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Examining the Labor Department's Proposed Reforms to the FECA Program

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INTRODUCTION

Chairman Walberg, Ranking Member Courtney and Members of the Subcommittee on Workforce Protections of the Education and the Workforce Committee:

Thank you for the opportunity to appear before you today. My name is Seth Seabury, and I am an Associate Professor of Research in the Department of Emergency Medicine in the Keck School of Medicine and the School of Pharmacy at the University of Southern California. I am also a Fellow at the Leonard D. Schaeffer Center for Health Policy and Economics. Prior to coming to USC, I was a senior economist at the RAND Corporation and the Associated Director of the RAND Center for Health and Safety in the Workplace. I have studied policy issues surrounding the compensation of work related injuries throughout my career. I have worked on and led a number of studies in California that have evaluated the efficiency, equity and adequacy of workers' compensation benefits and have influenced several reform efforts.

I am appearing before you today to discuss the implications of proposed changes to the Federal Employees' Compensation Act (FECA), the system for compensating federal employees for work-related injuries. In particular, there are two changes to FECA total and partial disability benefits that have been proposed by the Department of Labor (DOL) that are at issue:

- A change to the benefit schedule that would set benefits at a single rate of 70% of applicable wages at the time of injury, as opposed to the current system that uses separate rates of 75% and $66\frac{2}{3}\%$ for workers with and without at least one dependent, respectively.
- A mandatory reduction in benefits from the initial FECA rate to 50% of the applicable earnings (adjusted for inflation) once workers reach full Social Security retirement age.

To prepare for this hearing, I have reviewed the GAO report "Federal Employees Compensation Act, Analysis of Proposed Program Changes" (GAO-13-108) and the two follow up reports (GAO-13-142R and GAO-13-143R), as well as the report "Federal Employees Compensation Act: Benefits for Retirement-Age Beneficiaries" (GAO-12-309R). I have also

reviewed the testimony from the Subcommittee on Workforce Protection’s May 12, 2011 hearing “Reviewing Workers’ Compensation for Federal Employees,” and a slide presentation created by the United States Office of Personnel Management (OPM) titled “Long-Term FECA Recipients, Equitable Transition to the Retirement Years.” My testimony is based on my reading of these sources, a number of additional works that I cite below, and my accumulated experience in the area of workers’ compensation.

The key points of my testimony can be summarized as follows:

- The GAO reports estimate the long-term lost income that injured workers experience as a result of their injuries, including lost career growth, when assessing the adequacy of FECA benefits. This approach is widely believed to provide the best measure of benefit adequacy and is consistent with the methods that have been used in prior work in the area.
- Based on the GAO’s findings, the DOL proposal makes FECA benefits less adequate and also less equitable, in the sense that workers without dependents will have more of their income replaced than those that do. Making the system more equitable requires adjustments that are designed to equalize after-tax (as opposed to pre-tax) replacement rates.
- The GAO’s analysis shows that when lost career growth is considered, most workers earn less under FECA than what their normal retirement benefit would have been after a 30 year career had they not been injured. Reducing benefits at retirement age would thus worsen the adequacy of FECA benefits for most retirement-age beneficiaries.
- More work is needed to understand which workers might receive higher benefits at retirement age under FECA, and whether this has an impact on their incentives to return to sustained employment after an injury.

My testimony is organized as follows. I first discuss some criteria that can be used to evaluate changes in workers’ compensation benefits. I then outline some of the challenges of accurately measuring the economic effects of workplace injuries and some of the research that has addressed this issue. I then discuss the two proposed changes, in the context of these criteria, based on the GAO analysis. Finally, I offer some concluding thoughts and recommendations.

CRITERIA FOR EVALUATING WORKERS’ COMPENSATION POLICY

The purpose of providing income replacement benefits through FECA, as in state workers’ compensation systems, is to compensate workers for the lost income they suffer as a result of work-related injuries. While on the surface this is a straightforward objective, there are inherent challenges that arise in designing a system that provides these benefits in a fair and efficient manner. As a result, there have been many instances in state systems where public concern about how well the system is working has prompted legislative reform. However, such reforms often involve trading off the interests of competing agents. Thus, to understand the tradeoffs involved in any given policy proposal, it is important to have a clearly defined set of criteria with which to evaluate it.

