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An economist's perspective on tort reform

'A scholar ought to be tolerably open minded, unemotional and rational. A reformer must promise paradise if his reform is adopted. Reform and research seldom march arm in arm.'

George Stigler, Nobel Prize winner in economics.

The case for tort reform as a means of resolving affordability and availability problems in public liability insurance has been accepted uncritically in public debate, most recently by the Ipp Report. However, even if it is assumed for the sake of argument that there is a supply problem in public liability insurance that needs fixing, the proposed solution of tort reform needs to be assessed both by reference to its underlying premises and by reference to whether the trade-offs that its adoption would involve are worth it. With regard to the latter, there are a number of lessons from other countries' experiences with tort reform that are worth examining closely.

Looking first at the premises, an alleged failing of the current system which is frequently highlighted by proponents of tort reform is that it is too costly, that is, consumes too many resources. This line of argument is made in the Ipp Report. Unfortunately, the report defined the cost of the system as the sum of the compensation it provides and the costs of obtaining that compensation. This definition alone involves the panel in not just one but two elementary errors, though one is subtler than the other, and is implicit in all arguments against the tort system that are based on its alleged cost.

The first error is that in defining compensation payouts as one of the costs of the system, the Ipp Report is confusing a transfer with a cost. Economically speaking, compensation payouts should not be counted as a cost since they simply involve transferring money from one party to the other. Overall, there is no net loss or gain by virtue of the transfer alone and therefore no cost as defined in economics: the size of the pie available to society is not changed, though its distribution obviously is. This does not mean that the magnitude of a transfer might not have costly social implications (for example, by encouraging potential plaintiffs in a situation likely to lead to an accident to be more careless) – there may indeed be costly implications if it can be shown that the magnitude of compensation payouts is too high from that perspective. It is this potentially costly aspect of the system that should be examined, rather than the magnitude of total compensation *per se*.

A second, subtler error committed by the Ipp Report and many proponents of tort reform is to assume that lower administrative costs (for example, the costs of obtaining compensation) are necessarily better. Whether lower administrative costs are a good thing is a matter of what sort of trade-offs are to be socially preferred. Some of these administrative costs are presumably involved in filtering 'good' claims from 'bad' so it is rather inconsistent of the Ipp Report to allege as it does (but certainly does not prove) that the current system may give too much benefit to frivolous claims while seeming to adopt the position that lower administrative costs are an unqualified good.

Taking the argument that 'cheaper means better' at face value, the implication (one which has in fact been spelt out more explicitly by critics of the tort system in other jurisdictions such as the US) is that what is known as the 'compensation ratio' – that is, the ratio of net dollars received by claimants to total dollars expended in litigation – is a measure of efficiency. However, as a recent paper on the cost of civil justice[1] notes, it is a fallacy to use the compensation ratio to measure the efficiency of the legal system. This is because an efficient legal system has to track four outcomes – true positives (satisfying valid claims), true negatives (rejecting invalid claims), false positives (satisfying invalid claims) and false negatives (not satisfying valid claims) – obviously with the aim of reducing the incidence of the latter two. A compensation ratio is simply too one-dimensional to give an indication of how well a legal system performs this task.

To take but one example, one way in which the ratio can be reduced is to simply cut expenses spent on defending against negligence claims (in other words, reducing the denominator of the ratio) – but this can just as easily be done by making some defences against negligence unavailable (thus giving rise to a narrower range of defences which defendants might be able to spend money on pleading) as by restricting tort claims. In reducing the ratio, in other words, one could easily make the system less efficient rather than more. Clearly what public policy ought to focus on is not the ratio itself as the aim of reducing the incidence and ultimate cost of false pos-

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itives and false negatives.

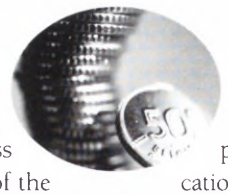
How then should the costs of the tort system be measured? This is easy to answer in theory, but not so easy in practice. Regardless, the Australian proponents of tort reform have neither recognised the 'easy' in principle answer, nor even made any attempts to operationalise the relevant considerations.

Society has an interest in the proper management of risk associated with various activities insofar as this minimises the incidence and cost of accidents. Tort law seeks to achieve this through the finding of liability for negligence against a party after the event. From an economic perspective, such findings should assign responsibility to the party that would have the greatest ability and opportunity to manage accident-related risks. The basic idea is to create incentives for individuals engaged in activities that involve the possibility of accidents to take as much care as is efficient – so as to avoid an adverse legal finding that either makes them responsible for the costs suffered by another party; or disallows claims for accident-related costs they suffer against other parties. For example, the net effect of the current product liability regime is to 'price in' manageable risk into goods and services. It is desirable for it to do so also because business proprietors are best equipped to take on this accident management role, and so can respond to that price signal in ways that ultimately reduce the costs accidents impose on society. Public liability law plays a similar role and seems similarly well-founded.

