Compendium on Workmen's Compensation

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Chapter 3

Theories and Objectives of Workmen's Compensation

Although workmen's compensation developed because of pragmatic and political considerations, various theories were developed to explain and justify the system. This chapter describes these theories and explains the objectives of workmen's compensation.

THEORIES OF WORKMEN'S COMPENSATION

Workmen's compensation theories can be divided according to whether they deal with (1) the justification for a no-fault approach, or (2) the extent to which such a system should be obligated to injured employees.

Justification for a No-Fault Approach

Economic theories.—The law of employers' liability, particularly the assumption of risk doctrine, had been justified by the theory that employees know how hazards vary among jobs, and that therefore wage rates for individual occupations in a perfectly competitive labor market would reflect all the advantages and disadvantages of each occupation, including the possibility of an industrial accident. Wage rates paid for hazardous work would include a sizeable allowance for potential injuries; wages for safe work would include only a small injury allowance. Making the employer responsible only in those cases where he was negligent also seemed fair and would, it was argued, stimulate him to avoid or reduce the consequences of accidents for which he might be held responsible.[1]

Although economic theory probably played a less important role in the abandonment of employers' liability than humanitarian and pragmatic considerations, it did contribute to the development and acceptance of workmen's compensation. The concept of a perfectly competitive labor market that would produce wage rates reflecting the hazards of employment was questioned increasingly around the turn of the century. In addition various theories were suggested to support the new no-fault approach to industrial injuries. Two of these theories attracted the most attention: (1) The theory of occupational or trade risk, and (2) the theory of least social cost.

According to trade-risk theorists, such as Miles M. Dawson,[2] because industrial injuries and diseases arise out of the production of goods or services, the prices charged for these products should reflect relative workmen's compensation insurance and self-insurance costs. According to a slogan attributed to Lloyd George, the cost of the product should bear the blood of the working man.

In the first instance these costs should be paid by employers who would then be expected to consider these costs in establishing the prices for their goods or services. In its purest form, trade-risk theory asserted that employers would be able to transfer all of these costs to consumers.

Later it was recognized that the demand for some, if not most, products was not infinitely inelastic. Raising the prices of products with a less than infinitely elastic demand due to rising costs would reduce the quantity demanded and hence employer profits. Employers might, therefore, elect to raise prices by less than the full increase in their costs and absorb part of the workmen's compensation costs themselves. Relative prices, therefore, would depend only in part upon relative workmen's compensation costs, but they would still be influenced by these costs.

This same line of reasoning could be applied to the cost of employers' liability insurance purchased by employers under the earlier negligence approach.

In 1924 E. H. Downey introduced a new justification of workmen's compensation when he stated that the "guiding principle for the determination of compensation benefits is that of least social cost." [3] Like the early trade-risk theorists, he believed that most employers could incorporate their compensation costs in the price of their goods and services but he sought a new justification for relating prices to compensation costs. His argument is summarized in the following quotations, certain sections of which are in boldface for emphasis:

> Since disabling injuries by accident and disease are inevitable concomitants of that mechanical industry which has made modern civilization possible, and the products of which are enjoyed in fullest measure by the classes least exposed to its hazards, **since the victims of these injuries are precisely those least able to bear the burden of economic loss themselves or to shift it to others,** since the resultant evils of poverty affect not alone the families immediately concerned but the State as well, and **since the whole pecuniary cost of work injuries can be so distributed as to be little felt by anyone,** public opinion has almost everywhere come to hold that those who are crippled in the production of the community's wealth, and the dependents of those who are killed, have a right to indemnity from the public for whom they wrought.
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> The principle of compensation is most conveniently and effectually applied by treating the economic cost of industrial injuries as a direct expense of production, in the same category with wages, machinery, and materials. The employer, in our entrepreneur system of industrial management, is the keeper of the purse; it is his function to assemble the instrumentalities of production and to cover the expenses thereof into the price of the product. If, then, the employer is held legally responsible for death or disability in the course of employment, he will protect himself by insurance against unusual loss and will incorporate the prevalent cost of industrial injuries in the price of vended goods and services. **This method secures the widest, the least burdensome, and perhaps on the whole the most equitable distribution of the cost of industrial accidents and disease.**[4]

