American Journal of Economics and Sociology, Inc.

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Source: *The American Journal of Economics and Sociology*, Vol. 51, No. 1 (Jan., 1992), pp. 101-108
Published by: American Journal of Economics and Sociology, Inc.
Stable URL: https://www.jstor.org/stable/3487661
Accessed: 05-02-2022 15:44 UTC

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A Public Choice Analysis of the Evolution of Tort Law:

Liabilities, Lotteries, and Redistribution

By WILLIAM T. HARRIS*

ABSTRACT. Economic analysis has generally concluded that most loss shifting under current standards of *personal injury liability* is allocatively non-*Pareto* optimal. The economic and legal arguments that support this conclusion are reviewed and an explanation is offered of why our *legal system* has evolved over time into an inefficient institution. It is argued that state sponsored *lotteries* and current personal injury *liability laws* have enough in common to be similarly viewed as a system of income redistribution demanded by the citizenry and supplied by the public sector.

I

Introduction

MOST ECONOMISTS would probably agree that loss shifting under current rules of personal injury liability is allocatively inefficient. Although economic analysis is well suited to determine the efficiency of different standards of tort liability, economic theory has not yet been able to explain why our legal system has evolved over time into an arguably inefficient system of shifting personal injury losses from the "victim" to someone else.

The purpose of this paper is two-fold: (1) to review the economic and legal arguments that support the conclusion that most loss shifting under contemporary standards of civil liability is non-Pareto optimal; and (2) to argue that the reason our legal system recently has embraced such inefficient rules results largely from the willingness on the part of rational individuals to participate in a type of extramarket lottery.

Government (primarily state sponsored) lotteries and existing personal injury liability rules have much in common: (1) they have evolved over time nearly simultaneously; (2) they have nearly identical "pay-out rates"; and (3) the distribution of benefits and costs is very similar. This paper discusses in detail these similarities and argues that a sufficiently large number of individuals have been

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American Journal of Economics and Sociology, Vol. 51, No. 1 (January, 1992).
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willing to accept an arguably inefficient system of personal injury loss shifting for the same reasons that they have enacted through their elected officials an arguably inefficient system of wealth transfers.

II

Efficiency of Personal Injury Liability Rules

THE PRIMARY ECONOMIC FUNCTION of tort law in general, and personal injury liability in particular, is to promote the efficient use of resources by reducing accident costs.[1] This can be accomplished when the law minimizes that sum of the costs of accidents and the costs of preventing accidents. If the nature of accident prevention and accident losses is such that they cannot be adequately handled by the private market, then there is an economic justification for the state to intervene. These instances would require that the courts adopt liability rules that create incentives which will minimize the number and severity of accidents and the cost of avoiding accidents.

The adoption of the negligence standard of tort liability in this country has been interpreted along several different lines. Only recently has an effort been made to explain in economic terms the change from liability without fault to the strict liability standard. Perhaps moral considerations concerning blameworthiness and fault, and the punitive nature of the law have obfuscated the economic consequences of changing liability assignments.

Nearly a hundred years ago, Oliver Wendell Holmes, Jr. alluded to an economic argument for not reassigning accident losses when he wrote ". . . the prevailing view is that its [the government's] cumbrous and expensive machinery ought not to be set in motion unless some clear benefit is to be derived from disturbing the *status quo.* State interference is an evil, where it cannot be shown to be a good."[2] It appears that the late Supreme Court Justice was saying, in effect, that when there is no gain from shifting a loss, there is no reason to shift it.

Despite its brevity, this interpretation is economically very sophisticated. If we ignore distributional consequences, then an efficiency criterion for reassigning losses through judicial interference would be to shift losses only when it can be shown there exist net gains from doing so. From the economist's perspective, we would want to know if the gains, somehow measured, from the given reassignment outweigh the costs associated with implementing the change. Unfortunately, Mr. Holmes did not provide any guidance for determining when "some clear benefit is to be derived from disturbing the *status quo.*"

Detailed analysis of the allocative effects of various liability rules has progressed rapidly within the past several years.[3] With respect to the negligence standard

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in particular, Richard Posner was one of the first to develop ". . . a theory to explain the social function of the negligence concept and of the fault system of accident liability that is built upon it."[4] Although Posner's analysis is not completely correct throughout, he does offer a testable hypothesis about the social function of the negligence concept to facilitate the attainment of the cost-justified level of accidents and safety.