For this testimony, I refer to four separate criteria that have been applied to evaluate changes in workers' compensation programs:

- Adequacy
- Equity
- Affordability
- Efficiency

I discuss each of these in turn. I spend the most time on benefit adequacy, because that is the criterion that is most central to the debate over the evaluation of the proposed FECA changes. However, the others are also relevant, so I provide a definition and a brief description of each.

Note that for these comments I am focusing on the application of these criteria solely to income benefits. Workers' compensation typically provides for other forms of benefits, such as medical care and vocational rehabilitation services, but these are unaffected by the two proposed changes at issue here.

Adequacy

Prior to the adoption of workers' compensation programs in the early part of the 20th Century, compensation for work related injuries was limited to the tort system.¹ Injured workers were entitled to full compensation for damages suffered as a result of their injuries, but only in the cases where they could demonstrate negligence on the part of employers. Like other torts, when the defendants (employers) were held liable, workers were entitled to full compensation of all damages suffered as a result of their injuries. This included noneconomic and economic damages, and possibly punitive damages. Economic damages in tort cases can cover a broad range of current and future damages, including factors such as expected future lost wages, medical costs and costs of attendant care or caregiving expenses. Workers' compensation was adopted as a carve-out from the tort system that provided no-fault compensation to injured workers. These benefits represented a compromise in which workers received benefits with greater certainty but only at reduced levels. Workers' compensation benefits offered no compensation for noneconomic damages and only partial compensation for lost wages, and none of the other economic costs related to an injury.

Because workers' compensation benefits provide only limited compensation, there has historically been intense interest in monitoring the system performance to ensure that the benefits reach minimum thresholds of compensation levels. The 1972 Report of the National Commission on State Workmen's Compensation Laws (the National Commission Report) provides the most comprehensive evaluation of the design of state workers' compensation programs.² The National Commission Report primarily relied on the *adequacy* and *equity* criteria to evaluate workers' compensation benefit programs. Benefit adequacy refers to the extent to which the benefits that are paid replace the income that is lost.

The adequacy of benefits is typically measured through the replacement rate of lost income. For temporary disability benefits, the standard for adequacy is generally held to be a replacement rate of two-thirds replacement of lost pre-tax income or 80% of after-tax income.^{2,3}

For permanent disability benefits, there is less of a consensus about what the target replacement rate should be, though two-thirds of lost income is usually held up as a benchmark.^{3,4}

Note the distinction between the *statutory replacement rate*, which is the legislated fraction of pre-injury wages a worker receives (usually two-thirds), and the *effective replacement rate*, which is the portion of lost income that is actually replaced. For the purposes of this testimony, I will refer to the effective replacement rate unless I specify otherwise.

Equity

Equity refers to the idea that workers in similar conditions with similar injuries should be treated similarly. From the standpoint of compensating workers for lost earnings, this means that workers with similar injuries should have similar replacement rates. The equity criterion, as it has been applied in practice by the states, does not require that workers necessarily receive the same dollar amounts in compensation. For instance, higher wage workers will tend to have greater dollar value of losses (conditional on other factors) and so they will receive more benefits on average. Nor does it require that everyone have exactly the same replacement rate. State systems routinely cap the total benefits at some fixed dollar value (usually tied to the state average weekly wage). This means that, all else equal, higher wage workers will have lower replacement rates the more their expected earnings exceed the statutory cap. Similarly, the presence of benefit floors means that, all else equal, the lowest wage workers will receive the highest replacement rates. Both of these represent deviations from a stricter definition of equity, probably reflecting a more general concept of perceived fairness.

Note that the estimated replacement rate of lost income can be used to evaluate the equity of workers' compensation income benefits. That is, workers' compensation benefits are equitable if workers with the same expected losses have approximately the same replacement rate of lost income.^{5,6}

Affordability

The affordability criterion refers to the cost of the workers' compensation system. An affordable system is one that all parties – employers, workers, and the public – can afford without serious adverse consequences.⁶ This can refer to both the actual cost of the benefits themselves as well as the cost of administering them. The administrative costs of workers' compensation benefits in state systems have generally been considered quite high.^{7,8} The administrative costs in FECA as reported by the DOL are much lower than is usually found in state systems (administrative costs in FECA are 5%, while administrative costs for privately insured employers in state systems average more than three times that amount⁸).

