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SHOULD "TAX NORMS" BE ABANDONED? RETHINKING TAX POLICY ANALYSIS AND THE TAXATION OF PERSONAL INJURY RECOVERIES

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I. INTRODUCTION

Traditional tax policy analysis has focused on whether the particular tax provision under examination is consistent with basic "tax norms" such as horizontal equity, vertical equity, ability to pay and the ideal tax base, typically Haig-Simons income. These norms are not grounded, however, in more general ethical principles. This Article will argue that this is a fundamental flaw and, thus, special tax principles should be discarded as a method of evaluating tax policy. Instead, this Article recommends that the likely consequences of the policies under consideration should be determined and then judged under explicitly stated general normative principles. This approach can lead to tax policy recommendations quite different from those generated by traditional methods.

In order to explore the differences between the traditional and suggested approaches to tax policy, the analysis of the taxation of personal injury recoveries will be examined under both approaches. Under current law, damage awards for personal injuries generally are excluded from an individual's gross income.[1] The exclusion applies to damages received for monetary losses from increased medical expenses and lost earnings, and to damages received for non-monetary losses such as pain and suffering and permanent bodily injury.[2]

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1.   I.R.C. § 104. All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

2.   The Internal Revenue Code was amended in 1989 to eliminate the tax exemption for punitive damages associated with personal injuries not involving physical harm. Omnibus Budge Reconeiliation Act of 1989, Pub. L. No. 101-239, § 76641(a). It is unclear whether this amendment should be viewed as endorsing the exclusion of

The exclusion for personal injury recoveries is a departure from the tax rule applied to business injury claims. For business injuries, courts apply an "in lieu of" test, which looks to the nature of the claim to determine the tax treatment of damages received.[3]

If an "in lieu of" test were applied to personal recoveries, damage awards received for lost earnings presumably would be taxed as ordinary income because they replace taxable wages or salary.[4] The proper treatment of recoveries of medical expenses under such a test, however, is less obvious. Perhaps the recipient should be taxed on the amount received and then granted a medical expense deduction.[5] On the other hand, medical expenses arguably should be given tax-free treatment on the grounds that they replace exempt employer-provided medical services, or because they do not constitute gain because they simply restore the recipients to their pre-injury status.[6]

Damage awards received for pain and suffering also raise thorny problems under an "in lieu of" test. Full taxation might be proper on the theory that individuals have no tax basis in their body parts, so that all amounts received constitute gain. On the other hand, an exemption might be appropriate under a return of human capital theory or simply because the recipients are no better off than they were before the injury.

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punitive damages associated with physical injuries. Mark W. Cochran, *1989 Tax Act Compounds Confusion Over Tax Status of Personal Injury Damages*, 49 TAX NOTES 1565 (Dec. 31, 1990); Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143 (1992). In recent cases, some courts have held that the § 104 exclusion is limited to compensatory recoveries. *See, e.g.*, Commissioner v. Miller, 914 F.2d 586 (4th Cir. 1990); Kemp v. Commissioner, 771 F. Supp. 357 (N.D. Ga. 1991).

    3.   *See* Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110, 113-14 (1st Cir.) *cert. denied*, 323 U.S. 779 (1944); Sager Glove Corp. v. Commissioner, 36 T.C. 1173, 1180 (1961), *aff'd*, 311 F.2d 210 (7th Cir. 1962), *cert. denied*, 373 U.S. 910 (1963); *Tax Aspects of Settlements, Judgments, Antitrust Payments and Recoveries*, Tax Mgmt. (BNA) No. 121, at A-2 (May 8, 1989); MICHAEL D. ROSE & JOHN C. CHOMMIE, FEDERAL INCOME TAXATION § 2.07, at 23 (3d ed. 1988).

    4.   A recovery for an injury to a taxpayer's *future* earnings capacity, however, might be viewed as replacement of an asset in human capital. *See* Jennifer J.S. Brooks, *Developing a Theory of Damage Recovery Taxation*, 14 WM. MITCHELL L. REV. 759, 775-76 (1988); Dodge, *supra* note 2, at 151. The recovery of capital justification for the exclusion of personal injury damages is discussed in part III, *infra*.

    5.   Medical expenses currently are deductible to the extent they exceed 7.5% of the taxpayer's adjusted gross income. I.R.C. § 213(a). A deduction is less favorable than an exclusion from the tax base because a deduction is only available to taxpayers who itemize—and then only to the extent that the cost of medical treatment exceeds a specified percentage of the taxpayer's adjusted gross income.

    6.   An individual may be taxed, however, even on a transaction that itself does not represent gain since the conversion of cash into property generally causes the realization of taxable income equal to the amount received less the individual's basis in the property. *Raytheon Prod. Corp.*, 144 F.2d at 114.

Excluding pain and suffering recoveries from the tax base also might be supported under an "in lieu of" test on the view that amounts received replace imputed income from good health that ordinarily is received tax-free.[7]

Tax scholars have generated a large literature exploring these issues.[8] In general, these commentators have analyzed how personal injury recoveries would be treated under "tax principles" such as the "in lieu of" test mentioned previously, and then have considered whether any "non-tax" reasons exist for departing from these principles. There is a consensus in this literature that personal injury recoveries received as compensation for lost earnings should be fully taxed and that recoveries received for medical expenses should be tax exempt. Scholars are divided, however, regarding the proper tax treatment of recoveries for pain and suffering.

The central theme of this Article is that the basic approach to tax policy taken in the existing literature should be discarded because it is not based on any attractive general normative principles. Instead, a two-step method should be adopted. First, the consequences of alternative tax policies should be considered. Second, those consequences should be evaluated under explicitly stated ethical principles.[9]

Part II of this Article develops a simple model comparing alternative tax treatments of personal injury recoveries. The model demonstrates

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7. See *infra* part IV for issues raised in this and the preceding paragraph.

8. *See, e.g.,* Joseph W. Blackburn, *Taxation of Personal Injury Damages: Recommendations for Reform,* 56 TENN. L. REV. 661 (1989); Brooks, *supra* note 4; J. Martin Burke & Michael K. Friel, *Tax Treatment of Employment-Related Personal Injury Awards: The Need for Limits,* 50 MONT. L. REV. 13 (1989); Douglas K. Chapman, *No Pain—No Gain? Should Personal Injury Damages Keep Their Tax Exempt Status?,* 9 U. ARK. LITTLE ROCK L.J. 407 (1986-87); Mark W. Cochran, *Should Personal Injury Damage Awards be Taxed?,* 38 CASE W. RES. L. REV. 43 (1987); Dodge, *supra* note 2; Lawrence A. Frolik, *Personal Injury Compensation as a Tax Preference,* 37 ME. L. REV. 1 (1985); Bertram Harnett, *Torts and Taxes,* 27 N.Y.U. L. REV. 614 (1952); Robert J. Henry, *Torts and Taxes, Taxes and Torts: The Taxation of Personal Injury Recoveries,* 23 HOUS. L. REV. 701 (1986); Daniel C. Knickerbocker, *The Income Tax Treatment of Damages: A Study in the Difficulties of Income Concept,* 47 CORNELL L.Q. 429 (1962); Patricia T. Morgan, *Old Torts, New Torts and Taxes: The Still Uncertain Scope of Section 104(a)(2),* 48 LA. L. REV. 875 (1988); Malcolm L. Morris, *Taxing Economic Loss Recovered in Personal Injury Actions: Towards a Capital Idea?,* 39 U. FLA. L. REV. 735 (1986); Aharon Yoran, *Tax Aspects in Tort Compensation,* 22 ISR. L. REV. 37 (1987); Edward Yorio, *The Taxation of Damages: Tax and Non-Tax Policy Considerations,* 62 CORNELL L. REV. 701 (1977).

9. *See* Thomas D. Griffith, *Theories of Personal Deductions in Income Tax,* 40 HASTINGS L.J. 343 (1989); James Mirrlees, *The Theory of Optimal Taxation, in* HANDBOOK OF MATHEMATICAL ECONOMICS iii (Kenneth J. Arrow & Michael D. Intrilligator eds., 1986).

that, under plausible assumptions, it is desirable to tax recoveries for lost earnings and for pain and suffering, and to exempt from taxation recoveries for medical expenses. Part III of this Article considers the reasonableness of the model's assumptions and examines the impact of varying them.

Part IV compares the analysis of personal injury recoveries in the existing literature with the approach taken in Part II and considers the usefulness of traditional tax principles, such as horizontal equity, Haig-Simons income, and the "normal tax base" in analyzing the proper taxation of personal injury recoveries. Part V is a conclusion.

The conclusions reached in this Article regarding the proper treatment of personal injury recoveries are less significant than the methodology. Personal injury recoveries have been chosen not primarily because of their independent importance, but because the existing tax literature on such recoveries provides a good analysis of tax policy under the widely respected tax norms of horizontal equity and the ideal tax base. The reader thus is asked to be patient with the rather lengthy development in Part II of a model for evaluating personal injury recoveries, as it provides a necessary foundation for the later critique of traditional tax policy frameworks.

II. DEVELOPING A MODEL OF PERSONAL INJURY RECOVERIES

A. Tax Exemptions as Insurance

The tax exemption for personal injury recoveries can be viewed as a form of insurance which provides additional income to an individual who is injured, at the expense of higher overall rates for individuals not injured.[10] Such insurance provided by the tax exemption is mandatory, since an individual may not choose to forego this tax benefit in exchange for lower rates.

The tort system itself serves as both a form of insurance for potential victims and as a way of encouraging potential tortfeasors to take the proper level of care.[11] To induce the proper level of care, an individual

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10. Revenue needs are assumed to be fixed, so the government must finance any tax exemption by raising general rates.

11. The tort system often is said to have other goals as well, such as punishing the wrongdoer, vindicating the victim's rights and preventing self-help. *See, e.g.,* RESTATEMENT (SECOND) OF TORTS § 901 (1965); W. PAGE KEETON ET AL., PROSSER & KEETON ON THE LAW OF TORTS §§ 1-4 (5th ed. 1984); Stanley Ingber, *Symposium: Alternative Compensation Schemes and Tort Theory, Rethinking Intangible Injuries: A Focus on Remedy,* 73 CAL. L. REV. 772 (1985). The tort system is seriously flawed as an insurance system because of its incomplete coverage, inconsistent compensation levels

who causes an accident is required to pay the full cost of the harm created.[12] If these payments are made to the accident victim, they provide insurance for the victim's losses. The tax exemption for personal injury recoveries thus can be viewed as supplemental insurance for accident victims since it provides additional after-tax consumption to the injured individual.[13]

Viewing tax provisions as a form of insurance is appropriate for many provisions of the Internal Revenue Code. The deductions for casualty losses and for extraordinary medical expenses provide partial insurance against such losses.[14] A progressive rate structure also might be viewed as a special form of insurance in which individuals, uncertain of their future income, accept a greater tax burden if they become high earners in exchange for a lesser tax burden if they become low earners.[15] When tax provisions are viewed as insurance, the desirability of a tax

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for those covered and high administrative costs. For a recent RAND Corporation empirical study of tort compensation, see DEBORAH R. HENSLER ET AL., COMPENSATION FOR ACCIDENTAL INJURIES IN THE UNITED STATES (1991).

12. A business tortfeasor generally should be permitted to deduct damage payments as ordinary and necessary business expenses. I.P.L. Png and Eric M. Zolt, *Efficient Deterrence and the Tax Treatment of Monetary Sanctions*, 9 INT'L REV. L. & ECON. 209 (1989).

