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## Bending the Employment, Income, and Cost Curves for People with Disabilities

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**C**urbing the growth of the federal deficit is a major priority for policymakers. One factor contributing to this growth is the shrinking pool of working-age people with disabilities who have jobs and pay taxes on their earnings (lower line in Figure 1). A growing number of these individuals are leaving the workforce and obtaining Social Security Disability Insurance (SSDI) benefits and Medicare, adding to the skyrocketing costs of these federal programs (Figure 2).<sup>1</sup> Although the support provided by these programs helps ease the financial strain on workers with disabilities, statistics show that the household incomes of these workers are falling behind those of workers without disabilities (upper line in Figure 1). This brief lays out a two-pronged approach for bending these curves—increasing the employment rate for people with disabilities, reducing their reliance on federal support, and increasing their household incomes—while preserving benefits for those who are unable to work.

### Realigning Incentives

Faced with unsustainable deficits, politicians might be tempted to tighten SSDI eligibility or reduce benefits in order to rein in spending—the same approach used to curb the growth in disability-program enrollment and spending in the early 1980s (Congressional Budget Office 2010). Such cuts would likely encourage more people with disabilities to find jobs, but cuts might also harm the very individuals these programs are designed to help. Even if cuts are made, they might well be short lived; the cuts of the 1980s were followed by significant eligibility expansions as part of the 1984 Amendments to the Social Security Act (Congressional Budget Office 2010).

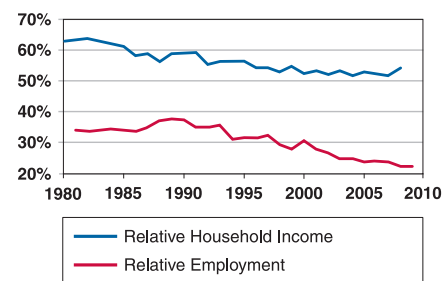
There is, however, another way to bend the employment and income curves

upward for people with disabilities while bending the cost curve downward, without cutting disability benefits. This brief presents a two-pronged policy option that would reduce the incidence of disability among workers, help them continue to work after disability onset, and encourage all working-age people in low-income households to find jobs. It would also boost the after-tax household incomes of people with disabilities, reduce entry into SSDI and Medicare, and shrink the federal deficit—while leaving SSDI and Medicare intact for those who need it.

The first prong of the policy option involves “experience rating” the disability component of payroll taxes—the share of payroll taxes used to pay for SSDI and the Medicare benefits of SSDI beneficiaries. Experience rating is a method of adjusting the tax rate for an employer and its workers based on the cost of benefits recently paid to

**Figure 1.**

**Employment Rates and Household Incomes Among People with Work Limitations, 1980-2009**



Source: von Schrader et al. (2010).

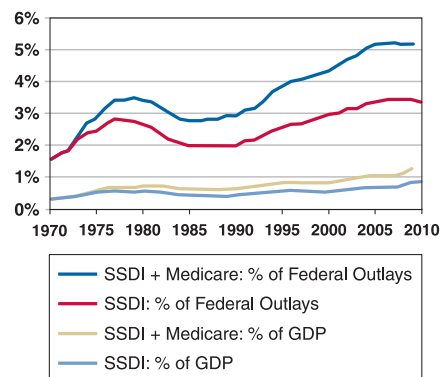
Note: The data shown are for people age 18 to 64 with health-related work limitations relative to the corresponding values for those without such limitations.

workers. Currently, the disability component of the payroll tax rate is about 2.3 percentage points, representing just 15.0 percent of the total 15.3 percent payroll tax, split equally between the

<sup>1</sup> SSDI beneficiaries with the lowest incomes and assets also receive Supplemental Security Income and Medicaid benefits. This brief focuses only on benefits financed by payroll taxes.

**Figure 2.**

**SSDI and Medicare (Part A and B)  
Expenditures for People Under Age 65  
as a Percentage of the Gross Domestic  
Product and Federal Outlays, 1970-2010**



Data sources: Social Security Administration (2011) for SSDI expenditures; Centers for Medicare & Medicaid Services (2011) for Medicare Part A and B expenditures; Bureau of Economic Analysis (2010-2011) for gross domestic product and federal outlays.

employer and employee.<sup>2</sup> The proposed rating system would shift some of these costs from low-risk employers and their workers to high-risk employers and their workers. The system would also be budget neutral for the federal government (that is, it would pay for itself) as long as there were no effects on employment and earnings. As discussed later, the policy option would also include features to counter the effects of experience rating that might discourage employers from hiring those already at risk for SSDI entry.

