Public Citizen
Buyers Up • Congress Watch • Critical Mass • Global Trade Watch • Health Research Group • Litigation Group
Joan Claybrook, President

Why Bush's Tort Proposals Won't Help the Economy

President Bush has made restricting the legal rights of consumers and patients one of his signature issues, claiming that lawsuits increase health care costs and lead to the loss of jobs. But any suggestion that his policy proposals, such as restricting medical malpractice and class action cases, will improve the economy or contain health care costs has no basis in reality. As explained in this briefing paper, neither economic theory nor empirical evidence support his attacks on the legal system.

Conservatives' embrace of the suggestion that lawsuits are bad for the economy is of recent vintage. There are no screeds against trial lawyers in classic conservative works by Barry Goldwater or William Simon. The founder of modern conservative economic thought, Milton Freidman, has never inveighed against the tort system; in fact, he endorsed the common law as fulfilling one of the three duties Adam Smith said were properly assigned to government, and prefers private lawsuits to government regulation.[1] Judge Richard Posner, America's preeminent conservative jurist and authority on the economics of the legal system, calls common-law doctrines such as tort law "commonsensical. Their articulation in economic terms is beyond the capacity of most judges and lawyers, but their intuition is not."[2]

As explained more fully below, "tort reform" is based neither on classic conservative thought nor on mainstream economics. Its adoption as a plank in the Bush economic platform can be attributed only to special-interest influence and the Republican Party's own interest in reducing trial lawyer money available for donation to their Democratic opponents.

The Sound Economics Underlying the Tort System

Tort law is driven by the basic economic notion of *externalities*—costs that one person's activity imposes on others. "The economic purpose of tort liability is to induce injurers to *internalize* these costs. Tort law internalizes these costs by making the injurer compensate the victim. When potential wrongdoers internalize the cost of the harm they cause, they have incentives to invest in safety at the efficient level."[3]

The echo-chamber effect of anti-lawyer rhetoric has convinced Republican officials that lawsuits harm the economy when they don't. When President Bush ordered a report on tort economics from his own Council of Economic Advisors, it informed the President that it too shares the conventional view:

For some transactions, however, it may be infeasible to account fully for all of the relevant benefits and costs. A consumer purchasing a new car, for example, may have neither the technical expertise nor the information necessary to fully evaluate the risk of injury posed by a particular design feature. It could also be costly to obtain complete information on every key aspect. Alternatively, a patient purchasing a medical procedure, for example, may be unlikely to fully understand the complex risks, costs and benefits of that procedure relative to others. Such a patient must turn to a physician who serves as a "learned intermediary," though there remains the problem that the patient may also not be able to judge the skill of the physician from whom the procedure is "purchased." In such a case, the ability of the individual to pursue a liability lawsuit in the event of an improper treatment, for example, provides an additional incentive for the physician to follow good medical practice. Indeed, from a broad social perspective, this may be the least costly way to proceed – less costly than trying to educate every consumer fully. In a textbook example, recognition of the expected costs from the liability system causes the provider to undertake the extra effort or care that matches the customer's desire to avoid the risk of harm. This process is what economists refer to as "internalizing externalities." In other words, the liability system makes persons who injure others aware of their actions, and provides incentives for them to act appropriately.[4]

Lawsuits Do not Harm the Economy

Despite the incompatibility of "tort reforms" with mainstream economic thought, a few academics with conservative, pro-business orientations have contrived a theoretical case to back them. Generally the argument they make is that the threat of lawsuits gives rise to over-deterrence, having perverse effects such as "defensive medicine" or chilling product innovation. But if hypothesized over-deterrence is the economic rationale for weakening the legal system, there are two fallacies:

