

# **Who Pays for Tort Liability Claims? An Economic Analysis of the U.S. Tort Liability System**

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## **Executive Summary**

With conservatively estimated annual direct costs of \$180 billion, or 1.8 percent of GDP, the United States tort system is the most expensive in the world, more than double the average cost of other industrialized nations. Whereas an efficient tort system has a potentially important role to play in ensuring that firms have proper incentives to produce safe products, poorly designed policies can mistakenly impose excessive costs on society through forgone production of public and private goods and services. To the extent that tort claims are economically excessive, they act like a tax on individuals and firms. This paper pursues this analogy between inefficient tort litigation and taxes, and examines the question of “who pays” for excessive tort costs. It finds that the cost of excessive tort may be quite substantial, with intermediate estimates equivalent to a 2 percent tax on consumption, a 3 percent tax on wages, or a 5 percent tax on capital income. As with any tax, the economic burden of the “tort tax” is ultimately borne by individuals through higher prices, reduced wages, or decreased investment returns.

## Introduction

With estimated annual direct costs of nearly \$180 billion,<sup>1</sup> or 1.8 percent of GDP, the U.S. tort liability system is the most expensive in the world, more than double the average cost of other industrialized nations that have been studied.<sup>2</sup> This cost has grown steadily over time, up from only 1.3 percent of GDP in 1970, and only 0.6 percent in 1950. The current cost amounts to nearly \$650 for every citizen of the United States, and is one reason that many commentators have called for reform of the tort liability system. The cost is especially troubling because only 20 percent of these dollars actually go to claimants for economic damages, such as lost wages or medical expenses.

Defenders of the status quo argue that the existing system protects consumers by making firms responsible for damages caused by their products and services.<sup>3</sup> Indeed, the underlying notion that firms are induced to recognize the full social cost of their products is one economic rationale for an *efficient* tort system.<sup>4</sup> That is, just as firms must pay compensation to employees and suppliers as part of the cost of producing output, ideally tort liability forces the firm to consider the potential for damage that the firm's products may cause. In this sense, it is analogous to "making polluters pay."

However, poorly designed policies can mistakenly make polluters pay too much and impose excessive costs on society through forgone production of public and private

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<sup>1</sup> Direct costs include awards for economic and non-economic damages, administration, claimants' attorney fees and the costs of defense.

<sup>2</sup> Tillinghast-Towers Perrin, "U.S. Tort Costs: 2000, Trends and Findings on the Costs of the U.S. Tort System," February 2002.

<sup>3</sup> Throughout this paper, we use the term "firm" to refer to any producer of goods and services.

<sup>4</sup> Another economic argument sometimes used to support tort liability is that the right to sue provides consumers with "insurance" in the event of an accident. For a discussion of the limitations of this view, see Paul Rubin, *Tort Reform by Contract*, Washington, D.C.: The AEI Press, 1993. For purposes of this paper, it should be noted that regardless of the rationale for the system, the cost is still borne by individual consumers, workers, or investors.

goods and services. Tort law alters firm behavior in a socially desirable manner if tort liability claims are optimal. If claims are excessive and fail to provide proper incentives, then these claims are a drain on resources that can deter the production of desired goods and services and reduce economic output. The United States bears the burden of an expensive and inefficient liability system through higher prices, lower wages, and decreased returns to investment, as well as lower levels of innovation.

The similarity between inefficient tort litigation and taxes suggests that the economic costs of the tort liability system may be better understood by pursuing the analogy between the expected costs arising from the tort system and taxes on firms. As with a tax, it is possible to examine the question of who bears the incidence of – that is, who pays for – excessive tort costs. An important lesson in the economics of taxation is that *people* pay taxes; firms are legal entities that can bear no real burden. Put differently, the burden of any tax depends not on who writes the check (the legal liability), which may be the firm, but rather on the market outcomes that shift the cost to workers, consumers or owners of capital.

### **What Are the Role and Limits of Liability Laws in a Market Economy?**

The production and sale of nearly every economic good or service entails a degree of risk, however small, that the product may cause unintended harm. Children can be injured playing with toys, patients may have adverse reactions to medications or medical procedures, and workers may fall off ladders or be injured by machinery. Because consumers often have less than perfect information about these risks and are generally unable to insure against them, the government plays a potentially important role in promoting health and safety.