It follows from this perspective that the 'costliness', or conversely the efficiency, of the tort system should be assessed by reference to how desirable and well placed the assignment of responsibilities implicit in current negligence doctrines are. This in turn involves an evaluation of how efficiently the different parties can act to manage the risk of accidents, in terms of reducing their incidence or mitigating their consequences.

Rather than focussing on reducing the social costs of risk, the proponents ▶

of tort reform seem to make 'distributivist' arguments – that is, arguments that presume it is better to favour one side ('business owners') over another (members of the general public). What is not taken account of is the likely 'ripple effects' of changing the trade-offs about assignment of management responsibilities for accident prevention on all parties. For instance, it follows as a matter of economics that the lower 'pricing in' of risk that would result from restricting liability claims by consumers and a shift of some accident management responsibilities away from business proprietors would lead to more accidents, depending on how significant the shift is. This in turn could well harm the very people the proponents of tort reform claim they are assisting, and in any event, is likely to be costly from society's point of view.



The likelihood of restrictions on claims leading to higher accident rates is consistent with studies of the consequences of adopting no-fault systems in other jurisdictions and with research on automobile accidents. A no-fault system is essentially just a logical extreme of current measures to both restrict the right of accident victims to sue and/or to reduce any compensation payouts arising from negligence-based lawsuits. Though accident victims get some compensation, the point of a no-fault system is that compensation awarded is not reflective of the actual damages suffered (since that would not be fiscally sustainable) or the degree of fault. There is consequently, under a no-fault system, a weakening of the deterrent effects that encourages potential tortfeasors to take due care.

Numerous studies confirm that the result of adopting a no-fault system is to increase the rate of accident fatalities. The earliest of such studies was by Landes (1982)[2], which used a dataset covering the years 1971-76 from US States and found that States which adopted no-fault rules had more fatal accidents. Landes also found that the higher the threshold value for opting out, the larger the increase in fatalities when no-fault is adopted. A more recent paper by Cummins *et al.* (2001)[3] reviewed previous research in the area in addition to performing its own quantifications of the likely effects of a no-fault regime. Cummins *et al.* noted that some US studies have not found a significant relationship between liability and accident rates, but argues that this is because of significant errors in their underlying methodology. Cummins *et al.* tried to correct for these errors which would otherwise distort results using a dataset of automobile accident fatality rates in all US States over the period 1968-1994 and comprising 312 no-fault State observations and 1038 tort State observations. They found that no-fault is estimated to increase fatal accident rates by 12.8 to 13.8 per cent using one measure of stringency of a no-fault indicator, and 7.2 to 7.5 per cent using another.

It follows that if the likely results of introducing a no-fault regime which dilutes incentives to take due care are higher accident rates, then tort reforms which have slightly weaker dilution effects (because the 'stringency' is weaker than a pure no-fault system) would likely also increase accident rates, albeit by amounts lower than those found for a move to pure no-fault regimes. The question then becomes – are these effects a price worth paying for the alleged benefits? Assuming for the sake of argument that there are benefits, the matter of balancing interests is a complicated one and would require at the very least some quantification of the expected effects on accident rates of proposed tort reforms. The Ipp Report, which simply ignored forty years of academic research in this area, did not even attempt such a quantification – rather, it preferred to rest its recommendations on vague concepts expressed in high-minded terms.

Accident rates should not be the only relevant consideration in assessing tort reforms. Given that the proponents of tort reform express concern about the administrative costs of the tort system, it is surprising that no equivalent concern is paid to the likely increase in transaction costs that would arise from some of the reforms proposed. Take, for instance, the Ipp Report's proposal to limiting recoverability for harm under $50,000. One likely effect of such limits on recoverability would be to encourage more individuals to take out insurance against harm falling below the threshold required. On balance, is this a good or bad thing? One cannot say without empirical evidence, but what cannot be denied is that the transaction cost of many individuals seeking such insurance could well be higher than the transaction costs associated with current arrangements. This is because under the current system, rather than each member of the general public insuring himself or herself for accidents occurring at commercial or other public premises, such accidents are covered by the insurance of the relevant proprietors. Thus there are likely some transaction cost savings from this arrangement which should be taken into account (along, of course, with the changes discussed above in accident rates) in any evaluation.

In summary, there are serious problems with current proposals for tort law reform. These problems can ultimately be related back to a normative framework that inadequately specifies the desired aims of reform and inadequately weights the associated costs and benefits among all affected parties. A mass of accumulated research has been ignored as the proponents of reform prefer to 'promise paradise' than to objectively analyse the impacts of the measures they so ardently advocate. PL

Footnotes:

1 Silver, Charles 2002, 'Does civil justice cost too much?', *Texas Law Review*, forthcoming.

2 Landes, Elisabeth M. (1982). 'Insurance, Liability, and Accidents: A Theoretical and Empirical Investigation of the Effect of No-Fault Accidents.' *Journal of Law and Economics*, 25 (April): 49-65.

3 Cummins, J.D., R.D. Phillips and M.A. Weiss 2001, 'The incentive effects of no-fault automobile insurance', February 26 2001.