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TORT COSTS AND THE ECONOMY

Myths, exaggerations, and propaganda

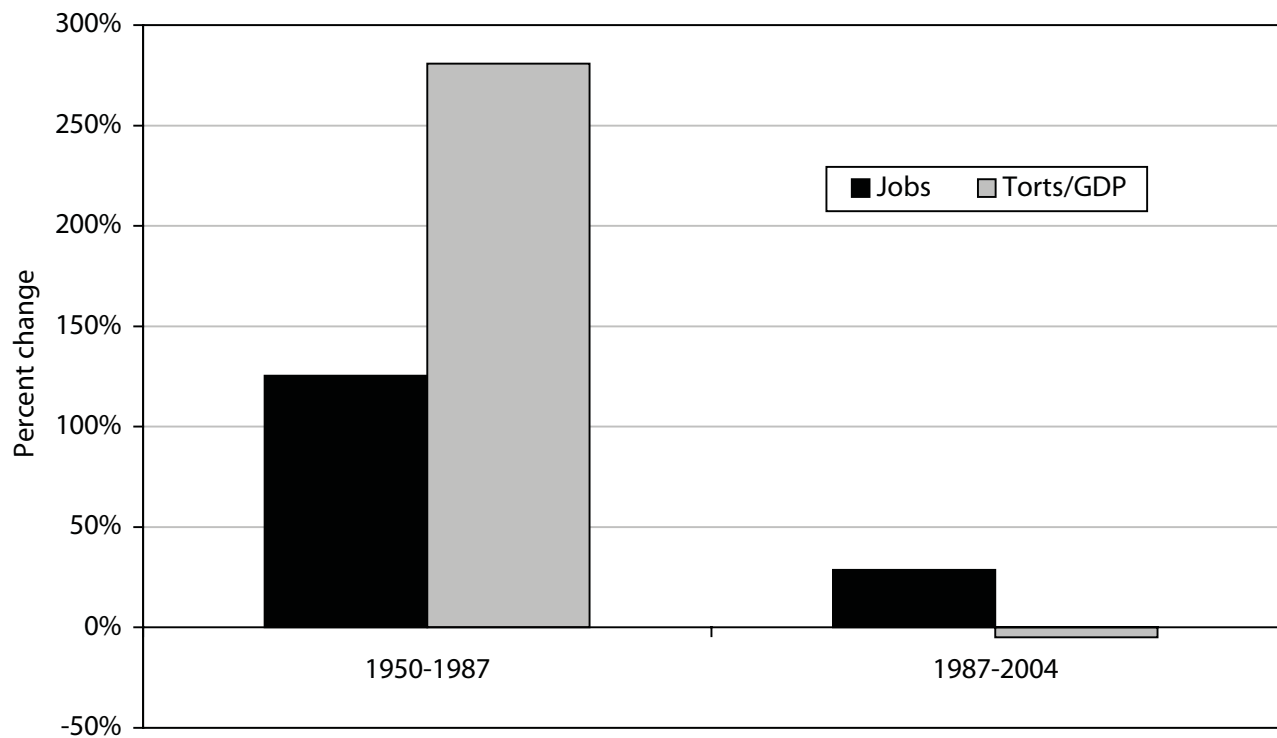
BY ROSS EISENBREY

The legal system for adjudicating tort claims in the United States delivers important benefits to the American people. Most notably, these benefits include the compensation of injured persons (including people harmed by giant corporations and other powerful interests), the deterrence of wrongdoing, greater investments in product innovation and safety, and the civilized, non-violent settlement of disputes. These benefits are rarely quantified, and critics generally focus exclusively on the system's costs, whose magnitude and impact they tend to exaggerate, claiming that job growth, productivity, health care, and corporate profits suffer under the current system. Although a full review requires an examination of both the costs and benefits of the system, this briefing paper reviews only the tort system's most commonly alleged economic costs and impacts and shows that most have little or no basis in reality.

