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Written Statement of
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Subcommittee on the Constitution
United States House of Representatives
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Hearing on: Can We Sue Our Way to Prosperity? Litigation's Effect on America's Global Competitiveness

Thank you, Mr. Chairman and distinguished Committee members for inviting me to provide testimony today on the effects of litigation on competitiveness. My name is Paul Hinton and I am a Vice President at NERA Economic Consulting. NERA is a global firm of experts dedicated to applying economic, finance, and quantitative principles to complex business and legal challenges. For half a century, our economists have brought academic rigor, objectivity, and real world industry experience to bear on issues arising from competition, regulation, public policy, strategy, finance, and litigation.

Prior to joining NERA, I earned a BA from Oxford University and a Master's in Public Policy from the Kennedy School at Harvard University. I have authored and co-authored a number of empirical studies that estimate the direct costs of the legal system to businesses and develop measures of the impact of the legal system on economic activity. I describe these studies below.

I. Summary

The direct cost of the U.S. tort system is estimated to be approximately $250 billion in 2009 or about 2 percent of GDP.[1] The U.S. costs are the highest as a percent of GDP amongst those reported for other industrialized countries and more than double the estimates for countries such as the U.K, France, and Japan.[2]

[1] "U.S. Tort Cost Trends, 2010 Update," Towers Watson, 2011.

[2] "U.S. Tort Costs and Cross-Border Perspectives: 2005 Update," Towers Perrin, Tillinghast, 2006.

One NERA study I directed on Tort Liability Costs for Small Businesses shows that tort costs are not borne evenly throughout the economy. Small businesses bear a relatively larger share of tort costs than larger businesses. For example, businesses with less than $10 million in revenues in 2008 represented only 22 percent of U.S. business revenues but incurred 83 percent of tort costs.[3] This is economically important because small businesses generate the majority of net new jobs, 65 percent over the past 17 years.[4]

The costs of the U.S. tort system may have effects on businesses similar to an implicit tax.[5] The economic literature on the effects of taxes on business activity is instructive in identifying the effects of higher costs of business on economic development.[6] This literature as well as surveys of business attitudes describe how business decisions on where to make investments and add jobs are sensitive to local costs of doing business. Tort liability costs may also affect the growth of existing businesses within the 50 states.

In another NERA study, I worked with colleagues to examine how relatively higher tort costs in the U.S. affect international competitiveness. We compared the growth of productivity in the manufacturing industries affected by asbestos litigation in the U.S. since the late 1980s to productivity growth of the same industries in other industrialized countries. We found that productivity growth in the U.S. industries affected by asbestos litigation was 0.5 percent per year slower than their counterparts in other countries. Over the period of study from 1987 to 2000, the lower U.S. productivity growth amounted to lost GDP of over $300bn, with $51bn of that loss realized in 2000.

Both these studies indicate that lowering the costs of the tort system could have a substantial impact on the promotion of business activity.[7]

[3] "Tort Liability Costs for Small Businesses," U.S. Chamber Institute for Legal Reform, May 2010.

[4] "Frequently Asked Questions," Small Business Administration, Updated January 2011.

[5] Taxes are typically paid on business profits whereas tort costs vary more closely with business revenues. However, both raise the cost of doing business.

[6] See e.g. Michael J. Waslenko, "Taxation and economic development: the state of the economic literature," New England Economic Review, March 1997.

[7] In addition, the U.S. Chamber Institute for Legal Reform has commissioned a NERA study, currently underway, that will quantify the effects of differences in legal climate across the states. Preliminary findings measure significant variation in tort costs between states with the best and worst legal climate.

II. The direct cost of the tort system and its effects on business

A. How the cost of the tort system can be estimated

The cost of the tort system is hard to quantify because information about the actual costs associated with resolving individual tort claims is not generally available. Verdict amounts are reported but only in the minority of cases that are resolved at trial. Attorney fees and settlements are generally not reported and the administrative costs of running the court system are shared between tort cases and other matters and so are hard to attribute.

