Public liability: An economist's perspective

By Henry Ergas*

A chorus of concern has arisen on both sides of politics on the issue of rising premiums for public liability insurance. The Premier of New South Wales, the Hon Bob Carr MP and The Prime Minister, the Hon John Howard MP, both agree that 'something must be done' to rein in these costs. The Assistant Treasurer, Senator Helen Coonan, has convened a national forum on rising premiums for public liability insurance.

Given that some small businesses have recently been hit with premium increases of up to 300 per cent and a February survey showed an average increase in public liability premiums of 28 per cent, it is perhaps not surprising that politicians are concerned and that many business groups have welcomed the holding of a national forum. But what is surprising is that the most popular theory for these rising premium costs – that it is due to lawyers advertising for clients – is thus far unsupported by any empirical evidence. It is also surprising that some fairly radical solutions to this problem have been advocated based on this so far unproven premise.

Photo: Darren Seiler/News Image Archive

The big Rocking Horse of Gumeracha is closed due to the high cost of insurance premiums

The Minister for Small Business and Tourism, the Hon Joe Hockey MP, has been prominent in expounding the theory that frivolous lawsuits, contingency fees and 'out of control' courts are to blame for rising public liability premiums. He has also proposed a list of radical measures to solve the problem including abolishing common law rights to sue for tort, establishing a national accident compensation scheme, limiting compensation payouts and/or clamping down on 'no win, no fee' arrangements and legal advertising.

But is there really a problem? And if so, what are its causes and how might they be tackled?

On whether there is a problem, Mr Hockey has quoted figures from the Australian Prudential Regulation Authority (APRA) showing that liability claims rose from 55,000 in 1998 to 88,000 in 2000. This is a steep rise. However, the figures are for aggregated public *and product* liability claims, and hence are potentially misleading.

Even on these figures, the biggest rise in the number of claims was from the year ending December 1998 to the year ending December 1999. The most recent data available for the period from July 2000 to June 2001 show that claims in this period rose only slightly, that is, by 4,000 claims, compared to the previous year when there was a rise of 13,000 claims.

It follows that to the extent that there is a straightforward link between liability claims, the number of lawsuits and level of public liability premiums, as Mr Hockey suggests, this should have manifested itself most fully around 1999 when there were steep increases in the number of claims. In fact, no such link is evident in the data. By contrast, the year ending June 2001 experienced a fall in claims expenses and premiums collected for this insurance category.

It may be that this rise and then fall masks a complex lagged relationship between increases in liability claims, number of lawsuits and increases in premiums. But Mr Hockey and his supporters have certainly not explained the nature of this relationship or how these purported links are supported by the evidence. In the absence of any such complex mechanism being made out, the APRA statistics seem to suggest that other factors may be at work.

This inference is all the stronger given that it is not difficult to work out what these 'other factors' might be.

First, the collapse last May of HIH, which used to be the biggest public liability insurance provider, and mergers between other major players have decreased competition in the insurance market. Second, the events of September 11, the general economic volatility following that, and lower investment returns to Australian insurers, have forced insurers to reassess their policies. This is reinforced by the fact that past competition took the form of discounting premiums and financing discounts with investments, perhaps to an unsustainable degree. Third, in light of the HIH collapse, APRA has recently required insurers to reserve $1.09 for every $1.00 received in public liability premiums compared to the previous 52 cents, thereby increasing costs.

It is difficult to argue with the proposition that the price and cost signals emanating from these three developments might have a lot to do with recent premium increases. Insurers might have simply found it rational to attempt to 'claw back' revenues from already unsustainable bouts of discounting made even more tenuous by recent economic instability.

This does not mean that the linkage between the number of lawsuits and premium rises is entirely implausible. For instance, NSW began to partially deregulate its legal system in 1994. It is possible that this set the scene for increased litigation and consequent increased liability claims and premium expenses. The post-September 11 and HIH effects, although the 'last nail in the coffin', may have added to costs that were higher than what would have occurred under a better-designed legal system.

Nonetheless, it is for the proponents of radical overhaul of the

** Henry Ergas is the Managing Director of the Network Economics Consulting Group, an economic consulting firm with offices throughout Australia, in New Zealand and in the United States. He has extensive experience in public policy analysis, and has served as an adviser to governments and leading corporations, as well as chairing a number of government policy reviews. He can be reached on H.Ergas@necg.com.au*

current liability system to prove their 'story'. Merely claiming that litigation for public liability claims has increased does not do this.