Posner begins by restating Judge Learned Hand's famous interpretation of what constitutes reasonable or ordinary care in a negligence case: If the probability of an accident occurring times the magnitude of the loss if an accident occurs is greater than the burden of taking precautions that would avert it, then the injurer's failure to take the precaution constitutes negligence. This interpretation coupled with a defense of contributory negligence (the victim was in a position to undertake cost-justified precautions at a lower cost than the injurer could) would generate the efficient level of accident and accident avoidance. This assumes zero transaction costs and complete information.

Under such a system of liability a potential injurer will take into account the "accident cost" associated with a particular undertaking or action. In the absence of negligence liability, these accident costs would be externalized from the injurer to the victim *in instances where the injurer and victim were unable to reach private agreement* over who is to undertake precaution, and how the losses will be spread among the affected parties. In economic terms, then, a negligence liability rule constitutes a social contract governing the ultimate distribution of accident losses when private agreement is not feasible. According to Posner[5] the negligence standard in its idealized form creates the correct set of incentives to generate the efficient level of accidents and safety.

Calabresi envisions a nearly identical economic role for tort liability; specifically, he states, "Apart from the requirement of justice, I take it as axiomatic that the principal function of accident law is to reduce the sum of the costs of accidents and the costs of avoiding accidents."[6] Both Posner and Calabresi agree that in the absence of transaction and decision making costs, and assuming perfect information, the negligence standard is capable of minimizing the costs of accidents and precaution.

The conclusions of Posner and Calabresi have been corroborated in a more formal, theoretical analysis by John P. Brown. He begins by stating, "(T)he social optimum we shall define as that combination of avoidance measures which minimizes the sum of the costs of the controls and the expected cost of the accident." He concludes that in *most* instances the rule of liability has little or no effect upon the attainment of efficient resource allocation.[7]

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The exceptions to this conclusion are accidents involving individuals who are brought together only by chance-encounter mishaps. These situations involve accidents among strangers, and consequently, the circumstances preclude any opportunity for the affected parties to agree voluntarily upon how to avoid the mishap or share the resulting losses. More formally, accident prevention may be under the control of two or more noncooperating individuals (*i.e.,* strangers). Under these circumstances, the affected parties cannot feasibly agree upon how the socially optimum level of accident avoidance will be supplied. As a result, the fault standard is allocatively superior to liability without fault in instances where accident preventers are unable to bargain before the mishap brings them together. The absence of preencounter bargaining will prevent the full exploitation of the gains from trade that would have resulted had negotiation been possible. The allocative effect of assigning liability on a fault basis is to provide incentives for accident preventers to undertake cost justified precautions.

During the past twenty years or so tort law has taken an interesting turn. Instead of fulfilling its economic incentive role of minimizing the combined costs of accidents and the cost of avoiding accidents, liability laws have embraced a new economic dimension—providing potential victims with the accident insurance that not all of them currently want to buy or can afford. By making producers of goods and services nominally pay for the costs of accidents (*i.e.,* holding them strictly liable for losses incurred when consuming their products), the courts have forced everyone to buy accident insurance in the form of higher product prices.

There are, however, two economic inefficiencies associated with this form of "insurance." The first is the fact that for a large number of individuals, they may not desire the "coverage." Many individuals as consumers would prefer to self-insure and enjoy lower product prices. Because the law cannot differentiate between those who want the insurance and those who do not, clearly those people who prefer the lower prices without coverage are made worse off.[8]

Second, and perhaps most important, is the fact that litigating to recover accident losses is an extremely costly (resource consuming) process. It is relevant to note that only a small percentage of liability premiums are ultimately received by plaintiffs. For example, only about twenty percent of the medical malpractice premium is eventually paid to patients, and about fifty percent of automobile liability premiums is received by injured motorists.

These low pay-out rates are not a necessary feature of insurance coverage. First-party health and accident insurance, for example, returns on average between eighty and ninety percent of premiums paid to sick or injured policyholders. The difference is that first-party coverage largely does not require the

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insured to engage in expensive litigation in order to receive compensation. The conclusion is that if individuals want efficient insurance coverage for accidental losses, it is cheaper for them to purchase their own first-party coverage against these particular risks.

