

Diminished Future Earning Capacity

A Primer

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One of the most significant changes made by SB 899, introduction of the concept of “diminished future earning capacity,” is causing considerable confusion among system participants. This paper provides some background and history concerning adoption of this change in order to clarify what was intended by this important revision..

In short, *diminished future earning capacity is the quantitative measure of the severity of a permanent disability*. The RAND Institute for Civil Justice developed this concept in a series of reports evaluating California’s permanent disability rating system. RAND criticized the prior Permanent Disability Rating Schedule (PDRS) due to “its reliance on ‘subjective’ criteria to measure disability.”¹ To correct this problem RAND recommended that long term earnings losses be used as an objective measure of the impact of the disability. RAND then developed a data base that measured the long term earnings losses for permanently disabled workers, *i.e.*, the *diminished future earning capacity* of these workers.

Using this objective measure of disability severity, RAND recommended adoption of an empirically based rating schedule under which assigned ratings would directly reflect the empirical measure of disability – the long term earnings losses. This would link the assigned rating to the empirical measure of diminished future earning capacity so that the level of the assigned rating directly corresponds to the measure of diminished future earning capacity.

Of course, by definition *diminished future earning capacity* is not measurable at the time a rating is assigned. Consequently, the rating process starts with medical information relating to the injury or illness that is causing the disability. Under the 2005 PDRS, the first step in the rating is to determine the Whole Person Impairment (WPI) percentage as determined under the *AMA Guides to the Evaluation of Permanent Impairment, 5th Edition*.

RAND had recommended adoption of a more objective impairment rating methodology in order to minimize rating inconsistencies. However, RAND also recognized that ratings under the *AMA Guides* are not empirically based,² and that “they provide guidelines only for measuring impairment and say nothing about the extent that impairments limit work.”³ Thus, although ratings assigned under the *AMA Guides* may help promote the statutory goals of being consistent, uniform, and objective,⁴ these WPI percentages neither provide an empirical basis for a rating schedule nor do they have any direct connection to *diminished future earning capacity*.

¹ Reville, Robert T., Seth A. Seabury, and Frank W. Neuhauser, *Evaluation of California’s Permanent Disability Rating Schedule, Interim Report*, RAND Institute for Civil Justice, December 2003, (“*RAND Interim Report*”), pg. 8.

² *Id.*, pg. 14.

³ *Id.*, pg. 13.

⁴ See California Labor Code Section 4660, subdivision (d).

Consequently, as noted by RAND in the *Interim Report*, the whole purpose of the rating schedule is “to convert the medical evaluation of an impairment into a quantitative measure of the severity of the disability.”⁵ In other words, the rating schedule should convert the non-empirical WPI percentage into an empirically based measure of diminished future earning capacity. The 2005 PDRS uses a Future Earning Capacity (FEC) adjustment for this purpose.

The FEC adjustment does not measure either impairment or diminished future earning capacity, instead, it measures a mathematical relationship between these figures. As a simplified example, if workers with a 10% rating under the 1997 PDRS have average earnings losses of 20%, a factor of 2.0 measures this relationship. But this factor of 2.0, by itself, doesn’t provide any information regarding either the 1997 PDRS rating or the earnings loss percentage. It merely measures a mathematical relationship between these specific numbers. .

The difference between the FEC adjustment – which is a measure of a mathematical relationship between ratings and earnings losses – and DFEC – which is a quantitative measure of the severity of a disability – has led to some major problems. For example, the FEC adjustments in the 2005 PDRS are not empirically based because the former Administrative Director misunderstood the fundamental nature of those adjustments. Because the FEC measures a mathematical relationship between specific numbers, the only correct use of the FEC is to convert one of these specific numbers into the other. In the example given earlier, the factor of 2.0 can correctly adjust the 1997 PDRS 10% rating to reflect the quantitative measure of 20% proportional earnings losses. But this same 2.0 adjustment cannot be used to adjust a rating assigned entirely under a different schedule, such as the 2005 PDRS. That is the fundamental error in the 2005 PDRS – it uses adjustment factors based on one schedule to adjust a completely different schedule. That is as illogical as using the conversion factor between dollars and pesos to adjust a price measured in euros.

