ACCIDENT COMPENSATION

The Faulty Basis of No-fault and State Provision

Richard A Epstein

NEW ZEALAND BUSINESS ROUNDTABLE
AUGUST 1996

This seminar, with Sir Geoffrey Palmer as commentator, was given in Wellington on 20 December 1995

First published in 1996 by
New Zealand Business Roundtable,
PO Box 10–147, The Terrace,
Wellington, New Zealand

ISBN 1–877148–15–6

Design and production by *Ruth Munro, Daphne Brasell Associates Ltd, Wellington*

Printed by *Astra DPS, Wellington*

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The nature of the tort system

To make sense of the tort system, we need to understand its operation *as* a system. Like any system, it consists of various parts which are closely interrelated. It has three distinct links, all of which need to be coordinated, no matter what policy regime we decide to implement.

The first link is the relationship between the injurer and the victim. One party suffers an injury at the hands of another party, in the simplest case by the use of force. The injured party can seek redress, under the classical common law regime, for the injury. The claim of the injured party rests on a mixture of distributive and corrective justice principles. The claim resonates with distributive justice to the extent that it stresses the original property rights that individuals have in their own persons. It resonates with corrective justice insofar as it seeks redress for the invasion of those rights when one person inflicts an injury upon another.

The second link concerns the role of the injurer. Even the low probability of a serious accident is likely to stimulate various adaptive responses to avoid causing harm or mitigate its consequences. This will be true even if potential injurers can do nothing to alter the nature of the liability rule linking injurer and injured. There are two types of adaptive response. One response is to take care to avoid loss. The second is to go into the insurance market and purchase insurance against the perceived risk. The insurance contract will be set at a price such that the anticipated benefits to the insurer exceed the firm's expected cost, and where the benefits

to the potential defendant also exceed that person's expected cost—the usual condition of mutual gain.

This insurance contract serves a complicated set of interrelated functions. One function is simply to smooth out the income stream of the potential defendant. Another might well be to introduce the insurer's supervision or monitoring in order to reduce the probability of causing injury. In this case insurance may actually help deter injury, rather than create moral hazard. In certain lines of insurance, the amount spent on inspection and supervision may be eight or ten times greater than the amount paid out in claims. This ratio is not constant across insurance categories—a fact which is itself, I believe, very instructive about the various roles played by insurers.

A further function of insurance is not as socially beneficial as the first two. Insurance enables some parties effectively to beat the system by reducing their damage obligations, sometimes below that which is socially optimal. In other words, insurers often supply a series of defence services to people who are potential defendants, which may well create a negative externality through the ability to avoid having to pay a legitimate claim. Liability insurance thus becomes the second link in our system.

The third link radiates from the victim. A potential victim has no certainty that she will receive from the courts a sufficiently large payout to compensate for her injury. She will be concerned about possible sudden changes in her income stream resulting from sickness or accident. In a completely unregulated market, most people would not rely on the tort law to cover them against every risk of disability; they would generally minimise their risks by taking out some first-party insurance. First-party insurance should be seen as an income protection device rather than an incentive control mechanism. It will still, however, need to be coordinated with any tort system in respect of the benefits received from successful tort action. Here the body of law that has developed involves the principle of subrogation or reimbursement: the plaintiff is allowed to recover a full tort award, but then some percentage of that award goes to the insurance company to offset its payouts under its own policies. This

preserves whatever deterrent or corrective effect is associated with the tort system, since the defendant pays exactly the same amount whether or not the plaintiff has disability or health insurance. Yet it also means that accident cover can be provided at a lower price than otherwise, since the insurer acquires part of the income stream of the tort victim to offset its own liabilities.

These, then, are the links in our system—the tort relationship between injurer and victim, and the insurance that both injurer and victim might decide to buy for their respective purposes. These links give rise to some extremely difficult questions. How should they be organised? Which activities should be undertaken by the state, and which should be left to the private sector? The very fact that an insurance contract for liability arising out of the ownership of premises is very different in nature from an insurance contract for product liability suggests that the interaction of these three links depends heavily on the nature of the underlying wrong. I propose first to examine more closely our three links, and how they tie together. We will then be in a position to evaluate government accident compensation schemes, both in New Zealand and abroad.

The first category of tort: accidents involving strangers

The first point about the link between injurer and victim is that injuries occur in a broad range of situations that correspond to the relevant common law categories of accident law—categories which have a peculiar way of surviving even in a no-fault world. First, there are injuries between strangers—like the classic common law categories of trespass and nuisance. We can also treat highway accidents as normally falling within this category. Secondly, there are physical accidents arising out of consensual arrangements. These include employers' liability, which was subject to the voluntary workers' compensation schemes of the late nineteenth century. Consensual arrangements also include medical malpractice. I myself would regard product liability as also falling within the category of consensual arrangements, since it involves a network of

contracts stretching from manufacturer through distributors, wholesalers and retailers to the ultimate consumers and users. In the case of product liability, the original supplier of the defective good may in some—but not all—circumstances be held liable to a consumer of the finished product.

How does one go about finding the optimal parameters of the system for all these various cases? In the history of the New Zealand system, and of its American counterpart, much of the debate—at least in the 1960s—centred on road accidents. Here there are a cluster of issues to consider. One is the shape of the tort system for the relationship between the injurer and the victim. There are also questions of how to deal with insurance cover at both ends. In New Zealand the Woodhouse report, which led to the development of your accident compensation scheme, raised some familiar objections to the common law system. Such a system is clearly painfully slow in some cases. Its findings can be highly capricious—especially in the case of American juries. Awards for damages show a great deal of variation. In short, the operation of the law has many of the characteristics of a lottery, as Woodhouse and his followers argued.

Some degree of tort reform is thus undoubtedly appropriate. Two of the possible avenues of reform are my own favoured approach and the approach explicitly adopted in the New Zealand accident compensation scheme. My own preference is to preserve the good features of the current system of tort liability, while removing from it those encrustations which are of relatively little value.

In particular, the negligence system as it operates at the appellate level leaves a great deal to be desired. I am in favour of a form of no-fault, but not the no-liability, no-fault system introduced in New Zealand. I would move to a strict liability system that, for example, in respect of road accidents would essentially say that if a person violates the rules of the road, then that party is responsible for any injury thereby caused to another party. Assuming the rules of the road are coherent, this would give three possible sets of outcomes. If both parties complied with the

rules of the road, there would never be a collision and the liability question would not arise. Next there would be situations where one party did not comply but the other party did: here the non-complying party would unambiguously be held liable. Finally, there would be cases where both parties failed to comply. In these circumstances the loss would be split. Only overt physical acts would be considered in determining whether there had been compliance with the road rules. We might wish to draw up a schedule of damages, which would set the framework within which payments for damages would be made. We may even prefer to set up a fast-track legal mechanism for handling these cases. This should not be a specialist court in the style, for instance, of the New Zealand Employment Court. Rather, within the normal High Court structure we might have one judge at a time sitting on traffic cases for six months, and then being rotated out in favour of somebody else.