An alternative approach developed by Towers Watson (formally Tillinghast) uses data on liability insurance costs to estimate the underlying tort system expenses that this insurance covers. This approach makes sense since most tort costs are insured: rather than paying the uncertain amount of tort costs that may emerge during a policy year, insureds choose to pay a premium to provide limited insurance coverage for whatever costs actually arise. The insurance companies pay covered liabilities as they arise and charge premiums sufficient to cover their costs over the long term. The insured liability costs are computed by multiplying the premiums charged by the combined ratio, (that is the ratio of losses and insurer expenses to earned premiums).

This approach relies on being able to separate lines of particular commercial lines, personal lines and medical malpractice insurance that pay tort costs from other lines.[8] Uninsured costs are estimated to account for companies that self-insure (including deductibles and other retentions) or pay out-of-pocket. Some specific categories of costs are not included such as tobacco settlements and the administrative costs of the state and federal courts themselves.[9] The components of the Towers Watson estimate for 2008 are shown in Figure 1.

Figure 1
2008 U.S. Tort Cost Estimate (in $ billions)[10]

	Business	Personal	Total
Liability Insured Cost	86	92	**179**
Uninsured Cost	45	2	**47**
Medical Malpractice Cost	30	N/A	**30**
Total	**161**	**94**	**255**

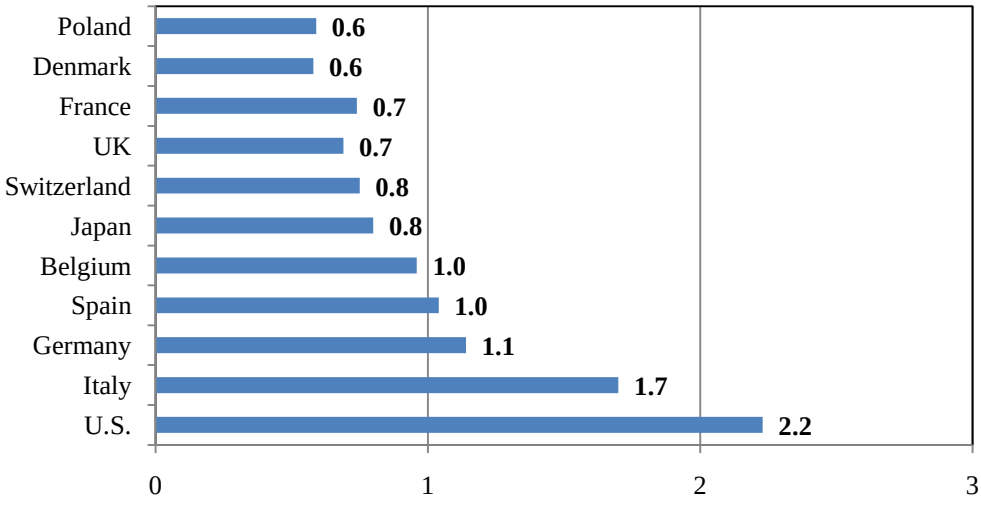
[8] Some lines of business cover both tort costs and property losses and for these the estimated proportion of premium related to property coverage is deducted. In particular, the non-liability portion of commercial multiple peril policies (A.M. Best line 5.1), and 91% of farmowners and homeowners multiple peril policies (A.M. Best line 3 and 4) are excluded. In addition, costs relate to non-fault auto insurance (A.M. Best lines 19.1 and 19.3) and automobile property damage (A.M. Best line 21) are also excluded.

[9] To the extent that punitive damage awards are excluded from insurance coverage these costs are not included. Certain types of contract and shareholder litigation costs are also excluded. See Towers Watson "U.S. Tort Cost trends, 2010 Update," p.10.

[10] "2009 Update on U.S. Tort Cost Trends," Towers Perrin, 2009.

Towers Watson developed similar estimates for selected industrialized countries in 2004. These estimates are expressed as a percent of GDP and are reported in Figure 2.

Figure 2
Tort Costs as a Percent of GDP, 2003



Source: "U.S. Tort Costs and Cross-Border Perspectives: 2005 Update," Towers Perrin, 2005.