Many policy tools are available to address such risks, including a reliance on market forces, contracts, direct regulation, social insurance, and the legal liability system. Each approach has its relative strengths and weaknesses, and reliance on any

single one may not be desirable.<sup>5</sup> In the United States, the tort system of legal liability is sometimes viewed as contributing to overall social objectives by ensuring that firms consider more fully the health and safety aspects of their products.

A guiding insight is that competition in private markets for goods and services pushes firms to produce the kinds of goods that consumers prefer using the most efficient combination of labor, capital and other inputs. If consumers and firms are already faced with incentives to weigh the social costs and benefits of their respective consumption and production decisions, the burden of government policy is to preserve economic efficiency by avoiding intervention.

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

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<sup>5</sup> For broader discussion of the role of each of these approaches, see W. Kip Viscusi, “Toward a Diminished Role for Tort Liability: Social Insurance, Government Regulation, and Contemporary Risks to Health and Safety,” *Yale Journal on Regulation*, Winter 1989.

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.

Central to this view, however, is the notion that the exposure of firms to potential tort liability costs provides proper incentives. In the specific context of punitive damages, Professor W. Kip Viscusi of Harvard University makes the point that "the linchpin of any law and economics argument in favor of punitive damages is that these awards alter incentives."<sup>6</sup> In his research on corporate decisions regarding environmental and safety torts, Viscusi evaluates the effect of punitive damages "by examining the risk performance in the four states that do not permit punitive damages as compared with other states that do." He finds that "this detailed effort to detect a deterrent effect yielded no evidence of any safety incentive role. This lack of evidence is consistent with the proposition that punitive damages are random." If punitive damages are essentially random, then they will not provide proper incentives for risk mitigation. Instead, they will operate purely as a "tax" on firms -- a cost with no corresponding benefit.

Some scholars disagree with Viscusi's conclusion. For example, Professor David Luban of Georgetown University argues that one should consider the "retributive aims of punishment" as well as the deterrent aims.<sup>7</sup> However, tort liability only achieves a goal of retribution if the economic burden of the punishment is borne by the responsible party, which may not be the case if the costs are ultimately passed through to investors, workers or consumers, or if punitive damages are essentially random, as Viscusi argues. Professor Theodore Eisenberg of Cornell Law School and several co-authors take an alternate view, claiming that tort liability is largely predictable and is

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<sup>6</sup> W. Kip Viscusi, "Why There is No Defense of Punitive Damages," *Georgetown Law Journal*, November 1998.

<sup>7</sup> David Luban, "A Flawed Case Against Punitive Damages," *Georgetown Law Journal*, November 1998.

therefore capable of providing proper incentives to firms.<sup>8</sup> However, while both authors question Viscusi's findings, neither provides direct empirical evidence to indicate that punitive damages actually have a deterrent effect. In fact, the empirical evidence that Eisenberg and co-authors do offer is consistent with the possibility that punitive damages are awarded on a random basis, as noted by Professor A. Mitchell Polinsky of Stanford University.<sup>9</sup>

Other research has examined the effect of expected tort liability costs on innovation and investments in safety. At lower levels of expected liability costs, Viscusi and Professor Michael Moore of Duke University<sup>10</sup> find that firms have incentives to invest in product safety research in an effort to reduce liability costs while still bringing a particular product to market. At higher levels of expected liability costs, however, firms will choose to forgo innovation or to withhold a product from the market, resulting in a net negative effect of expected liability costs on innovation. Based on their estimates, Viscusi and Moore identify many industry groups for which high liability costs exert a net negative effect on innovation.

Industry-specific studies by other authors have generally supported the results of Viscusi and Moore, documenting negative effects of liability on innovation in many areas, such as general aviation, chemicals, pharmaceuticals, and medical practice. The evidence of direct linkages between liability and safety in industry-specific analyses has been weak. Other factors, such as regulation and the fear of bad publicity, may provide stronger incentives to improve safety features than does legal liability, though liability

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<sup>8</sup> Theodore Eisenberg, John Goerdt, Brian Ostrom, David Rottman, and Martin Wells, "The Predictability of Punitive Damages," *The Journal of Legal Studies*, June 1997.

