involving possible product defects. The legal rules governing recovery from these third parties have important effects upon the actual allocation of the costs of accidents.

Subrogation

Subrogation is the right of the party who has compensated an injured person to sue a third party (who is primarily responsible for the injury) for reimbursement. Some states permit an employer to exercise this right at the same time that the injured employee may be suing the same third party; others establish a sequence for such suits. Four states unconditionally assign the employee's right of action against third parties to the employer if the injured worker has opted to accept workers' compensation. These four states permit no subrogation by the employee, and others allow it only in specified circumstances. When an employee is permitted to file suit against a third party, the employer is usually considered to have a lien on any award the employee receives; the employee may keep what remains after the employer has been reimbursed. There are long-standing arguments about whether the benefits of subrogation outweigh the detriments of increased litigation and possible reimbursement of negligent employers.

Contribution and Indemnification

Contribution is a process through which the payment of damages is apportioned between two or more parties who are jointly responsible

for a compensable injury. Each such party is typically required to pay a share of the judgment or settlement. However, most states do not permit a third party sued by an injured worker to secure contribution from the worker's employer even if the latter has been negligent. This policy reflects the view that workers' compensation law makes it impossible for an employer to be jointly liable with other injurers even though his negligence may have been a partial cause of the injury. One state does permit limited contribution in these circumstances, and at least one other prevents a negligent employer from collecting on his workers' compensation lien on judgments against third parties. The recent shift of most states to the "comparative negligence" method of apportioning liability according to degree of responsibility for the injury has resulted in a number of different approaches to apportioning contribution among injurers who do not enjoy the employer's immunity from liability.

Indemnification is a process in which an adjudged injurer is completely reimbursed by another party "more responsible" for the injury. Although this right has been generally denied to third parties (as to employers), some states have recently ruled that denial is unconstitutional. Other states allow such indemnification under special circumstances.

BASIC ECONOMICS OF WORKERS' COMPENSATION AND ECONOMIC ISSUES IT RAISES

In that work-related injuries and diseases are undesirable by-products of the creation of goods and services, they may be likened to pollution. Reducing injuries costs money, but so do the medical care and lost work time such injuries cause. It is possible to plot a firm's safety production function, showing the relation between expenditures for injury and disease prevention and the fraction of the firm's employees who are hurt or become ill. It is also possible to plot the expense of generating greater degrees of safety (i.e., the marginal cost of safety) and the cost-savings that results from improvements in safety (i.e., the marginal benefit of safety). The firm's optimal economic situation is achieved when the marginal cost of safety equals the marginal benefit of safety. A dollar unspent on safety below this expenditure level will generate more than a dollar of loss due to injury; a dollar spent above this level will generate less than a dollar of benefit to the company. Inevitably, though unfortunately, the expenditures necessary to achieve perfect safety (as distinguished from a high degree of safety) are never in the firm's economic interest.

One often-cited policy objective of the civil justice system is *social efficiency*, which may be said to exist when responsibility for injury compensation is assigned in such a way that the sum of the costs of injuries and the costs of preventing them is as low as possible. Some would maintain that this goal was achieved by the system that dealt with job-related injuries before workers' compensation was introduced. However, the accepted goal of *social equity* requires that costs be fairly allocated between employers and employees. Workers' compensation reflects an attempt to introduce equity into a system perceived to place an unjust share of the burden upon employees.

However, economists are raising serious questions about the degree to which workers' compensation meets its stated objectives. For example, the typical methods of calculation used to determine just levels of income maintenance for injured workers during recovery often overlook the tradeoff between salary and fringe benefits in establishing the worker's income. They also tend to ignore the worker's age and career stage. The subtle calculations required to estimate income lost through permanent partial and temporary total disabilities do not even appear in the technical literature dealing with workers' compensation. Therefore, very little is known about the degree to which the compensation system protects workers from economic hardships, although it is likely that the true protection is less, at least in some types of cases, than the 66-2/3 percent of income that most states seek to replace. Moreover, the superiority of this replacement level to other levels has not been analytically established.