There are undoubtedly good reasons for undertaking reforms of this type, rather than simply moving to a no-fault system. A tort system can preserve important incentive effects that a no-fault system will lose. I do not wish to engage in what I sometimes call the Chicago fallacy—the assumption that, if we had a series of rules embodying optimal incentives, there would be perfect compliance. Given that negligence requires unjustified and unreasonable conduct, and given that on such an assumption rational people never make mistakes, it would seem to follow that under a negligence system there would be zero liability no matter how many accidents actually occurred. That is not a proposition I would care to defend. By saying this, I am not meaning to imply that the instinct for self-preservation is an unimportant factor in encouraging optimal conduct. Indeed, since defendants often put themselves at risk in automobile accidents, the liability system here may, paradoxically, be less important than in the cases of occupiers' liability and medical malpractice, where defendants can inflict harm without putting themselves at risk. But we cannot rely on self-preservation alone to protect third parties. The higher the cost borne by the offending party, the lower will be the costs imposed on other parties. A strict liability system would

help to internalise these costs. Its objective is to make all of us bear the losses of another as though they were our own.

However, the exact magnitude of the incentive effect is very hard to measure. Many independent influences are at play, including the conditions of roads, the safety of cars and population densities. Attempting to isolate individual causal factors by standard regression analysis is fraught with difficulty. The evidence suggests that the incentive effect of tort liability could reduce the number of road accidents by around 10 to 15 percent, which I suspect is roughly correct. A slimmed-down tort system along the lines I have described would eliminate many of the excesses associated with negligence while preserving all of these desirable deterrent effects. Paradoxically, it would make the insurance function easier to discharge. Because of the clearer rules of a slimmed-down tort system, a greater percentage of the available dollars would go into compensation rather than claims administration, resulting in fewer deadweight losses. That is one solution for reforming the handling of road accidents.

The second category of tort: accidents in consensual settings

Other forms of accident are more complicated. Here the tyranny of categories is a real problem. There are also industrial accidents, medical accidents and product accidents. All occur in the context of consensual arrangements. There is no reason to believe that the optimal regime in consensual arrangements involving employment or other settings will be the same as for highways. In principle, we should give people the flexibility to develop their own solutions.

Anybody wanting to reform the no-fault system would do well to examine the nineteenth century voluntary plans for workmen's compensation that preceded by 30 to 40 years the adoption of the no-fault workers' compensation system under the 1897 English statute. All the criticisms conventionally made about the inefficiency of negligence systems are borne out by the evidence from last century. Richard Posner—my former colleague who is now a judge—claimed that the

negligence regime was efficient because he could find no contracting-out from the system. Posner had the right test, but the wrong history: when we contract out, we not only contract out of the tort system, we opt out of the court system as well. If we went looking in courts for people who never go there, we are not likely to find them. We need to go back and examine the arrangements that were in place. If we do that, we find that in the nineteenth century there was massive contracting-out from the liability system in large industrial plants, and often on the railroads and in the mines. The optimal conditions for contracting-out depend heavily on the mode of production. Team production tends to lead to workers' compensation, while individual production within loosely organised work settings tends to retain the system of negligence and the assumption of risk. But it is instructive that the consensual arrangement that usually turned out to be optimal was a version of workers' compensation, with no-fault (i.e. harm arising out of and within the scope of employment), limited damages and arbitration mechanisms.

One of the great benefits of the New Zealand system is that it avoids mistakes that we have made in America in the field of medical malpractice. Anybody who has ever been involved in that area can see that the deterrent function of a system with a reliability rate considerably less than 50 percent must be negative, or perverse.

We have medical malpractice in the United States because there is no contracting-out from that system. Instead, we should allow some other form of damages on the model of workers' compensation. This would include a commitment by the physician to take care of injuries caused to patients, in tandem with mechanisms for monitoring how physicians operate. The point to be made about the New Zealand regime is not that it is the optimal system for medical injuries, but that it is much better than the US system. Both suffer from not allowing contracting-out. The same is true for product liability.

We now come to a second question. Suppose we decide that the tort system has positive administrative costs but zero deterrent effect. In that case the socially optimum move is to abolish the system: we will

save administrative costs and lose nothing elsewhere. If we are deeply convinced about the mystical importance of some concept of justice, we could attempt to factor it in as an independent variable. However, it is impossible to be sure how justice enters such an equation. The Aristotelian model of redress for grievances may well be powerful in stranger cases, but in the end it is justified only by efficiency considerations. The more one talks like Ernest Weinrib about corrective justice, the less one understands its relevance to a particular case as an independent factor. Around 1970 Guido Calabresi came out with a famous minimisation formula, in which the objective was to minimise the sum of the cost of accidents, the cost of administration and the cost of prevention, subject to a constraint of justice. We have now waited over 25 years to see how that last constraint influences the first three elements of the analysis, and nobody has yet provided a strong and clear example where four variables give us a better analysis than three. Consequently, I will leave justice considerations aside, because I do not believe they provide anything not covered by our traditional concerns with externalisation, contractual optimisation and so on.

Tort and insurance

Let us assume that we have decided to abolish the tort system. The great non sequitur of the New Zealand accident compensation system is the assumption that the quid pro quo for abolishing the tort remedy for any individual is the creation of a state-funded and operated insurance programme. That is a giant conceptual leap in the dark, over the cliff and into the river.

We should think of the problem in these terms. If we assume that the tort system is inefficient, everybody would gain from its abolition, even if there were no first party compulsory state insurance system in place. All of us would save pro rata on the administrative expenses, and none of us would lose because the old system supplied no deterrent effect when in operation. When American courts say that the abolition of the tort system is unconstitutional because there is no quid pro quo, that

simply demonstrates their failure to understand the importance of reciprocal in-kind benefits. Abolition of tort would effectively constitute a massive state-induced barter, in which the surrender of person A's potential tort action against person B is the quid pro quo for the surrender of person B's potential tort action against person A. If we believed such a trade were efficient, abolition would be entirely logical. It then becomes clear what would happen to the two outer links of the three-link system I described earlier. On the liability insurance side, the relevant companies would simply disappear because they would no longer have a product anyone wanted to buy. In the case of first party insurance, the companies would discard their subrogation and reimbursement clauses, because these would now be meaningless. We would be left with a pure, voluntary, first party system.

Suppose that we have abolished the tort system for these reasons. What type of first party system would we now think appropriate? There are a great variety of alternatives, one of which is simply to keep the common law synthesis. Individuals would purchase their voluntary insurance in whatever market they chose. They could specify the coverage they wanted, based on information on the income streams they were expecting, age factors, other family members, personal wealth, and so on. One of my themes in this series of talks is that the one-size-fits-all model of state regulation is utterly inappropriate for circumstances of this type. If we observe a high degree of variation in the types of first party protection that individuals seek, either by themselves, through their employers, or through voluntary associations, that is not a sign of market failure or a reason for the government to intervene. Moreover, it is an issue quite divorced from the abolition of the tort system itself. If we dislike the tort system, we need only abolish it—not tamper with first party insurance on the side.

Suppose, however, that we do decide to tamper with first party insurance. A report of the Woodhouse variety says that it is a matter of social importance that everybody who loses wealth as a result of an accident should be compensated out of compulsory levies, to be brought back to

a higher income level, and restored to productive work. Yet it hardly follows that these important tasks should be done socially—through a mandated state insurance scheme. We should not forget John Stuart Mill's insight that the person most hurt by an accident is the person who is injured. It is the potential victim who has the most powerful incentives to take the appropriate action to prevent the accident happening, and then—once it has happened—to rectify the situation. It does not follow that we should collectivise this function simply because third parties will be adversely affected when a given individual has an accident. The same is true in the case of disease, and yet there is no general case for the socialisation of the cost of diseases. It is not sufficient that the underlying problem be serious. For socialisation to be justified, we must expect to receive greater social gains—after deducting administrative costs—than are available through voluntary first party mechanisms. The Woodhouse report never addressed that question, which is entirely separate from the question of tort reform.