<sup>9</sup> A. Mitchell Polinsky, "Are Punitive Damages Really Insignificant, Predictable, and Rational? A Comment on Eisenberg, et al.," *The Journal of Legal Studies*, June 1997.

<sup>10</sup> W. Kip Viscusi and Michael Moore, "Product Liability, Research and Development, and Innovation," *Journal of Political Economy*, 1993.

may play an indirect role by encouraging the spread of safety-related information and by bringing potential hazards to the attention of regulators<sup>11</sup>.

Reconciling these alternative views is beyond the scope of this paper. Instead, recognizing the controversy that exists about the incentive effects of tort liability in general, and punitive damages in particular, this paper will consider several scenarios. For our most cautious estimates of the size of the “litigation tax,” we make the very strong assumption that both economic (e.g., loss of wages, medical expenses) and non-economic (e.g., pain and suffering, loss of consortium, punitive) damages are currently set at an optimal level. We then consider an intermediate case that treats non-economic damages as essentially random and therefore part of the litigation tax. Finally, we consider the case in which all of the costs of the U.S. tort system are treated as economically excessive, which would result if both economic and non-economic damages were largely random and failed to provide proper incentives.

### **What Are the Direct Costs of the U.S. Tort Liability System?**

In the year 2000, according to a study by Tillinghast-Towers Perrin, the U.S. tort system cost \$179 billion. This includes \$128 billion of “insured” costs derived from financial data for the U.S. insurance industry. These data “are considered highly reliable in that they are subject to audit and reviewed by state regulatory agencies.”<sup>12</sup> The costs include benefits paid to third parties or their attorneys, claim handling, legal defense costs and insurance company administrative costs. Tillinghast estimates that \$30 billion in costs is paid by firms that insure themselves. Finally, they estimate that an additional \$21 billion is due to medical malpractice. We will make use of these Tillinghast estimates for illustrative purposes in this paper, although the main conceptual

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<sup>11</sup> Peter Huber and Robert Litan, eds., *The Liability Maze: The Impact of Liability Law on Safety and Innovation*, Washington, D.C.: The Brookings Institution, 1991.

<sup>12</sup> Tillinghast-Towers Perrin, “U.S. Tort Costs: 2000, Trends and Findings on the Costs of the U.S. Tort System,” February 2002, page 8.

contribution of this paper – that excessive tort claims act as a tax paid by individuals – would hold with equal force with any alternative measure of direct costs.

The estimate of nearly \$180 billion in direct costs of the U.S. tort system is likely to understate substantially the actual costs of the tort system for several reasons. First, the \$180 billion estimate pre-dates September 11. The terrorist attacks have increased the uncertainty surrounding legal liability claims. Insurance companies, uncertain how to assess new liability risks, are raising premiums and capping or denying coverage. As such, the cost of the tort system in the future will likely be even greater than the year 2000 estimates employed herein. Second, this estimate ignores the many economic distortions that arise as a result of individuals and firms trying to avoid lawsuits. These costs, which will be discussed in more detail below, can include distortions to labor markets (e.g., doctors deciding not to practice certain specialties or in particular communities for fear of being sued), the practice of “defensive medicine,” or the decision by manufacturers to keep products off the market.<sup>13</sup> Third, this estimate also ignores the potential deleterious effect of excessive tort claims on innovation. In product areas where litigation is frequent and costly, the prospect of high liability claims may be enough to ward off any potential new entrants.

Lacking a more comprehensive estimate of total costs, however, we will use the \$180 billion as an initial conservative estimate of total tort costs. An even more difficult issue is deciding how much of this \$180 billion is economically “excessive.” There is no easy or widely accepted empirical answer to this question. To the extent that awards are largely “random” and fail to provide incentives to firms, most, or even all, of the tort expenses are excessive. Alternatively, to the extent that damages awarded to claimants are a good proxy for the actual damages caused, the fraction of tort costs that

