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ECONOMIC VIEWPOINT
By Glenn Hubbard

Let's Put The "Litigation Tax" On Trial

Tort costs should be counted as a tax that hits more than companies

In a season of talk about tax cuts, there is a major one we could enact that would boost our prospects for economic growth without adding to the deficit. This reduction would also improve the fairness of the nation's tax burden. I'm talking about the "litigation tax" -- the tax on our economy from an inefficient tort system. Recently proposed federal legislation to reform class actions has been described as a battle between "trial lawyers" and "business." The truth is more complicated -- and troubling. Tort reform is about cutting the litigation tax, which is large and affects millions of us, not just a handful of corporate defendants. Indeed, businesspeople and consumers on both the Right and the Left have recognized the benefits of tort reform.

President Bush's Council of Economic Advisers estimated in 2002 that the U.S. tort system's direct costs total about $180 billion a year. This is likely a conservative estimate: It ignores the many economic distortions that arise as individuals and companies try to avoid lawsuits. Examples include defensive medicine and decisions by manufacturers to remove products from the market. The estimate also ignores the potential adverse effect of excessive tort claims on innovation in industries ranging from general aviation to chemicals to pharmaceuticals and medical practice.

How much of that $180 billion in tort costs is "excessive"? As a simple guide, only 20 cents of each dollar of tort cost is paid to victims, and that share has fallen since the late 1980s. Of course, some administrative costs are required. But, even taking administrative costs into consideration, the CEA estimated that at least half of the tort cost is excessive. Other leading industrial nations have tort costs half those in the U.S.

FROM AN ECONOMIC PERSPECTIVE, tort costs are a pure burden on companies -- a cost with no corresponding benefit. That's because punitive damages are random and fail to provide incentives to companies, many empirical researchers in law and economics have concluded.

Whatever estimates of the dollar amount one chooses, the total economic cost of the U.S. tort system is higher still. An additional "deadweight loss" arises because these costs distort decisions by producers, who generate less innovation because of high litigation outlays and by consumers who pay higher prices for goods and services because of embedded litigation costs.

In this political season much is being said about the distribution of tax burdens. Who pays the "litigation tax"? While the cost may be collected from a company, its burden is ultimately borne by workers who lose jobs or see their wages go down, by consumers who pay higher prices, by landowners who experience a decline in property values, and by investors via lower profits and share prices.

Assessing the true economic burden of a tax requires analyzing how wages and prices are adjusted throughout the economy as a result of it. While the legal burden of litigation costs falls directly on companies engaged in the production and sale of goods and services, overall litigation costs act more like corporate income tax, which has a broader economic impact. Much of this corporate tax is shifted to consumers through higher prices or to workers if wages decline because of lower demand for the goods whose prices rise with the added costs. The remainder falls on investors.

This "litigation tax" has an impact on owners of all capital, not just those companies most likely to fall prey to tort litigation. Why? When litigation costs make investing in high-tort-cost sectors less attractive, capital will flow to other sectors, driving down the rate of return in those sectors, too.

The burden on the economy is large. According to the CEA, if it were borne just by workers, litigation costs would be equivalent to 2.1% of wages and salaries. If the "tax" were borne by consumers, it would be equivalent to a tax on income from savings of 3.1%. And less conservative estimates of the litigation tax lead to a larger equivalent tax burden on American workers, consumers, and investors.

In the election campaign this fall, we will no doubt hear a lot about tax policy. But the sheer size of the litigation tax makes it an equally important topic as we debate America's competitiveness. A question for the Presidential candidates: Do you support the class-action reform being considered by Congress as a way to reduce the "litigation tax"?

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