Suppose, however, that we do ask ourselves that question. We might then reason as follows: "There is a huge social welfare system out there, and we need to ensure that the system is not bankrupted by individuals who do not take care of themselves. We should therefore compel everyone to take out insurance against accidents, since it will save us money in the long run". In other words, we can make the familiar argument that, since we do not have the capacity to say 'no' when someone is bleeding, we must require people to protect themselves in advance.

Even the University of Chicago is one of the inveterate weaklings on this score. One reason why universities have compulsory pension plans for faculty, and do not simply offer pensions as an optional form of remuneration, is that we do not want somebody coming to us at age 72, having spent all their money, saying: "Look, I served you for 43 years. I've been a little dissolute. I've made mistakes, but you can't let me starve. You have a duty to help me". We would not like having to say 'no' publicly to such a person, and so we require compulsion for our own protection. We tend not to give people lump sums until age 65, because

lump sums can be dissipated. At Chicago, most people are quite happy to be in the scheme anyway, and so the coercion involved in our case is not great.

But it is important to appreciate what is *not* being implied here. We may require somebody to have a pension plan, but at Chicago we quickly understood that there is no reason to have a single monopoly plan for all our pension arrangements. People are free to opt for equity investments, for fixed interest, for growth funds, and so on. There is a huge menu, and people can mix and match the plans as they see fit. Similarly, if we decide that we all must have mandatory first party cover with respect to accidents, it does not follow at all that we need a state-operated, state-funded plan. "Since negligence has a social cost, state funding is in" is a totally unwarranted leap of logic. Such a leap conceals a series of stepwise judgments, each of which has to be independently justified before the overall argument can be adjudged sound.

The problems of a state insurance scheme

What are the problems with a state-funded plan? I want to draw a parallel that is quite eerie. It is so frightening that, if I were you, I would be shivering in my boots. The parallel is with the American Medicare system, which has become a huge problem—one that in late 1995 helped temporarily to shut down the US government, an unanticipated benefit of sorts.

The Medicare report came out in 1965. Its basic message was that since private markets cannot deal with the insurance function, we needed a state monopoly to provide these services. The report added that the financial integrity of this plan would be a top priority. We would put in very stringent cost controls. The costs were projected to level out by the year 1973. This would be a splendid social innovation. The architects of Medicare did not pause to consider whether, given a state monopoly plan and the political process, the principles of fiscal integrity with which the plan was launched ceremoniously on to the high seas could actually survive 20 years of buffeting in the wind. Today we know that it did

not survive. The scheme first became waterlogged in a major way in 1973, when the political authorities said, more or less: "It would be very nice to limit the increase in Medicare costs to the increase in the cost of social security benefits. That is fair: we will just index it". The problem is that social security is based on a market basket of all goods and services which are increasing in price at one rate. Medicare is a basket of goods and services going up at a higher rate, in part because of the inflationary pressures generated by the system itself. The highest set of increases was indexed to the lowest set. So by that accounting change a 50/50 split between public support on the one hand and private payments on the other became a 75/25 split 20 years later. The whole programme turns out to be in a very serious financial state—indeed it is scheduled to go bankrupt, despite having a $100 billion surplus in its current account. The rate at which liabilities are growing relative to assets tells us that we will be falling over the cliff by the year 2002 or—if you are an optimist—by 2004. The debate is over exactly when the programme, in the absence of fundamental reform, goes belly up.

In New Zealand you made the decision to fund accident compensation by state mandate. Your next question was how it should be funded. And you made the same mistake that the United States made with Medicare. You assumed that if you could manage the system in the first year, you would be able to operate it soundly over the longer term. That assumption turned out to be very wrong.

Closed cases do not exit the system each year at the same rate as they enter. There is nothing that makes the accounts for one year separate from the accounts for the next year, or for the year after. And since there is a superannuation-type payment built into the system, client-friendly physicians will constantly certify a continuing state of disability in people. The malingering problem, which the lump sum common law damage payments tended to counter, becomes very large indeed. The workers' compensation system also used periodic payments but, unlike your scheme, involved intensive monitoring by the employer and insurer. When we begin to mix and match these programmes, the result is deep

trouble. We simply cannot have periodic payments unless we have independent monitoring. Accident compensation has thus seen a great deal of expenditure creep. New cases come in while the old cases stay.

A private insurer would have a means of dealing with this problem: it would ensure that the premiums for a particular year covered the future costs of all of the accidents for the year in which they occurred. Once that principle is established we have a degree of political protection against the pressure to change the benefit structure for past injuries. Since there will be no money in the fund to increase benefits, it will be necessary to make special appropriations. That will be rather difficult. Thus the system of separate accounts is a valuable means of resisting political pressures. That is also the way all private insurance companies work. In a competitive market, if we attempt to offload our risks on to future years, a competitor will enter the market and charge the 1985 insureds for the 1985 accidents only. It will not charge them for some proportion of the 1981, 1982, 1983 and 1984 losses in addition to the 1985 claims. The discipline of the market forces insurers to respond in that fashion. By contrast, the American Medicare system managed to work its payments sleight-of-hand in 1973—only eight or nine years after it came into operation. In the case of the New Zealand accident compensation scheme, the government in 1982 declared that it was all just a matter of bookkeeping, and that the scheme would henceforth work on a pay-as-you-go basis. Whatever was collected in a given year would cover the cost of running the scheme for that year, rather than the cost of the accidents incurred in that year. As usual this produced a short-term cost reduction and a long-term catastrophe.

In political terms, it is impossible to see this development as unrelated to the status of accident compensation as a public scheme. Every insurance scheme involving public payments that I have studied has eventually shifted from a scheme based on the principle "let's cover the cost of accidents in a given year with premiums collected that year" to a "let's run it off into the future" scheme. New Jersey, which had a state-assigned risk pool, had a statute that effectively barred the state government from

resorting to this trick. Yet within three years political pressures caused them to do so. After accruing around $4 billion in liabilities they decided that an unfunded scheme was not a very desirable scheme for the state to run, and so they imposed taxes on a wide range of activities, and tapped unrelated insurance reserves, to make up the difference.

Thus I do not believe that abolition of the tort system in New Zealand was the primary error. The enormously troublesome development was the creation of the state-operated monopoly plan—the giant non sequitur in the Woodhouse report. What should be done about it? Frankly, some breaking of china is bound to be involved. Once the wrong system is in place, it can only be rationalised by a decision to revert to the more prudent accounting method. This still leaves residual liabilities to be handled. I would urge that, whatever you do with the tort system, you simply announce that the only party in New Zealand that will be barred from running an insurance and accident compensation fund is the government. Anybody else could enter the market and start a fund, but the government would not be allowed to play with matches. Such a rule would at least ensure that the insurance job gets done correctly.

There is a second, almost inevitable, problem with a public system. As a rule, we want to impose liabilities or taxes on those enterprises that create externalities. Workers' compensation was handled by contract within the firm, without external subsidies from the government or cross-subsidisation between firms. Once we introduce mandatory levies and a single monopoly, the second cost—in addition to deferring current obligations to some future period—is that somebody will game the system and manage to extract some degree of cross-subsidy. This development, too, follows as night follows day. In New Zealand's case, the cross-subsidies are pervasive and of unknown magnitude, because of the absence of competitive pressures to discriminate according to risk. This creates a series of deadweight losses which are obscured from view if we simply look at the financial position of the overall system. In any attempt to privatise the scheme, the challenge would be to find a way of unwinding all of these cross-subsidies. We would not wish to leave employers to

bear the risk of all worker injuries, including those arising in non-work related situations. And while we may or may not decide to collect them from a single source, our aim should certainly be to send the premium back to the individual.