Despite evidence that the cost of tort insurance, litigation, and damage claims is lower now as a share of the economy than it was 20 years ago, various interest groups continue to claim there is a tort crisis and that the economy would benefit if the rights of tort plaintiffs were limited. According to insurance industry consultant Towers Perrin,¹ tort costs as a percent of GDP fell from 2.28% in 1986 to 2.22% in 2004, the most recent year for which there are data (Tillinghast-Towers Perrin 2006, 15). Towers Perrin predicts tort costs will remain below 2.28% of GDP at least through 2007 (Tillinghast-Towers Perrin 2006, 15). Yet business groups and others advocating changes in U.S. tort laws often claim that our tort system hurts U.S. competitiveness and employment. The 2004 *Economic Report of the President*, for example, claimed that, "Tort liability leads to lower spending on research and development, higher health care costs, and job losses" (Executive Office of the President 2004, 203). In addition, the *Economic Report* suggested that tort costs hurt the economy by slowing productivity growth. Yet the *Economic Report* made no real attempt to substantiate these claims, and the available evidence indicates that each of these assertions is false.

FIGURE A

Jobs and torts: no relationship between their growth



SOURCE: Bureau of Labor Statistics, Tillinghast-Towers Perrin.

Tort costs have not slowed job growth

Over the half century for which Towers Perrin has calculations of tort costs (1950-2004), there is no evidence of a negative relationship between tort costs and employment. According to Towers Perrin, tort costs rose steadily as a share of the economy from 1950 until they peaked in 1987 at 2.33% of GDP. Since 1987, tort costs have dropped back and stabilized. Given the rhetoric of the Bush administration and the business community, one would expect employment growth to have been slower from 1950 to 1987, when tort costs increased almost 300% as a share of the economy, and faster since then, when tort costs have fallen as a share of GDP. The opposite is true. As shown in **Figure A**, the average rate of employment growth was stronger in the earlier period.

We did a Granger causality test, which can determine whether one variable correctly predicts another, of the relationship between tort cost growth and employment growth over the entire 54-year period, correcting for business cycles. We found no Granger causality for tort costs and employment growth.²

The only real evidence of job loss attributable to the tort system in the *Economic Report of the President* involves asbestos-related bankruptcies. The *Economic Report* cites estimates that between 52,000 and 60,000 jobs were lost over the 24-year period from 1978 to 2002, due to asbestos-related bankruptcies, an average of 2,167 to 2,500 jobs per year. The net job loss in the economy—if any—after factoring in employment gains at competitor firms producing asbestos substitutes such as fiberglass and Kevlar, was undoubtedly far smaller, if not zero.

Asbestos-related bankruptcies are not random events. The legal claims that led to these bankruptcies were the result of an epidemic of disease, suffering, and death caused by the products sold by the bankrupt firms, many of which knew

of the dangers but concealed them. In other words, the costs were created by the companies, not those they injured. Between 1979 and 2001, at least 43,000 Americans died from mesothelioma and asbestosis, and more than 44,000 more may die by 2014 (Environmental Working Group 2004).

Even if we assume that asbestos liability legislation would have prevented all of the asbestos-related bankruptcies and the resulting loss of 2,500 jobs per year (by, for example, limiting compensation for non-economic damages to the victims or their survivors, or by denying awards of punitive damages), the effect on overall employment and the national unemployment rate in an economy with more than 130 million payroll jobs would have been imperceptible: a change of less than two-thousandths of 1%.

Tort reform will not increase employment

The historical record gives no reason to believe that changes in tort costs would lead to a burst of job creation. Nevertheless, to estimate how changes in the tort system might affect job growth, Dr. Mark Zandi, chief economist at the well-respected econometric consulting company Moody's Economy.com, conducted a macroeconomic simulation of the effect of changes to the tort system. The simulation assumed that: (1) changes to the tort system would be so effective that over the next four years (2006-09), tort costs would increase at the slow 3.3% per annum pace experienced during the 1990s rather than the 6.5% per year pace anticipated by Towers Perrin; (2) corporate tax liability will be reduced by an amount

Table 1
Short-term economic outlook
A comparison of a scenario with tort reform vs. a baseline with no reform

	Year 0	Year 1	Year 2	Year 3	Year 4
Real GDP (billions 2000 \$)					
Tort reform	\$11,134.8	\$11,527.5	\$11,872.4	\$12,255.2	\$12,649.5
Baseline	11,134.8	11,529.4	11,876.5	12,261.1	12,659.2
Real consumer spending (billions 2000 \$)					
Tort reform	\$7,856.9	\$8,098.1	\$8,330.6	\$8,573.7	\$8,821.2
Baseline	7,856.9	8,099.8	8,334.7	8,580.1	8,831.4
After-tax corporate profits (billions \$)					
Tort reform	\$1,060.2	\$1,217.1	\$1,236.6	\$1,296.2	\$1,381.2
Baseline	1,060.2	1,191.3	1,196.4	1,242.4	1,308.8
S&P 500					
Tort reform	1,207.1	1,303.5	1,376.1	1,458.1	1,556.6
Baseline	1,207.1	1,297.9	1,364.4	1,439.9	1,531.6
Employment (millions)					
Tort Reform	133.46	135.4	136.9	138.3	140.2
Baseline	133.46	135.5	136.9	138.4	140.4
Real median household income (2000 \$)					
Tort reform	\$45,503	\$47,449.4	\$49,089.1	\$50,701.5	\$52,308.2
Baseline	45,503	47,471.9	49,137.7	50,779.1	52,420.0

NOTE: The four-year period used is 2005-09.

