Restructuring Wages to Cut Workers' Compensation Costs

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Want to reduce outlays for workers' compensation? Join the crowd. This mandatory insurance has gotten frightfully expensive in California, and people have noticed. An article in the San Francisco Chronicle told of bicycle messenger services shutting down after their rates jumped to 75 percent of direct wages. A Los Angeles Times editor called workers' compensation "the benefit that ate California."

Indirect payroll costs are a significant part of total labor expenses in agriculture. For most farmers the largest component of these costs is for workers' compensation (WC) insurance, compulsory in California since 1914, and currently covering farm workers in 39 states (compulsory in all but five) plus Puerto Rico, the Virgin Islands, and District of Columbia [U.S. Department of Labor, State Workers' Compensation Laws, 1991]. By now just about every employer who has not been under a rock for two years understands that the amount due for WC insurance is a function of three factors: (1) the type of work performed by employees covered; (2) total payroll; and, for larger employers, (3) claims experience of the policyholder (employer) over a three-year period—the first three of the last four years.

For each of some 430 types of work, or "industries," there is a standard "manual rate" set by the Workers' Compensation Insurance Rating Bureau (WCIRB). This rate is adjusted up or down for employers with respectively worse or better claims records than others in their industry. An employer's experience rating ("experience modification factor", or "X-mod"), expressed as a percentage, is multiplied by the manual rate to determine the firm's adjusted premium rate, expressed as so many dollars of insurance premium per 100 dollars of payroll. Calculating the total premium due is then a straightforward matter of multiplying the firm's adjusted rate by total payroll and dividing by 100.

Total Premium= Manual Rate x Experience Modification Factor x Payroll ÷ 100

The most widely advertised means for an employer to lower WC premiums is to reduce the frequency and severity of injuries at the workplace. While the current wave of concern with workplace safety and adoption of accident prevention measures was precipitated mostly by enactment of Senate Bill 198 in late 1990, many farmers have long appreciated the potential for reducing WC costs through good management. Employers are clearly rewarded by the system for investing in equipment, inspections, employee training, and communications that help prevent injury and illness. After a year lag, below-average claims experience translates to a lower X-mod and smaller premium to be paid.
Another Way to Skin the Cat?

While many employers are doing their level best to cut accident frequency to the bone, some are throwing up their hands, and others have joined to pursue broader relief in the nearer term. Industry associations and special purpose organizations such as Californians for Compensation Reform are pushing for legislative and regulatory reform of the WC system. These organizations argue that outrageous WC premium rates are driving total production costs up, competitiveness down, and businesses right out of the state. Their efforts focus on controlling fraud, unnecessary litigation, standards for benefit eligibility, medical charges, and other factors contributing to the cost of claims.

Is there anything that an individual employer can do to lower WC expense right away? An obvious approach is to reduce total reportable payroll. But the work has to get done, and it takes a certain amount of time, more or less, to do. So this comes down to cutting hourly rates of pay, which could inspire employees to revolt. Or does it? Not all of payroll is reportable for WC purposes.

### Workers’ Compensation Insurance Premiums for Similar Farms

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Rules published by the WCIRB specify portions of total payroll that may be excluded from the computation of premiums. Employers are generally not to include in their WC base the value of meals and lodging, tips, severance pay, and contributions to benefit plans. A final and most important exclusion is overtime remuneration, if shown separately in the employer's books and records. "Overtime remuneration means that portion of the total remuneration which is derived from the application of an increase above and in addition to the regular rate . . . because of time worked on Holidays, Saturdays or Sundays; or because of the number of hours worked in any one week or day beyond the standard . . ."

[WCIRB Manual of Rules, Classifications and Basic Rates, p. 3]

A farmer who pays workers extra for overtime hours and keeps good track of it, therefore, need figure workers' compensation premiums on only the amount of pay that would have been earned at straight-time rates for all hours worked. If a greater portion of total payroll is in this excepted category, there is a smaller base to which to apply the adjusted rate and thus a lower premium cost to the ratepayer. The implications are profound.

**Different Prices to Cover the Same Hours and Earnings**

Suppose Farmer A pays fifty field workers a wage of $7 per hour for 60 hours in a week during harvest season. Each worker thus earns $420, and total payroll is $21,000 (50 workers x $7 per hour x 60 hours per worker). At a typical manual rate of $12 per hundred, and assuming an X-mod of 100 percent (average), the WC premium to cover those workers is $2,520 ($12 x 100% x $21,000 ÷ $100).