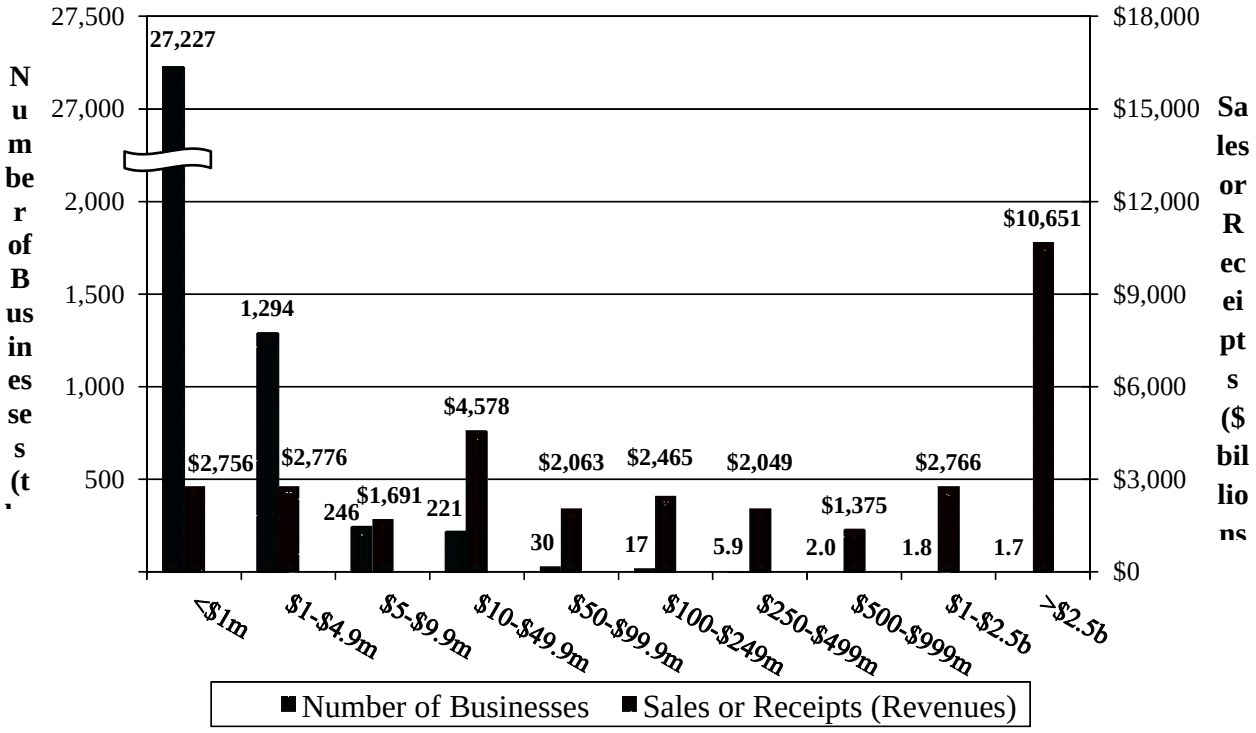
B. The NERA small business tort cost study

NERA used a similar approach to estimate the tort costs attributed to businesses of different sizes in the U.S. economy. This study, *Liability Costs for Small Businesses,* was commissioned and published by the U.S. Chamber Institute for Legal Reform in May 2010. This analysis is based on the costs of liability insurance to individual businesses who purchased liability insurance through Marsh Inc. a major insurance broker in 2008.[11] In the study, we use this data to estimate how the Towers Watson $161 billion estimate of U.S. tort costs paid by businesses in 2008, is distributed between large and small businesses.

[11] Marsh Inc. is a sister company of NERA Economic Consulting. They are both a part of Marsh and McLennan Companies.

For purposes of this study, small businesses are defined as those with $10 million or less in annual revenues. According to the Economic Census in 2008 small businesses in this category numbered over 28 million and represented 99 percent of all businesses (see Figure 3) and 22 percent of business revenues.

Figure 3
Estimated Size Distribution of US Business in 2008



Source: MarketStance 2008 data derived from the Economic Census.

The principal findings of the study are:

- The tort liability price tag for small businesses in America in 2008 was $133 billion (see Figure 4).
- Small businesses bore 83 percent of business tort costs (including medical malpractice costs) compared to only 22 percent of revenue.
- Small businesses paid $36 billion (27 percent) of their tort costs out of pocket as opposed to through insurance.