The same analytic uncertainty obtains regarding the safety incentive effects of workers' compensation. Even the relatively crude studies that have been done cannot show conclusively that such a system, working through compulsory insurance, results in fewer industrial injuries. One recent regression analysis of the period 1900 to 1940 suggests that both tort law changes and the imposition of workers' compensation reduced the rate of machine-related industrial deaths, and that of the two factors, workers' compensation was the more effective. But work by the same researcher indicates that more generous workers' compensation benefits are also historically associated with higher levels of industrial injuries. The analytic cupboard is entirely bare regarding the effects of workers' compensation on work-related diseases.

A few proposals for replacing or altering workers' compensation have appeared in the economic literature. One proposal would substitute a blend of safety standards, health insurance, and a general income maintenance program. This idea has been criticized on grounds that most accidents do not result from hazards susceptible to removal through standard-setting; that standards imply compliance enforce-

ment (with the related costs); that safety incentives would be lost or misdirected; and that other social programs would be distorted in order to accommodate the compensation purpose. Another proposal would preserve the compensation system, but it would emphasize major injuries, de-emphasize minor ones, and allow workers to sue employers for damages for pain and suffering. A third proposal would require both employers and employees to purchase insurance against work-related diseases and injuries, and let litigation determine the financial responsibility according to the adjudged negligence of each. (An initial payment would be made to the worker by his insurance company pending final resolution of responsibility.) Neither of these last two proposals has yet been accorded careful analytic attention, although the second has been faulted for returning to methods in effect prior to workers' compensation while not explaining how the courts and the insurance institutions would work under those methods.

SUGGESTIONS FOR FURTHER RESEARCH

Workers' compensation is meant to assign "certain but limited liability" to employers for work-related injuries and illnesses. The process of defining the limits of that liability has generated a great deal of uncertainty and a great many inconsistencies in administration, which troubles employers, insurers, and workers, alike. In order to evaluate various means for reducing some of these uncertainties, answers to the following questions must be found:

1. How do the practices of various actors within the system—administrators, insurers, employers, lawyers, employees, and unions—affect the system's outcomes (i.e., who pays and is paid, how much is paid and how promptly)?
2. How do statutes, administrative rulings, and judicial interpretations of the laws affect the outcomes of the system?
3. How do the rules that govern compensation affect the behavior of the key actors? How do the actors seek to cope with uncertainties created by changes in the rules?

Several possible approaches to answering these questions appear fruitful:

- a. A cross-state study of how administrative practices affect disposition of claims.
- b. A survey of closed claims to investigate the causes of litigation.

- c. A study of the impact of judicial rulings on the behavior of claimants, employers, and insurers.
- d. A study of the outcomes of federally administered workers' compensation programs.
- e. An international comparative study of how injuries in the various countries with workers' compensation systems vary according to the characteristics of the programs.
- f. A simulation model that considers production, wages, and job injuries in a general equilibrium context. Not only would such a model be a second way of examining the social effects of changes in workers' compensation and how it may conflict with or be reinforced by the Occupational Safety and Health Act, but it would also point out the type of information necessary to really understand the economic impact of workers' compensation. Subprojects of the model, each of which constitutes a study in its own right, would include research on (1) the degree to which workers accurately assess the risk of work-related injuries or disease; (2) the production and pricing of workers' compensation policies by insurance companies; (3) the relation between industrial production and injuries (how injuries respond to various prevention measures); (4) the relation between coverage and benefit levels and injury reporting and duration; and (5) the true fraction of real income loss currently replaced by workers' compensation insurance.
- g. A social experiment conducted on a large enough scale to produce reliable results. This is probably the best, although, of course, the most expensive, way to examine the social effects of changes in the parameters of workers' compensation.
- h. Studies of "naturally occurring" experiments in states where alternative approaches to loss prevention, provision of benefits, and rules for coverage or determination of compensability have been initiated.

A special bibliography (SB 1064) provides a list of other Rand publications in the civil justice area. To request the bibliography or to obtain more information about The Institute for Civil Justice, please write the Institute at this address: The Institute for Civil Justice, The Rand Corporation, 1700 Main Street, Santa Monica, California 90406, (213) 393-0411.

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