The second prong of the policy option is a series of income-tax changes that include an expansion of the Earned Income Tax Credit (EITC) for low-income households. These changes would (1) offset the negative effects of experience-rated payroll taxes on the after-tax earnings of low-income households and (2) be budget neutral as long

<sup>2</sup> This disability component is defined as the sum of the SSDI payroll tax (1.8 percent) and 13.8 percent of the Medicare Hospital Insurance (HI) payroll tax (2.9 percent). The SSDI tax applies only to annual taxable earnings up to a maximum (\$106,800 in 2010). The Medicare percentage is the share of all Medicare HI expenditures in 2009 spent on services to beneficiaries under age 65. In 2009, HI expenditures for SSDI beneficiaries totaled \$70 billion (CBO 2010), or 13.8 percent of total expenditures (\$509 billion), as reported by Medicare's trustees. Note that Medicare Supplementary Medical Insurance (SMI—Parts B and D) is financed by general revenues and beneficiary premiums rather than by payroll taxes.

as there were no effects on employment and earnings.

This two-pronged policy option has the potential to:

- Improve the employment and economic fortunes of people with disabilities
- Reduce entry into SSDI
- Increase revenues from payroll taxes

These outcomes might seem too good to be true. But they are possible because the two-pronged approach reduces problematic incentives that discourage or prevent many people with disabilities from using their full productive capacity.

### Prong 1: Experience Rating

**Experience rating is a common insurance practice.** It involves adjusting the premiums for people in an insurance pool, such as employees in a firm, based on the cost of claims for everyone in the pool during a recent period. Premiums are raised or lowered depending on the cost of claims for workers in the pool versus the average cost for all covered workers.

Experience rating is intended to keep costs balanced and equitable for both low- and high-risk pools. Without experience rating, low-risk pools implicitly subsidize high-risk pools and purchase less insurance than they would if their premiums were actuarially fair, while those in high-risk pools purchase more. Experience rating also encourages policy holders to avoid the insured event—such as injuries that may lead to disability—and to efficiently use covered services if the event does occur. Most group insurance purchased by employers is experience rated, including health insurance, private disability insurance (PDI), workers' compensation (WC), and unemployment insurance (UI). However, Social Security (which includes SSDI) and Medicare are important exceptions.

Social Security was originally designed to provide benefits to retired individuals and their spouses only. The primary event that Social Security insured against was unexpected longevity of the person or the person's spouse after age 62—an event unlikely to be discouraged by employer-based experience rating. The same applies to Medicare. For *nonretired* individuals and their employ-

ers, however, experience rating SSDI and Medicare might have a substantial impact on a different kind of event: it might markedly reduce the need to quit a job because of a disability.

**Unlike Social Security, WC and UI are experience rated.** WC is especially germane because it insures against work-related disability. Several recent studies have shown that experience rating WC substantially reduces the incidence of disability (see Burton 2009; Tompa et al. 2007; and Thomason 2005). Other studies have shown that experience rating reduces the length of injury-related absences (see McLaren et al. 2010; Reville et al. 2001; and Krueger 1990).

It is no accident that an entire industry—disability management—has grown up around WC. Because employers have a strong incentive to reduce the cost of disabilities covered by WC, they routinely purchase disability-management services to help reduce these costs. Two recent studies provide compelling evidence on this point (McLaren et al. 2010; Burkhauser et al. forthcoming). In contrast, employers do much less to prevent (or reduce the cost of) disabilities that are not work related.<sup>3</sup>

**One problematic consequence of experience rating WC is that it encourages employers to shift the cost of work-related disability onto SSDI and Medicare.** Experience rating substantially increases the incentive for employers to deny that an injury was work related. As a result, some workers may enter SSDI for a condition that should be covered by WC. Guo and Burton (2009) found that the tightening of WC eligibility rules by states has led to growth in the SSDI rolls since 1990, although others have found no such effect (McInerney and Simon 2010).

Employers that offer PDI have similarly strong incentives to shift costs to SSDI and Medicare. PDI plans usually provide a claimant with a fixed percentage of his or her past wages, but the amount of the payment is reduced dollar for dollar by any SSDI benefits the worker receives. Helping the claimant obtain SSDI is therefore financially attractive to

<sup>3</sup> The minority of employers that provide PDI—in essence, supplemental SSDI coverage—are the exception.

employers and insurers—possibly more attractive than encouraging the claimant to return to work (Stapleton et al. 2009).