Figure 4
Estimated Business Tort Costs[12]

	2008 Estimate of Number and Size of Businesses			Estimated 2008 Business Tort Costs				
Revenue Categories	**Number of Businesses**	**Revenues**	**Percent of Revenues**	**Insured Costs**	**Self Insured or Uninsured**	**Medical Malpractice**	**Total**	**% of Business Tort Costs**
< $1 Million	27,226,655	$2,756	8%	$41	$34	$22	**$97**	61%
$1 to $4.9 Million	1,293,670	$2,776	8%	$23	$1	$4	**$28**	17%
$5 to $9.9 Million	246,300	$1,691	5%	$6	$1	$2	**$9**	5%
< $10 Million	**28,766,625**	**$7,223**	**22%**	**$70**	**$36**	**$28**	**$133**	**83%**
$10 to $50.0 Million	221,195	$4,578	14%	$10	$2	$	**$13**	8%
> $50 Million	58,390	$21,368	64%	$6	$7	$1	**$14**	9%
Total	**29,046,210**	**$33,168**	**100%**	**$86**	**$45**	**$30**	**$161**	**100%**

U.S. commercial liability tort costs are estimated separately for commercial automobile liability, medical malpractice, and other commercial liability lines. For each line of insurance, median insurance premium costs per $1,000 in business revenues are computed for businesses of different sizes (as defined by revenues) and for businesses in different industries (as defined by one digit SIC codes).[13]

The insurance lines used in this analysis are commercial automobile liability, medical malpractice liability, the liability components of packaged products (including commercial multi-peril and business owners' policies), and all other primary and excess lines of liability insurance. These other primary and excess lines of liability insurance include many specialized lines of insurance, but the following lines constitute over 97% of the premiums:

- Excess/Umbrella Liability;
- Directors & Officers Liability;
- General Liability;

[12] Data are from "Tort Liability Costs for Small Businesses," U.S. Chamber Institute for Legal Reform, May 2010

[13] We use the medians within each category to reduce the influence of outliers in the sample within each category.

- Professional Indemnity/Errors & Omission;
- Employment Practices Liability;
- Fiduciary Liability;
- Pollution/Environmental Liability;
- Miscellaneous Casualty.

To control for the fact that Marsh's customers may not be representative of businesses throughout the U.S., the median insurance costs in each industry and size category is multiplied by the estimated U.S. revenues for the category (developed for 2008 by MarketStance from census data)[14] and the estimated proportion of businesses that purchase insurance. Estimated premium costs for non-employee businesses (over 99.9 percent of which have annual revenues less than $1 million) are assumed equal to the median cost of packaged policies.

Liability costs are estimated from premiums earned by multiplying by the combined ratio[15] for the corresponding lines, reported by A.M. Best for 2008. By adjusting liability premium data by the combined ratio, we estimate the total liability losses associated with the cost of insurance.

The total liability costs consist of insured costs and costs associated with uninsured and self-insured out-of-pocket costs. The proportion of liability costs that are uninsured or self-insured by businesses themselves is estimated from business surveys conducted by MarketStance Inc. (a market research firm specializing in insurance) for businesses in different revenue size categories. As shown in Figure 4, in aggregate, businesses' uninsured tort costs represent 28 percent of business tort costs (34 percent excluding medical malpractice).

We scale the costs reported by Marsh clients to match the aggregate national tort costs reported by Towers Watson. Uninsured costs are also scaled to match the aggregate values reported by Towers Watson.

III. The indirect costs of the tort system

The costs and uncertainty created by litigation affects defendant companies' borrowing costs and hence their ability to invest, grow and create jobs. Dealing with litigation occupies management time that could be used more productively. Also, many foreign companies are wary of becoming embroiled in U.S. litigation, which may deter foreign direct investment.