1. *There is no evidence of harmful effects of the tort system on the economy.* Anyone who watches an hour of prime-time television and is buffeted by ads for new prescription drugs can see that there is no lack of product innovation. There is one primary study that proponents rely upon to put a price tag on defensive medicine,[5] however, non-partisan researchers at the Congressional Budget Office and General Government Accountability Office have been unable to replicate its findings.[6] The existence of defensive medicine is crucial to the Bush Administration's claim of high tort costs, because at $9.6 billion a year, the cost of malpractice insurance constitutes less than one percent of national health expenditures.[7] The "defensive medicine" projection of $25 billion a year allows Bush to attach an artificially-inflated legal cost to the federal budget.[8]

2. *Bush's policy proposals are not aimed at over-deterrence.* For instance, experts have concluded that if defensive medicine does exist, it could be eliminated by mandating "practice parameters"—guidelines that authoritatively state what tests need to be given to patients with a particular condition, and that protect the doctor from liability for not ordering further tests.[9] Yet, even though this initiative would directly target the claimed

> $25 billion in additional annual costs to the Treasury, Bush has not endorsed it. This is most likely because medical providers haven't embraced a policy that would reduce, rather than increase, their earnings and autonomy.

But the over-deterrence theory has been eclipsed in political rhetoric by gimmicks and demagoguery. The main claims made by the Bush Administration and its allies—that lawsuits can "wipe out a business," that "junk and frivolous lawsuits" increase health care costs, and that Americans pay a "tort tax"—as outlined below, have no basis in fact or in economic theory. And one staple of partisan rhetoric, condemning the financial success enjoyed by some plaintiffs' lawyers, is clearly incompatible with Republican ideology.

Lawsuits Can't "Wipe Out a Business"

A lawsuit can't wipe out a business, unless the business depends upon unsafe or illegal activities to make a profit. Sometimes a business that is capable of earning a profit through lawful means will try to earn extra income by cutting corners. In such cases, court judgments awarded to those harmed by the unsafe or illegal practices could exceed the value of the business (i.e., its plants, equipment, customer relationships, etc.). But even if a company must be liquidated to pay judgments, the plants and equipment are not scrapped, nor are innocent employees fired. Viable business units will continue to operate under new ownership. (For instance, Johns-Manville continues to manufacture non-asbestos insulation; its 1982 bankruptcy simply led to much of its stock being held in trust for people injured by asbestos.) Only stockholders and culpable managers will lose their equity interests or jobs.[10]

The result is different if the business was viable only because it engaged in dishonest or unsafe practices. In such situations, the closing of the business benefits the overall economy. When a business relies on fraud or deception, the duped consumers' spending results in what economists call a "deadweight loss" of utility. When an unsafe business causes injuries, it imposes "external" costs in the form of lost wages and health care expenditures that offset any benefits it provides.

"Junk and Frivolous Lawsuits" Have No Impact on Health Care Costs

The reason that doctors, and President Bush, speak of "frivolous" lawsuits is, of course, because non-frivolous suits involve serious medical errors and seriously injured victims. But "frivolous" suits have little impact on health care costs. Doctors define as "frivolous" any lawsuit in which no payment is made to the victim, which is nearly 70 percent of all claims.[11] But they fail to mention that nearly all of those claims are filed to preserve patients' legal rights while the statute of limitations is pending—and withdrawn voluntarily[12] after attorneys investigate the cause of the injury (at considerable expense to themselves). Cases that are taken to trial and rejected by a jury constitute only five percent of all claims.[13] As far as truly frivolous suits—those that have no factual or legal basis whatsoever—an exhaustive search of anecdotes cited by doctors during their two-years legislative campaign finds mention of *only one malpractice case fitting the legal definition of frivolous.*[14]

Whatever the definition, so-called frivolous suits have a negligible impact on national health expenditures. According to data from the Physician Insurers Association of America, only about 12 percent of malpractice premium dollars are spent defending claims that are closed without payment.[15] If attorneys *never* filed an unsuccessful suit, the savings would constitute less than one-tenth of one percent of national health expenditures.[16]

Lawsuits Don't Impose a "Tort Tax" on the Economy

> We know that the current tort system is costing America well over $200 billion each year… that's a tort tax – paid in the form of lower wages, higher product prices, and reduced investments – of $809 for every individual and more than $3200 for a family of four. And this is a regressive tax, imposed indiscriminately across our economy—Treasury Secretary John Snow[17]

There is no "tort tax." The numbers to which Snow referred were generated by a private actuarial firm, Tillinghast-Towers Perrin[18] and represent the total cost of liability insurance purchased in the United States, including administrative costs ("overhead").