13. It has often been noted that the tort system is ill-suited as a system of accident insurance because of its high administrative costs and because it provides no compensation to individuals who are injured because of their own negligence or without fault. *See*, *e.g.*, ELI P. BERNZWEIG, BY ACCIDENT, NOT DESIGN: THE CASE FOR COMPREHENSIVE INJURY REPARATIONS 61, 71-80 (1980); PROSSER, *supra* note 11, § 83, at 597-600; Ingber, *supra* note 11, at 775.

14. One problem with insurance provided through a tax deduction is that it is effectively limited to the amount of the deductible loss multiplied by the taxpayer's marginal rate. Providing partial insurance through a tax deduction may discourage the purchase of the optimal amount of private insurance because the purchaser of private insurance sacrifices the free insurance provided by the deduction. Thus, the taxpayer may not purchase private insurance, even though he desires full protection against loss and would purchase insurance providing full protection in the absence of a tax deduction. These issues are explored in Louis Kaplow, *The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums*, 79 CAL. L. REV. 1485 (1991). Similar incentive problems do not exist for personal injury recoveries because no private insurance is necessary if an individual will be compensated through the tort system.

15. Jonathan Eaton & Harvey S. Rosen, *Labor Supply, Uncertainty, and Efficient Taxation*, 14 J. PUB. ECON. 365 (1980); Jonathan Eaton & Harvey S. Rosen, *Taxation, Human Capital and Uncertainty*, 70 AM. ECON. REV. 705 (1980); Jonathan Eaton & Harvey S. Rosen, *Optimal Redistributive Taxation and Uncertainty*, 95 Q.J. ECON. 357 (1980); Hal R. Varian, *Redistributive Taxation as Social Insurance*, 14 J. PUB. ECON. 49 (1980). For a recent critical examination of this literature, see LOUIS KAPLOW, A NOTE ON TAXATION AS SOCIAL INSURANCE FOR UNCERTAIN LABOR INCOME (National Bureau of Economic Research Working Paper No. 3708, 1991).

benefit can be evaluated by asking whether an individual would purchase the benefit as insurance in the private market.

The basic function of insurance is to provide additional consumption to an individual in circumstances in which it is more valuable.[16] Additional consumption will be more valuable to an individual in two cases. First, in general, income is worth more to an individual who has a lower level of current consumption. Maintaining a family's normal consumption level, for example, is the primary function of disability and term life insurance. Second, additional consumption is more valuable to an individual who has greater needs. Providing additional consumption in times of greater need is the central purpose of medical insurance.[17]

The model applies these principles to the tax exemption for personal injury recoveries and determines whether the tax exemption allocates additional income to those circumstances in which it is more valuable. Application of the model leads to the conclusion that exempting recoveries for accident-related medical expenses reallocates income to more valuable states, but that exempting recoveries for lost wages and pain and suffering does not.

B. Normative Criteria

The model incorporates several simplifying assumptions regarding the nature of personal injury recoveries and the way that consumption and other factors influence personal welfare. The model then is used to . calculate the impact of alternative tax policies on personal welfare in light of those assumptions.

The main normative criterion adopted is *ex ante* Pareto superiority.[18] A tax policy is *ex ante* Pareto superior if, prior to the

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16.   *See* STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 186-205 (1987).

17.   In many cases, insurance can be characterized as serving either goal. Consider, for example, fire insurance. An individual whose house burns down could be viewed as having greater needs because he now must purchase housing. Alternatively, he could be viewed as having the same needs, but fewer resources to satisfy them. In either case, insurance is desirable because it shifts consumption to circumstances in which its marginal value is greatest.

18.   Policy X is Pareto superior to policy Y if each individual is as well-off under X as under Y and at least one individual is better-off under X. Consistency with the Pareto principle often is considered a prerequisite to any sensible rule for social decision making. *See* EDWIN MANSFIELD, MICROECONOMICS: THEORY AND APPLICATIONS 468 (2d ed. 1988); DENNIS C. MUELLER, PUBLIC CHOICE II 374 (1989); Y. NG, WELFARE ECONOMICS 30-32 (1980); Frank I. Michelman, *Property, Utility and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law,* 80 HARV. L. REV. 1165, 1176 (1967). Amartya Sen has shown, however, that the Pareto principle is

time any taxpayer knows his particular circumstances, each taxpayer would prefer that policy. In the context of personal injury recoveries, the *ex ante* perspective means that each individual must choose the tax treatment of such recoveries without knowing whether or not he will be injured.

The model also can be used to evaluate tax policies under other consequentialist ethics like utilitarianism or a "Rawlsian" leximin.[19] Under utilitarianism, a tax regime which maximizes expected utility would be chosen. This generally will be the same regime as that chosen under an *ex ante* Pareto superiority norm.[20] Under the leximin, a tax regime which maximizes the well-being of the least well-off individual in the society would be adopted.[21]

C. Assumptions of the Model

Individual welfare is assumed to be a function of two variables: (1) consumption of goods and services and (2) all other factors that affect individual well-being, such as good health, leisure and job satisfaction. Each variable is assumed to enter the utility function separately, so that the additional improvement in welfare ·generated by consumption is

inconsistent with absolute individual rights. Amartya Sen, *The Impossibility of a Paretian Liberal*, 78 J. POL. ECON. 152 (1970).

19.   For an axiomatic definition of utilitarianism, the leximin and other welfarist ethics, see Amartya Sen, *On Weights and Measures: Informational Constraints in Social Welfare Analysis, in* CHOICE, WELFARE AND MEASUREMENT 226, 233-38 (1982).

20.   *See* John C. Harsanyi, *Cardinal Welfare, Individualistic Ethics, and Interpersonal Comparisons of Utility*, 63 J. POL. ECON. 309 (1955) (from an original position where no one knows his ability, tastes or social position, each individual would choose the regime which maximizes his expected utility).

21.   Rawls argues that in an original position (see note 20) individuals would choose a regime governed by the following two principles of justice. First, each individual would be ensured basic liberties. Second, inequality in the distribution of "primary" goods would be accepted only if the inequality leads to an improvement in the welfare of the least well-off group in the society. JOHN RAWLS, A THEORY OF JUSTICE 60-80 (1971).

Under Rawls' second principle of justice, a very small increase in the primary goods enjoyed by the poorest class would justify a large reduction in the primary goods enjoyed by the near poor and middle class. Rawls' second principle of justice is subordinate to the first, so that increases in economic well-being cannot justify departures from the principle of equal liberty. *Id.* at 60-61. The leximin resembles Rawls' second principle of justice in its focus on improving the well-being of the least well-off individual in the society. Unlike Rawls' theory of justice, however, the leximin would decide issues of social policy on the single principle of maximizing the utility of the least well-off individual. Where the utility of the least well-off individual is equal under two different regimes, the leximin will choose the regime which provides greater utility for the second least well-off individual. *See* Sen, *supra* note 19.

independent of any other factor affecting the individual's welfare. A utility function for each individual thus can be written as $U = U(C) + U(b)$, where C represents consumption and b represents all other factors affecting welfare. Consumption is assumed to have declining marginal utility, so that the value of additional consumption to an individual falls as the individual's total consumption increases.[22]

It also is assumed that some individuals will suffer personal injuries for which they will recover damages, but the identities of the injured individuals are unknown.[23] Finally, it is assumed that the government has constant revenue needs.

D. Application of the Model

The model will be applied to three types of personal injury recoveries: (1) lost wages, (2) medical expenses, and (3) pain and suffering. Each will be considered separately.

1. LOST WAGES

The analysis in this section concludes that, for any rate structure and distribution of income, each individual can be made better off *ex ante* by switching from a tax system which provides tax-free recovery of lost earnings to one which taxes lost earnings but which has lower overall rates.

An uninjured individual's consumption equals that individual's wage income less taxes paid. Thus, an individual who receives a tax exempt recovery for lost wages will enjoy a tax savings, and an increase in after-tax consumption equal to that individual's marginal tax rate multiplied by the amount of the recovery.[24]

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22. Declining marginal utility of consumption implies $U'(C) > 0$ and $U''(C) < 0$. Whether it is reasonable to assume that consumption has declining marginal utility is discussed in part III, *infra*.

23. This Article does not consider either the proper tax treatment of the tortfeasor who must pay damages or the ideal tort liability regime. Rather, payments made by the tortfeasor are exogenous to the model. In general, it is assumed that a liability regime will be adopted under which tortfeasors will be required to compensate victims fully for their injuries.

24. It is assumed throughout this Article that damages awarded for personal injuries will not be reduced to reflect the tax exempt status of such recoveries. Most, but not all, states do not permit a jury instruction that personal injury recoveries are tax exempt. Cochran, *supra* note 8, at 55-57. For discussions of the appropriate jury instruction regarding the tax exemption of personal injury recoveries, see Robert E. Burns, *A Compensation Award for Personal Injury or Wrongful Death is Tax-Exempt: Should We Tell the Jury?*, 14 DEPAUL L. REV. 320 (1965); Cochran, *supra* note 8, at 59-

If the tax exemption for recoveries of lost wages were eliminated, the additional tax revenues raised could be used to reduce general tax rates. This would provide a small tax benefit for all taxpayers rather than a large benefit for just those taxpayers who become injured. The choice between these two regimes can be analyzed using the model.

Let the consumption of an individual who is not injured equal C. If recoveries for lost wages are tax exempt, then the consumption of an injured individual will be $C+S$, where S is the tax savings from the exemption. If the probability of being injured is p, where $0<p<1$, the individual's expected consumption will be $C+pS$.[25] Expected utility from consumption will be $pU(C+S)+(1-p)U(C)$.[26]

The expected revenue loss to the government from exempting an injured individual's wage recovery from taxation is pS, so the government would lose no revenue if the tax exemption for wage recoveries were repealed and the tax burden reduced by pS for each taxpayer.[27] In that case, each individual's consumption would be $C+pS$ and each individual's utility from consumption would be $U(C+pS)$, whether or not the individual were injured.

Since with proper rate adjustments government revenues will be identical whether or not lost wage recoveries are taxed, the tax regime which maximizes each individual's *ex ante* expected utility should be adopted. The regime adopted will depend on whether $U(C+pS)$, the expected utility of a regime without the tax exemption, is greater than $pU(C+S)+(1-p)U(C)$, the expected utility of a regime with the exemption. It can be shown that if consumption has declining marginal utility, a certain increase of pS will generate a greater expected welfare improvement than will an increase of S with probability p.[28] Thus,

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64; Robert J. Nordstrom, *Income Taxes and Personal Injury Awards*, 19 OHIO ST. L.J. 212 (1958); Steven T. Potts, Comment, *Income Tax Issues in Personal Injury Litigation*, 46 MONT. L. REV. 59 (1985).

25. $p(C+S)+(1-p)C=C+pS$.

26.   Consumption is assumed to enter each individual's utility function separately, so the reduced earnings should not change utility generated by non-monetary factors. Thus, U(b) can be ignored in the analysis.

27.   It is assumed that the government does not prefer a certain amount of revenue from an individual to a lottery with an identical expected amount. This seems reasonable for a government that receives tax revenue from a large number of individuals.

28. $U'(C)>0$ implies that additional consumption continuously increases an individual's utility level. $U''(C)<0$ implies that the amount of the increase in utility generated by additional consumption continuously declines. The theorem that for any concave utility function, a certain consumption level is preferred to an uncertain consumption level with an equal expected value is known as Jensen's inequality. *See* EUGENE SILBERBERG, THE STRUCTURE OF ECONOMICS: A MATHEMATICAL ANALYSIS 449-51 (2d ed. 1990) (showing proof). *See also* SHAVELL, *supra* note 16, at 202-03 (proof that if insured individuals cannot influence risk, they will maximize expected utility

expected utility is maximized if recoveries of lost wages are taxed. These results are summarized in Table 1.