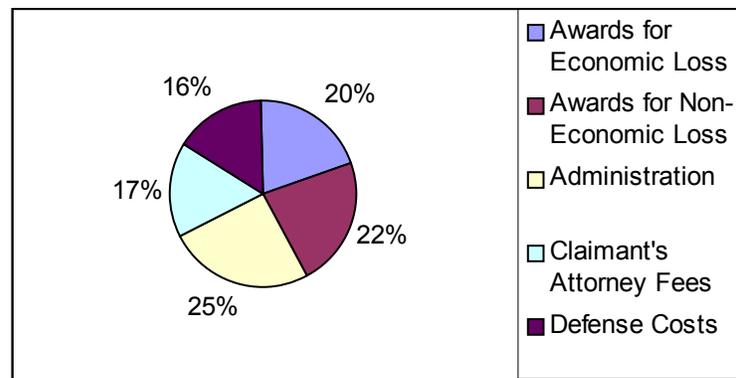
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<sup>13</sup> Some anecdotal evidence of these costs can be found in Michael Freedman’s “The Tort Mess,” *Forbes.com*, May 13, 2002.

go to claimants to compensate for damages, plus reasonable “transactions costs,” could be loosely viewed as the “right” level, and costs above this amount as being excessive.

To pursue this line of reasoning, recall that more than half of the total annual cost of tort is due to administrative expenses and legal fees. As observed, “viewed as a mechanism for compensating victims for their economic losses, the tort system is extremely inefficient, returning only 20 cents of the tort cost dollar for that purpose.”<sup>14</sup> This share of total tort costs that go to direct compensation for victims is lower than in the past. In the late 1980s and early 1990s, economic damages accounted for 22-25 percent of total tort system costs.<sup>15</sup>

**Figure 1: Distribution of Liability Costs**



Source: Tillinghast-Towers Perrin, February 2002.

As indicated in Figure 1, an additional 22 cents goes to claimants for non-economic damages, such as pain and suffering, loss of consortium and punitive damages. The remaining 58 percent of tort costs go to pay for administration, claimants’ attorney fees, and defense costs. However, one should not necessarily view the entire 58 percent as “excessive,” because some level of “transactions costs” is required in order to administer any system. As a guide for what is a reasonable level of costs, we use the experience of the Workers’ Compensation system in the United

<sup>14</sup> *Ibid.*, page 12.

<sup>15</sup> According to previous studies by Tillinghast-Towers Perrin published in 1995, 1992 and 1989.

States, which is designed to deliver compensation efficiently to workers who are injured on the job. Workers' compensation is a no-fault system, and thus litigation costs will be lower. According to the National Academy of Social Insurance, for every dollar paid to workers' compensation claimants, approximately 23 cents is paid in administrative costs.<sup>16</sup> Using this assumption that "fair" administrative costs should be roughly equal to 23 percent of damages paid to claimants, one can begin to estimate the "excessive" costs inherent in the U.S. tort system.

Even if we start with the extremely cautious assumption that both economic (\$36 billion) and non-economic damages (\$40 billion) are set at an economically efficient level, and that an additional 23 percent should be spent on administration, an efficient tort system would result in transfers of only \$93 billion per year.<sup>17</sup> By this cautious calculation, the current U.S. tort system includes "excessive" tort costs of \$87 billion per year.<sup>18</sup> Were one to adapt the assumption that non-economic damages are random, the "litigation tax" would rise to \$136 billion per year, even after accounting for reasonable administrative expenses.<sup>19</sup> To the extent that the economic damages awarded by the tort system are not well targeted and therefore fail to provide proper incentives to firms, the entire \$180 billion in direct costs is economically excessive.

Another useful perspective is provided by comparing the cost of tort liability in the United States to that of other developed countries. While it is difficult to make cross-national comparisons because of data limitations, estimates by Tillinghast-Towers Perrin suggest that the U.S. tort system is substantially more costly than that of other countries. As shown in figure 2, U.S. tort costs in 1998 were 1.9 percent of GDP, approximately double the average cost of the other nations studied. Only Italy, with

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<sup>16</sup> National Academy of Social Insurance, "Workers' Compensation: Benefits, Coverage and Costs, 1999 New Estimates and 1996-1998 Revisions," May 2001.

