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Enterprise Liability: A Prescription for Health Care Reform?

by Charles T. Carlstrom

In the last decade alone, the real cost of health care in the United States ballooned by 41 percent. Some members of the medical establishment have blamed soaring malpractice premiums —which currently cost doctors more than $7 billion a year—for much of the increase. This article examines that claim and takes a look at how one malpractice reform proposal, enterprise liability, would likely affect both the cost and the quality of medical services in this country.

Few issues facing society touch as many lives as health care. Although most Americans would probably agree that the quality of available medical services in the United States is first-rate, many question whether the price being paid for that quality is too high. Recognizing this, President Clinton, who made health care reform a central promise of his campaign, appointed a blue-ribbon task force headed by First Lady Hillary Rodham Clinton to look into ways of containing skyrocketing costs while increasing access to the nation's doctors and hospitals.

The task force has not yet made its final recommendations public, but it is quite possible that they will incorporate changes in the current medical liability laws. Many people believe that the malpractice system now in place is a significant factor in the spiraling cost of health care, and not just because of the direct costs of malpractice insurance. There is also a concern that the system encourages doctors to overprescribe certain tests and procedures simply to protect themselves from the possibility of future lawsuits, a practice known as defensive medicine.

The commission has discussed two possible malpractice reforms at length. The first is enterprise liability, which would 1) transfer liability in malpractice cases from the doctor to the patient's health care plan and 2) institute no-fault malpractice insurance. The second proposal would place caps on malpractice awards.[1]

Although limiting malpractice awards has emerged as the clear favorite, enterprise liability remains an option for the future. In fact, President Clinton is reported to be considering some demonstration projects to assess its long-term viability.[2]

Given the possibility that the administration may eventually endorse enterprise liability, it is important to examine the probable effects of this type of malpractice reform. In this *Economic Commentary*, I analyze the plan's costs and benefits, focusing particularly on its likely impact on the quality of medical care. I also take a brief look at the consequences of capping malpractice awards (see box on page 2).

Health Care and Malpractice Costs

Over the last decade, the inflation-adjusted cost of health care has shot up 41 percent. Malpractice premiums, which currently cost doctors more than $7 billion a year, are thought by some to be a major contributor to the increase.[3] But this view is clearly overstated. While malpractice insurance is expensive, it still amounts to only 1 percent of the nation's total health care bill.

About 55 percent of these premiums go toward direct administrative costs, including attorney and expert witness fees.[4] The savings that could emerge from controlling these costs, however, would likely be dwarfed by the additional $4 billion to $25 billion estimated to be spent each year on defensive medicine.[5]

Clearly, malpractice reform is not a panacea for the nation's health care ills. However, because as much as 5 percent of the total U.S. health care budget is devoted to defensive medicine and malpractice insurance, it is important to determine whether such reform could indeed effectively control these costs. The answer takes on further significance because many believe that changing the present system could jeopardize the quality of medical care that Americans have come to expect.

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■ The Potential Benefits of Enterprise Liability

Critics of the current system say that reining in malpractice costs is not only overdue, but that the system is administered so poorly that potential changes would have almost no effect on the quality of health services. They contend that most malpractice awards have little to do with actual malfeasance.

Joseph Newhouse and Paul Weiler, who rank among the nation's leading health policy experts, argue for two major changes in the current malpractice insurance system (see footnote 3). First, they contend that legal liability should be shifted from the individual physician to the patient's health care provider.[6] Second, they would institute no-fault insurance covering all medically caused injuries, not just those caused by negligence. Taken together, these changes are known as enterprise liability.

The idea behind transferring liability from doctors to patients' health care plans is to eliminate the high cost of defensive medicine. Currently, doctors have an incentive to order excess tests — which they do not pay for — to help reduce the likelihood of being named in a malpractice suit. Shifting malpractice liability from the physician to the party that pays for the tests means that a patient's insurance company would absorb the costs and reap the benefits of any testing. Thus, insurers would be less likely than doctors to agree to procedures having little potential medical benefit.

Making health plans liable for malpractice damages would also lower administrative expenses by reducing the number of claimants in such suits. Now, most malpractice cases involve a patient who is suing not just his doctor, but the hospital, the anesthesiologist, the nurse, and any number of other individuals directly or indirectly associated with his medical care. Under enterprise liability, the insurance company would be the only defendant.[7]

Newhouse and Weiler's second proposal, expanding liability to include all medically caused injuries and not just those caused by negligence, is modeled after workers' compensation. Here, liability for all on-the-job injuries falls on the employer, who pays a premium to cover the costs of administering the system. The plan is considered no-fault in that payment does not depend on whether the injury was caused by negligence on the part of the firm or the worker.