TABLE 1

Taxation of Recoveries for Lost Wages: General Case

	Consumption if Uninjured	Consumption if Injured	Probability of Injury	Expected Consumption	Expected Utility
Tax Exempt	C	C + S	p	C + pS	pU(C+S)+ (1-p)U(C)
Fully Taxed	C + pS	C + pS	p	C + pS	U(C+pS)

A simple numerical example can illustrate these results. Imagine a society with two identical individuals each of whom has a pre-tax wage income of $50,000 per year. To reflect declining marginal utility of consumption, assume that each individual's utility varies with the square root of consumption.[29] If $40,000 in tax revenue must be raised, each individual will pay a tax of 40% of $20,000, leaving consumption of $30,000 and utility of 173.21.[30]

Now suppose that one of the individuals suffers a personal injury resulting in $50,000 of lost wages for which the individual receives compensatory damages. If the recovery is taxed, the combined tax base from both individuals will remain at $100,000. Each individual again will pay a tax of $20,000 and will have an after-tax consumption of $30,000. Total utility in the two person society thus will be 346.41 and average utility will be 173.21.

A different result occurs if recoveries for lost wages are exempt from taxation. The tax base will be reduced from $100,000 to $50,000, since the $50,000 received by the injured individual for lost wages will not be taxed. To raise the same $40,000 of revenue from this smaller base, the tax rate must be increased from 40% to 80%. The uninjured individual then will be taxed at an 80% rate on an income of $50,000, leading to a tax of $40,000, consumption of $10,000 and utility from consumption of 100.[31] The injured individual will pay no tax and will enjoy after-tax

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by purchasing insurance to maintain constant wealth).

29. $U(C) = \sqrt{C}$. The qualitative results of the model would be the same under any utility function meeting the conditions stated in *supra* note 28.

30. $\sqrt{30,000} = 173.21$.

31. $\sqrt{10,000} = 100$.

consumption of $50,000 and a utility from consumption of 223.61.[32]
The combined utility of the two individuals will be 323.61, and each
individual's expected utility will be 161.81. Thus, if revenue neutrality
is maintained by changes in the tax rate, enactment of a tax exemption for
lost wages reduces total welfare from 346.41 to 323.61 and reduces each
individual's expected utility from 173.21 to 161.81. These results are
summarized in Table 2.

TABLE 2

Taxation of Recoveries for Lost Wages: Two Person Society

Wage Recoveries Taxed

	Wages	Damages	Taxable Income	Tax	Consumption	Utility
Uninjured	50,000	0	50,000	20,000	30,000	173.21
Injured	0	50,000	50,000	20,000	30,000	173.21

Tax Base = 100,000. Tax Revenue = 40,000. Tax Rate = 40%.
Utility = $\sqrt{c}$. Total Utility = 346.41. Expected Utility = 173.21.

Wage Recoveries Tax Exempt

	Wages	Damages	Taxable Income	Tax	Consumption	Utility
Uninjured	50,000	0	50,000	40,000	10,000	100
Injured	0	50,000	0	0	50,000	223.61

Tax Base = 50,000. Tax Revenue = 40,000. Tax Rate = 80%.
Utility = $\sqrt{c}$. Total Utility = 323.61. Expected Utility = 161.81.

In sum, providing a tax exemption for wage recoveries has the effect
of increasing the injured individual's consumption from $30,000 to
$50,000 and reducing the consumption of the uninjured individual from
$30,000 to $10,000. A net welfare loss results because $20,000 of
consumption is comparatively less valuable in the range of $30,000 to
$50,000 than in the range of $10,000 to $30,000. The welfare loss is not

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32. $\sqrt{50,000} = 223.61$.

trivial; the reduction in expected utility from 173.21 to 161.81 is equal to the utility loss caused by a reduction in each individual's after-tax consumption from \$30,000 to \$26,182.[33]

2. MEDICAL EXPENSES

Medical expense recoveries differ from lost wages in that increased medical needs change the marginal value of consumption.[34] Accident victims frequently require expensive medical treatment and receive damage awards to cover these costs. If, as seems reasonable, medical treatment is important enough to an accident victim's welfare that the individual could not be made better off by purchasing something other than medical care, then the marginal value of consumption will vary with an individual's level of consumption *after payment of accident-related medical expenses*. This can be represented by letting $U = U(C-M)$, where M represents medical expenses.[35] Under these assumptions, it can be shown that it is *ex ante* Pareto superior to exempt medical expense recoveries from taxation.

Suppose that recoveries for medical expenses are tax exempt. If an individual is not injured, the individual's consumption will be C and utility from consumption will be $U(C-M)$. This simplifies to $U(C)$ since the individual has no injury-related medical expenses. If the individual is injured and receives a tax exempt medical expense recovery M, then the individual's consumption will increase to $C+M$, but utility from consumption will remain $U(C+M-M)$ or $U(C)$ since the increase in consumption is precisely matched by increased medical costs. Thus, if recoveries for medical expenses are tax exempt, utility from consumption will be $U(C)$ whether or not an individual is injured and expected consumption will be $C+pM$.[36]

Now suppose that damages for injury-related medical expenses are fully taxed. If an injury occurs, the government gains additional revenues, R, equal to the recovery multiplied by the individual's marginal tax rate. If the probability of injury is p, the government's expected

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33. $\sqrt{30,000} = 173.21$. $\sqrt{26,182} = 161.81$.

34.   Medical expenses should be defined to include all additional expenses of living incurred as a result of an injury, not just the direct costs of medical services. Thus, medical expenses would include, for example, costs of any necessary modifications to a disabled individual's vehicle or home. This definition is consistent with the definition of deductible medical expenses under I.R.C. § 213. *See* Treas. Reg. 1.213-1(e)(iii).

35.   A utility function of the form $U = U(C-M)$ could be applied to the analysis of lost wages and pain and suffering damages without changing the results, since in those cases there are no injury-related medical expenses and, therefore, $M = 0$.

36. $p(C+M)+(1-p)C = C+pM$.

additional revenue from each individual will be pR. Thus, government revenue would be unchanged if the tax exemption for medical expenses were repealed and each individual's tax liability was reduced by pR.

If medical expense recoveries are taxed and tax rates are reduced, an uninjured individual's consumption and utility will be $C+pR$ and $U(C+pR)$, respectively, while an injured individual's consumption and utility will be $C+M+pR-R$ and $U(C+pR-R)$. Each individual's expected consumption will be $p(C+M+pR-R)+(1-p)(C+pR)$, which simplifies to $C+pM$, the same amount as under a regime with higher tax rates and a tax exemption for medical expense recoveries.

Since revenue raised is identical in either regime, the tax regime which maximizes each individual's expected utility from consumption should be adopted. Expected utility under a regime without a tax exemption will be $pU(C+pR-R)+(1-p)U(C+pR)$. If the tax exemption is implemented, on the other hand, utility from consumption always will be $U(C)$. Put differently, if recoveries of medical expenses are tax exempt, an individual will enjoy a fixed consumption level, after payment of medical expenses, whether or not the individual is injured. On the other hand, if recoveries are taxed, each individual will participate in a fair lottery with a (1-p) chance of additional non-medical consumption pR and a p chance of reduced non-medical consumption $(1-p)R$.[37] These results are summarized in Table 3.

TABLE 3

Taxation of Recoveries for Medical Expenses: General Case

	Consumption if Uninjured	Consumption if Injured	Probability of Injury	Expected Consumption	Expected Utility
Tax Exempt	C	C + M	p	C + pM	U(C)
Fully Taxed	C + pR	C+M+pR-R	p	C + pM	(1-p)U(C+pR) + pU(C+pR-R)

As shown previously, as long as consumption has declining marginal utility, a fixed consumption level generates higher expected utility than a lottery with identical expected consumption.[38] Thus, expected utility

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37. The expected return on the lottery is zero because $(1-p)pR = p(1-p)R$.
38. *See supra* note 28.

will be maximized for each individual if recoveries for medical expenses are tax exempt.

A numerical illustration may be useful. Assume there are two individuals, each of whom earns $50,000 in wages. One of the individuals incurs $50,000 of medical expenses as a result of a personal injury and receives compensatory damages. If damages for injury-related medical expenses are fully taxed, the injured taxpayer will have a taxable income $100,000 and the total tax base will increase to $150,000.[39]

If the government must raise $40,000 of tax revenues, a tax rate of 26.67% will be required.[40] The uninjured taxpayer will pay a tax of $13,333 on $50,000 of taxable income and enjoy an after-tax consumption of $36,667, resulting in a utility of 191.49.[41] The injured taxpayer will pay a tax of $26,667 on $100,000 of taxable income, leaving consumption of $73,333, allocated between $50,000 for medical expenses and $23,333 for non-medical consumption, and utility from consumption of 152.75.[42] Total utility will be 344.24, and expected utility will be 172.12.[43]

If damage recoveries for medical expenses are tax exempt, the injured and uninjured taxpayer each will have a taxable income of $50,000, the total tax base will be $100,000 and each taxpayer will be required to pay a 40% tax of $20,000 to raise the same $40,000 in tax revenues. The uninjured taxpayer will have an after-tax consumption of $80,000, which includes $50,000 to be spent on medical services. Thus, the injured taxpayer will enjoy $30,000 of non-medical consumption for a utility of 173.21,[44] while the injured taxpayer will have an after-tax consumption of $80,000, which includes $50,000 to be spent on medical services. The injured taxpayer will therefore enjoy $30,000 of non-medical consumption for a utility of 173.21.[45] Total welfare will be 346.41, which is higher than the welfare of 344.24 in a regime without an exemption. The additional expected welfare is equal to increasing each individual's non-medical consumption from $29,625 to $30,000.[46] These results are summarized in Table 4.

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39. The analysis in this Article assumes that no medical deduction is permitted. Permitting a full medical deduction for all medical expenses would be equivalent to exempting the recovery of medical expenses from taxation. A medical deduction, however, would have a broader effect because it would apply to non-injury related medical expenses as well.

40. $40,000 \div \$150,000 = 26.67\%$.

41. $U = \sqrt{(C-M)} = \sqrt{(50,000-13,333)} = \sqrt{36,667} = 191.49$.

42. $U = \sqrt{(C-M)} = \sqrt{(73,333-50,000)} = \sqrt{23,333} = 152.75$.

43. $191.49 + 152.75 = 344.24$.
     $.5 \times 344.24 = 172.12$.

44. $\sqrt{30,000} = 173.21$.

45. $U = \sqrt{(C-M)} = \sqrt{(80,000-50,000)} = \sqrt{30,000} = 173.21$.

46. $\sqrt{29,625} = 172.12$. $\sqrt{30,000} = 173.21$.

TABLE 4

Taxation of Recoveries for Medical Expenses: Two Person Society

Medical Expense Recoveries Taxable

	Wages	Damages	Taxable Income	Tax	Consump-tion	Medical Expenses	Utility
Uninjured	50,000	0	50,000	13,333	36,667	0	191.49
Injured	50,000	50,000	100,000	26,667	73,333	50,000	152.75

Tax Base = 150,000. Tax Revenue = 40,000. Tax Rate = 26.67%.
Utility = < < (C-M). Total Utility = 344.24. Expected Utility = 172.12.