NOTE: Tort reform assumes 3.3% per annum growth in tort costs. Baseline assumes 6.5% per annum growth in tort costs.

SOURCE: Moody's Economy.com.

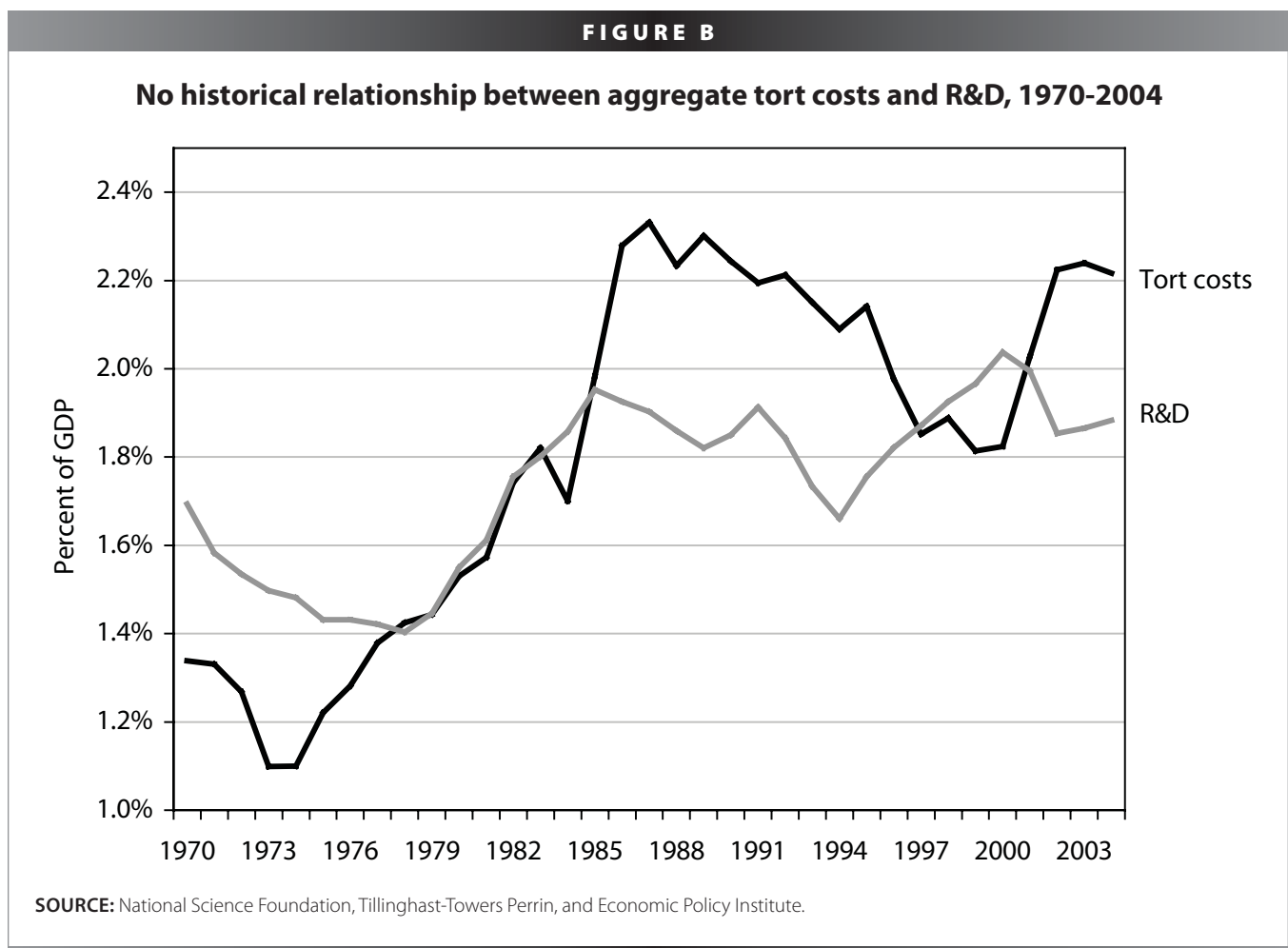
equal to the tort cost savings (this incorporates the unproved notion that tort costs impose a “tort tax” on employers); and (3) proprietors’ (law firms’) income and personal transfer payments (tort awards) will be reduced accordingly.