The Board is also struggling with this concept. For example, in view of the fact that the sole purpose of this adjustment is to develop a final rating that is “a quantitative measure of the severity of the disability,” the holding in a recent Board panel decision that “DFEC can’t replace the PDRS number” is simply wrong. In fact, the goal of an empirically based rating schedule is to assign a final rating that directly reflects the objective measure of diminished future earning capacity, or in other words the assigned rating should be a direct measure of DFEC.. Of course, the final rating must reflect all statutory considerations, so age and occupation adjustments must also be applied in conjunction with the FEC adjustment. But in the end the rating schedule cannot be considered empirically based unless the final ratings are directly linked to diminished future earning capacity. Indeed, the DFEC doesn’t *replace* the PDRS number, it is the PDRS number!

Similar misunderstandings have recently been seen in a few cases in which the applicant has introduced evidence of diminished future earning capacity through the use of testimony by a diminished future earning capacity expert in rebuttal to the 2005 PDRS. Reactions by Workers’

⁵ RAND *Interim Report*, pg. 8.

Compensation Judges and the Board have varied, often reflecting this misunderstanding of the nature and meaning of diminished future earning capacity.. In fact, although the DFEC expert is obviously still required to reflect all required statutory factors in his or her analysis, the end product of this analysis – an empirically measured diminished future earning capacity percentage – is the exact same end product as is produced under an empirically based rating schedule.

In its final report on California's permanent disability rating schedule, RAND noted that the use of an FEC adjustment is not the only empirically-based method by which the goal of assigning an empirically-based rating that accurately reflects diminished future earning capacity can be achieved. RAND described a number of different methods used in other states to develop ratings based on the disabled worker's loss of earning capacity. As explained by RAND,

The loss of earning capacity approach considers the seriousness of a worker's permanent impairment and functional limitations and other factors that may affect the loss of the worker's earning capacity resulting from an injury. These factors may include the worker's age, prior education, and prior work experience. In addition, factors such as the job opportunities in a given location may be considered.⁶

Conclusion

The new concept of Diminished Future Earning Capacity was introduced to provide an objective basis for assigning permanent disability ratings. The intent was to link an objective measure of disability – earnings losses – to the rating assigned to a disabled worker. Linking the assigned permanent disability rating to this objective measure of disability assures that workers with high disability, *i.e.*, high earnings losses, will receive a high rating, while disabled workers with low disability (earnings losses) receive correspondingly lower ratings.

By statute, this linkage must be based on the empirical data and findings from the RAND *Interim Report* and upon other empirical data. RAND recommended adoption of an empirically based system because it found that the 1997 PDRS failed both employers and disabled workers. Linking the permanent disability rating to an empirical measure of earnings losses assures that ratings (and benefits) are both adequate and equitable, improving outcomes for disabled workers. In addition, by assigning a rating only where there is an objective measure of disability, and by reducing disputes and eliminating unnecessary frictional costs, this new system also improves outcomes for employers.

But to accomplish these goals, the assigned rating must accurately reflect diminished future earning capacity as measured by earnings losses. Because the AMA *Guides* impairment rating is a subjective number that does not reflect the impacts of the injury or illness on work,

⁶ Reville, Robert T., Seth A. Seabury, Frank W. Neuhauser, John F. Burton, and Michael D. Greenberg, *An Evaluation of California's Permanent Disability Rating System*, RAND Institute for Civil Justice, 2005, (the RAND *Final Report*), pg. 100.

RAND recommended the use of an adjustment factor to convert the impairment percentage into a measure of diminished future earning capacity. Unfortunately, the FEC adjustments in the 2005 PDRS are not based on empirical data, so the final adjusted ratings under the 2005 PDRS do not reflect anything more than the selected policy judgment of the Administration.

However, FEC adjustments that measure the relationship between *AMA Guides* WPI ratings and long term earnings losses can be developed to accurately convert ratings assigned under the 2005 PDRS to reflect diminished future earning capacity. But the use of an FEC adjustment under the 2005 PDRS is not the only method by which a rating can be accurately linked to diminished future earning capacity. The key point is that however the final rating is developed, the assigned permanent disability rating must be a direct reflection of the empirically-measured loss of earning capacity. Only by linking this objective measure of the severity of disability to the assigned permanent disability rating will the rating process fulfill the mandate of SB 899 to assign permanent disability ratings that equitably and adequately reflect the severity of the worker's disability.