Medical Expense Recoveries Tax Exempt

	Wages	Damages	Taxable Income	Tax	Consump-tion	Medical Expenses	Utility
Uninjured	50,000	0	50,000	20,000	30,000	0	173.21
Injured	50,000	50,000	50,000	20,000	80,000	50,000	173.21

Tax Base = 100,000. Tax Revenue = 40,000. Tax Rate = 40%.
Utility = < < (C-M). Total Utility = 346.41. Expected Utility = 173.21.

3. PAIN AND SUFFERING

a. Inclusion in the tax base

Pain and suffering damages include compensation both for actual pain and for any reduction in welfare due to permanent bodily impairment. Unlike recoveries for lost wages and for injury-related medical expenses, pain and suffering damages compensate individuals for non-monetary losses. Application of the model shows that expected utility is maximized if pain and suffering recoveries are fully taxed.[47]

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47. The reasoning in this section is similar to arguments made in the tort literature for restricting or eliminating pain and suffering awards. *See* SHAVELL, *supra* note 16, at 228-31.

Pain and suffering recoveries are assumed to compensate an injured party precisely for any harm incurred;[48] that is, the amount received, if not taxed, is assumed to make an injured individual as well-off as before the injury.[49] This assumption is not essential, however, to the results; it is optimal to tax damages for pain and suffering, even if doing so means that injured individuals will not be fully compensated for their losses.

Suppose recoveries for pain and suffering are tax exempt. For an uninjured individual, after-tax consumption will be C and utility from consumption will be U(C). If an individual is injured, after-tax consumption will be C+D, and welfare from consumption will be U(C+D), where D represents damages received for pain and suffering. If the probability of injury is p, expected consumption will be C+pD and expected utility will be pU(C+D)+(1-p)U(C).[50]

The expected revenue loss from a tax exemption for pain and suffering recoveries is prD, where r is the marginal tax rate. Equal revenue thus will be raised by a regime in which pain and suffering recoveries are tax exempt and a regime which taxes such recoveries, but which reduces each individual's tax liability by prD. If pain and suffering recoveries are taxed, consumption will be C+D+prD-rD if an individual is injured and C+prD if an individual is not injured. Each individual's expected consumption will be C+pD,[51] and each individual's expected utility from consumption will be pU(C+D+prD-rD)+(1-p)U(C+prD). The results are summarized in Table 5.

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48.   Pain and suffering awards obviously often do not fully compensate victims. Some personal injuries are so severe that no amount of cash can compensate the victim. Moreover, awards vary widely for similar injuries. *See* Randall R. Bovbjerg et al., *Valuing Life and Limb in Tort: Scheduling "Pain and Suffering"*, 83 Nw. U. L. REV. 908, 919-28 (1989). The difficulty of accurately measuring pain and suffering damages raises interesting and difficult problems for determining the appropriate damages rule under the tort law. *E.g., id.*; Clarence Morris, *Liability for Pain and Suffering*, 59 COLUM. L. REV. 476 (1959); Marcus L. Plant, *Damages for Pain and Suffering*, 19 OHIO ST. L.J. 200, 210-11 (1958).

49.   In general, courts have not asked juries to award the pain and suffering damages in an amount which would make a victim indifferent between receiving the injury or the recovery, but have adopted an undefined standard of "fair compensation." *See* Bovjberg et al., *supra* note 48, at 912-13 and sources cited therein.

50. $p(C+D)+(1-p)C=C+pD$.

51. $p(C+D+prD-rD)+(1-p)(C+prD)=C+pD$.

TABLE 5

Taxation for Recoveries for Pain and Suffering: General Case

	Consumption if Uninjured	Consumption if Injured	Probability of Injury	Expected Consumption	Expected Utility
Tax Exempt	C	C + C	p	C + pD	pU(C+D) + (1-p)U(C)
Fully Taxed	C + pD	C+prD + D-rD	p	C + pD	[pU × (C+D + prD-rD)] + [(1-p)U × (C+prD)]

The government raises equal revenue under either tax regime, so the regime which maximizes each individual's *ex ante* expected utility should be chosen. Exempting pain and suffering damages from taxation is equivalent to issuing each individual a lottery ticket which yields additional consumption in the case of injury at a price of lower consumption in all other cases. Since, as shown earlier, a fixed level of consumption will generate greater utility than a lottery with the same expected value,[52] a tax regime with lower rates and full taxation of pain and suffering damages should be adopted.

The preceding results can be illustrated numerically. Assume a society with two individuals, each of whom earns $50,000 in wages. One individual receives a $50,000 recovery for pain and suffering. If total tax revenues of $40,000 are required by the government and pain and suffering recoveries are not taxed, each individual will pay a 40% tax of $20,000 on a taxable income of $50,000. The uninjured individual will have an after-tax consumption of $30,000 for a utility from consumption of 173.21, while the injured taxpayer will have consumption of $80,000 and utility from consumption of 282.84.[53] Total utility will be 456.05 and expected utility will be 228.02.[54]

If recoveries for pain and suffering are taxed, the injured individual's taxable income will increase from $50,000 to $100,000 and the tax base will increase from $100,000 to $150,000. The necessary $40,000 of

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52. *See supra* note 28.
53. $\sqrt{30,000} = 173.21$. $\sqrt{80,000} = 282.84$.
54. $173.21 + 282.84 = 456.05$.
    $.5 \times 456.05 = 228.02$.

revenue then could be raised by a tax rate of 26.67%.[55] At this rate, the uninjured taxpayer will pay a tax of $13,333 and will enjoy an after-tax consumption of $36,667 for a utility from consumption of 191.49, while the injured taxpayer will pay a tax of $26,667 and consume $73,333 for a utility from consumption of 270.80.[56] Total utility from consumption will be 462.29 and expected utility will be 231.14.[57] Thus, elimination of the tax exemption for pain and suffering damages increases expected utility from consumption from 228.02 to 231.14. This is equivalent to the improvement in welfare that would result from an increase in consumption from $51,993 to $53,425.[58] These results are summarized in Table 6.

TABLE 6

Taxation of Recoveries for Pain and Suffering: Two Person Society

Pain and Suffering Recoveries Taxable

	Wages	Damages	Taxable Income	Tax	Consumption	Utility
Uninjured	50,000	0	50,000	13,333	36,667	191.49
Injured	50,000	50,000	100,000	26,667	73,333	270.80

Tax Base = 150,000. Tax Revenue = 40,000. Tax Rate = 26.67%
Utility = $\sqrt{c}$. Total Utility = 462.29. Expected Utility = 231.14.

Pain and Suffering Recoveries Tax Exempt

	Wages	Damages	Taxable Income	Tax	Consumption	Utility
Uninjured	50,000	0	50,000	20,000	30,000	173.21
Injured	50,000	50,000	50,000	20,000	80,000	282.84

Tax Base = 100,000. Tax Revenue = 40,000. Tax Rate = 40%
Utility = $\sqrt{c}$. Total Utility = 456.05. Expected Utility = 228.02.

The preceding analysis does not take into account any reduction in the welfare of the injured party from the pain and suffering. This omission is appropriate because the welfare loss from pain and suffering

55. $40,000 ÷ $150,000 = 26.67%.
56. $\sqrt{36,667} = 191.49$. $\sqrt{73,333} = 270.80$.
57. $191.49 + 170.80 = 462.29$.
.5 × 462.29 = 231.14.
58. $\sqrt{51,993} = 228.02$. $\sqrt{53,425} = 231.14$.

is identical whether or not recoveries are taxed. Including the welfare loss from pain and suffering in the calculation would lower expected utility under each tax regime by an identical amount, but would not affect the *marginal* utility of additional consumption and, thus, would not alter any individual's *ex ante* utility maximizing choice.[59]

b. Confiscatory taxation

A further improvement in welfare can be gained by taxing pain and suffering damages at a 100% rate and using the revenue raised to reduce overall tax rates.

If revenues raised from taxing pain and suffering recoveries are used to lower general rates, an individual's expected utility from consumption will be $pU(C+prD+D-rD)+(1-p)U(C+prD)$, where r is the tax rate applied to pain and suffering damages. The goal is to choose the tax rate, r, that maximizes expected utility. This occurs where r is equal to 1; that is, where the tax rate is 100%. This can be seen by noting that when r equals 1, an identical consumption of $C+pD$ will exist in all states,[60] thus maximizing expected utility.[61]

Adopting such a regime, nevertheless, may not be desirable. Although taxing damages for pain and suffering at a 100% rate will maximize expected utility under the model, a confiscatory tax will leave injured individuals with little incentive to make pain and suffering claims. If such claims are not made, tortfeasors may not bear the full cost of accidents and may not have the proper incentive to reduce accidents. The welfare gains from equalizing consumption over alternative states, therefore, must be balanced against the social costs of reducing incentives to make tort claims.[62]

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59.   The welfare loss from pain and suffering could be included in the model by reducing the injured individual's welfare by a fixed amount. The assumption that pain and suffering does not change the marginal utility of other consumption is discussed in part IV, *infra*.

60.   If $r = 1$, then $C+prD+D-rD = C+pD$ and $C+prD = C+pD$.

61.   *See supra* note 28.

62.   Of course, any taxation of tort recoveries will reduce the rewards of a successful action and thus reduce the incentive to sue. A first-best result is impossible to achieve under a tort liability system if the optimal awards for purposes of compensation and for purposes of deterrence are different, as is the case for recoveries for pain and suffering. Thus, it may be desirable to adopt non-tort methods, such as government fines, for deterring accidents which generate non-pecuniary losses. SHAVELL, *supra* note 16, at 231-33.

Many proposals have been made to limit tort recoveries for non-monetary losses, although such proposals seldom are based on maximizing expected utility. *See* Stephen D. Sugarman, *Taking Advantage of the Tort Crisis*, 48 OHIO STATE L.J. 329 (1987)

A tax on pain and suffering damages also might be rejected on the theory that individuals should be compensated for their losses, even if providing such compensation does not maximize *ex ante* expected utility. This objection is considered in Part IV below.

III. VARYING THE MODEL'S ASSUMPTIONS

The validity of the conclusions reached in the basic model is critically dependent on its premises. This Part considers the reasonableness of the model's central assumptions and the impact of adopting plausible alternatives.

A. Declining Marginal Utility

The model assumes that the government always raises the same amount of revenue, so that expected consumption is unaffected by the choice of tax regimes. Thus, welfare gains and losses are entirely a result of shifting consumption of individuals for whom the consumption has a greater or lesser marginal value. The assumption that consumption has declining marginal utility is critical to this result. If consumption has constant marginal utility, for example, expected utility is unaffected by the choice of tax regime and the analysis of the model collapses.

Fortunately, the assumption that consumption has declining marginal utility seems reasonable and is common in economic analysis.[63] It seems sensible to believe that an individual will find an extra dollar of consumption to be worth less if she already has a million dollars than if

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(describing various damage limitation proposals and presenting his own).

    63.   *See, e.g.,* MANSFIELD, *supra* note 18, at 583-89 (analyzing insurance); SILBERBERG, *supra* note 28, at 449-53.