Another problem inherent in state systems is the tendency to use the same fixed premium for everybody. This is done on the grounds that discrimination according to risk is unfair. It leads to implicit redistribution between risky and non-risky individuals, which increases the overall welfare losses from the system. In that respect, too, the system is very wasteful.

Conclusion

Let me now summarise how I would propose to reform the system. First, we need to decide how we wish to reform tort law. In stranger cases and highway cases, I would personally go for strict liability rules, very tight defence rules, automatic allocation rules and rather simplified adjudication. Once we have a liability system, the key principle on the insurance side is that funding must be voluntary. We would keep the deterrence function of insurance by saying that, if somebody is a severe risk and cannot obtain insurance, he or she simply does not undertake the relevant activity. We do not require insurers to provide a person with insurance in order for that person to be able to drive. We put it around the other way: if somebody cannot obtain liability insurance, that person is not allowed on the highway. Other transport options will be available. That is the way to run an insurance system with real deterrence. If we make insurance compulsory, any deterrence function disappears altogether. Indeed it becomes anti-deterrence, and has exactly the opposite effect to that intended.

Within the second category of tort, i.e. in the case of consensual arrangements such as employment, parties should be allowed to mix, match and roll liability any way they see fit. If they are allowed that freedom, the common law system will be found not to compare favourably with the range of contractual alternatives. The alternatives will tend

to involve broader coverage, lower damages and essentially weaker defences, and can be handled through administrative and arbitral resolution.

Once we have done that, the insurance will now follow the basic liability and we could concentrate on the plaintiff's side. Here, if we have a strong paternalist impulse—which I do not share—we could make insurance mandatory. But we should do that by allowing people to enter various voluntary markets and acquire the type of insurance they want. The Achilles heel of this approach is the problem of how to handle the hard-to-place risks. Do we have an assigned risk pool? The moment we do, the whole scheme begins to unravel again. That is the great advantage of not having insurance mandated: we would actually get very high levels of coverage by keeping costs down.

To conclude, my view is that the New Zealand accident compensation scheme is fundamentally flawed, although some of its consequences are desirable. Many of the criticisms Sir Geoffrey Palmer has made of the tort system are certainly correct. However, the response involving free contracting will generally be superior to any response involving regulation.

Commentary by
Sir Geoffrey Palmer

IT IS A REMARKABLE AND INTERESTING CIRCUMSTANCE that Richard Epstein should be speaking here today, since he is a University of Chicago professor. In 1964 there appeared in the United States a book by Keeton and O'Connell entitled *Basic Protection for the Automobile Victim.* That book focused attention all around the world on the deficiencies of the tort system. It led the Woodhouse Commission—which had been set up in New Zealand at that time—to go to the United States and visit the University of Chicago. Two University of Chicago professors—Harry Kalven and Walter Blum—had written an excellent book entitled *Public Law Perspectives on a Private Law Problem*, which was essentially a commentary on the Keeton and O'Connell book. They analysed the very great difficulties we get into once we start down the road of reforming the tort system.

The great thing about that book is that it takes students through the development of the common law of torts, which is essential to understanding this problem. Many analysts in New Zealand—including some in the Treasury—have not understood the common law of torts, and therefore have failed to appreciate the motivation for the whole accident compensation movement. I am in total agreement with what Professor Epstein said on that subject. The history of the law of torts, as laid out in Professor Epstein's own textbook, takes us from trespass to negligence to strict liability as a common law development.

We get students to think about the principles of liability. If one party does something to another party, when should that first party be held

liable? What is the principle upon which payment should be made? There is a thirteenth century English case, cited very early in Professor Epstein's book, involving an assault. Somebody knocks on an innkeeper's door and demands that the door be opened. The person has a hatchet. Unsurprisingly, the person inside gets extremely nervous. There is no physical striking, but it constitutes an assault because the common law is sophisticated enough to regard this as a tortious action, impute a legal damage and give a remedy.

When we start applying principles of tort law, we inevitably get into a debate about the competing theories of liability. Should the system be based on fault or negligence, or should it be based on what lawyers term strict liability? Professor Epstein wrote a very interesting and elegant piece, very early in his career, arguing that strict liability should take over the whole of tort law, and in the United States it has already taken over much more tort law than it has here. Product liability law in the United States is strict liability. Our common law of torts knows nothing of strict liability for dangerous and defective products. Indeed, when New Zealand manufacturers are told about what they may face in the US market, they shudder at the thought. Product liability was one of those judicial reforms made by common law judges, particularly by Roger Traynor in California. The judges said that negligence was not enough to deter dangerous and defective products, and that strict liability was needed. Yet when I look at how strict liability has worked out in the case of dangerous and defective products, I worry considerably. The case for strict liability is in some ways attractive, because it means that more plaintiffs recover. However, there are serious practical questions involved in deciding who pays what to whom.

A very interesting book has just been published by Donald Dewees, David Duff and Michael Trebilcock, entitled *Exploring the Domain of Accident Law: Taking the Facts Seriously*. Trebilcock and his co-authors have spent many years studying how the tort system performs empirically, which is not an easy undertaking. However, the conclusion of this book is very bleak about the effectiveness of tort law. In an article I wrote

last year in the United States, I actually argued that the American tort system was such a shambles that tort should be abolished altogether, without any replacement. We should allow private institutions to work out their own replacement arrangements since we can not agree on a collective solution. I argued that abolition of tort—and allowing whatever would then happen to take its course—would at least be an improvement on the current system.

So there is no disagreement with the conclusion that we need serious reform of the tort system. In New Zealand, however, things developed in a very different way from the United States. And when we come to the second part of Professor Epstein's analysis, it is important to appreciate some of the differences in political culture between the United States and New Zealand. Historically, there has not been any assumption or evidence that New Zealanders are opposed to state action. Indeed, in this country there have been some Labour governments which thought that state action was an extremely good thing, and that the state should do many—if not most—things for its citizens. That was never the case in the United States. It has never had a Labour government, nor socialist political movements of any substance. When the Woodhouse report came out in New Zealand, the Labour Party greeted it with quiet enthusiasm and said that it was democratic socialism. But the scheme was actually implemented by a conservative National government, which was dominated by farmers. For a number of reasons, farmers are often attracted to socialist solutions.

Common assumptions lay behind such developments. The pattern of income maintenance that had developed in New Zealand since the 1938 Social Security Act involved a large number of people being paid a large amount of money by the state because they were thought to be in some way deserving. This was called the welfare state. It was more highly developed here, in terms of the size of the transfers, than anything Franklin Roosevelt introduced. In a tradition of that sort, if the view was taken that the tort system was not working, it seemed natural enough to attempt to mesh its replacement into that comprehensive system of

income maintenance. Of course the welfare state was later supplemented by a retirement scheme of unbelievable generosity. That scheme is now being managed somewhat better than formerly, but it still makes the transfer payments involved in accident compensation look quite small.

