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EXECUTIVE SUMMARY

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Incentive effects of experience rating in disability insurance

Career-ending disability continues to be a major reason for an early exit from the labour market, and therefore disability benefits have a considerable effect on the dependency ratio and the sustainability of the entire pension system. Various features of the pension system have been designed with the aim of providing incentives to both employers and employees to extend working lives. In this study, we consider the effectiveness of economic incentives due to the experience rating of disability insurance contributions of private sector employers.

When an individual's illness is prolonged, he or she can apply for a cash rehabilitation benefit or a disability pension. The former is granted for a specific period while the latter is granted for an indefinite period of time. The costs of disability pensions are allocated to the employers according to their disability risk. As part of the pension insurance contribution, employers pay a disability insurance contribution, which is partially experience-rated. An employer's disability risk is defined by comparing the costs of new disability pension claims of its workers to the average disability pension costs of all private employers with a workforce of the same age structure. This relative risk level defines the contribution category of the employer, which in turn determines the level of the experience-rated contribution rate.

For the purposes of our study, an important feature of the contribution technique is that the degree of experience rating varies with firm size. The smallest employers are not subject to experience rating but only pay flat-rate contributions. In other words, their disability risk does not affect their contribution rate. Medium-sized employers pay a weighted sum of the flat-rate and experience-rated contributions. Among these employers, the degree of experience

rating – the weight of the experience-rated contribution – increases linearly from 0 to 1 with firm size. The largest employers are fully experience-rated in the sense that they only pay experience-rated contributions. Thus, the largest employers suffer the most from the costs of their workers' disability pensions. On the other hand, they also benefit the most from prevented cases of disability. This should provide an economic incentive to implement measures that reduce the onset of health problems and help employees with medical impairments to continue working. There are no such economic incentives for the smallest employers, as they cannot influence their contribution rate by investing in disability-reducing measures. The medium-sized employers, depending on their size, fall in between these two extremes in terms of incentives.

It is worth emphasizing that different types of disability benefits are treated differently when determining an employer's disability risk. Only disability pensions affect the employer's disability risk and hence the experience-rated contribution rate. And, since a partial disability pension amounts to half of the value of a full disability pension, its impact on the employer's disability risk is smaller than that of the full disability pension. On the other hand, cash rehabilitation benefits are not taken into consideration at all in the determination of the disability risk, so they have no effect on the experience-rated contribution rate. The aim is to encourage employers to support the rehabilitation of their workers and, if necessary, adjust post-rehabilitation work tasks to correspond to the workers' working capacity. However, it is not obvious how employers react to these cost differences. In the best case scenario, the cost differences steer employers to support rehabilitation measures more actively and prompt them to offer part-time employment to workers with a reduced working capacity. In that case, a full disability pension – that is, an early exit from working life – can be prevented. In the worst case scenario, the incentives only lead to workers being transferred from one type of benefit to another because employers try artificially to postpone retirement on a full disability pension in order to minimize their contributions.

Using comprehensive register data from the Finnish Centre for Pensions and Statistics Finland, we compare disability inflow rates in firms of different sizes that are subject to different degrees of experience rating. We analyse the inflow into sickness allowance periods, cash rehabilitation benefits and disability pensions separately, since their cost effects deviate from each other. First, we examine the use of cash rehabilitation benefits and what the workers do after the benefit period. The cash rehabilitation benefit is intended as a short-term benefit, granted if it is likely that the worker will be rehabilitated and return to work. Employers participate in, among other things, the drawing up of a rehabilitation plan. The plan specifies, for example, which tasks the worker can undertake after a rehabilitation period, and possible retraining measures. Although the aim is to rehabilitate workers so that they could return to work, approximately half of cash rehabilitation benefit recipients were awarded a disability pension. In other words, they exited from the labour market altogether within a month of the termination of the cash rehabilitation benefit. Only one third of the workers returned to work. The majority of those who did so were employed by the same employer that they worked for before drawing the cash rehabilitation benefit. The larger the former employer was (i.e.,

the larger the employer's degree of experience rating), the shorter were the periods on a cash rehabilitation benefit. In addition, workers from larger firms were more likely to return to work for the same employer after the rehabilitation period. This could reflect the effect of the incentives, if large employers really put more effort into helping their disabled workers to return to work due to the risk of an increase in the experience-rated contribution rate.

We also use statistical methods to estimate the causal effect of experience rating on the disability inflow rates. Because the degree of experience rating is a deterministic function of firm size and because the experience rating system has remained unchanged throughout our observation period, the problem is how to separate the incentive effect of experience rating from the direct effect of firm size. To identify the causal effect of experience rating we exploit discontinuities in the rule that specifies the degree of experience rating as a function of firm size. A key result of our analysis is that experience rating does not affect the disability inflow rates. Namely, we find no evidence that the degree of experience rating would affect the likelihood to end up on sick leave, a cash rehabilitation benefit or a disability pension. Nor do we find any effects on disability benefits which have been granted on the basis of illnesses that the employer could possibly influence, such as musculoskeletal diseases.

Our findings suggest a possibility that employers' opportunities to affect the working capacity of their workers are so limited that experience rating in disability insurance is generally an ineffective policy to reduce the disability inflow. On the other hand, the complexity of the current contribution technique may hinder employers from internalizing the economic incentives of experience rating. Among small employers, in particular, awareness of the details of the contribution technique may also be limited, which might reduce the power of the incentives.

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