    Some view the willingness to play lotteries and engage in other forms of gambling as inconsistent with the notion that consumption has declining marginal utility. The simultaneous existence of insurance and gambling, for example, has been cited as evidence that consumption may have declining marginal utility within some ranges and increasing marginal utility within others. *See* Milton Friedman & L.J. Savage, *The Utility Analysis of Choices Involving Risk,* 56 J. POL. ECON. 279 (1948). This theory, however, would predict that individuals with consumption in the range of increasing marginal utility would place one large bet (since most gambles have less than fair odds) to leave the range. In fact, however, most gamblers place many small bets. Such behavior suggests that individuals gamble because of the entertainment value, not because consumption has increasing marginal utility. *See* SILBERBERG, *supra* note 28, at 452-54. Individuals also may play lotteries because they are unable to comprehend how small the chances are of winning. *See* Daniel Kahneman & Amos Tversky, *The Psychology of Preferences,* SCIENTIFIC AMERICAN, Jan. 1982, at 160, 164 (low probabilities commonly overweighed). The method of choosing winning lottery numbers in most states (typically picking 6 of about 50 numbers) is designed to make the lottery appear easier to win.

she is poverty-stricken. Rational individuals will use their first dollars of consumption to purchase items they value the most, so purchases made with later dollars will be less valuable. Thus, while total utility rises continuously as consumption increases, the utility contributed by each additional dollar of consumption drops steadily.[64]

Declining marginal utility implies only that the first dollar of consumption by an individual is more valuable to that individual than the tenth dollar. It does not imply that the first dollar of consumption by one individual generates more utility for that individual than the tenth dollar of consumption generates for a different individual. Thus, the assumption that consumption has declining marginal utility for each individual says nothing about the relative value of consumption to different individuals.

Whether meaningful utility comparisons can be made among different individuals is controversial. It is sometimes useful, nonetheless, to assume that interpersonal utility comparisons can be made.[65] In the hypothetical two person society analyzed in the numerical examples in Part II, for example, it was assumed not only that such comparisons were

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64.   However, if goods are complementary, the marginal utility of consumption might not decline even if individuals always purchase more valuable goods before less valuable ones.

65.   Nineteenth and early twentieth century economists often assumed that utility was measurable cardinally and that interpersonal utility comparisons could be made. Pigou, for example, argued that "since it is impossible to take account of variations between different people's capacity for enjoyment, this consideration must be ignored, and the assumption made, for want of a better, that temperamentally all taxpayers are alike." ARTHUR C. PIGOU, A STUDY IN PUBLIC FINANCE 58 (3d ed. 1947). By the middle of the twentieth century most economists rejected this view as unscientific. See JOHN R. HICKS, VALUE AND CAPITAL (1946); LIONEL ROBBINS, AN ESSAY ON THE NATURE AND SIGNIFICANCE OF ECONOMIC SCIENCE 136-43 (2d ed. 1962); PAUL A. SAMUELSON, FOUNDATIONS OF ECONOMIC ANALYSIS (1947); Lionel Robbins, *Interpersonal Comparisons of Utility: A Comment*, 48 ECON. J. 635 (1938).

Even if interpersonal utility comparisons are impossible, however, expected welfare may be maximized by a more equal distribution of consumption. Lerner showed, for example, that if consumption has declining marginal utility for each individual and if it is impossible to identify which individuals value consumption most, expected utility is maximized by an equal distribution. ABBA P. LERNER, THE ECONOMICS OF CONTROL 29-34 (1944). Sen has extended this result to show that expected welfare is maximized by equal distribution under all welfarist principles. Amartya Sen, *On Ignorance and Equal Distribution, in* CHOICE, WELFARE AND MEASUREMENT 222 (1982).

In recent years, there has been renewed interest in interpersonal utility comparisons; some economists argue that such comparisons are essential for meaningful social decision-making. If such comparisons are not permitted, it has been noted, any two social states must be regarded as equally desirable unless one is Pareto superior to the other. See · JAMES E. MEADE, THE JUST ECONOMY 20-29 (1976); NG, *supra* note 18, at 12-15; Amartya Sen, *Personal Utilities and Public Judgements: or What's Wrong with Welfare Economics?, in* CHOICE, WELFARE AND MEASUREMENT 327 (1982).

possible, but that each individual in the society had the same utility function. This made it easy to generate precise figures for total and expected utility. The general findings of Part II do not depend on interpersonal utility comparisons, however, since the recommended tax policies are *ex ante* Pareto superior for each taxpayer.

B. Separability

The model assumes that consumption enters eacb individual's utility function separately, so that the additional utility generated from consumption is independent of other factors affecting an individual's welfare. In many situations, of course, the value of additional consumption will depend on other factors such as individual needs. The marginal value of consumption is likely to be higher for an individual who has many dependents or who has a medical condition requiring expensive treatment than for an individual who is unattached and healthy.[66]

The model in Part II assumes that neither lost wages nor pain and suffering changes the marginal value of consumption, but that greater medical needs make additional consumption worth more to an individual. The latter assumption seems fairly safe. Medical treatment for injuries generally bas a very high value to an individual and would be purchased before most other consumption.[67] Thus, the consumption of medical services displaces other purchases with high utility and makes additional dollars of consumption more valuable.[68]

The impact of lost wages on the marginal value of consumption is more difficult to determine. An individual who is not working might

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66.   Differences in taste or talent can also affect the marginal value of consumption. A bookworm who suddenly falls in love with skiing may discover that additional consumption is more valuable, while a skier who abandons her sport for the joys of reading may find additional consumption less valuable. Even if it were desirable to consider such differences in tastes in an idcal tax structure, problems of measurement would make it impossible to do so.

67.   In many tort actions, moreover, the amount of recovery for medical costs relates to amounts that already have been expended.

68.   To see this, suppose that the next two goods that would be purchased by an individual if she received $1000 would be a $500 television set generating utility of 100 and a $500 stereo generating utility of 80. If the individual received $1000, she would purchase the television and then the stereo so that the utility generated by the last $500 spent would be 80. Now suppese that the individual were injured and required $500 of medical care. Presumably, receiving the medical care would provide a greater improvement in welfare than purchasing either the television or the stereo. Thus, if the injured individual received $1000, she would purchase the medical carc and the television. In this ease the utility generated by the last $500 spent would be 100.

have fewer expenses and greater opportunities for home production. This would reduce the marginal value of other consumption. On the other hand, the individual's increased leisure might make possible the pursuit of interests which would make additional consumption more valuable. On balance, it seems sensible to assume that a given level of consumption generates the same utility for an individual who is unemployed as for an working individual.[69]

The impact of an injury on the marginal value of consumption, medical expenses aside, also is difficult to assess.[70] Consider, for example, an individual who suffers a back injury which prevents her from engaging in active sports. Her overall welfare clearly is reduced as a result of the injury, but the effect on the marginal value of consumption is unclear. If the individual previously spent her weekends scuba diving, but now spends her free time reading, then her expenses would decrease and the marginal utility of consumption might drop. If, on the other hand, the individual switched from jogging to art collecting as a result of the injury, her expenses and the marginal utility of consumption might increase.

In light of the uncertain impact of pain and suffering on the marginal utility of consumption, the model assumes that pain and suffering has no effect. The implications of varying the assumption of separability are straightforward. If a personal injury increases the marginal value of consumption, then recoveries should be taxed at lower rates than other income. On the other hand, if an injury decreases the marginal value of consumption, then recoveries should be taxed at higher rates.[71]

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69.   In general, of course, reduced earnings due to personal injuries are coupled with at least a temporary physical impairment, so that the impact of additional leisure on the value of other consumption is combined with the impact of the physical injury.

70.   SHAVELL, *supra* note 16, at 228-29. A recent empirical study of the relationship between health status and the marginal utility of consumption found that poor health reduces the marginal utility of non-medical consumption, so that less than full insurance for lost earning capacity is optimal. *See* W. Kip Viscusi & William N. Evans, *Utility Functions that Depend on Health Status: Estimates and Economic Implications*, 80 AM. ECON. REV. 353 (1990). For a critique of the methodology of this study and of the insurance theory of compensation generally, see Ellen S. Pryor, *The Tort Law Debate, Efficiency, and the Kingdom of the Ill: A Critique of the Insurance Theory of Compensation*, 79 VA. L. REV. 91 (1993).

71.   *See* Viscusi & Evans, *supra* note 70, at 370-71 (poor health lowers the marginal utility of consumption so incomplete insurance for lost earnings is optimal).

C. Undercompensation

1. OVERVIEW

The model in Part II assumes that, prior to the assessment of any tax, damages paid to an injured individual will fully compensate the individual for any losses suffered. Payment of full compensation is assumed to be required as part of a sound tort system to ensure that potential tortfeasors take the proper level of care.[72] It is beyond the scope of this Article to consider whether other compensation systems would better serve the objectives of the tort system; it may be valuable, however, to consider the implications for tax policy if injured individuals were to receive less than full compensation.

A tax exemption for personal injury recoveries might be justified on the basis that the tort system systematically undercompensates plaintiffs for their injuries.[73] For some injuries, the tort system could not do otherwise—no amount of additional consumption could make whole an individual who suffers a severe physical impairment. Undercompensation also might occur in the calculation of recoveries for lost wages if juries do not calculate accurately the impact of inflation and career advancement on injured individuals' expected future income. In addition, undercompensation might arise because of the costs of litigation.[74]

A tax exemption, though, is not an ideal remedy for less than full compensation because the benefits of an exemption vary according to the injured individual's marginal tax rate, rather than according to the degree of undercompensation. A uniform tax credit, therefore, would be a better

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72. SHAVELL, *supra* note 16, at 127-31 (to ensure the proper level of care and activity, damages must reflect both pecuniary and non-pecuniary losses).

73. *See* Stephen D. Sugarman, *Doing Away with Tort Law,* 73 CAL. L. REV. 558, 593-94 (1985).

74. Contingent legal fees are generally the exclusive method of payment for personal injury litigation. A plaintiff pays her attorney a percentage of her compensation, usually after other legal expenses are deducted. Typically, a plaintiff pays up to one-third of his recovery to the attorney, although for difficult cases an attorney may charge one-half of the recovery. Plaintiffs also incur other legal expenses such as court filing fees, costs of hiring experts, and expenses associated with travel and transcripts. In 1985, tort plaintiffs paid between $6.3 and $7.6 billion in legal fees, averaging $7300 to $8800 per plaintiff per lawsuit. These payments represented approximately 30% of total compensation awarded. *See, e.g.,* BERNZWEIG, *supra* note 13, at 82; KEETON ET AL., *supra* note 11, § 83, at 599; JAMES S. KAKALIK & NICHOLAS M. PACE, COSTS AND COMPENSATION PAID IN TORT LITIGATION 37-39, 42 (1986). Litigation costs also can change the optimal level of liability. A. Mitchell Polinsky & Daniel L. Rubinfeld, *The Welfare Implications of Costly Litigation for the Level of Liability,* 17 J. LEGAL STUD. 151 (1988).

approach. Nevertheless, it might be argued, an imperfect remedy may be fairer than none at all.[75]

The argument for a tax exemption on the grounds that victims are undercompensated presumes that it is desirable to compensate injury victims fully for their losses.   As shown below, however, full compensation is not necessarily desirable.

2. UNDERCOMPENSATION FOR PAIN AND SUFFERING

A tax exemption for pain and suffering recoveries provides an injured individual with additional consumption in the event of an injury. If such recoveries were taxed, tax rates could be lowered slightly for all individuals. As shown in Part II, the certain increase in consumption produced by lower rates generates greater expected utility than the chance of the larger increase if an injury occurs.[76] This analysis is unchanged where damages for pain and suffering provide less than full compensation. Thus, pain and suffering damages should be taxed even if they do not provide full compensation.