Thus while the political culture in New Zealand may be changing, in the past we have accepted a high level of collectivist solutions to the misfortunes of individuals, and have regarded them as a state responsibility. Given the acceptance of that political principle, the problem is turned on its head. It is no longer seen as a tort problem but as a problem of income maintenance, and the issue is how that should be managed. These days the question of the appropriate degree of state involvement in the scheme is legitimately debated. However, when it was being put in place the question was never asked, even by the National government. Any replacement scheme is a substantial intellectual challenge for policy, because the tort system still dominates this issue from its grave. The measure of damages in tort has a great deal to do with the replacement system we provide, and with the generosity of its payments, because if we abolish tort we must in some sense match it. That is why our analysis must start with tort.

But New Zealand is now in a very unhappy no man's land with the accident compensation scheme. It is no longer based on the principles it was founded on, and people are playing around with it at the edges in ways that are unlikely to produce a satisfactory outcome. There remains a great deal of support among the New Zealand public for the proposition that suing people in tort was not a very good idea. That was the essential reform, and the question now is where we should go from here.

Discussion

Richard Epstein

In New Zealand the tort system and the social welfare system were never clearly separated, and that is always very dangerous. It was assumed that you could have either a tort system with entirely private mechanisms, or a state-funded public insurance system. Yet there are severe drawbacks to both of those polar options. I myself favour a strong modification to the tort system, even if I would not go as far as to advocate a no-fault regime. US tort law as it applied to industrial accidents was a huge and ungovernable tangle. That is clear from the fact that unions and management were contracting out feverishly from it before it all became regulated by the state. The state regulations simply ratified the preferred contractual form, which is why workers' compensation turns out to be viable. I have nothing against this outcome. But we should remember that the compensation system has associated incentive effects on both parties that are very powerful. The problem with industrial accidents is that we need to find a way to make employers and employees behave optimally at the same time—the simultaneity problem. No single set of rules enforced by transfer payments will have perfect incentives for both parties.

The voluntary workers' compensation system operated as follows. There was external monitoring by safety committees of workers and management. In addition, payments to workers were deliberately designed to leave them less well off than if there had been no injury at all. That

was an integral part of the scheme—not a coincidence or a failure of generosity. It was done that way so that workers would know that, despite the provision of compensation, they needed to be careful because they had something to lose if injured. Under these circumstances the incentives for workers to alter the severity or the probability of injury were very high. Moreover, the firm would think: "If we do not ourselves take precautions, our compensation payments will be large enough to really sting, so we are better off taking safety seriously". So by having a strict liability system for work-related accidents with reduced damages, incentives on both sides are established.

In addition, that system has the advantage of weeding out of the workplace people who do not belong there. Guido Calabresi's favourite example is that a future pianist is unlikely to work in a mine if flat damages for injuries are the rule. When such a person's hands are damaged, the opportunity cost is vastly greater than it is for the average person. There is thus a very powerful sorting and signalling effect in this system. Moreover, the adjudication process bears no relationship to the common law. It is typically done consensually by arbitration, with representatives from both sides. They try to exclude appellant reviews. There are different rules of evidence. There is nothing resembling a common law jury. They get an adjudication within weeks or even days, rather than years, and so escape the queuing problem. And there are no cross-subsidies from other sectors of the economy because every mine and every plant must operate on a self-contained basis. That is a very different set of principles from the traditional view of workers' compensation as a social welfare system. It survived when regulated because the regulation had the right form. Where the numbers and formulas in the compensation schedules were not doctored so as to compromise the incentive patterns, it worked well.

We were never able to achieve that with medical malpractice, because the incentive patterns are different. In medical malpractice, patient precautions play a relatively small role. When people are about to go under an anaesthetic, we do not usually remind them to behave well.

There are some problems with respect to post-operative care. And there are multiple inputs—the diagnostician, the anaesthetist, the surgeon, and so on. Every effort to introduce no-fault in this area has failed. If a physician misses a diagnosis that nobody else could have made, should she be liable? If so, there would be so much money being paid out that the cost of insurance would become crippling. So instead we retain clear boundary lines. In the Swedish plan, the New Zealand plan, and all of the proposed American plans, everyone without exception is driven back to negligence when it comes to diagnosis. And negligence should be determined through protocols established by custom, rather than through one of those weird cost-benefit tests where the strict liability rule re-enters in disguise.

Thus in reforming the system I would disaggregate torts into stranger cases, highway cases, medical cases, employer cases and product cases. They would all operate under contract. But the contracts would be very different—reflecting the different inputs, different capacities for avoidance, and different alternative mechanisms of complementary and supplementary control. I am not simply saying that we should take the common law of trespass and carry it over. I think Sir Geoffrey made a mistake in attributing all the problems of American tort law to strict liability. There are two heads under which liability is determined for prima facie cases. One is the definition of a defect. The other is the question of whether or not the plaintiff needs to show negligence—which is much more sympathetic for the defendant—or whether there is strict liability for a defect. Tort liability can expand either by changing the defect definition or by moving from negligence to strict liability. This essentially gives us an interactive function in which these two parameters combine together.

My favourite illustration is cigarettes, and it is instructive to look at the experience of the cigarette industry in the light of the two dimensions of defect definition and negligence. In the case of cigarettes, by 1964 the basic common law tradition had laid down strict liability for defective cigarettes. A defect was the condition resulting from somebody putting, say, cyanide into the cigarette along with the tobacco, as with a snail-in-

a-bottle incident. On this definition, only around five or ten cigarettes are defective out of the 600 billion sold each year in the United States. Most of these are detected with the first puff, at which point the obvious course of action is to stop smoking and to demand a new pack. The defect liability under this regime—which is strict—is, at a guess, somewhere between $100 and $200 in a multi-billion dollar industry. This is clearly not what the cigarette industry has been resisting. The attitude of the industry is that if consumers receive a defective cigarette they get sent pack after pack and box after box as compensation. (Indeed where there is a hint of a broader defect, the industry has gone to great lengths to remove huge quantities of unsold products from the market, to preserve brand reputation.) Companies stand by their product. They say they are not prepared to make a defective product, and that if they did not have a strict liability regime they would adopt it voluntarily, at greater cost to themselves.

However, the new legal regime is a negligence regime. A defective product is defined as one that, taking into account all of its attributes, has some capacity to cause danger that is not justified by its benefits. In other words, we now have defect defined in terms of risk and utility. On that definition every cigarette in America may be defective, depending upon how we take into account the subjective valuations associated with smoking it. What kind of defence will negligence give us if all cigarettes are defective?

There has thus been a huge shift in the definition of a defect from the Traynor days—from the early days of product liability to the modern day. From meaning a product different from the one that we thought we had purchased because of some latent fault or contaminant, a defective product is now one that is not optimal given our views about the use and desirability of various alternatives. It turns out that once we shift to the new definition of defect, we always go back to negligence. A major area of expansion of tort liability in the United States in this non-contractual world concerns the crash-worthiness of automobiles. Huge sums of money have changed hands under this negligence rule, because

the plaintiff's astute lawyer in the light of hindsight will often be able to make a credible case given the legal standard. And many plaintiffs' lawyers reason as follows: "If they are telling me I can take a strict liability course of action, I won't take it. I always want to demonstrate negligence. I want that jury to understand what kind of a louse my client is up against, and I will present experts to prove it". That is where things are now at. Once we understand that, what happens? To the extent that manufacturers want to reintroduce negligence into product liability law, I believe they are simply jumping out of the frying pan and into the fire. We need to work instead on the defect definition.