The results, using assumptions extremely favorable to the arguments in favor of changing the tort system, do not provide any support for the Bush administration’s claims that tort law changes would generate employment growth (Table 1). Far from stimulating job creation, the Economy.com model predicts that a tort law change effective enough to reduce tort cost increases by 3 percentage points per year would *reduce* employment growth.

As Table 1 illustrates, Zandi found that, four years after such a change took effect, employment would be about 200,000 jobs lower than if no changes were enacted and tort costs continued to increase at the 6.5% annual rate Towers Perrin predicts. In addition, both real GDP and real median household income are predicted to be lower if tort law changes are enacted that reduce awards to plaintiffs.

No evidence of significant effects on research and development spending

As tort costs were rising from the late 1970s to the mid-1980s, R&D spending rose rather than fell (Figure B). Moreover, R&D spending has been relatively stable as a percent of GDP over the last 20 years, but tort costs declined from 1987 until 2001. It should not be surprising, therefore, that formal Granger causality tests indicate no causal relationship between R&D spending and tort costs.



In fact, higher tort costs may lead to greater investment in R&D. More than a decade ago, research revealed that there is a generally positive relationship between liability costs and product R&D. W. Kip Viscusi and Michael J. Moore found that, for most industries, increased product liability costs led to higher spending on product R&D and more innovation, not less. “It is clear, however, that net expenditures on product R&D relative to sales rise with increases in product liability costs up to some level and that the portion of sales due to new products is similarly affected. We infer from these results that the development of new, safer products is the primary outcome engendered by the recent growth in the cost of product liability to firms” (Viscusi and Moore 1993, 192).

No evidence of significant effects on productivity

The *Economic Report of the President* suggests that tort costs harm the economy by diverting resources to non-productive uses (Executive Office of the President 2004, 207). However, the *Economic Report* presents no data or analysis to substantiate this claim.