In effect, even if the volume of claims had increased, and that increase had increased premiums, these effects are not *per se* harmful. In this area, as in others, litigation involves benefits as well as costs, and any assessment of societal impacts needs to weigh both of these. There is, in other words, a socially desirable level of litigation, and it would need to be established that current levels exceeded that socially desirable amount.

It may seem counter-intuitive to speak of a socially desirable level of litigation. But this is a well-accepted notion in economics, which considers the relative costs and benefits of alternative institutional mechanisms for dealing with pervasive social issues such as public safety. As the Tasmanian Treasury concluded in a recent review, the compensation regime and insurance system is a market mechanism that acts as a deterrent to negligent behaviour and a financial incentive to minimise risks to the public. Of course, there are other institutional mechanisms to deal with these issues – safety regulations being an obvious example. But the fact that disputes over safety issues arise nonetheless suggests that 'safety through litigation' is picking up some of the slack in incentives that these other means have not fully dealt with.

There is, in other words, a socially desirable level of litigation, and it would need to be established that current levels exceeded that socially desirable amount.

Indeed, it can be argued that until the reforms of recent years, demand for litigation services may well have been inappropriately suppressed by regulatory restrictions and the rarity of 'no win no fee' arrangements compared to today. This would undoubtedly have been a loss for some people denied access to legal services as a consequence, especially those with very limited means who had genuine claims to make. The reforms of recent years, even if they increased the volume of claims and associated litigation, would then merely have moved Australia closer to efficient arrangements.

Faced with these arguments, Mr Hockey and his supporters wave the specter of a US-like explosion in litigation. Unless decisive action is taken now, they say, we will march down the US path.

It is indeed true that excessive litigation has overwhelmed the US legal system. But will it happen here? The reality is that the situation in the US differs from that in Australia in crucial ways. These center on the allocation of the costs of litigation.

In the US, each party to litigation generally bears its own costs. In contrast, Australian litigation operates according to the so-called 'English rule' in which the losing plaintiff in a case pays the legal costs of the defendant.

There are complexities involved in an economic comparison between this rule and the American system. However, research is fairly conclusive on the point that the 'English rule' supports plaintiffs with relatively high probabilities of victory while discouraging those who think they face a low probability of winning. In other words, the 'English rule' is more likely to discourage frivolous lawsuits, to the extent that there is some relationship between the 'frivolity' of a lawsuit and the expected probability of victory. Indeed, there are grounds for believing that the 'English rule' may be overly effective in this respect, suppressing or discouraging some suits that would be socially worthwhile. It is precisely because it does so discourage claims that adoption of the 'English rule' figures prominently in proposals for reform in the US.

Photo: Rohan Kelly/News Image Archive

The Hon Joe Hockey MP

It is true that economic research suggests that the English rule, at the same as discouraging more frivolous lawsuits, may actually encourage more serious claims to be pursued rather than settled. This is because the claims which litigants decide to proceed with under the English rule are of course the ones with an expected higher probability of victory. The expected value of pursuing these claims is therefore higher than under the American system, making settlement somewhat less likely. This means that in aggregate the total costs of litigation in a system that discourages frivolous lawsuits will not necessarily be lower than in other systems.

But is this a bad thing? No, because the resources expended on meritorious claims are, from a social perspective, money well spent to the extent that they create incentives for socially desirable changes in behaviour.

More specifically, the expenditure of resources on litigation may induce the party that can most efficiently avoid risks to safety to do so. This is not to suggest that frivolous lawsuits should be encouraged – far from it. Rather, the point is that there should be no automatic presumption that aiming to reduce the amount of resources expended on litigation is a sensible goal in and of itself.

Additionally, and contrary to the presumption behind one of Mr Hockey's proposals, contingent fee contracts which base attorney-client agreements on a percentage of the lawsuit award, though common in the US, are not permitted in Australia. As a result, there is no point in legislating against them. If instead what Mr Hockey is proposing is that the more limited 'no win no fee' agreements be outlawed, then this is likely to have adverse repercussions for lower income earners because legal aid is not available for personal injury claims. According to some legal experts, abolition of 'no win no fee' agreements may also undermine the ability to undertake class action lawsuits which would constitute an additional social loss, because the coordination problems involved when multiple parties are involved (and which class action lawsuits are designed to solve) may frustrate the proper pursuit of meritorious claims.