Note that there is often a direct conflict between making a system more adequate and making it more affordable. Holding expected losses constant, we make workers' compensation benefits more adequate by increasing them, but this makes the system less affordable. However, interventions that reduce expected losses, such as promoting the adoption of employer-based return to work programs, can serve the dual aim of making a system more affordable and more adequate.^{9,10} Additionally, improvements in administrative efficiency can lower the overhead

cost of delivering benefits, which makes the system more affordable without hurting its adequacy.

Efficiency

Broadly defined, I use the term efficiency to incorporate the indirect costs associated with workers' compensation benefits. This includes behavioral effects such as disincentives to return to work. For example, a workers' compensation system is more efficient if it achieves a given level of adequacy without creating adverse work incentives. Efficiency can also incorporate factors such as administrative delay or the levels of disputes. Other factors such as incentives for injury prevention – by employers and workers – can also be included here. While not all of these are easily measured, the impact of any given reform proposal on the efficiency of benefits could represent a significant portion of the total social costs or benefits of the proposal.

MEASURING THE ECONOMIC IMPACT OF WORKPLACE INJURIES

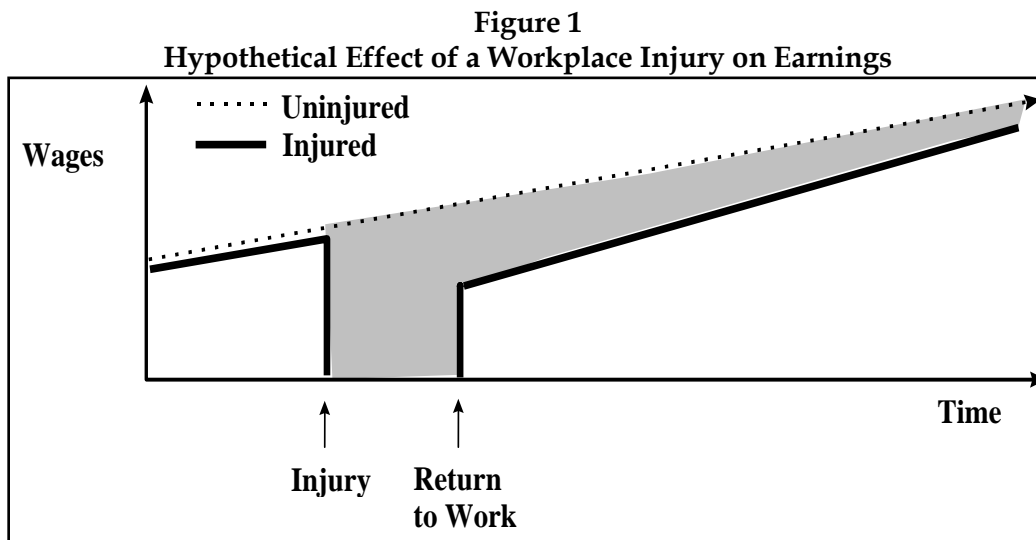
Both the adequacy and equity criteria described above require some measure of the replacement of lost income. Probably the most challenging part of measuring income replacement is defining and measuring “lost income.” A simple way to compute lost income is to compare what someone was making at the time of injury to what they make afterwards. However, for most people income changes over time. This can be positive if individuals get promoted and advance in their careers, as is most often the case with younger workers. Or wages can decline if individuals are fired, if they cut back on hours, or if they retire, as will be increasingly likely as workers age. In either case, simply comparing what someone made before they were injured and what they made after an injury provides a misleading picture about the impact of the injury on income.

We illustrate the challenge of evaluating the impact of injuries on lost income with Figure 1.¹¹ Figure 1 illustrates the hypothetical losses from a permanently disabling workplace injury. The solid line represents the actual income that the worker earns from his or her job. The dashed line represents the worker's “potential” earnings – the earnings that a worker would have received in the absence of an injury. Prior to the date of injury, the potential earnings and actual earnings are the same. However, at the date of injury, the worker's actual earnings decline while the potential earnings continue to increase, reflecting the worker's increasing experience in the labor market.