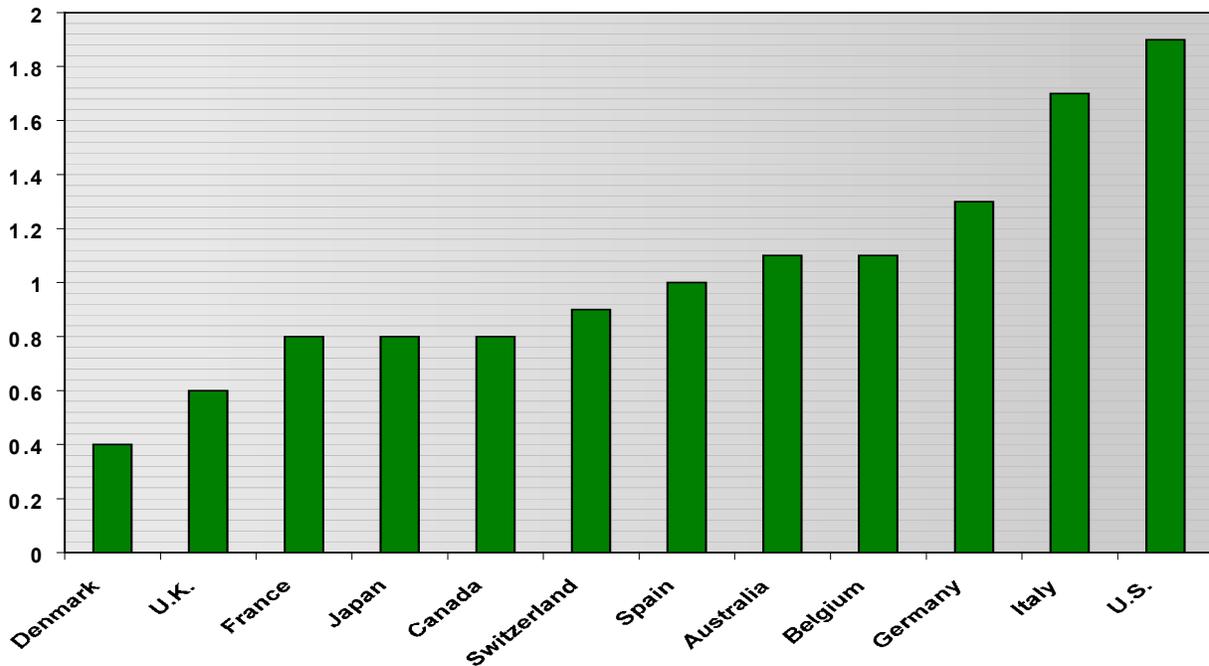
<sup>17</sup> (Economic damages (\$36 b.) + Non-Economic damages (\$40 b.)) \* Administrative cost factor (1.23) = Non-excessive tort costs (\$93 b.)

<sup>18</sup> Total tort costs (\$180 b.) – Non-excessive tort costs (\$93 b.) = Excessive tort costs (\$87 b.)

<sup>19</sup> Total (\$180 b.) – (Economic(\$36 b.) \*Admin cost factor(1.23)) = Excessive tort costs (\$136 b.)

costs of 1.7 percent of GDP, rivaled the U.S. in total direct costs. Tort costs in Denmark, the United Kingdom, France, Japan, Canada and Switzerland are all estimated to be less than 1 percent of GDP.

**Figure 2**  
**International Tort Costs as a Percentage of GDP, 1998**



Source: Tillinghast-Towers Perrin, "U.S. Tort Costs: 2000"

### **How Large is the Burden of the Litigation Tax?**

Regardless of which estimate of the direct cost presented above is closest to the truth, it is likely to substantially *underestimate* the total economic cost of the U.S. tort system. In the analysis of taxation, economists recognize that the total burden of a tax exceeds the revenue it collects. The excess burden or "deadweight loss" of taxation arises because taxes distort production and consumption decisions. In the current setting, an example of this phenomenon is that physicians may prescribe unnecessary precautionary treatments, often referred to as "defensive medicine," in order to avoid

non-financial litigation penalties such as harm to their reputations and the time and stress associated with a malpractice suit.<sup>20</sup> Some socially desirable products and services are likely never produced due to excessive tort liability claims.