3. UNDERCOMPENSATION FOR MEDICAL EXPENSES

Increased medical expenses displace other valuable consumption and increase the marginal value of additional consumption to the individual. Since, as demonstrated in Part II, even full recoveries for injury-related medical expenses should be tax exempt, partial recoveries should also be received tax-free.[77]

4. UNDERCOMPENSATION FOR LOSSES

The proper tax treatment for less than fully compensatory recoveries for lost wages is more difficult to calculate. As noted above, if a personal injury does not alter the utility derived from consumption, full recoveries of lost wages should be taxed at ordinary rates, because doing

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75.   Recoveries for pain and suffering are sometimes justified as a means of compensating plaintiffs for legal expenses. *See* Gregory A. Hicks, *Statutory Damage Caps Are an Incomplete Reform: A Proposal for Attorney Fee Shifting in Tort Actions*, 49 LA. L. REV. 763 (1989); Jeffrey O'Connell, *A Proposal to Abolish Defendants' Payment for Pain and Suffering in Return for Payment of Claimants' Attorneys' Fees*, 1981 U. ILL. L. REV. 333.

76.   *See supra* note 28.

77.   *See supra* notes 34-46 and accompanying text.

so guarantees that an individual will enjoy equal consumption whether or not an injury occurs.[78]

If a recovery for lost wages provides less than full compensation, an individual's level of consumption will be reduced if the individual is injured. In such a case, a tax exemption for partial recoveries of lost wages would help to equalize consumption and thus increase expected utility.

Wholly exempting partial recoveries is not ideal, however, if the tax savings from the tax exemption is larger than the amount of undercompensation, since the exemption would cause an individual who is injured to have a greater consumption than one who is not injured. In such a case, a partial exemption is necessary to equalize the consumption of injured and uninjured taxpayers.

D. Recoveries for More Than One Type of Injury

If an individual receives a partial recovery for more than one type of loss, the appropriate tax treatment may be different from that which is ideal when each type of recovery is considered separately. The basic principle, however, is the same—expected utility is maximized by a tax system which leaves an injured individual, after payment of medical expenses, with a level of consumption identical to an uninjured individual. Thus, since the receipt of damages for pain and suffering leaves an injured individual with a higher level of non-medical consumption than an uninjured individual, taxing all recoveries, including those for medical expenses, might help equalize non-medical consumption. On the other hand, if injured individuals are undercompensated for medical expenses or lost wages, so that their non-medical consumption is less than that of an uninjured individual, exempting all damages from taxation may help to equalize consumption.[79]

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78.   *See supra* notes 24-33 and accompanying text.

79.   In an interesting recent article, Professor Dodge argues that the federal tax treatment of personal injury recoveries should vary with the level of compensation provided under state tort law. Under his proposal, tort recoveries would be taxed in a manner which would place plaintiffs in the same post-tax monetary position after receiving a recovery as they would have been in if they had not been injured. This would require taxing plaintiffs in states whose tort systems provide greater compensation at a higher rate than plaintiffs in states which provide smaller levels of compensation. *See* Dodge, *supra* note 2. Although Professor Dodge's proposal is not justified in terms of maximizing the expected utility of taxpayers, his approach is consistent with the utility-maximizing goal of equalizing consumption over alternative states of the world. Varying the tax treatment of tort recoveries to reflect differences among states, however, would add complexity to the tax code and would subsidize states that adopt tort regimes which provide lower compensation to plaintiffs.

IV. TAX POLICY AND PERSONAL INJURY RECOVERIES

A. Overview

This Part will examine the various ways in which the taxation of personal injury recoveries has been analyzed by courts, the Treasury, and, especially, by tax scholars. In particular, this Part will look at the application of two important traditional tax norms: the ideal tax base and horizontal equity.

The literature on the taxation of personal injury recoveries applies the norm of an ideal tax base by analyzing whether compensatory tort damages constitute "gain." To determine this, commentators often consider whether a basis exists in human ability. Attempts to determine the proper taxation of personal injury recoveries by looking at the treatment of "similar" transactions such as involuntary conversions of property, voluntary sales of personal rights, and the exclusion of imputed income from good health reflect the horizontal equity norm.[80]

Ideal tax base and horizontal equity arguments are viewed as attempts to support the tax exemption for personal injury recoveries on "tax principles." If a tax provision cannot be justified under tax norms, traditional analysis then considers "non-tax" policy justifications.[81] For personal injury recoveries, the most common non-tax justification is sympathy for the victim.

This Article argues that evaluating tax policy in terms of special tax norms that can, perhaps, be overridden by other ethical principles in unusual cases is inappropriate. Instead, the two-step approach taken in the model in Part II should he followed. Under this approach, the policy maker should determine the likely consequences of the tax policies under consideration and then choose the policy whose consequences are most consistent with explicitly-stated general normative principles.

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80.   *See, e.g.,* Frolik, *supra* note 8, at 17-32.
81.   *See, e.g.,* Cochran, *supra* note 8, at 44, 51-52.

B. *Gain, Horizontal Equity and the Ideal Tax Base*

1. A BRIEF HISTORY

The tax exemption for personal injury recoveries was first introduced into the federal income tax code in 1918, five years after the income tax was authorized by the Sixteenth Amendment to the U.S. Constitution.[82] While the legislative history of the Revenue Act of 1918 gave little indication of the policy underlying the exclusion,[83] court decisions and Treasury rulings issued in the wake of the Act justified the tax exemption by reasoning that personal injury recoveries did not represent gain and, thus, did not fall within the definition of taxable income.[84]

Some of these early rulings viewed personal injury damages as recovery of capital because "[t]hey merely take the place of capital in human ability which was destroyed by the accident."[85] Other decisions followed the rationale of the Supreme Court in *Eisner v. Macomber*,[86] which defined income as "gain derived from capital, from labor, or from both combined."[87] Personal injury recoveries were not taxable under the *Macomber* standard because they were compensatory and, thus, did not constitute "gain."[88] As stated by the Board of Tax Appeals in *Hawkins*

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82.   The Sixteenth Amendment was ratified on February 13, 1913. Amounts received as compensation for personal injury recoveries were excluded from gross income under § 213(b)(6) of the Revenue Act of 1918. Revenue Act of 1918, Pub. L. No. 65-254, 40 Stat. 1057 (1919). For good summaries of the early history of the personal injury exemption, see Chapman, *supra* note 8, at 413-17; Yorio, *supra* note 8, at 703-06.

83.   The legislative history of the exclusion of personal injury recoveries in the 1918 Act simply noted that it was "doubtful" whether such recoveries would constitute income in the absence of a statutory exclusion. H. Rep. No. 767, 65th Cong., 2d Sess. 9-10, *reprinted in* 1939-1 C.B. (Part 2) 86, 92.

84.   Two years after enactment of the first statutory exemption for personal injury recoveries, the Service noted that the section was "merely declarative" that a recovery which represented a return of capital rather than gain did not represent taxable income. S. 1384, 2 C.B. 71, 72 (1920) (citing 31 Op. Att'y Gen. 304 (1918)).

85.   31 Op. Att'y Gen. 304, 308 (1918). *See also* Clark v. Commissioner, 40 B.T.A. 333 (1939) (exempting damage award because it compensated for loss which impaired petitioner's capital); Farmers' & Merchants' Bank v. Commissioner, 59 F.2d 912 (6th Cir. 1932) (holding settlement exempt because it compensated for injury to business).

86.   252 U.S. 189 (1920).

87.   *Id.* at 207.

88.   Prior to *Macomber*, the Treasury had argued that the personal injury exclusion applied only to physical injuries and, thus, did not apply to libel actions or actions for alienation of affection. S. 957, 1 C.B. 65 (1919) (libel); S. 1384, 2 C.B. 71 (1920) (alienation of affection). Two years after *Macomber*, however, the Treasury ruled that damages received for alienation of affection, defamation of personal character or surrender of the custody of a minor child were not taxable because they did not constitute

v. Commissioner, "[s]uch compensation as general damages adds nothing to the individual . . . . It is an attempt to make the plaintiff whole as before the injury."[89]

The rule that taxable income can be derived only from labor or capital was overturned in 1955 by the Supreme Court in *Commissioner v. Glenshaw Glass*.[90] In *Glenshaw Glass*, the plaintiff in an antitrust action argued that punitive damages were not taxable income under the *Macomber* standard because they were "windfall" due to the culpability of the defendant, rather then "gain derived from capital, from labor, or from both combined." The Court rejected the view that only the products of labor or capital are subject to taxation and held that Congress intended to tax all gains, regardless of their source.[91] Since punitive damages clearly represent gain, they must be included in taxable income.[92]

More important for the taxation of personal injury recoveries, however, was the *dictum* in a footnote addressing compensatory damages. Here, the court stated that *compensatory* recoveries for personal injuries would not be taxable income because they represented "return of capital," rather than gain.[93] Thus, the gain requirement of *Macomber* was preserved even as the source requirement was overthrown.

Following *Glenshaw Glass*, the Treasury ruled that various compensatory recoveries, including payments by the German government to victims of Nazi oppression and payments to prisoners of war for violations of the Geneva Convention, were not taxable income because they did not represent gain to the recipients.[94] Consistent with the

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gain. Sol. Op. 132, I-1 C.B. 92 (1922). For similar reasons, the Treasury ruled in subsequent decisions that various other damage recoveries should not be considered taxable income. *See, e.g.*, I.T. 1852, II-2 C.B. 66 (1923) (annulment of marriage); I.T. 2420, VII-2 C.B. 123, 124 (1928) (payment to wife of husband killed on Lusitania); Rev. Rul. 54-19, 1954-1 C.B. 179 (wrongful death actions). More recontly, however, the Treasury ruled that the personal injury recovery exclusion is based on § 104, rather than the notion that the recovery is not income. Rev. Rul. 74-77, 1974-1 C.B. 33.

    89.   Hawkins v. Commissioner, 6 B.T.A. 1023, 1024-25 (1927), *acq.* 1 C.B. 14 (1928).

    90.   348 U.S. 426 (1955), *reh'g denied*, 349 U.S. 925 (1955). *See also* Helvering v. Bruun, 309 U.S. 461 (1940) (broadening *Macomber* definition of income).

    91.   348 U.S. at 429-30. A modern reformulation and defense of the *Macomber* standard is contained in Norman H. Lane, *A Theory of the Tax Base: The Exchange Model*, 3 AM. J. TAX POL'Y 1 (1984).

    92.   348 U.S. at 431.

    93.   348 U.S. at 432 n.8.

    94.   Rev. Rul. 56-518, 1956-2 C.B. 25 (victims of Naziism); Rev. Rul. 55-132, 1955-1 C.B. 213 (violations of Geneva Convention). *See also* Rev. Rul. 56-462, 1956-2 C.B. 20 (Korean war prisoners); Rev. Rul. 58-370, 1958-2 C.B. 14 (Austrian payments to concentration camp victims); Rev. Rul. 74-77, 1974-1 C.B. 33 (alienation of affection, surrender of child custody); Rev. Rul. 84-108, 1984-2 C.B. 32 (compensatory damages

definition of gain in *Glenshaw Glass*, Congress recently amended the
Internal Revenue Code to eliminate the tax exemption for punitive
damages received for non-physical injuries.[95]

2. THE SCHOLARLY DEBATE

Tax commentators generally agree that lost wage recoveries and
punitive damages arising from personal injuries cannot be excluded from
taxation on a "no-gain" rationale.[96]   Punitive damages, they observe,
place injured individuals in a better position than if they had never been
hurt,[97] while recoveries for lost wages replace gains from labor which
ordinarily are taxed.[98]

It is not clear, however, why "gain" should be the touchstone of
taxation. A better rationale for taxing punitive damages and lost wages
recoveries is that given in Part II of this Article—taxing such gains and
lowering tax rates to maintain revenue neutrality will increase each
taxpayer's *ex ante* expected welfare.[99]

Tax commentators generally support the exclusion for unreimbursed
medical expense recoveries.[100]   The remainder of this Part, then, will
focus on the more controversial issue of the proper taxation of damages
received for pain and suffering.