At the time of injury, the worker receives no earnings for some time while recovering from the injury. In this example, at some point, the worker returns to work, perhaps in some modified capacity. In this hypothetical example that is shown in the figure, the worker returns at lower earnings than prior to injury. The worker recovers earnings over time, as the wages converge closer to what they would have been absent the injury. In this example, at the end of the observed period the worker makes more than she made prior to the injury, but not as much as she would have made if she had not been injured.

The shaded area in the figure represents the total lost income over the period after the injury. The fraction of these losses that is replaced by workers' compensation benefits is equal to the replacement rate of lost income. However, the figure also highlights the challenge of measuring

lost income. Whereas wages received while the workers' actual earnings (the solid line in Figure 1) are readily observable, the potential earnings represented by the dashed line are unobservable for any individual and must be estimated.



In order to get an accurate assessment of the long-term economic consequences of an injury, we need to compare what an individual actually makes to what he or she *would have made* in the absence of an injury. Since this is a counterfactual that is unknowable in the sense that it cannot be directly observed, it must be estimated. Researchers have combined data on workers' compensation claims linked to information on earnings to estimate losses dating back to the 1960s. This research was described more completely in the 2004 NASI report, but I will summarize it here.³ The earlier studies used the pre-injury earnings of injured workers and estimated potential earnings by projecting expected earnings using aggregate trends in earnings.¹²⁻¹⁵ This approach is limited by the assumption that average earnings growth for injured workers mirrors aggregate trends, ignoring possible differences between injured and uninjured workers.

Starting in the late 1990s, researchers began using more advanced empirical methods to estimate potential earnings. These studies used a quasi-experimental design that compared the earnings of injured workers to a sample of uninjured control subjects before and after the date of injury. As long as the selected control workers have expected earnings in the post-injury period that are approximately equal to the expected earnings of injured workers, on average this method will produce unbiased estimates of earnings losses. Past studies have primarily relied on one of two criteria to identify control workers.¹⁶ The first is to use workers who were injured but with minimal severity and little time out of work (e.g., medical only injuries).¹⁷⁻¹⁹ The other commonly used approach is to match injured workers to workers who were never injured, but who worked at the same firm and had very similar earnings to the injured workers prior to the injury.^{4,20,21}

In their reports, the GAO used matching to estimate the lost earnings of FECA beneficiaries. The GAO matched FECA beneficiaries to observably similar federal employees who weren't injured. What the injured workers would have made absent an injury was estimated by the actual earnings of the injured workers' matched, uninjured controls. Taking the difference between the average value of what matched, uninjured workers made and what injured workers made provides an estimate of expected wage loss for the FECA beneficiaries in the sample (note that this approach is only valid over large enough samples, not for a single individual).

With an estimate of earnings loss in hand, it is then possible to assess benefit adequacy by dividing total workers' compensation benefits by total earnings losses over some fixed period of time. This ratio is the estimated fraction of lost income that is replaced by workers' compensation benefits. This approach has been termed the "wage loss" approach to evaluating benefit adequacy. The National Academy of Social Insurance (NASI) argued that this approach is the preferred approach for assessing the adequacy of disability benefits.³

Because the process for estimating replacement rates generally requires linking state administrative workers' compensation benefits to state unemployment insurance information, these estimates have only been conducted for a comparatively small set of states. Berkowitz and Burton (1987) were the first to conduct such a study, and they compared replacement rates in Wisconsin, Florida and California.⁷ Using more recent estimation techniques and data sources, a series of studies have estimated losses in states such as California, New Mexico, Washington, Wisconsin and Oregon. In general, replacement rates fall well below the standard definitions of adequacy. In a comparison of these five states, the estimated pre-tax replacement rate ranged from 29% to 46% of lost income over a 10-year period post-injury. Even accounting for the favorable tax status of benefits, these findings have consistently shown that benefit adequacy is a significant problem in the states.

PROPOSAL TO REIMBURSE WORKERS AT A SINGLE RATE

Currently, FECA offers two different statutory replacement rates: two-thirds for injured workers who have no dependents and 75% for those who have at least one dependent. This is a departure from the standard model of workers' compensation that has been adopted in state system, which rarely offers differential compensation based on the number of dependents. The DOL proposes to set compensation at a single rate of 70% of pre-tax income, regardless of the number of dependents.