Anecdotal evidence suggests that some products that may have a net benefit to society as a whole are withheld from the marketplace due to excessive concerns of liability from the tort system. For example, concerns over liability have resulted in withdrawals of certain medicines, and halted the production of vaccines such as smallpox and DPT. In trying to gauge the size of these costs, the appropriate measure of loss is the difference between the value of the good that is not produced and the value of the next best alternative. Because only one of these goods is produced in the market, it is difficult to assess this loss. The net economic cost of these types of actions is difficult to quantify, and is not included in the \$180 billion estimate.

Despite these difficulties, one can approximate the magnitude of the deadweight loss through the literature on taxation. Recent research by Professor Dale Jorgenson of Harvard University estimates that the marginal deadweight loss per dollar of revenue raised by the corporate income tax in the United States is 27.9 cents.<sup>21</sup> If all tort claims have a comparable deleterious effect on the economy, the deadweight loss resulting from the \$180 billion in direct costs would be an *additional* \$50 billion. Even using the most cautious estimate that excessive direct costs total \$87 billion, an additional 27.9 percent deadweight loss would bring the total cost of the litigation tax to \$111 billion. In the intermediate case with direct costs of \$136 billion, the total economic burden would be \$174 billion annually.

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<sup>20</sup> Daniel Kessler and Mark McClellan, "Do Doctors Practice Defensive Medicine?" *The Quarterly Journal of Economics*, May 1996.

<sup>21</sup> Dale Jorgenson and Kun-Young Yun, Investment, Volume 3, *Lifting the Burden: Tax Reform, the Cost of Capital, and U.S. Economic Growth*, 2001, Table 7.10, page 287.

## Who Pays for Excessive Liability Claims?

Who pays the litigation tax? While a tax may be collected from a firm, its burden must ultimately be borne by individuals through job loss or a reduction in wages (workers), an increase in consumer prices (consumers), a decline in property values (landowners), or a reduction in profits and thus share prices (owners of capital). Of course, these categories are not mutually exclusive. The same person could suffer from lower wages, face higher prices for products, and have lower returns on his pension assets.

Determining the true economic burden, or economic incidence, of a tax is a complex undertaking, as it requires that one consider how wages and prices have adjusted throughout the economy as a result of the tax. If wages fall as the result of a tax, economists say that the tax has been *shifted backward* onto labor. If prices rise, economists say that the tax has been *shifted forward* to consumers.<sup>22</sup> Alternatively, firm profitability could be reduced, in which case the tax burden is borne by participants in private pension plans and owners of stocks and mutual funds.

For example, in the United States, the Social Security system collects 12.4 percent of a worker's wages<sup>23</sup> to support retirement and disability benefit payments. Half of this, or 6.2 percent, is levied on the worker. The remaining 6.2 percent is levied on the employer. However, most of the employer-paid portion of the social security tax is shifted backward so that the employer portion of the payroll tax has the same effect on a worker as does the portion levied directly on the worker. Thus, even though employees *legally* bear only half of the payroll tax, they bear the full – or almost full – economic burden of the tax through lower wages.<sup>24</sup>

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<sup>22</sup> Joseph E. Stiglitz, *Economics of the Public Sector*, Third Edition, New York: W. W. Norton, 2000, page 483.

<sup>23</sup> Up to a maximum taxable amount of \$84,900 in 2002.

<sup>24</sup> Joseph E. Stiglitz, *Economics of the Public Sector*, Third Edition, New York: W. W. Norton, 2000, page 483.

The *legal* incidence of the costs of the U.S. tort system falls on firms engaged in the production and sale of goods and services. Moreover, to the extent that the distribution of tort costs is largely random, tort costs only increase a firm's costs and decrease profits in a manner similar to the corporate income tax. Thus, to a first approximation, one can view the economic incidence of excessive tort costs as being similar to the corporate income tax in the United States.

The incidence of the corporate income tax is the subject of considerable debate among tax economists. Most economists believe that a substantial portion of the corporate tax is shifted to consumers through higher prices, or to workers if wages decline due to a decreased demand for the taxed good. The remainder falls on investors. Importantly, to the extent that it falls on capital, it is on owners of *all* capital, not just those firms most likely to fall subject to tort litigation. To see this, suppose that some industries or sectors are more likely to be subject to liability losses. If the high cost of liability makes investing in these sectors less attractive, capital will move out of the higher cost sector, driving down the rate of return to capital in other sectors. The lower return reflects the cost of the litigation tax. Thus part of the burden of these tort claims can be borne by all owners of capital not just those in the sector with higher tort claims.