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for wrongful death); Priv. Ltr. Rul. 83-52-025 (Sept. 26, 1983) (government
compensation to crime victims). In 1988, the tax code was amended to exempt explicitly
from taxation amounts paid as restitution to U.S. citizens of Japanese ancestry as
compensation for internment during World War II. Civil Liberties Act of 1988, Pub. L.
No. 100-383, § 105(f)(1), 102 Stat. 903, 908.

    95.   *See supra* note 2.

    96.   *But see* Brooks, *supra* note 4, at 775-80 (recovery for lost earning capacity
should not be taxed because it replaces lost human capital which ordinarily is not taxed).

    97.   Frolik, *supra* note 8, at 34-35.

    98.   Cochran, *supra* note 8, at 60; Frolik, *supra* note 8, at 12-15; Harnett, *supra*
note 8, at 625; Morris, *supra* note 8, at 745, 747-48; Yorio, *supra* note 8, at 712.

    99.   *Ex ante* expected utility is maximized by taxing punitive damages at a 100%
rate. The reasoning is the same as in the case of pain and suffering damages. *See supra*
notes 60-62 and accompanying text.

    100.   *See, e.g.*, Dodge, *supra* note 2, at 145; Morris, *supra* note 8, at 748-49. One
commentator suggests that the exclusion for medical expenses should be repealed and,
instead, that accident victims should deduct their medical expenses as itemized deductions
subject to the statutory floor. *See* Frolik, *supra* note 8, at 9-10, 37.

3. RETURN OF CAPITAL

Tax scholars often have analyzed whether pain and suffering recoveries should be excluded from taxation under a return of capital theory by looking at the tax treatment of recoveries for damage to property.[101] If damages are received for the tortious destruction of property, the amount received is taxed to the extent that it exceeds the owner's adjusted basis in the property—in most cases the amount paid, less any depreciation taken.[102]

Scholars who have applied these principles to the taxation of personal injury recoveries thus argue that pain and suffering recoveries should be taxed to the extent they exceed the victim's basis in his or her injured human capital. This, in turn, necessitates determining whether a basis exists in human capital.[103]

In determining the basis of human capital, commentators typically look to the taxation of business assets. If human capital were treated like ordinary business capital, individuals would acquire a tax basis in their human capital from expenditures made to improve their earning capacity. Amounts spent on education would generate a basis for the individual whose earning potential was thereby increased, just as amounts spent to improve the earning capacity of a business asset increase the basis of the asset.[104]

Although a few scholars have suggested that a recovery of capital theory might justify the tax-free receipt of pain and suffering damages,[105] most argue that it is impossible to distinguish between the personal and business elements of investments in human capital. Expenditures for food, clothing, housing and general education, it is noted, obviously involve personal consumption, and even the costs of professional school may have a substantial personal component.[106]

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101.   See, e.g., Cochran, supra note 8, at 45-46; Frolik, supra note 8, at 16-35.

102.   See generally I.R.C. §§ 1001, 1011-1019.

103.   See, e.g., Brooks, supra note 4, at 766-68; Cochran, supra note 8, at 45-46; Frolik, supra note 8, at 26-27; Yorio, supra note 8, at 711-13.

104.   See Frolik, supra note 8, at 26-27. In some ways, educational investments in human capital are taxed more favorably than investments in other non-human capital. For example, education typically is subsidized by the public sector (either directly or through the charitable deduction) and students are not taxed on their imputed income from studying. See generally Paul B. Stephan III, Federal Income Taxation and Human Capital, 70 VA. L. REV. 1357, 1369-75 (1984).

105.   See, e.g., Morris, supra note 8, at 749 (return of capital and sympathy notions might support exclusion for pain and suffering recoveries); Stephan, supra note 104, at 1415-16 (favoring exclusion for recoveries for physical injuries).

106.   An educational expense will be deductible as a business expense under § 162 only if the education "maintains or improves" the taxpayer's skills required by his present

Since the business portion of these expenditures cannot be isolated, it is argued, a zero basis should be assumed.[107] Commentators note that a zero basis is assumed for the voluntary sale of human capital, such as the sale of intangible personal rights like the right to privacy,[108] or the sale of blood and other bodily parts or products.[109]

Previous scholars who have considered the taxation of personal injury recoveries have presented thoughtful discussions of the basis problems and other difficulties of applying traditional tax principles to such recoveries. The implicit assumption of this literature, however, is that the proper tax treatment of personal injuries (and tax policy questions) can be determined by applying generally accepted "tax norms."

The analysis of pain and suffering in the existing literature is grounded in two of the most common norms for evaluating tax policy: the ideal tax base and horizontal equity.[110] While these norms overlap, the concept of an ideal tax base underlies much of the analysis of whether

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trade or business or if the education meets the express requirements of the employer or a law or regulation which is a condition for the retention of the taxpayer's job, status or pay. A deduction will not be allowed, however, if the educational expense is necessary to satisfy the "minimum educational requirements" of the taxpayer's employment or if the education will qualify the taxpayer for a new trade or business. I.R.C. § 162; Treas. Reg. § 1.162-5 (as amended in 1967). The problem of distinguishing business from personal expenditures is common in other areas of the tax law as well, such as business-related entertainment and travel, office furnishings, and employer-provided food and housing.

107.   *See* Frolik, *supra* note 8, at 17, 26-27; Yorio, *supra* note 8, at 712. *Cf.* Cochran, *supra* note 8, at 46 (no basis recovery because personal injury compensation is not for damage to the body *per se*); Dodge, *supra* note 2, at 153 (noting conceptual problems of treating human capital as asset with basis).

108.   Starrels v. Commissioner, 304 F.2d 574, 577 (9th Cir. 1962), *aff'g* 35 T.C. 646 (1961).

109.   *See* Frolik, *supra* note 8, at 24; Note, *Tax Consequences of Transfers of Bodily Parts,* 73 COLUM. L. REV. 842, 854-55 (1973) [hereinafter *Bodily Parts*] (arguing that, though assumed to be zero, basis in one's body is considerable). In Green v. Commissioner, 74 T.C. 1229 (1980), the court held that a taxpayer with a rare blood type who sold her plasma was taxed on the amount received without recovery of basis. The taxpayer was permitted, however, to deduct special diet supplements needed to maintain the quality of her plasma. On the other hand, in United States v. Garber, 607 F.2d 92 (5th Cir. 1979) (en banc), the court overturned the criminal conviction of a taxpayer who had not reported income from the sale of plasma. The court held that it was not settled whether or not the taxpayer had any basis in her plasma. *Id.* at 95 n.2, 97.

110.   A third common tax norm is "vertical equity" which is sometimes defined as placing a greater tax burden on individuals with a greater "ability to pay." Like horizontal equity, vertical equity is seldom explicitly grounded in a more general normative theory. For a justification of a progressive tax structure using utilitarian and other welfarist norms, see Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation,* 75 CAL. L. REV. 1905 (1987).

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personal injury recoveries constitute gain, and the norm of horizontal equity underlies the comparison of the taxation of personal injury recoveries with the taxation of other transactions. The next sections will consider whether either of these traditional norms makes sense as a basis for tax policy.

4. THE IDEAL TAX BASE

a. Two ideals

Evaluating tax policies in terms of their conformity with an ideal tax base is common in tax policy discussions. The two most prominent ideal tax bases are the "normal tax base" and Haig-Simons income.[111]

The ideal of a normal tax structure is associated with the concept of "tax expenditures" advocated by Stanley Surrey and embodied in tax expenditure budgets prepared by the Treasury and the Joint Committee on Taxation.[112] Under the normal tax base, some provisions of the tax law are categorized as part of the normal tax structure and other provisions as tax expenditures designed to favor a particular class of taxpayer.[113]

The normal tax structure typically is defined to include the choice of taxable unit, the rate structure, the realization requirement, the non-taxation of most imputed income and the separate corporate tax. Tax expenditures, on the other hand, include personal deductions, tax-free employer-provided fringe benefits, the capital gains preference and most statutory nonrecognition rules such as the tax-deferred treatment of like-

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111. A third popular ideal tax base is the consumption tax. The comprehensive consumption tax base is identical to the Haig-Simons income tax base, except that changes in wealth are not taxed. The issue of whether a consumption tax is superior to an income tax has generated a large literature. *See, e.g.,* DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 59-99 (1986); WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE (Joseph A. Pechman ed. 1980); William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren,* 88 HARV. L. REV. 947 (1975); William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax,* 87 HARV. L. REV. 1113 (1974); Alvin C. Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?,* 89 YALE L.J. 1081 (1980); Alvin C. Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax,* 88 HARV. L. REV. 931 (1975).

112. The first tax expenditure budget was prepared for the fiscal year 1968. 1968 SECRETARY OF THE TREASURY ANN. REPORT ON THE STATE OF THE FINANCES 322-40 (1969). For recent tax expenditure budgets, see JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1992-1996 (JCA-4-91), March 11, 1991; OFFICE OF MANAGEMENT AND BUDGET, "TAX EXPENDITURES," SECTION XI, PART THREE, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1992, at 17-41.

113. STANLEY S. SURREY, PATHWAYS TO TAX REFORM 6-14 (1973); STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 3 (1985).

kind exchanges, involuntary conversions and corporate reorganizations.[114]

This approach is admittedly positivist—its advocates do not claim to have a general theory of the ideal tax base,[115] but instead look at features of the existing tax system and classify those features as either structural provisions or tax expenditures. Advocates of this approach have had little success, however, in providing clear principles for classifying tax provisions. It is not obvious, for example, why the non-recognition of unrealized gains and tax-free stepped-up basis at death generally are considered part of the normal tax base, while the deferral of interest on savings bonds is a tax expenditure.[116]

In contrast to the normal tax structure, the Haig-Simons tax base is defined independently of existing law. Under the Haig-Simons ideal, income is defined as the sum of an individual's consumption plus his change in wealth during the relevant time period.[117] The Haig-Simons tax base encompasses many items not taxed under existing tax law, including most items which would be viewed as tax expenditures under the normal tax base. It also includes items not taxed under the normal tax structure, such as unrealized capital gains and imputed income from owner-occupied housing.

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114.   SURREY, *supra* note 113, at 15-24; SURREY & McDANIEL, *supra* note 113, at 3.

115.   Surrey saw his tax base as a modified version of the Haig-Simons concept of income, discussed *infra*. SURREY & McDANIEL, *supra* note 113, at 4. Surrey's normal tax base, however, contained substantial departures from the Haig-Simons ideal, such as acceptance of the corporate tax, the realization requirement and the non-taxation of imputed income from property.

116.   JOINT COMMITTEE ON TAXATION, *supra* note 112, at 16. The tax expenditure budgets prepared by Treasury and the Joint Committee on Taxation differ on the classification of various items, with the Joint Committee providing a long list of tax expenditures. *Id.* at 6-7. Although the exclusions from income of employer-provided medical insurance and the personal deduction for extraordinary medical expenses are listed in the tax expenditure budget, the exclusion for personal injury recoveries is omitted. *Id.* at 15.

The classic attack on the concept of tax expenditure is contained in Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969). *See also* Stanley S. Surrey & William F. Hellmuth, *The Tax Expenditure Budget—A Response to Professor Bittker*, 22 NAT'L TAX J. 528 (1969); Boris I. Bittker, *The Tax Expenditure Budget—A Reply to Professors Surrey & Hellmuth*, 22 NAT'L TAX J. 538 (1969). For my views, see Griffith, *supra* note 9, at 345-66.