[14] The most recent Economic Census data is available for 2002. MarketStance uses these data along with more up to date payroll data to estimate the total revenues in the U.S. economy for 2008. The estimate is based on the historical ratio of revenue to payroll computed from the 1992, 1997, and 2002 Economic Censuses by industry group. The aggregate payroll of businesses in 2008 is computed using County Business Patterns data from the U.S. Census Bureau and employment data from the Bureau of Labor Statistics. The ratio of revenue to payroll, adjusting for historical trends for certain industries, is multiplied by the aggregate payroll data to estimate total revenues for employer businesses in 2008. Separately, MarketStance estimates the number and aggregate revenues of non-employee firms using data from the census.

[15] The combined ratio is a standard financial ratio used by insurers to express the cost of paying losses and administering policies as a percent of the premium revenue they earn.

Surveys of business attitudes reveal ways in which the costs of the tort system influence business decisions. For example:

- Nine of ten global companies that de-listed from U.S. stock exchanges between 2003 and 2007 mentioned the troubled U.S. litigation environment as one factor in their decisions.[16]

- Two-thirds of corporate counsel surveyed said that stated legal environments are a major legal consideration when their companies make important business decisions, such as whether to invest in a particular state.[17]

- More than one in three small business owners surveyed said they would likely have to postpone hiring of new employees, reduce benefits for existing employees, and have a harder time getting credit.[18]

The Department of Commerce recently released a report titled "The U.S. Litigation Environment and Foreign Direct Investment, Supporting U.S. Competitiveness by Reducing Legal Costs and Uncertainty." This report presents the argument that a relatively costly tort system could discourage foreign direct investment in favor of less litigious countries. As it is often said, and *ceteris paribus*, "investment capital goes and stays where it is well treated."[19]

Another effect of the liability system that is easier to measure is the effect on growth of existing businesses in the United States. A NERA study used the manufacturing industries affected by U.S. asbestos litigation since the 1980s as a case study on the potential effects of high liability costs on productivity growth.[20] The study compared the performance of affected U.S. industries over 14 years with the same industries in 10 other industrialized countries that were not affected to the same extent by asbestos litigation. This study measured a cumulative $303 billon loss in GDP due to slower U.S. productivity growth in these industries relative to other countries.

A. NERA productivity growth study

First, we identified the industries that have been heavily affected by asbestos litigation. More than 6,000 companies have been hit by asbestos personal injury lawsuits, so almost all sectors have been somewhat affected.[21] We compiled a list of asbestos-related bankruptcies and

[16] "Global Capital Markets Survey," The Financial Services Forum, Policy Research, 2007, p.8.

[17] "Small Businesses: How the Threat of Lawsuits Impacts Their Operations," Harris Interactive, May 10, 2007, conducted for U.S. Chamber Institute for Legal Reform.

[18] Public Opinion Strategies and Douglas E Schoen LLC national survey of 1,000 small businesses, August 19-31, 2010, #10737, conducted for The U.S. Chamber Institute for Legal Reform.

[19] "The U.S. Litigation Environment and Foreign Direct Investment, Supporting U.S. Competitiveness by Reducing Legal Costs and Uncertainty." U.S. Department of Commerce, October 2008, p. 2.

[20] http://www.nera.com/83_media1.htm.

[21] Stephen J. Carroll, et al., "Asbestos Litigation Costs and Compensation. An Interim Report," Institute for Civil Justice, 2002, RAND DB-397-ICJ.

identified the primary industries in which the bankrupt companies did business and produced traded goods: we label these industries as "heavily affected." Industries heavily affected by asbestos litigation, represent 13 percent of GDP and about half the manufacturing sector in 2000, including:

- Metal Ore Mining;
- Nonmetallic Mineral Mining and Quarrying;
- Utility System Construction;
- Building Equipment Contractors;
- Building Finishing Contractors;
- Other Specialty Trade Contractors;
- Basic Chemical Manufacturing;
- Plastics Product Manufacturing;
- Rubber Product Manufacturing;
- Clay Product and Refractory Manufacturing;
- Glass and Glass Product Manufacturing;
- Lime and Gypsum Product Manufacturing;
- Foundries;
- Electrical Equipment Manufacturing;
- Motor Vehicle Parts Manufacturing;
- Ship and Boat Building;
- Engine, Turbine, and Power Transmission Equipment Manufacturing;
- Other Heavy and Civil Engineering Construction;
- Foundation, Structure, and Building Exterior Contractors;
- Petroleum and Coal Products Manufacturing;
- Resin, Synthetic Rubber, and Artificial Synthetic Fibers and Filaments Manufacturing;
- Pesticide, Fertilizer, and Other Agricultural Chemical Manufacturing;
- Pharmaceutical and Medicine Manufacturing;
- Paint, Coating, and Adhesive Manufacturing;
- Soap, Cleaning Compound, and Toilet Preparation Manufacturing;
- Other Chemical Product and Preparation Manufacturing;
- Cement and Concrete Product Manufacturing;
- Other Nonmetallic Mineral Product Manufacturing;
- Iron and Steel Mills and Ferroalloy Manufacturing;
- Boiler, Tank, and Shipping Container Manufacturing; and
- Agriculture, Construction, and Mining Machinery Manufacturing.

We then constructed a database of industry-level labor productivity (output per employee) for the U.S. and ten other industrialized countries.[22] For each industry, in each country, we calculate the average rate of annual productivity growth over 1987-2000 and compare this to the U.S. rate. The industrial countries used as a comparison are the ten that had the necessary data available: Austria; Denmark; Finland; France; Germany; Italy; Japan; Korea; Luxembourg and Norway .

[22] The source of the data is the Organization of Economic Cooperation and Development's (OECD) "STAN" database. The OECD is the leading source of internationally comparable economic data from developed countries. The 10 countries are all of those for the OECD data from 1987-2000.

We compare the performance of industries heavily affected by asbestos litigation in the U.S. with the same industries in ten other industrialized countries. It would be incorrect to simply compare the productivity growth across different countries because growth may be slower in some countries for other reasons including local economic or regulatory conditions. To control for country specific differences in growth we use the productivity growth in the non-asbestos industries.

We compute the productivity differential in the heavily affected sectors with each of the ten countries, and then compare the differential growth to the corresponding differential growth in non-asbestos industries. We find that the heavily affected sectors in the U.S. lag behind. The average annual U.S. productivity growth was 0.5% lower relative to the other countries.

Half of one percent may seem like a small difference, but it cumulates and it compounds. By 2000, the productivity differential amounted to a value of $51 billion per year.[23] The total loss from 1987-2000 was $303 billion.

IV. Effects of the legal climate on state tort costs

Liability insurance cost data is also available at the state level and can be used to study the extent to which differences in the legal climate across the 50 states affect tort costs. The periodic Harris survey of business perceptions of the legal climate in each state provides a quantitative metric with which to assess the effects of legal climate.[24]

Just as the tort system imposes higher costs on businesses operating in the U.S. than in other industrialized countries (see Figure 3), variations in legal climate from one state to another means that some states impose higher tort costs than others.

A survey of economic studies on the effect of taxation on economic development by Michael J. Wasylenko provides a useful summary of the range of effects on employment and investment of interregional and interstate differences in taxation.[25] The median effect of taxes on total employment he reports is an elasticity of -0.58. This means that a 10 percent reduction in taxes (e.g. from 10 percent to 9 percent) would result in a 6 percent increase in employment. Similar effects could result from a reduction in business tort costs.

The U.S. Chamber Institute for Legal Reform has commissioned a NERA study, currently being conducted, that will quantify the effects of differences in legal climate across the states using this methodology. While I cannot get into the details of the study until it is finalized,

[23] We turned the productivity differential into a dollar figure by multiplying it by the current dollar value-added in the affected U.S. sector. While the actual effects of lagging productivity are more complex, this is a reasonable way to evaluate the loss in U.S. competitiveness.

[24] See e.g. 2010 U.S. Chamber Of Commerce, State Liability Systems Ranking Study, Humphrey Taylor, Chairman, March 9, 2010.

[25] Michael J. Waslenko, "Taxation and economic development: the state of the economic literature," New England Economic Review, March 1997.

preliminary findings measure significant variation in tort costs between states with the best and worst legal climate.

V. Conclusion

I would like thank the Chairman and distinguished Committee members again for this opportunity to testify on this important topic. The effect of the legal climate on the economy is a subject that deserves further attention and I hope to contribute further to the body of research of these effects in the months ahead.