Let me give you an instructive illustration. There was a case called *Collins v Uniroyal* in the United States, in which the Uniroyal Tyre Company said, as it were: "We need to market our tyres. One of the ways we can do that is with warranties. And one way to provide a warranty is to back ourselves. We can give a warranty saying that if somebody is driving on a Uniroyal tyre, and it breaks up, that person will get compensation unless the tyre has been sabotaged. The compensation will be a new tyre and there will be no need to prove anything". It was a type of no-fault system, voluntarily assumed by the manufacturer. The issue then came before a court. The court in effect said: "This is a wonderful programme. We will accept half of what you are doing. We accept your willingness to give complete, comprehensive coverage without proof of defect". But in addition it said: "It is absolutely unconscionable that when you expand liability in this fashion you deny full tort coverage. You've given them a free tyre; we're giving them a free tort".

As a consequence every one of these contractual warranties was gutted from within. They kept the coverage term and got rid of the liability for damage term. The courts had not recognised that manufac-turers could perform multiplication. The net result is that since that time there has not been, to my knowledge, a single voluntary warranty of this sort on the market. Thus a potential consensual arrangement has been curtailed. I have talked with a number of companies who say to me: "Why don't we just introduce our own no-fault system. We have a good

product that we're willing to stand behind. We can signal that we're better than our competitors by giving better warranties". My response is to ask them whether they know the rules of unconscionability. Once I have explained them, they just fold up their notebooks and say: "We have enough problems with the tort system already. We don't need self-inflicted wounds".

Consequently, we could make a great improvement to product liability law by a statute which says that if a company gives a warranty, its terms should be decisive and conclusive in all respects. Those terms would include basic coverage, conditions default and damage limitations. This would lead to amazing transformations in the marketing of goods. I do not know how much publicity there would be but it would have all the desirable signalling effects. Currently there is no voluntary market in these safety features because, having opened up the door to liability in the way I have described, we do not just slide down a hillside as regards liability. We fall off a cliff.

So here we have another illustration of a problem which does not occur in other areas of tort law. It was never a problem with industrial accidents in the same way. But in the case of mass marketing, the original impulse of businesses was to overcome privity by putting themselves into direct contractual arrangements with their customers. In his ignorance, Traynor said that businesses were running away from their responsibilities, and were trying to insulate themselves from liability. It was the anti-contractual bias of both product liability and workers' compensation that was the key judicial mistake. If we want to make an innovative reform, we should allow people to voluntarily choose to have strict warranties—no-fault liabilities, no proof of defect, no nothing—on condition that they limit their damages and have essentially what is implicit in all default systems, namely discontinuing the use of a product once a defect is discovered. In other words, after that Uniroyal tyre blows, we cannot keep driving on it. We must take it off and bring it back for substitution. Standard consumer warranties also work for physical injury. If we recognise that the tort issue needs to be disaggregated, and that all of the

common law rules developed originally in stranger cases do not carry over to consensual cases, then we will understand the essential problem in many so-called tort issues to be one of optimal contractual allocation—the assignment of certain kinds of market risks or physical injury risks, some of which are sudden and some cumulative.

We should think very seriously about the cumulative trauma question. How did you think about it originally in your no-fault scheme?

Sir Geoffrey Palmer

Basically it was ignored, because the old workers' compensation methods of handling it were taken over. Our scheme had its origins in the defects of workers' compensation. The Royal Commission was set up because that system had become so mean that there was considerable political resistance to it. Our workers' compensation system was quite different from the American one. We had an additional ability to sue for personal injury damages. We could pursue both remedies to judgment, which meant that the workers' compensation periodic payments fuelled the common law actions. By contrast, the basic deal made in the United States was that people gave up their right to sue and received instead the guaranteed workers' compensation benefits. That was never the position in New Zealand.

Richard Epstein

Incidentally, that was the explicit quid pro quo of the original voluntary contract. The employer said that workers could not have it both ways, that is, keep compensation when negligence was not provable, but then get the larger tort award when negligence was provable. But the integration of tort and workers' compensation created complications with respect to third party suits. Suppose somebody drives a truck into a factory and injures you. The compensation rule is that you could sue the truck driver on the ground that you only surrendered your action against the employer, but not against a third party stranger whom the employer had no incentive to protect (and from whom the employer might recover some of its expenses). When, however, that third party

ceases to be a passing truck driver and becomes a supplier of the employer, the law becomes very dicey. We can sue the third party in tort, because we have this non-contractual regime of product liability. Remember that the privity requirement essentially meant that people needed to take action through contract against the person with whom they traded directly. The trouble is the modern American tort system broke that down, without even knowing why it was there. There was never a single serious analysis of the role of privity in resource allocation at the time judges decided that it was bad. A classic illustration was Prosser's analysis of the privity doctrine. He called it: "Privity, that wishbone in the throat of the law".

Sir Geoffrey Palmer

It follows that the American courts—at least from our perspective in New Zealand—are engaging in activities we would think are more appropriate for legislatures. They suspend a great many things, changing the face of the common law with radical decisions that our judges would not make. Here they would say that that is the role of parliament. I suspect that many of the attitudes that people have about these matters in the United States actually originate in the courts and the judicial system, whereas in New Zealand they are directed to parliament.

Richard Epstein

That is very true. There are two ironies. Sir Geoffrey mentioned the whole business of the integration of separate systems. We stumbled on the question of how to integrate the tort system with the workers' compensation system in product liability cases. If we were doing it as a pure contractual system, it would be a network of contracts. A manufacturer might sell a capital good to an employer. There would be a series of provisions, the principal one of which would say, I think, that if the employer inspects the good and accepts it, the manufacturer is released from liability associated with defects in the good even though the employer will bear a potential liability to his or her workforce. That is a standard way of handling the problem. The worker will then operate

the capital good and the workers' compensation bargain will apply. Because of the privity limitation, the worker will know that there will be no liability going back to the manufacturer. So we effectively treat privity as a forcing doctrine: it means that everybody now has to do business with the immediate party to the contract. If we proceed in that manner, the next question is whether the employer can obtain an indemnity against the manufacturer in addition to the right of inspection. How that will play out will depend on many things. There will be many clean deals, particularly as a capital good in a factory has a long life, and the manufacturer who sold it is not in charge of its maintenance, its alteration or its integration with other equipment. This will often be the optimal contractual solution, given that the party in possession of the equipment is presumptively always the best placed to bear the risks of defects or injury.

Where there is a third party remedy against the manufacturer, the opportunity for tort action will arise. We will then need to discover whether any of the modifications to the equipment, or changes to its patterns of use, will sever the causal connection with the manufacturer. In reality, we know perfectly well what the answer to most issues in product liability is likely to be. Intervening acts in proximate cause cases are always decided by juries, which means the plaintiff is likely to score heavily. There have been some bizarre cases of machines being reconstructed, having safety valves removed, and so on, where the court found that it is almost always foreseeable that somebody will be a first-class idiot while holding the manufacturer responsible for that person's behaviour. The American position has become insane: the party least able to avoid the harm has become the dominant source of liability. The manufacturer therefore thinks: "I have to get an indemnity". Then the accident victim sues the employer, and in turn the employer takes action against the manufacturer over the indemnity. The result is a plaintiff who is successful with the tort action. Then the employer turns around and says: "You have this tort recovery. You have to give me back my workers' compensation cover". So instead of having one action, suddenly we have a tort

action, an indemnity action, and another indemnity action. All this senseless litigation is proceeding in all directions on the wrong principles.