One way to address these problems is to implement prong 1 of the policy option proposed here—to experience rate the disability portion of payroll taxes. This would give employers an incentive to help claimants stay in the workforce, thereby reducing the number who enter SSDI. Experience rating would also lead employers to invest in more disability-management services and make them less likely to shift costs from WC and PDI to SSDI and Medicare.

It is worth noting that the positive effects of this policy option on SSDI entry, as mentioned above, have been seen in other countries. For example, the Netherlands—long notorious for having many workers on the long-term disability rolls—recently introduced experience rating. The number of workers entering the rolls has since declined sharply (de Jong 2008; Burkhauser et al. 2008). Other developed countries are also seriously considering this option for their equivalent of the SSDI program (Organisation for Economic Co-operation and Development 2003).

**One complication of this approach, however, is that it would reduce the after-tax wages of low-income workers.** These workers tend to hold jobs with high rates of disability and would therefore pay higher premiums in an experience-rated insurance pool, which would reduce their take-home pay. At the same time, the take-home pay of high-income workers would go up; these workers tend to hold jobs with lower rates of disability and would thus pay lower premiums. Further, employers in competitive labor markets can usually shift any exogenous increases in benefit costs onto their employees in the form of lower wages.<sup>4</sup> Because experience rating would lead employers to pay more for benefits for low-wage (but high-risk) workers, these workers are likely to experience a drop in their take-home pay, while the average high-wage, low-

risk worker would experience the opposite. These changes in take-home pay would be reflected in after-tax incomes of low- and high-income households, although imperfectly. Low-wage workers are more likely than high-wage workers to live in low-income households, but not all of them do.

**Another problematic consequence of experience rating is that it discourages employers from hiring or retaining workers perceived to be at high risk for disability.** These workers may include older people; people with visible disabilities; and people with visible conditions or behaviors that put them at risk for disability (such as obesity or smoking). Fortunately, an SSDI rating system could be easily modified to address this problem for most such workers. For instance, the system could use an age-adjusted standard, so that the employer's rate is based on the employer's claims history compared to the claims history for all workers of comparable ages. The system could also reduce payroll tax rates for workers with significant disabilities. Such tax reductions by themselves would encourage employers to hire and retain these workers. Experience rating the disability component of payroll taxes would strengthen the incentives such reductions would create to hire workers with disabilities.

Workers with invisible disabilities would not be eligible for payroll-tax reductions unless they chose to disclose their disability to their employer. This is not problematic, however, because the reductions are intended to keep employers from discriminating against those with known, visible disabilities. Nor would workers who are obese or who smoke be eligible for reductions unless they have another SSDI-eligible disability. To do otherwise would be to reward behaviors that increase the risk of disability. An experience-rating system, on the other hand, would encourage such workers to lose weight or quit smoking and thus decrease their risk of disability.

As described above, we could modify the experience-rating system to encourage employers to hire those at high risk for disability. However, we need to look outside the rating system to address its detrimental effect on the wages of low-

income workers. Prong 2 of our policy option serves this purpose.

## Prong 2: Expanding the EITC

**The EITC has a long history of success in helping low-income adults increase their income.** Congress enacted the EITC in 1975 to provide (1) a work incentive for adults in low-income families and (2) a supplement to these families' income. The size of this tax credit initially increases with earnings, remains fixed at moderate income levels, and gradually decreases at higher income levels. Several expansions of the EITC, most notably in 1993, have targeted low-income families with children. Prominent welfare researchers credit these expansions with helping to substantially increase employment and earnings among single mothers, as well as dramatically reduce their reliance on welfare, in the decade that followed (Eissa and Hoynes 2006; Hotz and Scholz 2003). Such outcomes strengthen the case for expanding the EITC to help achieve the same goals for working-age adults with disabilities.

One limitation of the current EITC is that it provides a much larger tax credit for low-income workers with children than for those without children. In 2010, the maximum annual credit for a family with three children was \$5,666, while the maximum credit for a family with no children was just \$457.<sup>5</sup> These same rules also apply to workers with disabilities—those without children receive a much lower EITC.

In 1996, a panel convened by the National Academy of Social Insurance recommended increasing the EITC for workers with disabilities as a way to boost their low employment rates and reduce their entry into SSDI and Medicare (Mashaw and Reno 1996). One important deterrent to doing so, however, is the administrative challenge of identifying the eligible population.