His neighbor, Farmer B, has the same size of workforce harvesting the same crop for the same number of hours per week on the same number of acres. He pays a lower regular hourly wage of $6 but believes that
higher overtime pay of $9 for each hour in excess of 40 is an effective inducement for workers to put in a full workweek. Although the law does not require him to pay this overtime differential,2 he has heard of other growers who do so and thinks that it is a wise management practice.

Each of Farmer B’s workers also earns $420 \[(40 \text{ hours} \times \$6) + (20 \times \$9)\], and his total payroll, like that of Farmer A, is $21,000 (50 workers x $420). The equivalence stops there, however. Farmer B is entitled to exclude the $3 per hour overtime differential from his base payroll used to figure WC premium. The reportable payroll on which his premium is computed is only $18,000 (50 workers x $6 straight per hour x 60 hours per worker). Assuming the same rate of $12 per hundred and 100 percent X-mod as above, Farmer B pays only $2,160 ($12 \times 100\% \times \$18,000 \div \$100), a full $360 (or 14\%) less than Farmer A.

If Farmer B recognizes the existence of and reason for his WC cost advantage, he might be inclined to maximize it by lowering further his rate of straight-time pay and, of course, making it up to workers through a larger overtime differential. If he paid the minimum wage of $4.25, he could keep his employees whole by using an overtime rate of $12.50. Each would still earn $420 in a 60-hour week, $170 for the first 40 hours ($4.25 \times 40) and $250 for the remaining 20 ($12.50 \times 20).

How much would Farmer B then pay for workers’ compensation? Since his reportable payroll would be only $12,750 (50 workers x $4.25 straight per hour x 60 hours per worker), the WC premium would be down to $1,530 ($12 \times 100\% \times \$12,750 \div \$100), making his expense nearly 40 percent below what Farmer A is paying and giving him a tidy additional savings of $630 off his own former cost. And this is for but a single week. Farmer B could even bump each worker's earnings, say to $430 by raising the overtime rate to $13.00, and still end up with $130 more in his own pocket than he would have without restructuring wages.

The table summarizes these differences in WC premiums computed from three payrolls that are equal in total payout to employees but different in the portion attributed to additional overtime pay.

**Equity Issues**

Besides suggesting how to instantly reduce premiums, this comparative example raises fundamental questions about how the workers’ compensation system is structured. Costs of this insurance are not only steep but also may be unfairly distributed among employers.

Why should a farmer who offers wages a cut above the market have to pay correspondingly higher WC premiums? While the amount of replacement income (indemnity) to which injured workers are entitled is partly a function of their normal pay levels, only one-quarter of the premium dollar goes to pay for this benefit. Do higher wage employers have greater frequency or severity of claims? Probably quite the contrary, and the question is empirically answerable.

Does the pegging of WC and other indirect labor costs (e.g., unemployment insurance) to payroll—a direct function of wage rate—keep some employers from setting wages as high as they would otherwise? Would not a system in which adjusted manual rates were applied to time on the job instead of earnings provide a more faithful link between exposure to claims and cost of premiums?

Why is it that rates are based on dollars of payroll in California? Primarily, I am told, for convenience in reporting and enforcement. Payroll is easy to verify against other mandatory employer filings with state and federal agencies, and hours worked are not. Only in the state of Washington is the system based on hours rather than earnings.
A payroll-based system is most likely to be inequitable with respect to jobs that have high wage variance. California has taken a baby step toward neutralizing the effects of pay rate differences on WC premiums. Recognizing the bimodal distribution of construction wages among union and non-union scale firms, the WCIRB has established dual rates for about a dozen occupations in that industry.

For example, a manual rate of $11.70 (per $100 payroll) applies to earnings of carpenters with hourly wages of $19 or more and a rate of $28.28 to payroll based on wage rates of $18.99 or less. If the ratio of average high-group wage to average low-group wage does not exceed 2.42 (=28.28 ÷ 11.70), then the total of WC premiums paid for high-wage carpenters is no more than it would be for an equivalent number of hours paid at low wage. The same cannot be said, however, about premiums to cover high- and low-paid tractor drivers, irrigators, or broccoli harvesters. Higher pay on the farm makes for higher insurance premiums.

**Conclusion**

There are several means by which individual employers can affect workers' compensation costs. Reducing accidents, cracking down on fraud, and helping injured employees back to work as soon as possible are all part of living well within the current rules.

Many proposals for reform of the WC system have been introduced this year in the California legislature, and most are aimed at constraining benefits to both undeserving and dubiously deserving claimants. But there is another type of reform, longer overdue and more clearly compatible with the principle of equitably distributing the costs of WC benefits.

While the rules are being reexamined, there ought to be serious consideration given to replacing total payroll as the base for premium determination. Unless and until there is, farm employers may be able to reap handsome savings by simply restructuring their straight-time wage rates and overtime differentials.