Traditionally, three governmental agencies have engaged in the distributional analysis of tax policy: the Joint Committee on Taxation (JCT), the Office of Tax Analysis (OTA) at the Department of Treasury, and the Congressional Budget Office (CBO). During the 1980s and early 1990s, "JCT did not distribute corporate income tax changes at all, on the ground that the incidence of the tax was too uncertain."<sup>25</sup> Beginning in 1992, JCT allocated the corporate income tax to owners of capital generally, and for the past several years, the JCT has not conducted distributional

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<sup>25</sup>Michael J. Graetz, "Distributional Tables, Tax Legislation, and the Illusion of Precision," in David F. Bradford, Ed., *Distributional Analysis of Tax Policy*, 1995, page 47.

analysis at all. OTA makes the assumption that the tax is borne by owners of capital. Traditionally, the CBO has used three different variations: 100 percent by capital, 100 percent by labor, and half by each. The inconsistent set of assumptions and methodologies across agencies highlights the uncertainty about the economic incidence of the corporate income tax. In fact, a recent survey of economists who specialize in public finance found that virtually all of these economists believe that the burden of the corporate income tax is shared by both capital and labor generally, but “there is significant disagreement about the precise division.”<sup>26</sup>

To the extent that capital markets are globally linked, allowing capital to flow freely across borders, the after-tax rate of return to capital must be equated across countries. One implication is that if tort liability raises the cost of capital in the United States, mobile capital will seek the relatively higher return available elsewhere, until rates of return are again equalized. The result is that the capital stock in the United States may be smaller with high tort costs than with low tort costs. A smaller capital stock means there is less capital per worker, thus lowering productivity and wages. In this way, the costs of tort may fall on the less mobile factors of production, namely labor. If global capital markets were fully integrated and capital freely mobile, then the entire burden of the costs of excessive tort in the United States could be shifted to labor through reduced real wages and consumers through higher prices.

The relative magnitude of the burden of excessive tort costs in the U.S. is quite substantial. For perspective, in the year 2000, total wage and salary disbursements to private industries (i.e., excluding government workers) totaled just over \$4 trillion.<sup>27</sup> Taking the extremely conservative excessive cost estimate of \$87 billion – an estimate that treats the current level of economic and non-economic damages as appropriate,

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<sup>26</sup> Victor R. Fuchs, Alan B. Krueger, and James M. Poterba, “Why Do Economists Disagree about Policy? The Roles of Beliefs about Parameters and Values,” National Bureau of Economic Research Working Paper No. 6151, August 1997, page 12.

<sup>27</sup> *Economic Report of the President*, February 2002, Table B-29.

allows for a reasonable administrative charge of 23 percent of the award, and ignores the deadweight burden – the litigation tax is equivalent to a 2.1 percent wage and salary tax shifted onto private sector workers. Alternatively, if this \$87 billion were shifted forward to consumers through higher prices, this would be equivalent to a 1.3 percent tax on personal consumption.<sup>28</sup> If the excess burden were not passed through to labor or consumers, and instead was borne entirely by capital, then it would be equivalent to a tax on capital income of 3.1 percent.<sup>29</sup> It should be noted that nearly 80 million Americans own corporate stock, either individually or through their pension funds.<sup>30</sup> In fact, over 20 percent of corporate stock in the U.S. is held by public and private pension funds – suggesting that if this litigation tax is not passed through to workers via wage reductions or price increases, workers are still harmed through reduced returns on their retirement saving.

Table 1 below illustrates the “tax equivalence” of tort litigation costs under various assumptions about the incidence of the tax, and the size of the excessive tort costs. As a lower bound on the size of the litigation tax, we treat all economic and non-economic damages as economically appropriate, allow for 23 percent administrative costs, and ignore the deadweight burden. This translates to a litigation tax of approximately \$87 billion per year. For an intermediate estimate, we include non-economic damages in the excess cost of tort, following the work of Viscusi. This implies a litigation tax of \$136 billion per year, ignoring the deadweight loss. For an upper-bound estimate, we treat *all* tort costs as economically excessive, and also include an estimated \$50 billion in deadweight loss.