Tillinghast implies that this cost would disappear if there were no tort system. That is not true. The costs of liability insurance represent the costs of injuries that would take place with or without a tort system. For instance, the National Highway Traffic Safety Administration estimates that automobile crashes have an annual societal cost, in death, injury and property damage, of $230 billion.[19] If none of the costs of those injuries were covered by a tort system, where the responsible party pays, they would have to be covered by the individual victim's own insurance (called "first-party insurance").

About $174 billion of auto accident costs are covered by auto insurance; $93.4 billion of that is liability insurance and is thus included in the Tillinghast figure, while $80.3 billion is first-party insurance and is not included as a tort cost. If all the liability insurance were replaced by first-party, no-fault insurance, the arbitrarily-defined "tort tax" would drop by 40 percent, from $809 to $486,[20] but the actual cost of automobile insurance per American would remain the same, as would the overall cost of automobile injuries.

Senate Republicans ordered a report on tort costs from the Congressional Budget Office, hoping that government economists would confirm their talking points. But CBO, adhering to the mainstream view. It explained that most of the payments Tillinghast includes as "costs"

> merely shift money from injurers to victims and thus are not true costs to society as a whole. In economic terms, payments that do not involve any use of resources to produce goods or services are called "transfer payments." Those that do involve using resources for production are known as "real resource costs" (also "social costs" or simply "costs"). Specifically, the portion of a settlement or judgment that goes to the plaintiffs is a transfer payment.[21]

While they are not costs to the economy, "tort costs" are costs that businesses would be able to shift to others if the legal system did not exist.

The Tillinghast study also breaks down where "tort costs" go. Their breakdown further illustrates the specious nature of their "tort cost" calculation:

- 46 percent of the "costs" are for payments made to injured plaintiffs for lost wages, medical care, and pain and suffering. These costs are the result of injuries caused by defendants and would be borne by society anyway, through private health insurance, government programs, charities or absorbed by the victims and their families.
- 21 percent of the tort cost study's puffed-up cost estimate is for insurance industry overhead. Much of this insurance overhead would exist even in the absence of lawsuits because administering first party insurance would also require underwriting, claims adjusting, marketing, profit, etc.

The appropriate way to calculate the real cost of the tort system would be to take its transaction costs and subtract them by the administrative costs of a no-fault or social insurance program that would otherwise pay for injury costs. One would then have to subtract as well the benefits, in reduced injury costs, attributable to the tort system's deterrent effect on unsafe practices. Nobody has attempted to quantify this latter amount, yet it is easy to see how simple safety measures, such as a sign reading "Shallow - Do Not Dive," which might not exist in the absence of liability, could save literally millions of dollars in injury costs. To illustrate, consider a 2003 study by the Bush White House examining the costs and benefits of 107 federal regulations – primarily health, safety and environmental protections – covering a 10-year period. The analysis found that: "The estimated total annual quantified benefits of these rules range from $146 billion to $230 billion, while the estimated total annual quantified costs range from $36 billion to $42 billion."[22] If the tort system did not provide similar benefits, it would have been dismantled long ago.