Newhouse and Weiler believe that this change would also reduce administrative expenses, for two reasons. First, plans such as workers' compensation usually provide a standard scale of damages for certain types of injuries. Second, no-fault insurance would eliminate the high cost of proving negligence in court while reducing the uncertainty about whether the claimant will be held responsible for the injury. Reducing uncertainty and increasing the uniformity of judgments would likely dampen the injured party's incentive to go to trial to bet on a particular outcome.

Newhouse and Weiler contend that, taken together, these two changes would dramatically cut administrative costs, from 55 percent of total malpractice premiums to closer to the 20 percent associated with workers' compensation.[8] The bulk of the savings would probably be due to the no-fault provision of enterprise liability rather than to the transfer of liability away from doctors.

■ Malpractice and Health Care Quality

In the eyes of many, the major problem with instituting enterprise liability is that the present system, though imperfect, increases the safety of medical care by punishing negligent doctors. Simply transferring liability from the physician to a health plan, critics argue, could erode this protection.

But the effect of this change alone would depend on whether physicians have better information about their own abilities than do patients or their health insurance companies. In a world where all parties have free access to information, legal placement of liability would make no difference. The party that actually

AN ALTERNATIVE PROPOSAL

An alternative to enterprise liability being considered by the Clinton administration is capping malpractice awards. The argument behind this type of tort reform is that juries frequently award settlements that are not commensurate with, and sometimes far outstrip, the damages actually incurred by the injured party.

Proponents believe that capping malpractice payments will reduce administrative costs both by eliminating the lengthy and expensive appeals process that "excessive" judgments often go through and by increasing the number of malpractice cases settled out of court. The hope is that by reducing the uncertainty surrounding juries' possible decisions, the incentive to go to trial to bet on a particular outcome will be diminished.

There are two problems with this plan. First, just as juries' judgments are considered arbitrary, so too are the limits on monetary damages that the caps would impose. If caps are set too low or are allowed to erode over time, then a patient's recourse for receiving poor medical care would be restricted.

Second, it is doubtful whether caps would have any significant impact on the cost of medical care. While directly attacking malpractice premiums — which currently constitute 1 percent of the nation's total health care bill — the plan does little to reduce doctors' incentive to engage in defensive medicine. That's because the major cost of losing a malpractice case is not necessarily the size of the judgment, but the effect that a guilty verdict can have on a doctor's reputation. Thus, even if caps succeeded in cutting malpractice premiums by 33 percent, the net reduction in the nation's total health care bill would still amount to only 0.33 percent.

bears the ultimate liability would be independent of the party decreed liable by the courts. Even if doctors were not held legally liable, those prone to making mistakes would still pay because the demand for their services would fall and their malpractice premiums would rise.

With full information, it would not matter whether doctors or health insurers were liable for malpractice damages. Under enterprise liability, doctors would no longer have to charge extra to cover expected malpractice costs, and insurers would pay out less in medical claims. The cost of health insurance would remain the same, however, since the additional "profits" collected by the health plans would in essence be used as premiums to pay future malpractice awards.[9]

Unfortunately, full information is an unrealistic assumption in the field of medicine. It is likely that physicians are more aware of their own skills than are patients or patients' insurance companies. Because of this, moral hazard problems could arise if liability is switched from doctors to insurers. Moral hazard is the idea that a person's behavior is affected by liability. In the medical realm, the fear is that the quality of care would suffer because doctors would behave differently once the threat of being sued was removed.

■ Moral Hazard Considerations

Moral hazard problems associated with enterprise liability could affect health care quality through several channels. First, doctors may no longer have the same incentive to select a specialty according to their comparative advantages. For instance, while many doctors may have the knowledge necessary to be good surgeons, few have the physical skills (dexterity) required. Under the present system, expected malpractice costs would lower anticipated earnings for less adroit doctors and thus discourage them from choosing surgery as a specialty.

Another more ominous possibility is that enterprise liability may cause doctors to exercise less care or to take unnecessary risks when treating patients. For example, malpractice liability may govern how hard doctors push themselves. A surgeon who has been in the operating room all day and who is both mentally and physically spent currently has an incentive to postpone any additional surgery or to defer to colleagues, since a mistake could mean being hit with a large malpractice suit. Personal liability provides an incentive to set appropriate personal limits.

Malpractice liability can also influence the amount of time a physician spends keeping up with medical advances. To maintain quality, a good doctor must spend time reading the latest medical journals and attending professional conferences. Although this limits income by reducing the amount of time that can be devoted to seeing patients, it is one way to help minimize the chances of being sued for malpractice.