To construct their replacement rate estimates, the GAO matched injured workers to uninjured workers with similar pre-injury characteristics. They also conducted a number of specification checks that appear to verify that they have high quality matches. This is important, because for the matching estimator to work well, the income of the matched control workers must be close proxies for the expected income for injured workers (assuming they had never been injured).

The GAO found that this proposal would reduce the after-tax replacement of lost income by a modest amount overall (from 80% to 77% for non-postal employees), due to the fact that a majority of employees currently qualify for the higher rate. However, the proposed change to a

single rate also appears to have some implications for the equity of benefits. According to the GAO, currently the system favors beneficiaries with a dependent by a modest amount (approximately 3.5% for the median worker). This difference is less than the approximate 7.3% difference in the statutory replacement rates because the absence of dependents implies a higher tax rate, so workers without dependents receive a higher effective replacement rate given a fixed statutory rate. However, under the proposed change to a single statutory rate, the lower tax rates of workers with a dependent imply that the change will result in workers without a dependent having a 5.8% higher replacement rate than workers with dependents. Thus, the reform will change the system from being skewed towards workers with dependents to being more skewed towards workers without.

Subsequent analyses by the GAO studied the implications of moving to the single 70% rate for postal workers, and moving to a single rate of two-thirds replacement of pre-tax, pre-injury wages (as proposed by the Senate). Postal employees generally had higher replacement rates before the change (88% before the change, reduced to 84%), but the pattern of moving towards a system that is comparatively more generous to workers with dependents to one that is more generous to those without was essentially the same. The Senate proposal of moving to a two-third replacement rate for all workers had the same impact on benefit equity, but lowered the overall median replacement rate even more (to 73% for non-postal employees and 80% for postal employees).

The implications of these findings for the DOL single rate policy proposal are mixed. On the one hand, the proposal does lead to a net decline in benefit adequacy, in terms of a lower replacement rate. The effect is fairly modest, though it is more pronounced under the Senate's proposed reduction to a single two-thirds rate for all workers. It also reduces the after-tax rate below the 80% level recommended by the National Commission Report – though the statutory rate is higher than the standard used by NASI.

Because there is a net reduction in benefits, moving to the single rate would produce net savings. Thus, one could attempt to justify a decline in adequacy on the basis that it makes the system more affordable. But there appears to be little argument for making the changes based on equity. In fact, the GAO reports that the change actually makes the benefits less equitable, because the current system corrects for the differences in tax rates across the two groups. To make the benefits more equitable would require adjusting the system according to the after-tax replacement of lost income as opposed to the pre-tax replacement (for example, by directly targeting replacement rates of “spendable” income as is done in some states, or by adjusting the statutory pre-tax rate proportionally to the number of dependents).

PROPOSAL TO REDUCE BENEFITS AT RETIREMENT AGE

The second proposal suggested by the labor department is to reduce the FECA benefit to 50% once individuals reach their full Social Security retirement age. The DOL argues that this is necessary because the current system provides an incentive to injured workers to avoid returning to work. The argument for this is based on the OPM slide deck that indicated workers would receive higher benefits under FECA than under the Civil Service Retirement System (CSRS), a finding that was confirmed by the GAO (GAO-12-309R). Early return to sustained employment after an injury is something that is generally considered good for workers and

good for employers,⁹ so if the system created significant work disincentives this would be a serious concern.

The comparison between FECA and the CSRS is of limited utility, however, since the proposed legislative changes are prospective and the vast majority of current federal employees (90%) are now covered by FERS. Given that employees covered by CSRS represent a small and shrinking share of the federal workforce, the GAO analyzed the differences between employee compensation under FECA and FERS. One of the key challenges of making this comparison is that the FERS system is relatively new (covering federal employees beginning January 1, 1984), and there are no beneficiaries who have worked a full 30-year career covered by and retiring under FERS. Thus, the GAO conducted a simulation that compares the FECA benefits to FERS benefits at normal retirement age after a 30-year career. Under this simulation, FECA benefits were approximately equal to or less than FERS benefits, depending on what assumption was made about employee contributions to the Thrift Savings Plan (TSP). In this case, under the reductions at retirement proposed by DOL, workers receive less under FECA than what they would have received after working a 30 year career and retiring under FERS (35% less for non-postal employees and 29% less for postal employees, assuming 10% contribution to TSP). From the GAO analysis it appears clear that most workers who would have worked a full career and contributed to their retirement at a reasonable level over that time would not do better under FECA compared to FERS. This suggests that reducing FECA benefits from their current levels would likely reduce the adequacy of benefits for FECA recipients over retirement age.