III

The Strict Liability Standard

TORT LIABILITY, as previously noted, has changed dramatically in this country during the past quarter century. Huber explained this "revolution" as follows:

> The revolution began and ended with a wholesale repudiation of the law of contract. Until well into the 1960s, it was up to each buyer to decide how safe a car he or she wanted to buy. Then as now, the major choices were fairly obvious: large, heavy cars are both safer and more expensive; economy cars save money but at some cost in safety. In case after case today, however, the courts struggle to enforce a general mandate that all cars be *crashworthy*. That term is perfectly fluid; it is defined after the accident by jury pronouncements; it is defined without reference to preferences and choices deliberately expressed by buyer and seller before the transaction. . . . the views of the courts have become the driving force in determining what may be bought and sold. Not long ago, workplace safety was something to be decided between employer and employees, often through collective bargaining, perhaps with oversight from federal and state regulators, while compensation for accidents was determined by state workers' compensation laws. Today the courts supervise a free-for-all of litigation that pits employees against both employers and the outside suppliers of materials and equipment, the latter two against each other, and both against their insurers.
>
> What brought us this liability tax, in short, was a wholesale shift from consent to coercion in the law of accidents. Yesterday we relied primarily on agreement before the fact to settle responsibility for most accidents. Today we emphasize litigation after the fact. Yesterday we deferred to private choice. Today it is only public choice that counts, more specifically the public choices of judges and juries. For all practical purposes, contracts are dead, at least insofar as they attempt to allocate responsibility for accidents ahead of time. Safety obligations are now decided through liability prescription, worked out case by case after the accident. The center of the accident insurance world has likewise shifted, from *first-party* insurance chosen by the expected beneficiary, to *third-party* coverage driven by legal compulsion.[9]

Personal injury liability has expanded enormously during the past two decades for at least three reasons: (1) the number of tort suits filed has increased; (2) the probability of an award has increased; and (3) the average size of awards has grown rapidly. Again, Huber documents this growth:

> Begin with the number of cases. Traffic accident claims, which account for about 40 percent of all tort cases today, have held steady or even declined as states have passed no-fault laws. But other cases have been on a steep rise. Cases where appliances, factory machinery, chemicals, automobiles, and other products are blamed for injuries increased fourfold between 1976 and 1986. More medical malpractice suits were filed in the decade ending in 1987 than in the entire previous history of American tort law. One survey found that damage claims

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against cities doubled between 1982 and 1986. In the space of a single year, between 1984 and 1985, claims filed against the federal government grew from 41,000 to 54,000 and the amount demanded from $112 billion to $149 billion, an increase of over 30 percent by either measure.

The plaintiff's probability of winning has also risen steadily. The likelihood of success rose from 20 to 30 percent in a product case in the 1960s to more than 50 percent in the 1980s, with similar increases in other classes of lawsuit, again excluding traffic cases.

Finally, there has been sharp growth in the size of awards. The average judgment in all tort cases rose from an inflation-adjusted $50,000 in the early 1960s to more than $250,000 in the early 1980s—a fivefold increase. The inflation-adjusted median award—the amount exceeded in half of all judgments—has been rising steadily too, by more than 80 percent in the same period. Average verdicts against cities rose almost tenfold, to $2 million. The first jury verdict exceeding $1 million came in 1962; in 1975 there were fewer than twenty; today there are over 400 a year, an increase that could not possibly be ascribed to inflation alone. Inflation-adjusted awards in medical malpractice cases have doubled about every seven years.[10]

If, as argued earlier, this change in tort law is not to remedy any market failure and, more importantly, if the change is allocatively inefficient for the reasons discussed, one may wonder why the law has evolved into a less efficient institution.

The usual public choice explanation is the special interest model. In this case the parties to benefit are the relatively small number of well organized lawyers who gain employment and income from litigation. Their interests are promoted by increased personal injury lawsuits and court ordered loss shifting. Their gains individually and collectively are relatively large. The "losers" in this case are the very large number of unorganized consumers and taxpayers who individually are only a "little bit" worse off because of slightly higher (than necessary) product prices and taxes.

IV

Special Interest or Lottery Thinking

THERE IS AN ALTERNATIVE EXPLANATION that one can argue which is akin to the acceptance by a large number of individuals of perhaps equally inefficient wealth transfer systems in the form of state lotteries. As noted in the introduction, existing personal injury liability rules and government sponsored lotteries have much in common.

The first interesting coincidence is that the legal "revolution" in tort liability occurred during the same time that citizens in a majority of the states voted to establish lottery games. For example, there were no state lotteries until New Hampshire adopted one in 1964. Within ten years, eleven states had enacted lottery games; and between 1981 and 1988 alone, fifteen more states established

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lotteries. Today thirty states and the District of Columbia, with over seventy percent of the US population, have enacted lotteries. Between 1979 and 1988, spending on lotteries rose from just under $2 billion to nearly $16 billion. It has been during this past quarter of a century that the courts have been redistributing enormous sums of money in personal injury liability cases.