If we do not like privity, we can start having direct contracts between manufacturers and consumers. When drugs and pharmaceuticals are sold in the United States, companies always try to have direct contracts with the customers. They literally write on the packets: "If you open this, you agree to such and such conditions with respect to the use of the contents". We always end up banning these kinds of contractual arrangements, yet we should surely be attempting to facilitate them. The way to handle this problem is through network contracting. The privity doctrine seemed to work fairly well. The American judges who rejected it never understood the way the system operated. They would tinker with one part of the system, and five years later they would tinker with another, and in the end they created a situation where the only winners were the lawyers. I would not want to defend the New Zealand system, since no-liability in the product area is not optimal either. But no-liability brings us closer to the optimum than American tort liability. Our real task is to define ways to get at the latent defects that cause harm in ordinary use. That is the magic formula for a responsible set of product liability rules, because the latent defect cases are cases of information asymmetry, to use the modern jargon. One party does not know about the defect and the other party has the capacity to discover it. And the ordinary use criterion handles the problem of plaintiff misconduct.

The third condition in the original synthesis was that liability would result only if the product was sold in its unaltered and original condition. This was to handle the problem of third party misconduct. Thus the 1903 American tort synthesis—which effectively let a small window open—was closer to the social optimum than all the so-called sophisticated approaches that came later. Ironically the older judges, who did not know any economics, had the habit of getting it right on economic grounds, while judges who think they know a lot of economics often manage to mangle the law beyond recognition. Ignorance is not necessarily bliss. But the efficiency rationales put forward for the tort

system tend to be vigorously interventionist in ways that have very undesirable side effects.

Your position is that if you cannot get any insurance, you should not be in the activity. At the Accident Rehabilitation Compensation and Insurance Corporation, one of the largest costs involves accidents by young men between 18 and 25 who make errors of judgment while driving motor vehicles. They go through the windscreen and are head injury patients for the rest of their lives. That sort of injury costs between $5 million and $10 million a case. Under our system they pay their insurance with their motor vehicle registration each year, and they get the benefits. If you did not have that system, and insurance was voluntary, they would not insure because many people of that age group simply do not bother. It never occurs to them that an accident could happen to them, and they would still drive. How would you see them covered?

Richard Epstein

You have raised the fundamental question of what we are prepared to do with uninsured victims of serious accidents. There may well be no will inside the system to let them rely on private resources and voluntary charity. Of course if we actually did take that option, the first such accident case would have an incredible impact on that type of behaviour. Deep down I believe that is the right solution. In terms of incentive effects, if people see the desperate situation of the first quadriplegic, the number of motorcycle accidents will soon fall sharply. I even think we could give publicity to people in that condition who have insurance, on the grounds that getting badly injured is still a terrible fate. Having $10 million in insurance does not compensate for spending the rest of your life as a quadriplegic.

Forget about people going through the windscreen. What about the person hit by a truck—the innocent person walking across the pedestrian crossing?

Richard Epstein
If that person gets hit by a truck, and the truck driver has no third party insurance, then under common law it is back to the first party mechanism—first party insurance and the right to sue.

But the driver is not insured. We're talking about the 18–25 year old who does not think. How do we deal with this case?

Richard Epstein
Under those circumstances we need to tell people that when they buy their general first party insurance they should ensure that the provisions are as good for uninsured accidents as they are for being struck by lightning with the same consequences. The question I would pose is this: suppose that same person was struck by lightning the moment before she was about to be hit by another driver. How should she have protected herself in advance? She should have evaluated whether she wanted to buy comprehensive catastrophic insurance of one type or another, and whether that would be available in the market. Typically if the probability of injury is low enough, people can get cover at reasonable rates. That is what most of us would do. What type of cover should people get? Well, in some instances there should probably be no cover. The risk of becoming a quadriplegic as a result of an accident is a risk that should be covered, because the person remains a sentient being suffering all sorts of pain. In the case of permanent vegetative states, my own view is that the state support system should be strictly palliative and generally nothing should be done by way of so-called medical improvement for people in those conditions. That is a judgment we will have to make—it is just not worth the resources. Accidents are in fact a small proportion of those cases. There are now a large number of people getting into such states as a result of sickness or disease. The mechanism we put in place for them should be the same as the mechanism for people injured in uninsured accidents. And it will not be an easy decision, because there will not be enough money inside the system to rehabilitate them to the level

we would all desire. Whatever social mechanisms you are prepared to use for non-accident compensation scheme first party cases of trauma will be the same ones you should use for accident cases once you abandon the ACC scheme.

Returning to the issue of premiums, I do believe there is one initiative we can take. Politically, you will not be able to turn young, uninsured accident victims away, nor the person who was hit on the pedestrian crossing. That is the reality in the United States, and we are tougher-minded than you. Without discussing how the social welfare net might cope with these cases, a step with respect to short-term injury is to calculate the premium payments you require of the 18–25 year old at a higher rate than those for people in a lower risk category. Uniform rates are characteristic of a state system, whereas in the United States premiums would often vary according to risk, which is arguably both fairer and more effective.

Sir Geoffrey Palmer

There has been a long history to the question of how far the cost of accidents should be internalised in the New Zealand system. There have been several obstacles to developing a sophisticated system. First, the statistical basis on which to calculate premiums on a risk basis has been very limited. There are also a series of political problems. Very early in the days of the scheme, there was an effort to target motorcyclists, a high risk category. They literally got on their bikes, and rode round and round parliament without their silencers on. It had an effect.

Another problem is that sports such as rugby cause a considerable number of injuries, as the casualty wards of hospitals on Saturday night and Sunday morning in winter bear witness. Internalising that cost—which economically would be a sound step and fully in line with proper insurance principles—would be very difficult politically. Admittedly, now that rugby is a professional sport the position may be different.

Richard Epstein

I can understand the political issue created by sports injuries, but what about the attitude of those paying the bills? This is an international problem. The impulse with regard to rate classification inevitably is towards everybody getting covered at a flat rate in a politicised system. Because the formal coverages are identical, people assume that there are no cross-subsidies, yet in practice they are enormous. The lower cost people try to exit the system but we force them to stay, and so inequities and distortions are created and the insurance market is no longer able to play its proper role. The assigned risk pool in the United States is a slightly different version of the problem that you have here. All I can say is that if you yield to the political problem it will drive everything, and the scheme will remain in a state of crisis. The only thing you can do intellectually is to tell people honestly that this *ex post* equality is an *ex ante* catastrophe. Even if you keep your existing accident compensation framework and do nothing else, you should at least introduce differential rates or surcharges. The registration fee for a motorcycle should be higher than for a motor vehicle. In the case of sports accidents, you may not wish to charge the players but you should charge the teams, or the clubs, and try within your framework to have differential rates.

Private markets do just this. They are utterly unsentimental and, oddly enough, their lack of compassion is their greatest strength. Whenever you socialise the function of provision, either through regulation or through direct administration, you will get cross-subsidies, inaccurate price signals, and ultimately a misallocation of resources which makes everyone poorer.

The Swiss have a system of mandatory insurance, but a person can obtain cover from any insurance company. Is that a possible approach?

Richard Epstein

The last aspect is surely right. The moment we require people to take insurance and leave it to a competitive market, we will start seeing risk variations emerge. But there are still issues that will have to be faced.