In order to affirm the suggestion that all of Tillinghast's tort costs are "excessive," President Bush's Council of Economic Advisors engaged in some amusing gymnastics, such as *assuming* that the tort system did not provide any safety benefits; *assuming* that any transaction costs in excess of those in Workers Compensation systems constitute "excess," and *assuming* that any damages awarded for pain and suffering are "random," and that even awards for lost wages or medical bills are "not well targeted."[23] When these four factors are "assumed," the entire Tillinghast "tort cost" number can be deemed wasteful. Needless to say, however, even the most highly partisan economists are unwilling to accept such flights of fancy as true because there is no evidence to support them. As such, the Council never concluded that, in fact, the $200 billion figure was correct, nor that the tort system is inefficient.

As a Congressional Budget Office report concluded, reduced damages awards "do not affect economic efficiency: they modify the distribution of gains and losses to individuals and groups but do not create benefits or costs for society as a whole.[24]

The Difference Between Bush and the Democrats on Tort Costs: Bush Targets "Transfer Payments" and Democrats Target "Transaction Costs."

What is ironic is that Republicans, once thought to be practitioners of hard-headed economics, have made the centerpiece of their tort policy the reduction of transfer payments, precisely the payments that *don't* impose any cost on the economy. Their key initiatives are caps on damages for "pain and suffering" and eliminating damages insured by "collateral sources," such as health or disability insurance.

According to the conservative Judge Posner, these initiatives make no economic sense. In fact, he says that "damage awards for pain and suffering, even when apparently generous, may well undercompensate victims seriously crippled by accidents."[25] Posner says that relieving defendants of injury costs covered by collateral sources "would result in underdeterrence." If "the economic cost of an accident, however defrayed, is $10,000, and if the judgment against [the defendant] is zero, his incentive to spend up to $10,000 to prevent a similar accident in the future will be reduced."[26] Posner also mocks the notion that insured victims get "windfalls" or "double recoveries."[27]

But because transfer payments are costly to the special interests backing Bush, such as corporations and medical providers, politics, not economics, dictates that they be reduced.

Democrats, meanwhile, have focused their policy efforts on reducing the transaction costs of litigation that do consume economic resources. In 1990, Senator Joe Biden (D-Del.) achieved passage of the Civil Justice Reform Act, which established policy experiments to reduce litigation expenses and delays. The CJRA succeeded in identifying ways to reduce litigation costs without harming litigants' substantive rights.

An alternative medical malpractice bill unveiled by Senate Democrats in 2003 would have required lawyers who file malpractice cases to first secure an affidavit from a medical expert, certifying that a case is valid. This is intended to force plaintiffs' lawyers to do more investigation of their cases before filing suit, in hopes of reducing doctors' defense lawyer costs in cases that are eventually withdrawn.

How would Bush's medical malpractice initiative impact on the economy? The $250,000 cap on damages for pain and suffering, as CBO indicates, would have no positive impact because transfer payments do not use economic resources. In fact, it would more likely have a negative impact by causing more injuries.

Another Bush initiative, capping plaintiffs' attorneys' fees, targets lawyers' income. If the customary 33 percent legal fee truly is excessive, then this would represent a lowering of the tort system's transaction costs. But plaintiffs' lawyers' fees are set by the market. Victims of malpractice are free to shop for the lowest contingency fee. As *Business Week* has noted, "A legislative cap amounts to price control." [28] The actual intent of the fee limitation Bush proposes is to discourage attorneys from bringing complex malpractice cases that require more work than the reduced fee can pay for.

Ironically, the Bush Administration did have a proposal to prevent inefficient legal costs from inhibiting the economy, but abandoned it in the face of special-interest opposition. When he first took office, Bush and his then-Secretary of Housing and Urban Development, Mel Martinez, proposed a rule change that would have forced competition on the title insurance industry.[29] Only about 5 percent of title insurance premiums are paid out in claims. Nearly all the remainder goes to title companies and title agencies that are operated, and in many cases owned, by lawyers. There is no price competition for title services, because the company is selected by a home seller's broker or lawyer. Many brokers and lawyers refer the client to a title agency that they own. Clearly, title-related legal services are a better candidate for regulation than tort-related legal services.