The second feature that personal injury liability and lotteries have in common is that the pay-out rates are very similar. In the case of lotteries about one-half of total ticket sales are returned to winners. As noted earlier, this is approximately equal to the amount of liability premiums that are ultimately received by successful plaintiffs.

There is another similarity insofar as the total number of individuals who "win big" in liability cases and in lotteries is a minuscule percentage of the total population. Although, possibly, both liability insurers and promoters of state lotteries would like the public to believe large numbers of individuals are made instant millionaires from lottery games and lawsuits, the fact is that only a very few fortunate people "win big". Nevertheless, both lawsuits and lotteries allow people the (albeit extremely remote) chance to win large sums of money for a relatively small premium or payment.

Given the similarities between lotteries and current rules of personal injury liability, it can be plausibly argued that a sufficiently large number of individuals have been willing to accept an arguably inefficient system of loss shifting for the same reasons that they have enacted through their state legislatures an arguably inefficient system of wealth transfers. Rational individuals may have chosen to have available the opportunity to participate in another "lottery game," liability lawsuits.

Notes

1. One referee disagreed with this statement, and stated that, "The function of tort law is to require negligent people to compensate other people for their damages." This statement focuses on the distributional consequences of the law and equity concerns. My aim is to point out that appropriate compensation to victims is the cost of negligent behavior. This compensation to the victim is secondary to the effect payment has on the behavior of potentially negligent individuals. The potential injurer prevents those accidents that impose more cost on the victim than it cost to avoid. The works of Brown, Calabresi, and Posner are noted in order to support my position.
2. Holmes, Jr., O. W., *The Common Law* (Boston: Little, Brown and Company, 1881), p. 96.
3. Blum, W. J. and Kalven, Jr. H., *Public Law Perspectives on A Private Law Problem - Auto Compensation Plans,* (Boston: Little, Brown and Company, 1965). Blum, W. J. and Kalven, Jr. H., "The Empty Cabinet of Dr. Calabresi," *University of Chicago Law Review,* Vol. 34, 1967. Calabresi, G., "Fault, Accidents and the Wonderful World of Blum and Kalven," *Yale Law Journal,* Vol. 75, 1965. Demsetz, H., "When Does the Rule of Liability Matter," *Journal of Legal Studies,* Vol. 1, 1972). Prosser, W., "The Assault Upon the Citadel," *Yale Law Journal,* Vol. 69, 1960.

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4. Posner, R. A., "A Theory of Negligence," *Journal of Law and Economics,* Vol. 1, 1972, p. 29.

5. *Ibid* and Posner, R. A., "Strict Liability A Comment," *Journal of Legal Studies,* Vol. 2, 1973.

6. Calabresi, G., *The Costs of Accidents: A Legal and Economic Analysis* (New Haven: Yale UP, 1970), p. 26.

7. Brown, J. P., "Towards A Theory of Liability," *Journal of Legal Studies,* Vol. 3, 1973.

8. There are, of course, risk averse individuals who may prefer higher product prices and the injury compensation that the law requires. For these individuals, the only inefficiency noted below is relevant. For individuals who would want even more safety and personal injury coverage than the law currently mandates, the private market supplies many forms of first-party disability, medical, and life insurance policies to cover losses not provided by product liability. With respect to the level of safety sought, again the private market offers many, although not necessarily low cost, alternatives that can satisfy one's desire for risk avoidance.

9. Huber, P. W., *Liability: The Legal Revolution and Its Consequences,* (New York: Basic Books, Inc., 1988) pp. 7–8.

10. *Ibid.,* pp. 9–10.

Like Father, Unlike Son

. . . Mr. Daniel Malthus had a clever son, Robert, whom he educated with great care and to whom doubtless, in season and out of season, he communicated his favorite ideas; at any rate, Robert grew up with a proper antipathy to them. The instructive reaction of child against parent, which more than almost anything keeps men moving, and prevents "one good custom" from "corrupting the world," has seldom had a better example. "Train a child up in the way he should go," a cynic has observed, "and then you may feel safe that he will not walk in it:" let a child hear much from infancy of nice dreams and pleasing visions and to the best of your ability you will have prepared him for prosaic carefulness and a dismal rationalism.

WALTER BAGEHOT

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