Where does this leave the range of measures being advocated by Mr Hockey and others concerned with the current legal system? The proposals to suppress legal advertising and 'no win no fee agreements' has already been discussed – such proposals presume that there is 'too much' litigation, a thus far unproven and even unanalysed proposition, and may well be throwing the baby out with the bathwater.

The proposal to impose caps on compensation payouts seems superficially more appealing, as it does not seem to restrict access to justice in the way that the other proposals would. However, it is far from clear that the proposal makes much economic sense.

The purpose of an award of damages is to put a claimant in the

same position he/she would have been in, but for the harm. Thus placing caps on damages awards means that the accident victim effectively subsidises the cost of cutting insurance premiums. However, this is not all – there is also a redistribution of responsibility for payment of *future* costs from insurance users to the public welfare system. This occurs to the extent that a cap on damages means that instead of meeting medical expenses from an award, a claimant may turn to the public health system instead. These undesirable effects can be mitigated somewhat by setting a cap only at the top end of possible awards – but this obviously reduces the extent of cost savings involved, and hence of the likely fall in premiums.

All this is assuming, of course, that any savings in claims costs would indeed be passed on to consumers in the form of reduced premiums. However, if one of the reasons for the current increase in premiums is a lack of competition in the insurance market, then the efficacy of a cap on awards would be severely limited. As a result, capping awards could create the problems discussed above (such as shifting of costs to the public welfare system), while having little or no impact on premiums.

The other proposed 'solution' has been to abolish the common law right to sue for compensation for tort and move to a 'no fault' national accident compensation scheme similar to the one currently operating in New Zealand. Given the facts set out above, this 'solution' seems disproportionate to the problem. Moreover, the New Zealand experience to date suggests that it is far from easy for such a scheme to improve on matters.

The compensation scheme in New Zealand had as of 30 June 2000, an unfunded liability of over NZ$6bn. Furthermore, many observers of the compensation scheme in New Zealand have noted flaws in its design which are likely to work against efficient incentives as well as imposing disproportionate burdens on particular groups. For instance, women are penalised because they account for fewer accidents from sport, crime and motor vehicles than men, yet pay the same levies. The scheme's levy rates have also been criticised for not accurately reflecting industry accident records, so that resources are misallocated across industries, as have its experience ratings, with safe employers in an industry effectively subsidising unsafe ones.

It may be that a scheme such as New Zealand's could do better than these criticisms suggest. But it is also plausible to think that many of these problems stem from the necessarily limited ability of a national compensation scheme to properly reflect all actuarially relevant factors without turning into an administrative nightmare. The price to be paid for all this is then distortion across groups and industries, and arbitrary transfers of income. These pitfalls suggest at least that the regulatory costs of setting up and administering such a scheme may exceed whatever benefits it is meant to provide.

One benefit from the New Zealand scheme which has been touted is its allegedly low administrative costs. However taking this claim on face value, low administration costs tell us nothing about the efficiency of an insurer; rather, they may simply be a sign of insufficient claims investigation and monitoring, and therefore a source of higher overall accident costs. Of course we know that one of the reasons for the low administration costs of the New Zealand scheme is its unfunded liabilities, and another is the actuarial shortcomings already discussed.

Aside from this one disputable benefit, worldwide research is extremely inconclusive on the economic impact of national compensation schemes imposed in other jurisdictions and in other areas of law. There is, at least to date, no firm evidence that these schemes actually lead to cost savings for the economy without backfiring in other respects such as by reducing efficient incentives to take proper care.

For instance, one 1982 US study by Medoff and Magaddino found that no-fault compensation schemes increased liability loss rates while another by Landes found that states in the US that imposed minor restrictions on tort claims experienced increases of 2-5 percent in fatal accidents while those imposing greater restrictions suffered 10-15 percent more. A 1989 study by McEwin found that add-on no-fault schemes did not increase automobile fatalities but where tort liability was abolished altogether fatalities increased by 16 percent. Other studies, in contrast, have found no relationship between no fault compensation schemes and fatalities schemes.

In short, the case for a radical overhaul of the current liability system is far from having been established. There is little evidence of a problem, much less systematic analysis of its causes. To the extent to which litigation in this area has increased, it is not clear that it has imposed net social losses. And the proposed solutions seem of dubious efficiency. It would be a pity if so poorly informed a public debate were to serve as a foundation for sweeping changes in public policy.