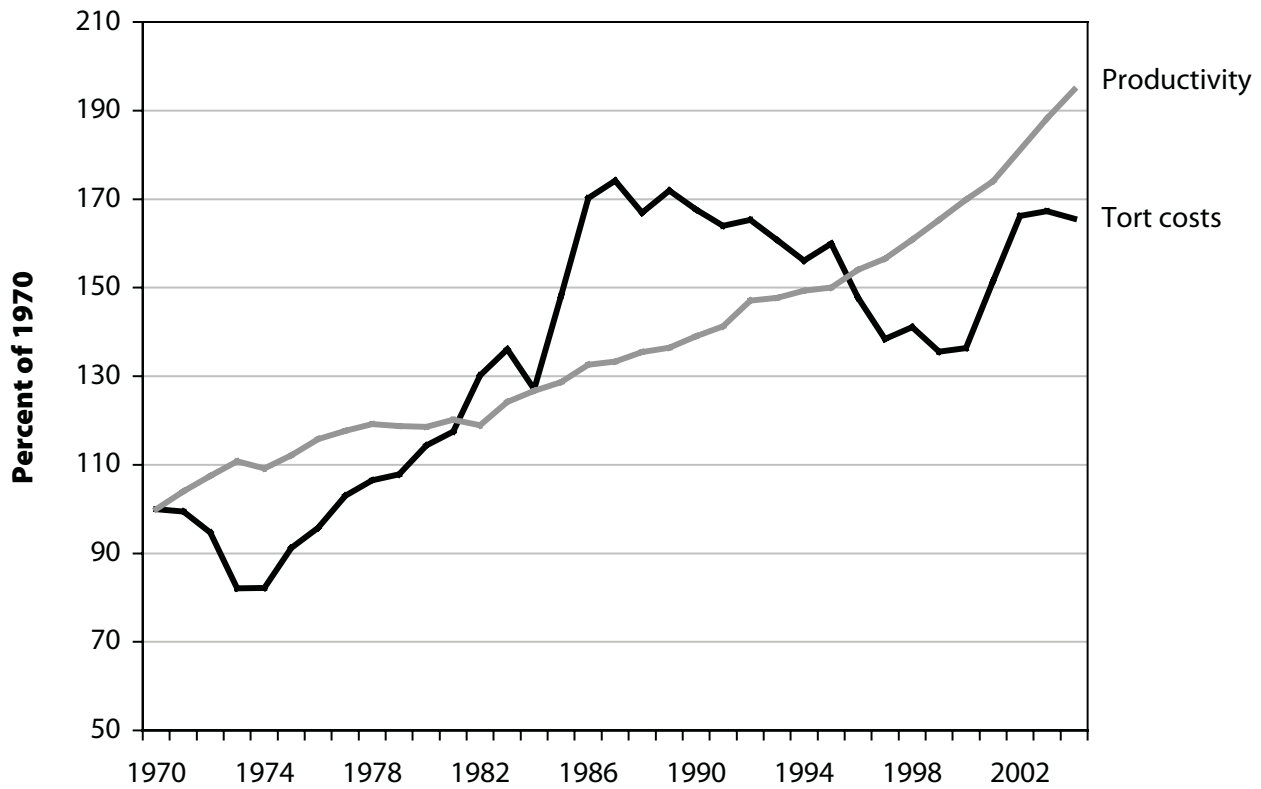
Chart 11-6 in the *Economic Report* presents an international comparison of tort costs as a percent of GDP, ranking a dozen countries, from Denmark with the lowest tort costs as a percent of GDP to the United States with the highest (as calculated by Towers Perrin). This ranking is problematic for several reasons. No one outside of Towers Perrin knows with any certainty how it estimated the tort costs of the United States, let alone the other countries portrayed. And the ranking does not take into account the fact that all or almost all of the other countries have national health insurance programs that remove the cost of compensation for medical injuries from the tort system.³ It is obviously inequitable to count the medical care U.S. plaintiffs receive as a tort cost, but not the medical care plaintiffs receive overseas. In a like manner, nearly every country has a much more generous unemployment insurance system than does the United States, so compensation for lost wages will artificially appear greater in the U.S. tort system than elsewhere, even when the injured party is made whole to the same extent overseas.

Nevertheless, even if we accept Towers Perrin’s ranking of international tort costs (Tillinghast-Towers Perrin 2004, 12), it undermines the *Economic Report’s* own argument because higher tort costs do not lead to lower productivity. If high tort costs are a brake on productivity, countries with the highest costs should have the lowest productivity. But no such relationship exists.

To the extent that there is an association between tort costs and productivity, higher tort costs appear to be loosely associated with *higher* productivity. In fact, of the dozen countries in Towers Perrin’s newest ranking, four of the five (United States, Germany, Italy, Belgium, and France) with the highest productivity (meaning they are the most efficient at translating work effort into economic output) are also four of the five with the highest tort costs. To be sure, there are countries with relatively low tort costs and high productivity, such as France and Denmark, but overall there is no reason to believe that tort costs are a major driver of a country’s efficiency or productivity level.

The adverse impact of tort costs on productivity that is claimed by advocates of tort law changes is also contradicted by trends within the United States. The measurement of tort costs developed by Towers Perrin shows no correlation with productivity growth on a national basis over time. This is especially true when underlying macroeconomic conditions are taken into account, since there is a close relationship between productivity growth and overall economic growth.

Figure C shows the growth of both productivity and tort costs in the United States, indexed to 1970.⁴ The impressive gains in U.S. productivity undermine any claim of a tort crisis. Productivity growth has been as strong recently as it was decades ago when tort costs were half what they are today. According to the National Bureau of Economic Research (NBER), “Based on a range of measures, U.S. productivity growth has averaged 2 to 3 percent per year in the period 1995-2004” (NBER 2005). During that period, according to Towers Perrin, tort costs averaged about 2% of GDP, about double the share in the period from 1948 to 1973. Yet, again according to the NBER, “The strong productivity growth of the past decade is comparable with the 1948-73 period” (NBER 2005).

FIGURE C**No historical relationship between tort costs and productivity, 1970-2004**

SOURCE: Bureau of Labor Statistics, Tillinghast-Towers Perrin.

Productivity growth during the recession and stagnation of 2000 and 2001 was extraordinary for such a period of economic weakness—in fact, no other recession since World War II experienced such strong growth in productivity. Yet those were the years in which Towers Perrin’s estimate of tort costs jumped sharply. And while tort costs were supposedly high from 1985 to 1995, this period was followed by a unique acceleration of productivity growth in the later 1990s. Conversely, the decline in tort costs in the early 1970s was followed by years of productivity stagnation.