**The EITC expansion proposed here would include all workers in low-income households.** Such an expansion would not pose the administrative

<sup>4</sup> The rating system would be based on claims of all employees in a firm, but the impact on after-tax earnings would depend on the rate of disability in an employee's specific job, not just on the firm's payroll tax rate. Experience rating is expected to reduce employer demand for workers in high-risk jobs because of the effect of SSDI entry on employer costs.

<sup>5</sup> Information on the EITC was obtained from the Urban Institute and Brookings Institution Tax Policy Center website, <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=36>, on December 15, 2010.



challenge mentioned above because it would not be necessary to determine which workers have qualifying disabilities. It would also be in line with recent proposals to expand the EITC for all low-income workers without children (Steuerle 2010). In the short term, such an expansion would stimulate economic growth. In the long term, it would increase the federal deficit, although the costs would be partially offset by higher payroll taxes and lower benefits. To prevent deficit growth, the expanded EITC must be financed in a way that does not hinder future economic activity.

One way to accomplish this would be to increase income-tax rates for high-income households. Such increases would pay for themselves as long as there were no changes in individuals' or employers' behavior. This tax increase, combined with the EITC expansion, would counteract the undesirable effects of prong 1—namely the redistribution of after-tax wages from low-wage workers to high-wage workers. Further, the small tax increases that high-income households would pay to finance the expanded EITC would be unlikely to affect their economic activity.

**If funded in this way, an EITC expansion would be an essential complement to the experience-rating portion of the policy option.** Of course, it would not offset the loss in take-home pay for every worker whose wages fall because of experience rating. It would, however, counteract the income losses for low-income households as a group, and it would counteract the income gains that would otherwise be experienced by high-income households as a group.

## Bending the Curves

The two-pronged policy proposal would simultaneously:

- Introduce an experience-rating system for the disability portion of the payroll tax
- Expand the EITC for workers in all low-income households, funded by higher taxes on high-income households

Both prongs of the proposal would pay for themselves *if the behavior of employers and workers remains unchanged*. The expectation, of course, is that their behavior would change—in ways that would increase employment and earnings. These changes would in turn reduce the federal deficit by slowing entry into SSDI and increasing tax revenues. Increased employment would also mean higher income for workers, as their wages would likely more than make up for any loss of SSDI benefits. In addition, the after-tax income of those in low-income households would receive a boost from the EITC.

Another attractive feature of this two-pronged policy option is that it can achieve these results without reducing SSDI or Medicare benefits for people with disabilities who are unable to work. It reduces the number of workers who need these benefits but preserves the benefits for those who do.

## Moving Ahead

If designed and implemented well, the two-pronged policy option would boost employment rates and incomes among people with disabilities, help contain the deficit, and preserve SSDI and Medicare for those who are unable to work. The devil is in the details, of course, which include:

- The rules for experience rating
- The expanded EITC and associated tax increases for high-income workers
- The administration of both an experience-rating system and the EITC
- The transition from the current policies to the new policies

The effects on specific employers, workers, and workers' families will depend very much on these details.

The idea of experience rating the disability component of the payroll tax is not new. Burkhauser and Daly (forthcoming) most recently made a case for this policy option. Others have proposed policy options that, like experience rating, would motivate employers to prevent disabilities and retain workers who experience disability onset (Social Security Advisory Board 2006; MacDonald and O'Neill 2006; Stapleton et al. 2009; Autor and Duggan 2010). The most well-developed

proposals would establish a new work insurance program, funded by payroll taxes or employer/employee premiums (MacDonald and O'Neill 2006; Autor and Duggan 2010).

These proposals, however, do not address the adverse effects they would likely cause—specifically, the decline in after-tax wages for workers with high-risk jobs. Because many SSDI entrants come from high-risk (but low-income) jobs, the result would be reduced earnings for low-income workers. However, the expansion of the EITC for all workers, as proposed in this brief, addresses this issue. It would therefore be an attractive addition to any policy designed to enlist employers' help in slowing the exodus of workers from the labor force into SSDI.

Although the policy option presented here could have a number of desirable outcomes, careful design and implementation would be necessary to avoid bending the employment, income, and cost curves in the wrong direction—reducing employment rates among people with disabilities, eroding their incomes, or increasing the deficit. Much work remains to design an effective system that will fulfill the promise of this two-pronged policy option as well as garner enough political support to enact it.

## References

For the full list of references, go to [www.disabilitypolicyresearch.org/brief11\\_01\\_ref.asp](http://www.disabilitypolicyresearch.org/brief11_01_ref.asp).

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