As illustrated in Table 1, under the assumption that the tax is fully shifted forward through prices, the annual excessive tort costs are equivalent to a tax on consumption

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<sup>28</sup> *Economic Report of the President*, February 2002, Table B-1.

<sup>29</sup> According to unpublished data from the Productivity and Technology Division of the Bureau of Labor Statistics, the capital (non-labor) share of nonfarm business output was \$2,762 billion in 2001.

<sup>30</sup> Investment Company Institute, *Equity Ownership in America*, 1999.

ranging from 1.3 percent to 3.4 percent. Alternatively, if shifted backwards onto labor, the “litigation tax” is equivalent to a tax on wages from 2.1 percent to as high as 5.7 percent. If the incidence of the tax falls on investors, it is equivalent to a tax on capital ranging from 3.1 percent to 8.2 percent. The final row of Table 1 illustrates the case in which the burden of the litigation tax is shared by consumers, workers and investors.<sup>31</sup>

Whether it falls entirely on labor, or whether some portion of it also falls on capital owners in the U.S., the cost to the U.S. economy is substantial. For example, in the year 2000, the intermediate cost estimate of \$136 billion is more than the Federal government spent on all of the following programs *combined*: Education, training, and employment; general science; space and technology; conservation and land management; pollution control and abatement; disaster relief and insurance; community development; Federal law enforcement and administration of justice; and unemployment compensation.<sup>32</sup> Alternatively, \$136 billion is two-thirds the amount of revenue collected from the corporate income tax<sup>33</sup> or nearly half (46 percent) of the amount spent on national defense.<sup>34</sup> Viewed differently, at more than 3 percent of wages per year, the cost of the litigation tax is also far more than enough money to solve Social Security’s long-term financing crisis. To a family of average income, three percent of wages is also the cost of more than three months of groceries, six months of utility payments, or eight months of health care costs<sup>35</sup>. That is, \$136 billion represents a large drain on the productive resources of the United States.

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<sup>31</sup> The assumed division is 25 percent through prices, 25 percent through wages, and 50 percent through reduced investment returns. This incidence assumption is based on one of the corporate tax incidence scenarios used by Joseph A. Pechman in *Who Paid the Taxes, 1966-85*, Washington, D.C., The Brookings Institution, 1985, p.35.

<sup>32</sup> *Budget of the United States Government*, Fiscal Year 2003, Historical Tables, Table 3.2, pages 54-69.

<sup>33</sup> *Ibid*, Table 2.1 page 30.

<sup>34</sup> *Ibid*, Table 3.1, page 51.

<sup>35</sup> Bureau of Labor Statistics, “Consumer Expenditures in 1999,” May 2001.

**Table 1**  
**Size of the Tort Litigation Tax**

Incidence Assumption	Equivalent Tax Base	Annual "Excessive" Tort Costs		
		\$87 billion	\$136 billion	\$230 billion
Fully shifted forward Through prices	Consumption Tax	1.3%	2.0%	3.4%
Fully shifted backward Onto workers	Wage Tax	2.1%	3.3%	5.7%
Fully borne by Investors	Capital Tax	3.1%	4.9%	8.2%
25% shifted through prices, 25% shifted through wages, 50% borne by investors	Consumption Wage Capital	0.3% 0.5% 1.6%	0.5% 0.8% 2.4%	0.8% 1.4% 4.1%

Source: CEA calculations. The taxes are calculated by dividing the annual excessive tort costs by the appropriate base. The consumption base is total personal consumption expenditures which totaled \$6,728 billion in the year 2000. The wage base is total wage and salary disbursements to private industries, which totaled \$4,069 billion. The capital base is non-labor payments in national income, which totaled \$2,789 in the year 2000.

## **Summary**

The cost of the U.S. legal liability system has increased substantially over the past several decades. While economic theory suggests a potentially useful role for a tort system in providing proper incentives, excessive tort costs are akin to a tax on firms. Like any tax, this “litigation tax” imposes deadweight losses on the economy in the form of products and services that are never produced as a result of the fear of litigation. Both the direct and indirect costs of excessive tort must ultimately be borne by individuals in the economy through some combination of higher prices, lower wages, and reduced returns to investments.