Moral hazard problems are pervasive not only in medicine, but whenever people are not held liable for damages caused by their own actions. Insurance companies, in particular, are well aware of this. One reason automobile insurance firms require deductibles is so that insured drivers will bear some of the costs associated with their actions and hence will be motivated to drive more safely.

■ Reputation Effects

While the moral hazard complications cited above are worth considering, they may in fact overstate the likelihood that medical care would suffer under enterprise liability. Proponents argue that, currently, malpractice insurance creates moral hazard problems for doctors in much the same way that automobile insurance does for drivers.

Although insurance reduces the amount of damages actually paid by a negligent physician, it is clear from the costs associated with defensive medicine that it does not eliminate all of the burden. That's because the cost of being found guilty in a malpractice suit is not simply a matter of how much money is awarded to the injured party. The loss of reputation that negligent doctors must endure, coupled with the fact that future malpractice premiums could become prohibitively expensive, can threaten the livelihood of some practitioners.

If reputation rather than direct financial loss governs a doctor's behavior, then the obvious question is, would the risks associated with losing one's reputation be as great under enterprise liability? For reputation effects to work, others must be aware when a doctor has made a mistake. Under the current system, malpractice suits are the obvious conduit of this information — particularly if the doctor is found guilty.

No-fault malpractice insurance, however, would eliminate the need to prove negligence in court. This means that the amount of information available to the public and to other health plan administrators regarding the quality of a physician's care would be reduced.

But there is another avenue through which reputation effects can operate. Since enterprise liability would make a patient's health plan liable for malpractice damages, it would encourage the trend toward health maintenance organizations (HMOs), where doctors work for specific plans. Plan administrators, fearful of being sued, would likely institute intensive monitoring and screening of their doctors to weed out the bad ones. Chip Kahn, executive vice president of the Health Insurance Association of America, maintains that "insurance companies would have to be breathing down physicians' and hospitals' necks even more than they do now." Frederic Entin, general counsel of the American Hospital Association, echoes that sentiment, arguing that enterprise liability would reduce the autonomy of doctors and hospitals in practicing medicine (see footnote 1).

■ Conclusion

There is reason to believe that enterprise liability could reduce malpractice costs by eliminating both extended litigation and the current incentive doctors have to engage in defensive medicine. The savings may not be as large as proponents assert, however, since health plans will have to devote more

of their resources to screening and monitoring their staff.

There are other costs associated with enterprise liability that have not been considered here. One is that it may reduce mobility among the *best* doctors. With no malpractice cases to provide a public signal of a doctor's abilities, performance evaluations by HMOs and individual health plans would become increasingly important. These reports would probably remain private, however, possibly making it harder for the most able practitioners to change jobs and thus reap the rewards of their expertise.

The arithmetic dictates that malpractice reform is but a small step toward reducing the cost of health care in this country. Even if enterprise liability were to lower administrative expenses from 55 percent of malpractice premiums to 30 percent, and with the costs of defensive medicine cut in half, the U.S. health care bill would still fall only 0.5 to 2.0 percent.

Despite these figures, it is likely that some type of malpractice insurance reform will eventually be prescribed. While clearly more than a placebo, this treatment is best viewed as one small dose of what will ultimately be a much larger — and perhaps even more unpalatable — regimen.

Footnotes

1. See Hilary Stout, "Clinton Mulls Barring Lawsuits against Doctors," *The Wall Street Journal*, April 29, 1993.

2. See David Rogers, "Initial Clinton Medical Malpractice Reform Plan Pulled after Resistance by Entrenched Interests," *The Wall Street Journal*, June 15, 1993.

3. See Joseph P. Newhouse and Paul C. Weiler, "Reforming Medical Malpractice and Insurance," *Regulation*, vol. 14, no. 4 (Fall 1991), pp. 78–84.

4. Ibid.

5. This estimate is from a study by Lewin–VHI, a consulting firm (see footnote 1).

6. If the patient does not have health insurance, then Newhouse and Weiler propose that the hospital where the injury took place be held liable.

7. An exception to this rule could occur if the patient has secondary insurance. It is not clear how Newhouse and Weiler's proposal would handle this situation.

8. However, they also point out that administrative costs under enterprise liability would probably always be higher than under workers' compensation. This is because it is more difficult to ascertain whether an injury is due to an underlying condition or to poor medical care than it is to determine whether an injury occurred at work.

9. The cost of health insurance could fall *slightly* if transferring responsibility from doctors to health plans successfully reverses the administrative costs of malpractice insurance.

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