Downey's explanation has been rephrased by some economists in utility terms as follows. For most persons, the additional utility or satisfaction they derive from an increase in their wealth diminishes as their wealth increases. Consequently, other things being equal, the payment of a specified sum to a person with little wealth produces a much greater increase in the utility in society than is lost if an equal amount is taken from a person with substantial wealth. The net increase in utility in society would be even greater if several persons with substantial wealth shared the dollar loss offsetting the dollar gain. By the same reasoning the utility of payments to injured workers whose wages have stopped or who have incurred medical expenses exceeds the loss of utility to consumers through small increases in prices (or, in those cases where part of the cost cannot be transferred to consumers, to employers through increased insurance or self-insurance costs).

The least-cost theory was reformulated and popularized in a 1929 address by Edwin E. Witte, a noted social insurance scholar and reformer.[5] Witte attacked two propositions in the trade-risk theory. First, he noted that workmen's compensation does not pay all of the income losses suffered by injured workmen. Employees, therefore, still bear part of the costs of industrial accidents. Second, Witte denied that employers were able to transfer all their compensation costs to consumers. In Witte's own words,

> If employers were able to shift all their costs, they would have no reason to be concerned about the level of compensation benefits. In fact they are very much concerned; and who would say that their concern is foolish?

In Witte's view workmen's compensation

> does not place the cost of accidents upon industry, but provides for a sharing of the resulting economic loss between employers and employees on a predetermined basis, without reference to fault, under a plan designed to insure prompt and certain recovery, at minimum expense.

Such a theory is presumed to stress the prevention of accidents and medical and vocational restoration; prompt and certain benefits that enable the injured worker to maintain his standard of living but give him an incentive to return to work; and the reduction of administrative expenses. Indeed, he argued, costs to employers and competitive factors should be given consideration as well as the needs of injured employees. The test of the system is not, according to Witte, whether employers are made responsible or whether exact justice is achieved, but what arrangements on balance result in the least cost to society.

More recent attempts to develop a theoretical justification for workmen's compensation also stress least social costs.[6] In a perfectly competitive economy in which employees perceived accurately the hazard differentials among various occupations, employees would demand a risk premium in their wages that would substantially exceed their expected or average losses in the long run. Employees would react this way because most persons are risk averters; before they will assume a risk which involves a chance of loss but no chance of gain, they will demand a reward in excess of their expected loss. Many of these workers might be persuaded to accept a wage increment equal to the premium for an individual insurance policy that would eliminate their financial uncertainty by promising benefits in the event they are injured on the job.

Because insurers can, through the operation of the law of large numbers, predict fairly well what will happen to the average insured, their uncertainty is small. They charge a premium equal to the expected loss plus an expense and profit loading. The risk premiums demanded by many employees in their wages would exceed this insurance premium because the amount they would require in excess of their expected losses would exceed the insurer's expense and profit loading. Indeed this explains why most persons buy any type of insurance.

In practice, however, many workers will prefer current consumption over protection and will demand the risk premium in cash. If they are injured on the job later, both they and society suffer. Perfect perception of occupational hazards and a perfectly competitive labor market are also unrealistic assumptions. Workmen's compensation makes protection compulsory and substitutes the power of the State for the market system. It also requires all covered employers except self-insurers to purchase this protection on a group basis, which is less expensive to sell and service than individual insurance. Self-insurance is restricted to large employers whose uncertainty is small because they can predict fairly well the expected losses of their employees. Both the permiums paid by insured employers and the compensation costs of self-insurers should be less than the total risk premiums of employees who correctly perceive and evaluate the risks they face.

Legal theories.—In addition to the two economic theories described, two legal theories have been advanced to justify workmen's compensation: the social compromise theory and the status theory.

According to the social compromise theory both employers and employees gained and lost when workmen's compensation replaced employers' liability.[7]

Employers were made responsible for all occupational injuries, regardless of fault, and compensation benefits were calculated in a more logical, equitable manner than tort liability awards. On the other hand, workmen's compensation became the exclusive remedy of employees against employers, with the effect that injured employees ordinarily lost the right to seek a higher tort liability award than their compensation benefits. This compromise is commonly termed "the *quid pro quo*" of workmen's compensation.