This analysis is more complicated when considering the implications for workers with partial disabilities. This is because workers with partial disabilities are compensated differently under FECA. FECA benefits for the partially disabled are designed to reflect an injured worker's ability to work. Workers who have recovered from their injury and are deemed to have some capacity to work receive long-term FECA benefits based on their lost earnings capacity. The process for determining lost earnings capacity is based on whether a worker finds post-injury employment and whether this employment is deemed commensurate with their ability to work. This means that the difference between FECA and FERS benefits depends on the actual work history of the permanent disability claimants. The GAO considered several case studies, and in these case studies there were some workers appear to have higher benefits under FECA than FERS, but those are also the workers who have the lowest earning capacity and thus would be able to save or contribute little to retirement during their working years. More generally, most workers with partial disabilities already receive lower benefits than they would with a total disability, even if their circumstance was otherwise identical, and the DOL proposal would lower these benefits even more.

As far as return to work incentives, the implications here appear mixed. In general, this is only an issue for workers with partial disabilities (that is, workers who are totally disabled lack the ability to work regardless of incentives). It is true that cutting FECA benefits at retirement age could provide these workers with additional incentives to return to work. However, FECA benefits for workers with partial disabilities who are deemed to have sufficient earnings capacity are already reduced. Thus, it is unclear how much affect further reducing benefits on retirement age would have on these workers' labor supply decisions.

Ultimately, there appears to be a lack of sufficient evidence about which workers might receive higher benefits from FECA under FERS, and how much their work incentives would actually be affected by this difference. In particular, it is unclear how adequate FECA compensation is for partially disabled workers with different levels of perceived loss in earnings capacity. A more detailed analysis of the relationship between FECA compensation, lost earnings capacity and long-term replacement rates of lost income for partially disabled workers should be considered.

SUMMARY AND CONCLUSIONS

The GAO provides convincing evidence that, on net, shifting to a single rate would reduce benefit adequacy while possibly reversing and exacerbating the disparity in compensation between workers with and without dependents. If the goal of this policy proposal is to make compensation more equitable, some alternative approach should be considered that focuses more on equalizing post-tax replacement rates. The GAO also found that the adequacy of FECA benefits vary considerably across individuals, though that is likely to be true in any compensation system. Benefits under FECA do appear much more adequate than those under state systems, even after the DOL change. However, that is due in large part because state systems have generally been found to fall considerably below standard definitions of adequacy for permanent disability compensation.

The DOL provisions to reduce FECA benefits at retirement age would also lead to a net reduction in the generosity of FECA. The implication of this reduction on the adequacy of benefits depends on whether or not the long-term impact of earnings on employment and career growth are accounted for. Failing to account for career growth, FECA benefits appear generous relative to FERS and a reduction would make compensation across the two systems more equitable. However, lost career advancement is a real consequence of disabling workplace injuries, and once that is accounted for, the DOL reduction could result in workers facing substantially lower income in their retirement years than they would have experienced absent their injury. Justifying this on the basis of eliminating inefficient work disincentives would seem to require more evidence than is currently available about the extent to which the current system is actually deterring permanently disabled workers from re-entering the labor market. Further study on this issue and on the adequacy of FECA benefits for partially disabled workers is warranted.

In terms of the GAO analysis, one of the centers of the dispute seems to be whether we should consider the long-term impact of injuries on potential earnings – or career growth – when assessing different policy proposals. In general, there is a tradeoff in workers' compensation between benefit adequacy and the affordability and efficiency of the system. When choosing between different policies and balancing this tradeoff, it is important to have a full and complete understanding of the impacts on both sides of this ledger. Most previous work in this area has generally accepted that to fully understand benefit adequacy it is necessary to estimate the expected post-injury wage path of injured workers.

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