Working Paper

Increasing Experience Rating for Small Employers

Would Lowering the Threshold for Experience Rating Improve Safety?

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Summary

Experience-rating (ER) is the common practice in insurance markets of adjusting premiums to take into account the actual losses of the insured. Insurers apply experience rating as a means of underwriting heterogeneity among policyholders that may be hard or costly to otherwise observe. In workers' compensation experience rating is also advanced as a method to re-introduce a stronger financial incentive for firms to prevent losses, an incentive that the loss-spreading effect of insurance tends to weaken. The use of experience rating in workers' compensation is controversial. Some argue that the financial incentives provided by experience rating are an essential incentive for improving workplace safety. Others argue that experience rating has little impact on safety but causes some employers to suppress legitimate claims, depriving workers of benefits. What is lacking is sufficient evidence on the causal impact of experience rating on outcomes.

The current California threshold for mandatory application of experience rating by insurers excludes 80% of employers. Excluded employers are smaller firms whose experience insurers consider too limited to be credibly predictive of future losses. This paper explores, in the California context, what happens to the loss experience of small firms when they become just large enough to be experience-rated for the first time. By doing so, the paper provides insight about the impact that lowering the threshold to subject more employers to experience rating would have on safety outcomes for workers at these smaller firms.

We obtained data on workers' compensation losses from the Workers' Compensation Insurance Rating Bureau of California (WCIRB) for every insured employer from 1993-2006. We selected employers who were in the WCIRB file for 5 consecutive years during the study sample; were not experienced-rated in the first two years; had a premium the next year that was within 30% of the threshold needed for experience-rating in that year; if experience rated in year 3, continued to be experience rated in years 4 and 5; if not experience-rated in year 3, then were not experience-rated in years 4 and 5.This gave us a representative sample of the set of firms that are most likely to be affected by a change in the threshold for experience rating.

Using these data we compared the change in losses for the firms that did not become experience-rated with the change in losses for those firms that became experience-rated. We

found that those firms which became experience-rated had a decline in losses relative to those whose status did not change. Specifically, the workers' compensation losses at firms that became experience-rated declined 6% to 9% compared to those that did not. We found that virtually all of the reduction in losses is due to the reduction in claim frequency; and not due to a decline in the average cost per claim. As we discuss in detail in the report, this finding suggests that the changes are a real safety improvement and not artifacts of increased efforts to suppress claims. Expanding experience rating to more employers would reduce occupational injuries without substantially increasing claim under-reporting.

We also examine whether, absent regulatory or statutory intervention, insurers would, *de facto*, experience rate more or fewer firms than currently required. We found that insurers do not adjust premiums for employers below the current threshold, suggesting that increasing the fraction of employers subject to experience rating would require state intervention.

We also analyzed any extra cost that a newly experience-rated employer could incur by reporting a claim under the current rules and found a surprisingly big effect. In many cases the increase in a small employer's premiums triggered by a claim can be substantially greater than the actual cost of the claim. Thus, any extension of experience rating to impact more firms should be mindful of the potential cost that large variance in year-to-year premiums could impose on some employers. Future research should focus on the design of experience rating for smaller employers that retains incentives for safety while limiting large swings in premium costs.