According to the status theory, a worker injured in the course of his employment is entitled to compensation because of his employer's relationship to the employment out of which the injury arose.

> The liability is based, not upon any act or omission by the employer, but upon the existence of the relationship which the employer bears to the employment because of and in the course of which he has been injured.[8]

Measurements of Obligation

The earning capacity theory and the whole-man theory have been developed to explain the obligation of workmen's compensation to the injured worker. Under the earning capacity theory, the system is obligated to restore as much of the worker's earning capacity as possible through rehabilitation, to pay his medical expenses, and to pay his earnings loss, both actual and potential. Under the whole-man theory, the system is obligated to consider not only the diminution in the worker's earning capacity but also the degree to which the worker is less than a whole man as a result of the injury. Under this approach, awards should be made for physical impairment as such; they should not depend solely upon loss of earnings. Ideally avocational as well as vocational rehabilitation would be provided and the worker would be indemnified for the effect on his personal activities as well as his work.

Supporters of the whole-man theory argue that some injuries such as the destruction of procreative capacity may have little or no effect upon the worker's earning capacity but have extremely adverse effects upon his personal life. To pay no benefits or limited benefits in such cases is unduly harsh. Claimants suffering such injuries will consider the earning capacity theory unjust. Opponents respond that the "basic *quid pro quo* of workmen's compensation is that the employer assumes nonfault liability, but in return has his liability restricted to wage-loss restoration within fixed limits." [9]

They also note the subjectivity and arbitrariness of the determination of impairment under the whole-man theory. Finally, they argue that making payments for nonwage losses would fritter away workmen's compensation benefit dollars and make it difficult to provide adequate payments to those suffering wage losses.

Although some court opinions seem to make impairment rather than loss of earnings the test of disability,[10] almost all workmen's compensation cases in the United States are handled under the earning-capacity approach. Permanent partial disability awards of a specified number of weeks or permanent total disability awards for certain identifiable losses of limbs or sight, regardless of earnings, is sometimes cited as a departure from the earning-capacity theory. On the other hand, the practice can be regarded as an efficient way to apply the earning-capacity theory, on the assumption that the scheduled injuries typically result in the loss of a certain number of weeks of earnings.

OBJECTIVES OF WORKMEN'S COMPENSATION

Workmen's compensation programs can be evaluated by the extent to which they satisfy the following commonly accepted objectives: [11]

(1) income replacement,
(2) restoration of earning capacity and return to productive employment,
(3) industrial accident prevention and reduction,
(4) proper allocation of costs, and
(5) achievement of the other four objectives in the most efficient manner possible.

Not all of these objectives are equally important or accepted. The first two generally are considered most important. These objectives sometimes conflict with one another but in most ways they are linked by the design of the program.

Income Replacement

The first objective listed for workmen's compensation is to replace the wages lost by workers disabled by a job-related injury or sickness. According to this objective the replacement should be adequate, equitable, prompt, and certain.

To be adequate the program should pay the entire wage loss (present and projected, including fringe benefits) less those expenses such as taxes and job-related transportation costs that do not continue. The worker, however, may be asked to share a small proportion of the loss in order to provide some incentives for rehabilitation and accident prevention. The two-thirds replacement ratio that is found in about one half the State statutes is generally considered acceptable where it is not undercut by maximums.

To be equitable the program must treat all workers fairly. According to one concept of fairness, most workers should have the same proportion of their wages replaced. However, a worker with a low wage may need a high proportion of his lost wage in order to sustain himself and his family. If a guaranteed minimum income plan existed, there would be less need to favor low-income workers. A high income worker who can afford to purchase private individual protection may have his weekly benefit limited to some reasonable maximum. If workmen's compensation insurance is regarded primarily as a wage replacement program, however, relatively few persons should be affected by this maximum. An alternative philosophy would argue in favor of a more substantial welfare component with a higher minimum benefit, low maximum benefit, and extra benefits when there are dependents.

