

# findings brief

By Christal Stone

## Investment Returns and Size of Damage Caps Impact Rising Cost of Malpractice Premiums

### key findings

1. A national cap of \$250,000 could save 8 percent on total malpractice premiums, or \$1.4 billion annually.
2. The level of damage caps makes a difference; caps of more than \$500,000 increased premiums.
3. Investment returns affect malpractice premiums.
4. No other tort reform had significant effects on premiums.

Policymakers, health care providers, and researchers have given their attention to the most recent medical malpractice “crisis” characterized by rapidly increasing malpractice insurance premiums. After several years when increases were little more than the rate of inflation, *Medical Liability Monitor* (2005) reported premium increases of 10 to 49 percent, depending upon specialty, in 2003 and 7 to 25 percent in 2004.<sup>1</sup>

Many observers of the malpractice insurance market disagree on the cause of the problem or the appropriate solution to increasing malpractice premiums. Some argue that increased frequency and soaring rewards are to blame, while others attribute rising premiums to insurance company’s losses on investments during the economic downturn. A number of laws have been introduced that attempt to stabilize premium prices, damage caps being the most well-known, but their effectiveness has been unclear.

While the call for federal medical malpractice reforms has cooled with the change in leadership in the Congress, the American Medical Association and nine other physician organizations continue to identify tort reform as a

key element in reforming the U.S. health care system. Thus far, the Bush Administration has proposed legislation to impose a \$250,000 national cap on non-economic damage awards and many state legislatures continue to actively consider limitations on the size of medical malpractice awards.

Researchers at the Lister Hill Center for Health Policy, University of Alabama at Birmingham conducted a rigorous analysis to help eliminate some of the confusion created by the conflicting findings of past studies. In order to conduct a more comprehensive study on the effects of tort law and insurer investment returns on physician insurance premiums, the researchers examined the strengths and weaknesses of the different methodological approaches and tested how different results could be produced.

The research team, led by Michael Morrissey, Ph.D., Meredith Kilgore, R.N., MSPH, Ph.D., and Leonard Nelson, J.D., L.L.M., found that damage caps do have an impact on premium growth, though other tort reforms have either minimal or no effect. In fact, they found that the impact caps have on premium growth is related to the size of the cap. Damage



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caps set at \$250,000 or less in 2004 dollars were estimated to reduce internal medicine premiums by 25 percent, caps of \$250,000 to \$500,000 reduced premiums by 11.5 percent. However, caps of \$500,000 to \$750,000 *increased* premiums by an estimated 7.9 percent and caps above \$750,000 increased premiums even more. With regard to insurer investment returns, the researchers found that returns do play a role in the cost of premiums.

Morrissey and his colleagues believe that this study is important so that, “as the states and perhaps Congress debate legislation, they will have a rigorous analysis of the current environment in order to identify the effects that may result from changes in the law.”

### Purpose/Methods

There has been relatively little rigorous analysis conducted on the effect of tort laws on malpractice premiums since the early 1990s—an era that preceded significant managed care penetration and the economic swings of that decade. Given the substantial changes that have taken place in the market place, Morrissey and colleagues undertook an update of prior research, bringing the analysis current through 2004. The results of the research were published in *Inquiry* (Fall 2006).<sup>2</sup>

In order to conduct a rigorous analysis, the team could not rely on past efforts to characterize local and state tort laws and judicial decisions, since these were often inconsistent, incomplete, and out of date. To help eliminate the disagreement about what state laws were in effect when and where, an independent study was conducted of the statute and case law related to malpractice liability in each state from 1975 onward. An annotated listing of the damage cap laws, with dates of enactment and legal citations is available on the Lister Hill Center website, <http://images.main.uab.edu/isoph/LHC/MalpracticeTable.pdf>.

The researchers collected malpractice data from 1991 through 2004 and conducted three types of multivariate regression models simulating approaches taken in prior stud-

ies. The first set of models, labeled Type I, produced unreliable estimates since they did not control for the unobserved state characteristics, which can introduce bias.

Type II models included controls for state-level effects, but not unobserved trends over time. The impact of changes in investment returns was tested using a Type II model since capitol markets are national in scope and premiums are set annually.

The Type III models were preferred by the researchers since they controlled for state characteristics and historical national trends that could have an effect on malpractice premiums but not be related to changes in tort law.

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— Michael Morrissey, Ph.D.

Finally, the team simulated the cost savings if a national damage cap were instituted in all states currently without them.

### Findings

The researchers found that both damage caps on non-economic awards and investment returns affect the rate of growth of malpractice insurance premiums. This analysis provides evidence that malpractice premiums do, in part, depend on the performance of investments made by insurance companies. When investment returns were higher for the more conservative stocks found in the Dow Jones industrial average, premium growth was more constrained, but the performance of riskier stocks in the Nasdaq Index did not have a meaningful effect.

“This makes sense intuitively; when investment returns are high, firms have income over and above collected premiums and would be expected to keep premiums low in a competitive market,” explained Morrissey.

The researchers used the Type III model to examine the effect of caps on non-economic damages and the effect of certain states making inflation adjustments over time. They determined that caps have a significant effect on reducing the growth of medical malpractice premiums, supporting evidence found in past studies.<sup>3</sup> This effect is increased in states that do not adjust for inflation over time since their caps become more restrictive compared to states that make modifications.

The analysis found that the implementation of a new cap lowered malpractice premiums for internal medicine by 17.3 percent, general surgery by 20.7 percent, and obstetrics/gynecology by 25.5 percent. They also found that the level at which the cap was set made a difference. Premiums increased by 3.9 percent with each \$100,000 increase in the level of the inflation adjusted damage cap.

The only other tort law changes with any effect were statutes of repose, which limits the time period in which a claim can be made after an incident took place, regardless of discovery. None of the other malpractice-related tort reforms were found to have an impact on premium growth. Part of the reason for these findings was that few changes in the non-cap tort laws took place over the study period although evidence from other studies addressing time periods with more change did not find significant effects either.

Finally, a simulation of a national damage cap was conducted to predict the potential savings that could be gained on malpractice premiums. Morrissey stated, that the, “simulation results indicate that extending a national cap of \$250,000 on awards for non-economic damages to all states that do not currently have them would save \$1.4 billion annually, or about 8 percent of total premiums.”

### Policy Implications

The research conducted by Morrissey, Kilgore, and Nelson provide several important lessons for policymakers. First, because financial investments by malpractice insurance companies do affect premium rates, the state of the economy needs

to be taken into account when examining a malpractice “crisis.”

Second, more than 11 types of tort reforms have been introduced that do not involve caps, but none of them have had a meaningful impact on reducing the growth of malpractice premiums.

Finally, caps on non-economic damages do matter and the level of the inflation adjusted cap is particularly important. Restrictive caps are more effective at decreasing malpractice premiums over time, while high caps may produce the counterproductive result of raising premiums.

The savings that could be gained with a national non-economic damage cap of \$250,000 (in 2004 dollars) was estimated to save \$1.4 billion annually or about 8 per-

cent in malpractice premiums—a relatively tiny portion of overall health care costs.

“The tradeoff of establishing caps means that the severely injured who bring suit aren’t going to get as high of compensation,” stated Morrissey. “Policymakers must determine whether the savings in premiums justify imposing those costs.”

### Next Steps

Further research is needed to determine whether malpractice reforms can effect the level of health care costs by reducing the extent of defensive medicine. There also needs to be further research on the potential of other strategies to control the incidence and costs associated with medical malpractice events.

### About the Author

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