Title services cost $23 billion a year,[30] and everyone, from conservative HUD economists to consumer advocates, agrees that this cost is excessive. Indeed, most title insurers will sell policies for half the usual price (the "re-issue rate") when pressed by a savvy customer. It is likely that lawyers in the title industry suck many times as much money out of the economy as do "overpaid" malpractice lawyers—HUD estimated the rule would save $8 billion a year.[31] The initiative would have had the added benefit of eliminating an entire category of class-action lawsuits—those brought to recover padded fees charged at closings, a problem that would no longer exist if the rule were adopted. Yet Bush abandoned this policy initiative.

Why abandon an anti-lawyer initiative based on sound economics yet continue to push one based on nonsense? Because plaintiffs' lawyers give most of their contributions to Democrats. A massive lobbying campaign by the title industry (from which came two of the 2000 Bush campaign's "Pioneers"[32]) succeeded in persuading Bush to drop the pro-competition title services initiative.

How a Bush Tort Initiative Replaced the Private Sector with a Government Program

Tort law is the prototype for the kind of outcome-based regulations favored by conservatives. Juries issue no "command-and-control"-type rules; they simply assign the costs of injuries to those responsible, letting the private sector find creative ways to prevent them.

To see the ideological vacuity of tort "reform" at its most absurd, one need look no further than the S.A.F.E.T.Y. Act, passed last year as part of the law creating the Department of Homeland Security. The S.A.F.E.T.Y. Act's stated purpose (and its "F-E-T") was to "foster effective technologies" by reducing liability for manufacturers of anti-terrorism products. But the law goes about this in a most un-conservative way.

Under the tort system, a company hoping to obtain product liability insurance for its anti-terrorist devices might be required to have it tested by Underwriters Laboratories (UL), a private entity. But under the S.A.F.E.T.Y. Act, the role of companies like UL is handed over to the government. Homeland Security officials will test the product instead of UL and decide whether to indemnify it.

Needless to say, the companies that had endorsed the S.A.F.E.T.Y. Act after hearing a lawyer-bashing pitch from lobbyists are now facing a morass of government red tape, and wondering if they've been had.[33] Reducing liability served only to de-privatize a function that UL had performed adequately during World War II.