We conducted two statistical tests of the relationship between tort costs and productivity. The results of neither support critics of the tort system. A Granger test suggests that tort costs “Granger cause” productivity growth (meaning only that they do predict movements in productivity) but not vice versa. To determine whether the correlation was positive or negative, we also regressed the log change in productivity against the log change in tort costs, controlling for real GDP growth to account for business cycles. The tort variable is significant for numerous lags, meaning productivity growth last year correlates with changes in the tort variable in both the last year and previous years. Some of the coefficients on the tort variable were positive and some were negative. They tended to cancel each other out, and their sum was statistically insignificant.

No evidence of significant effects on health care costs

The cost of medical malpractice claims and litigation is so small a part of national health care expenditures as to be insignificant—even as calculated by Towers Perrin, which inflates its tort cost estimates (Chimerine and Eisenbrey 2005).

According to Towers Perrin, medical malpractice tort costs, broadly defined to include the costs of insurance industry overhead (including profits) and claims handling, as well as all claims paid without litigation, totaled \$28.7 billion in 2004, only 1.5% of the nation's \$1.9 trillion bill for health expenditures. The Congressional Budget Office (CBO) concludes that "even a reduction of 25 percent to 30 percent in malpractice costs would lower health care costs by only about 0.4 to 0.5 percent" (CBO 2004, 6). To put the insignificance of this into context, health care inflation in 2004 would have been 7.8% instead of 8.2%.

If, as Towers Perrin has claimed, damages awarded to plaintiffs are 46% of total tort costs (Tillinghast-Towers Perrin 2003, 17), and non-economic damages are about half of all damages awarded to plaintiffs, then fully eliminating non-economic damages in medical malpractice (and the attorney fees associated with them) would have a negligible effect on U.S. health expenditures, reducing them by 0.5% or less.⁵ It follows logically that legislative changes like those recently debated in Congress that would cap such damages at \$250,000 would have an even smaller effect.

No evidence of significant effects on U.S. corporate profits

According to Towers Perrin and the Bush administration, tort costs have grown much faster than the economy for decades and—according to Towers Perrin—now consume a share of the economy more than three and a half times greater than in 1950: 2.20% of GDP in 2004 vs. 0.62% in 1950. Has this growth in tort costs hurt the profitability of U.S. businesses? No.

If tort costs suppress business activity, it should be apparent in damage to corporate profits. However, despite Towers Perrin's claim of mounting tort costs, and especially large increases in 2001 and 2002, U.S. corporate profits *increased* at double-digit rates in each of the past four years and are now at an all-time high. In the first quarter of 2006, annualized corporate profits were \$1.595 trillion dollars (U.S. Department of Commerce, Bureau of Economic Affairs, NIPA Table 6.16D).

Conclusion

It is hard to find any evidence that increased tort costs have harmed the U.S. economy. The economic case made by tort system critics to justify changes in the system is remarkably weak. The costs of the tort system have been grossly exaggerated, and its supposed impact on job creation, R&D, productivity, and profits has been exaggerated or simply invented. With respect to job creation in particular, significant tort law change would be more likely to slow employment growth than to promote it. There is no reason to believe that the kinds of tort law change the Bush administration advocates will have significant positive effects on the economy.

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Endnotes

1. Towers Perrin's Tillinghast subsidiary publishes an annual update of its tort cost estimate. These estimates have been criticized as inflated and unverifiable but are widely cited.
2. "In econometrics the most widely used *operational definition* of causality is the *Wiener-Granger* or *Granger definition of causality*...It can be formulated in a simplified way as follows: Definition: *x* is a *Granger cause* of *y* (denoted as *x-y*), if present *y* can be predicted with better accuracy by using past values of *x* rather than by not doing so, other information being identical" (Charaemza and Deadman 1997, 165).
3. Towers Perrin concedes this point for the first time in its 2004 update.
4. When the line representing one or the other factor on the chart rises, it means that that factor has increased relative to its 1970 value.
5. Non-economic damages [$\$28.7 \text{ billion} \times .46 \times .5 = \6.6 billion] + attorney fees [$\$6.6 \text{ billion} \times .33 = \8.8 billion]. $\$8.8 \text{ billion} / \$1.9 \text{ trillion} = .46\%$.