For example, can an insurer turn down a motorcyclist, if she will not pay X times as much as a car driver? And if somebody fraudulently fills out an application, can the insurer repudiate the policy on traditional grounds? Nancy Reagan's "just say no" does not apply only to drugs. It also applies to people when they are told they need to run through a given set of hoops in order to be eligible for certain benefits. If they do not run through the hoops, but then are still able to recover the benefits, everybody soon comes to understand the nature of the game.

There are many American illustrations of this point. There are very expensive policies for flood insurance if you happen to live near a coastal area. People move to a coastal area, and they say: "I'm not going to buy this insurance". After their house is wiped out, the government comes along and bails them out as if they had bought the insurance. In the next period other people say: "We get full protection without the premium. We might as well save the premium, because Uncle Sam is writing us residual guaranteed political risk insurance". The ultimate effect is disastrous. Huge numbers of homes are built in hurricane paths, or on fault lines, or on contaminated nuclear waste sites. It has become a multi-billion dollar problem. My position has consistently been: "Don't bail them out. Just don't do it". But the insurance industry foolishly argues that there should be mandatory standards, and that these standards need to be uniform. So if somebody is building in the middle of Wyoming—where there are no natural disaster risks—it is still necessary to build a hurricane-proof house, because that is the only way somebody in Florida can be required to do the same thing. So we get inefficient insurance driving inefficient locational decisions driving inefficient construction decisions.

Sir Geoffrey, when Professor Epstein said that the only person who should not be allowed to supply insurance is the government, I got the impression that you agreed with him, but that you were concerned to point out that in New Zealand there has been a strong philosophy of government intervention. Is that what you were saying?

Sir Geoffrey Palmer

It depends on whether you regard our system as an insurance scheme. It was not designed as such. Certainly Justice Woodhouse would never have accepted it as a system of insurance. It is a really a system of community responsibility, not an insurance system in the way that term is understood in the private sector. Though the word 'insurance' is now placed in the statute, I do not believe that the essential character of the system has changed. It was a cosmetic move.

I believe the state should not run insurance schemes. Selling the State Insurance Office was a good idea. It seems to me that insurance is a private market activity and insurance should be run by private markets. But here the state has made a decision that private market activity will not provide protection against the social effects of accidents. The state has intervened to say: "Thou shalt pay premiums and thou shalt get benefits".

Richard Epstein

The real point is that social insurance is insurance with cross-subsidies, while market insurance bleeds those subsidies out. The moment we decide to have a system of social insurance, we must have a system of government intervention, even if the system is privately operated. That is the Medicare problem. Medicare is a defined benefit programme. There are constant premiums and differential benefit rates for all individuals. The subsidies within the risk pool are always concealed, a situation which could not persist in competitive markets. Social insurance should not be seen as a category of insurance. Social insurance should be understood as one word, not two. It has phonetic but not intellectual similarity to genuine insurance. Because subsidies are normally inefficient and reduce economic welfare, social insurance subsidies will also be inefficient. True insurance markets do not misallocate resources. We have to ask ourselves whether social insurance is justified by all the other values talked of by its proponents.

Typically the most important externalisation from social insurance is inter-generational. Poor people not yet born will be picking up the

pieces of systems such as the ACC and Medicare. It is clear what has happened in Medicare: people who are now dead had a wonderful trip, starting in 1965, and enjoyed every moment of it. People who will be 65 in the year 2002 will find the road a good deal rockier than it had previously been. In New Zealand, your unwillingness to accept current funding of current accidents means future generations yet unborn will be taxed in order to carry the burden. If I were trying to sell the alternative idea—the anti-social insurance programme—I would stress very strongly the inter-generational inequity of the current regime. Even a philosopher identified with the political left, John Rawls, has made the point about inter-generational equity: he sees "thou shalt not steal from the unborn generation" as a moral imperative. This argument has a powerful emotional appeal.

Sir Geoffrey, I took you to be suggesting that Michael Trebilcock implied that tort processes would not give an effective deterrent.

Sir Geoffrey Palmer
Absolutely. That is one of his findings.

We have had two New Zealand examples that we could consider in this regard. Air New Zealand flew a plane into a mountain and everybody on board was killed. The flight coordinates had been changed but the crew were not told. If we had a tort system would it alter the incentives in that type of case?

Sir Geoffrey Palmer
In might in respect of that accident.

The second case concerns the Department of Conservation which constructed a faulty viewing platform that collapsed, causing the death of 14 people. What is the role of tort in that situation?

Sir Geoffrey Palmer

There is scope in that type of case—where there may have been what one could call gross or contumelious disregard for proper principles—to bring an action for exemplary damages under New Zealand law. The Court of Appeal has said that such an action survives the Accident Rehabilitation and Compensation Insurance Act 1992. In the case of Cave Creek, it is possible that a court might award exemplary damages if it found that such a breach had occurred.

Are you agreeing that a system in which people can be sued if they kill other people through negligence does have a deterrent effect?

Sir Geoffrey Palmer

No. The literature on that matter is very complex. As Professor Epstein said, complicated analysis is required because there are so many variables.

Richard Epstein

Let me break the problem down. Where the tort system works best is the area in which it was born. Somebody flies a plane and it falls on the roof of a house and kills everybody inside. I believe that the strict liability rule was correct in that case. I do not like defences to the effect that the house was built in the wrong location. But such stranger cases are a relatively small fraction of the total tort caseload. In the United States they are overshadowed by medical malpractice and product liability. When I disaggregated torts I gave you five or six different categories, each with a different solution. In the pure stranger case, the right solution is the tort solution, and the incentive effects will be generally benevolent. The Trebilcock analysis generally concerns product liability cases and medical malpractice cases, with some occupiers' liability and industrial accidents. Tort works best with motor accident cases. If we improved the rules in the way that I described, we could improve efficiency substantially.

I should mention an excellent book from the 1970s by H Lawrence Ross entitled *Settled out of Court*. He looked at how the claims system

worked in practice. In the small claims area, nobody uses an adversary system. Everybody works with rules of thumb. They are all strict liability rules. Ross said that every claims adjuster approved this system for the small cases, and everyone used it. The moment there was a serious accident it became a negligence case because it was going to court. And suddenly people were worrying about the epileptic fit, the momentary dizziness, and all manner of other behavioural antecedents. The predictability of the system collapsed.

My conclusion is that claims adjusters know best. Rather than having judges making foolish rules that comport with their rather exaggerated sense of morality, we should follow the claims practice. It should govern the big cases as well as the small cases, and then the big cases will disappear because there will be very little to fight about any more. The reaction from judges, when this idea was proposed in a case from California in the early 1970s called *Hammontree v Jenner,* shows the quirks of the American tort system. Judges had been willing to abandon the privity doctrine and change all of the rules of product liability through judicial activism. But when somebody proposed this marginal improvement with respect to accident cases they said that it was properly a function of the legislature. This proposal would have expanded liability, expanded compensation and reduced administrative costs, but they would still not touch it. Ross's book is very useful, because Trebilcock does not address this point.

Another weakness in Trebilcock's book is his failure to recognise that the reason our automobile insurance system is so inefficient is because the incentives are driven, not by the tort system, but by the insurance system which interacts with it. The insurance system undermines the tort system by essentially socialising risks. An assigned risk pool means that insurance does not perform any of its correct functions. It no longer accurately prices risks to the driver, nor does it allow bare risks to be excluded because underwriting is guaranteed.