Dec. 14, 2004

---

[1] Friedman & Friedman, Free to Choose (1980).
[2] Posner, Economic Analysis of Law (6th Ed. 2003), p. 254.
[3] Cooter & Ulen, Law and Economics (4th Ed. 2004), p. 290.
[4] Who Pays for Tort Liability Claims? An Economic Analysis of the U.S. Tort Liability System, Council of Economic Advisers, April 2002, p. 4.
[5] Mark McClellan and David Kessler, "Do Doctors Practice Defensive Medicine," *Quarterly Journal of Economics*, May 1996.
[6] See also Congressional Budget Office, Cost Estimate for H.R. 5, HEALTH Act of 2003, ordered by the House Committee on the Judiciary, submitted March 10, 2003: the "research was based largely on a narrow part of the population and considered only hospital spending for a small number of ailments. …[U]sing a different data set, CBO could find no statistically significant difference in per capita health care spending between states with and without malpractice tort limits." See also United States General Accounting Office, Report GAO-03-836, "Medical Malpractice: Implications of Rising Premiums on Access to Health Care," p. 27, August 2003: Medical provider groups admitted to GAO investigators that "factors besides defensive medicine concerns also explain differing utilization rates of diagnostic and other procedures. For example, a Montana hospital association official said that revenue-enhancing motives can encourage the utilization of certain types of diagnostic tests, while officials from Minnesota and California medical associations identified managed care as a factor that can mitigate defensive practices. According to some research, managed care provides a financial incentive not to offer treatments that are unlikely to have medical benefit."
[7] According to the Department of Health and Human Services actuaries' most recent report on growth in health care expenditures, in 2002 health care expenditures rose 9.3% to $1.553 trillion. Expenditures on malpractice premiums reported to the National Association of Insurance Commissioners that year were $9.6 billion, making malpractice costs about 0.62% (less than one percent) of national health care expenditures. Malpractice costs rated only an 11-word mention in the actuaries' 13-page report.
[8] "Remarks by the President at Elizabeth Dole for Senate Finance Dinner," July 25, 2004, http://www.whitehouse.gov/news/releases/2002/07/20020725-5.html
[9] See e.g. Arnold Rosoff, The Role of Clinical Practice Guidelines in Health Care Reform, Leonard Davis Institute Issue Brief, October 1994.
[10] An interesting illustration is found in the case of Maxfield v. Bryco Arms. A child left paralyzed by a defective gun won a multi-million dollar judgment against Bryco, which forced it into bankruptcy. The owner of the company, Bruce Jennings, lost his interest in the company, but its assets were sold to the plant manager at a bankruptcy auction. The plant manager outbid activists and friends of the victim in the case, who had attempted to buy the assets in order to junk the plant. See "Shooting Victim is Outbid for O.C. Gun Maker," *Los Angeles Times*, August 13, 2004.
[11] Physician Insurers Association of America (PIAA) Claim Trend Analysis, 2001 Edition, Exhibit 1, Trend Analysis of Claims by Close Year, Combined Specialties.
[12] Id.
[13] Id., Exhibit 6a, Claims That Result in a Verdict, Claims Closed Between 1985 and 2001.
[14] Pennsylvania Medical Society press release, "Personal Injury Lawyer Admits Filing Merit-less Malpractice Lawsuit," June 22, 2004.
[15] Id. PIAA companies spent $741 million on claims and expenses in 2001. $94 million, or 12.6 percent, was spent on claims that were closed without payment to the plaintiff.
[16] .12 x .0062 of national health care expenditures =.00078
[17] Remarks by Treasury Secretary John Snow to the American Tort Reform Association's Annual Membership Meeting, Washington, DC, March 16, 2004.

[18] Tillinghast-Towers Perrin, *U.S. Tort Costs: 2003 Update.*
[19] Economic Impact of Motor Vehicle Crashes, 2000, http://www.nhtsa.dot.gov/people/economic/econimpact2000/.
[20] $93.4 billion is 40 percent of Tillinghast's total $233 billion "tort cost" figure.
[21] The Economics of U.S. Tort Liability: A Primer, Congressional Budget Office, October 2003, p. 19.
[22] *Informing Regulatory Decisions: 2003 Report to Congress on the Costs and Benefits of Federal Regulations and Unfunded Mandates on State, Local and Tribal Entities*, Office of Management and Budget, Office of Information and Regulatory Affairs, September 22, 2003, p. 3
[23] Council of Economic Advisers, Who Pays for Tort Liability Claims, p.10.
[24] Congressional Budget Office Issue Brief, "Limiting Tort Liability for Medical Malpractice," January 8, 2004.
[25] Posner, Economic Analysis of Law, p. 197.
[26] Id. at p. 201.
[27] Id.
[28] "Reform Liability Laws, But Carefully," *Business Week* April 21, 1986.
[29] "HUD Chief Seeks Simpler Sale Closings" *Washington Post*, June 2, 2001.
[30] Ward's Business Directory, 46th Ed. 2003.
[31] Remarks of Secretary Mel Martinez, March 12, 2003, http://www.hud.gov/news/speeches/ncrc.cfm
[32] William Foley, CEO of Fidelity Title Co.; Michael R. Haas, Senior Sales Manager, Chicago Title Insurance.
[33] The Chamber of Commerce complained that the timetable for approvals was "too lengthy and rigid" and that the agency's rules required submission of "detailed financial information that goes well beyond what is required by other government agencies." The Information Technology Association of America complained that the information submission requirements "are so massive as to ignore real-world business issues." See testimony at hearing of House Committee on Government Reform, October 17, 2003.