Ideally workers would be treated the same regardless of the jurisdiction in which they are injured. This criterion, therefore, implies a minimization of interstate differences in statutory provisions and their administration.

The program should pay all disabled persons an income starting as soon after their disability commences as possible. Finally, workers should know in advance what benefits they will receive if they are injured on the job and that these benefits will be paid regardless of the continued solvency of the employers.

Under the whole-man theory, the system would be required to indemnify the worker or his family for the effect on all his personal activities, not his earning capacity alone.

Restoration of Disabled Workers

The second listed objective is medical and vocational rehabilitation and return to productive employment. To achieve this objective the worker should receive quality medical care at no cost to himself, care which will restore him as well as possible to his former physical condition. If complete restoration is impossible, he should receive vocational rehabilitation that will enable him to maximize his earning capacity. Finally the system should include incentives to disabled workers and prospective employers to return the workers to productive employment.

If the whole-man theory is accepted, the objective should include avocational as well as vocational rehabilitation.

Accident Prevention and Reduction

Occupational accident prevention and reduction is a third commonly accepted objective of workmen's compensation. Those who consider this objective to be important believe that the system should and can provide significant financial and other incentives for employers to introduce measures that will decrease the frequency and severity of accidents. More specifically, the pricing of workmen's compensation should reward good safety practices and penalize dangerous operations. Employees should also have some incentive to follow safe work practices by sharing some of the losses. Injured workers should have the opportunity and be encouraged to return to work as soon as they are physically able.

Those who minimize this objective of workmen's compensation recognize the importance of safe work places and procedures but believe that workmen's compensation rates and other incentives have little effect upon how employers behave. Consequently they favor other approaches such as public safety inspectors and criminal penalties.

Proper Cost Allocation

The fourth objective of workmen's compensation, which has a narrower support than the first three, is to allocate the costs of the program among employers and industries according to the extent to which they are responsible for the losses to employees and other expenses. Such an allocation is considered equitable by supporters of this objective because each employer and industry pays its fair share of the cost. The economic effects are considered desirable because this allocation tends in the long run in a competitive economy to shift resources from hazardous industries to safe industries and from unsafe employers within an industry to safe employers. Higher workmen's compensation costs will force employers with hazardous operations to consider raising their prices. To the extent that consumers will not accept the price increase, employer profits and their willingness to commit resources to this use will decline.

Critics of this objective argue that workmen's compensation costs are such a small part of the cost of production that they have little, if any, effect on resource allocations. Consequently, they would avoid the complicated pricing practices necessary to achieve this objective.

Efficiency

Like any program, workmen's compensation should be designed in such a way as to achieve its objectives in an efficient manner. Operating costs should be minimized through the most efficient administration of the system consistent with the accomplishment of the other objectives. Litigation and legal costs should be reduced to the minimum amount consistent with the achievement of justice in the operations of a program designed on a no-fault principle.

Interrelationship Among Objectives

Sometimes these objectives conflict with one another. For example, the income maintenance objective ideally calls for full restoration of the wage loss but, as noted earlier, to encourage the worker to return to work as soon as he is physically able may require that he personally bear part of the wage loss. Although loss prevention efforts may be stimulated most by forcing each employer to pay benefits directly to impaired workers instead of through insurers, such a requirement would distort the cost allocation effects of the system and threaten the continued solvency of the employer and hence certainty of the payments. On the other hand, these objectives also reinforce one another. For example, raising inadequate benefits to an adequate level should stimulate accident prevention efforts by employers; distributing this cost among employers according to their past experience should produce a fair allocation and encourage employers with unsatisfactory experience to improve their records.

Workmen's compensation should achieve a proper balance between competing objectives. It should also encourage the accomplishment of multiple objectives wherever possible.

References for Chapter 3

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11. The first, third, and fifth objectives were stated over 30 years ago by Marshall Dawson, "Problems of Workmen's Compensation Administration in the United States and Canada," Bulletin 672 (Washington, D.C. : U.S. Department of Labor, Bureau of Labor Statistics, 1940), pp. 5–6. The second objective has received more attention in recent years.