117.   HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938). *See also* Robert M. Haig, *The Concept of Income—Economic and Legal Aspects, reprinted in* THE FEDERAL INCOME TAX 7 (Robert M. Haig ed., 1921).

The precise scope of Haig-Simons income, though, is far from obvious.[118] Neither the proper treatment of charitable contributions nor is the correct taxation of home production, for example, clear under the Haig-Simons standard. Despite these and other uncertainties, Haig-Simons income is widely accepted by tax scholars as an attractive tax base, and reforms are often judged according to whether they help conform the tax base to the Haig-Simons ideal.[119] Commentators sometimes invoke the normal tax structure or Haig-Simons income in their analysis of the taxation of personal injury recoveries. Moreover, even those who do not directly refer to these norms often employ reasoning which suggests one or both.

b. The normal tax structure

The tax exemption for personal injury recoveries generally is viewed as a deviation from the "normal tax structure" and thus is characterized as a tax expenditure.[120] To determine the "normal rules" for the taxation of personal injury recoveries, commentators have looked for guidance to the rules that apply to the taxation of business damages.[121] In general, the recipient of damages for the destruction of business property is taxed on any amount received, less her basis in the property destroyed.

Commentators have argued that applying these "normal rules" to pain and suffering damages requires determining the basis of the injured individual's human capital. Most commentators, however, despair of separating the business and personal aspects of outlays which affect human productivity. The difficulty, and perhaps the fruitlessness, of such a distinction is suggested by attempts to assign a basis to an individual's genetic endowment and to determine the appropriate method of allocating basis to lost or disabled body parts.[122] Thus, commentators generally argue that human capital should be deemed to have a zero basis.[123]

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118.   *See* Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967).

119.   *See, e.g.,* WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 76-77 (9th ed., 1993).

120.   Frolik, *supra* note 8, at 7-8; Cochran, *supra* note 8, at 51-52.

121.   *See* Frolik, *supra* note 8, at 34.

122.   *See, e.g.,* Frolik, *supra* note 8, at 23-32 (damages paid on account of pain and suffering represent the proceeds of a forced conversion of a zero basis asset); Stephan, *supra* note 104, at 1388-91 (basis of endowment component of human capital is equal to value at birth); *Bodily Parts, supra* note 109. *Cf.* Frolik, *supra* note 8, at 17 (basis of consortium rights may depend on whether dowry was paid).

123.   *See* Frolik, *supra* note 8, at 26.

The inability of tax commentators to develop a satisfactory method of assigning basis to human capital does not arise from measurement problems alone; there is also no consensus on how such basis should be assessed in theory. Should an individual be permitted to amortize any portion of her education? Is an individual's body a wasting asset that should receive depreciation deductions? Should an injured individual who does not recover damages be permitted a deduction for her pain and suffering?

Analogies to the taxation of business assets do not seem helpful in answering these questions. Indeed, many of the obstacles encountered in determining the appropriate taxation of human capital stem directly from attempts to apply basis recovery rules designed for non-human capital. Conforming the taxation of human capital to standard basis recovery rules is valuable only if it serves the normative principles underlying traditional basis rules. It is necessary to determine why basis recovery generally is appropriate and then to ask if those reasons—or others—support the application of similar rules to personal injury recoveries.

Traditional basis recovery rules serve at least two important purposes. First, permitting recovery of basis is essential in order to tax businesses on their net rather than gross income. Second, permitting recovery of basis is often required for an accurate measurement of an individual's financial well-being. Such a measure might be important for the optimal redistribution of income through a progressive tax system.[124]

Consideration of the underlying goals of the basis rules suggests that basis recovery for human capital should be permitted in areas where failure to do so would lead to underinvestment in human capital. Such areas might include the costs of professional and other advanced education and the expense of on-the-job training.[125] It is unclear, however, how these goals would be served by allowing basis recovery for pain and suffering damages.

c. Haig-Simons income

Haig-Simons income is defined as consumption plus change in wealth during a specified period. It is not clear, however, how personal injury recoveries should be taxed under this standard. The argument in favor of taxation is straightforward—if an individual receives a damage award it will increase either her consumption, if spent, or her wealth, if saved. It is less certain whether a personal injury generates an offsetting reduction in consumption or wealth.

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124.   *See generally* Bankman & Griffith, *supra* note 110.

125.   *See supra* note 106.

A loss of earning capacity from a personal injury might be viewed as a reduction in wealth. Nevertheless, it seems likely that no deduction for lost earning capacity would be permitted under a Haig-Simons standard; no depreciation deduction, for example, presumably is permitted for the decline in an individual's earning capacity over time due to aging. Instead, reduced earning capacity would be reflected by a reduction in Haig-Simons income in future years.

A loss in Haig-Simons income arguably also might be created by pain and suffering associated with an injury. A permanent physical disability might be viewed as a decline in wealth, and temporary discomfort during treatment might be characterized as a reduction in the consumption of imputed income from good health. Similarly, amounts spent on medical expenses might not be viewed as consumption under a Haig-Simons standard because they only restore the injured individual to a baseline level of good health.[126]

These arguments for excluding personal injury recoveries from the tax base are grounded in the notion that an individual who receives compensation for a personal injury is no better off and thus should not be viewed as having greater income than one who was never injured. Henry Simons, however, saw his definition of income as measuring an individual's control over societal goods and services. He rejected the idea that the tax base should consider mental states.[127] It is unlikely that he would favor a deduction for pain and suffering or physical disabilities.

More broadly, it is not clear why it is relevant, as a matter of tax policy, whether an item is included within the Haig-Simons definition of income. Conforming the tax system to Haig-Simons income or any other tax base is desirable only to the extent such conformity advances more general normative principles. Haig-Simons income, especially if it is defined as control over goods and services, might serve as a useful starting point for determining the financial well-being of different individuals for purposes of redistribution. Redistribution of financial resources is consistent with a number of normative principles, including utilitarian and Rawlsian ethics.

d. The proper role of a tax base

The correct relationship between normative goals and the choice of tax base is simply stated. First, the policymaker should adopt explicit normative goals. Next, she should choose a tax base which will help

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126. *See* William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972).

127. SIMONS, *supra* note 117, at 42-43.

achieve those goals. Different tax bases will be "ideal" depending upon the particular normative goals which are selected. To illustrate, it may be useful to consider briefly how the tax base might vary according to whether a utilitarian, egalitarian, or "Rawlsian" norm is employed.

A *utilitarian* tax structure would attempt to maximize total utility in the society. This would require taxing those individuals who will suffer the smallest decline in utility from the tax. A utilitarian tax base, thus, should provide a good measure of the marginal utility of income to each taxpayer. Marginal utility of income is likely to be a function of an individual's financial resources and needs. A utilitarian tax base, therefore, would have a broad definition of income, including income from bequests and unrealized appreciation where practicable. This tax base would then be modified by various deductions and credits to reflect differences in needs among taxpayers. A progressive rate structure would be applied to this base, with the level of progressivity determined by balancing the utility gains from redistributing income from the rich to the poor against the disincentive effects of higher marginal rates.[128]

The basic question asked when selecting the tax rules under a utilitarian tax base is whether a rule helps make the tax base a better measure of the marginal value of income to the individual without generating an unreasonable administrative burden. If this standard is applied to personal injury recoveries, it is likely that recoveries for lost wages and for pain and suffering would be included in the tax base because they increase an individual's monetary income without increasing the individual's needs. Recoveries for unreimbursed medical expenses, on the other hand, would be excluded from the tax base because the individual's increased income is offset by increased expenses. This, of course, is the conclusion of the model in Part II.

Under an *egalitarian* norm, the ideal tax base will depend on what the egalitarian desires to equalize. Suppose, for example, that an individual wants to equalize overall individual utility levels. The tax base then would be very broad indeed, taking into account all factors that might affect individual welfare. An individual would be taxed on the welfare generated by non-monetary factors which increase welfare—such as robust health and a happy family life—and would receive a deduction for non-monetary factors which reduce welfare. The well-being generated by some such attributes, of course, would be difficult or impossible to measure. Nevertheless, the egalitarian could design a tax base which would adjust for differences in non-monetary well-being from physical

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128. I discuss these issues in more detail in Bankman & Griffith, *supra* note 110. An excellent summary of the literature on optimal income taxation is contained in MATTI TUOMALA, OPTIMAL TAX AND REDISTRIBUTION (1990).

disabilities. Injured individuals might be assigned a lower tax burden not only to reflect any higher medical expenses, but also to offset their presumed lower level of welfare.

Under an egalitarian tax base, personal injury recoveries for medical expenses and for pain and suffering would be excluded since they do not represent a net utility gain to the individual.[129] Indeed, recoveries for pain and suffering represent one of the rare cases where valuation problems would not limit adjustments in the tax burden for non-monetary welfare losses because the value of the loss already has been calculated in determining the amount of damages. Lost wage recoveries, on the other hand, would be included in an egalitarian tax base because they increase the welfare of the recipients to the same extent as ordinary wages.

A *Rawlsian* tax base would be consistent with Rawls' two principles of justice: (1) maximize equal liberty for all individuals; and (2) accept inequality in the distribution of primary goods only to the extent that the inequality increases the primary goods enjoyed by the least well-off group in the society.[130] These principles are often collapsed by economists into the single leximin principle of maximizing the utility of the least well-off individual in the society. Two different versions of the leximin could be adopted. First, an ethic might seek to maximize the *overall utility* of the individual with the least overall utility. Second, an ethic might seek to maximize the *utility from consumption* of the individual with the least utility from consumption.

If the goal is to maximize the overall utility of the least well-off individual, a very broad base similar to that under the egalitarian norm would be adopted. All factors affecting individual welfare would have to be considered to determine the worst-off member of society. Thus, as under an egalitarian norm, the tax base would include recoveries for lost wages, but not those for medical expenses or for pain and suffering.

Alternatively, the goal might be to maximize the utility from consumption of the individual with the least welfare from consumption. This version of the leximin is closer to the actual content of Rawls' second principle, which seeks to maximize the primary goods enjoyed by the poorest group. Under this norm, the tax base would attempt to measure each taxpayer's needs and control over goods and services and, thus, would be similar to the utilitarian base.

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129. Alternatively, such recoveries might be included in the tax base and an offsetting deduction might be granted for losses due to pain and suffering or increased medical expenses.

130. RAWLS, *supra* note 21, at 60.

Finally, an individual might wish to follow more closely Rawls' own theory and adopt a tax base which conforms to both Rawlsian principles of justice.   Since Rawls regarded the first principle of justice as lexigraphically prior to the second, a primary goal of the tax structure would be to maximize equal liberty in the society.

Maximizing equal liberty might call for high taxes on the very rich to prevent concentrations of wealth which might threaten political liberty.[131]   This could require a tax base which takes into account wealth as well as income. Maximizing equal liberty might also require a tax on large inheritances to prevent the accumulation of excessive political power within a small number of families. Liberty concerns also might constrain the sort of information that the government could require from taxpayers and might support favorable tax treatment for goods that enhance political debate, such as newspapers and magazines.[132]

Once the liberty goal has been met, a Rawlsian tax structure would seek to maximize the primary goods enjoyed by the least well-off group. As was the case under a utilitarian norm, a tax base which measures an individual's needs and control over goods and services would be optimal.

The analysis of the ideal tax base under these different normative principles has necessarily been incomplete. The important point is that the choice of tax base must be made with reference to some external ethical theory.

C. Horizontal Equity Claims

Horizontal equity is, perhaps, the most widespread norm underlying traditional tax policy analysis. It is also the least helpful. This section argues that horizontal equity cannot provide the answer to the proper tax treatment of personal injury recoveries or, in fact, to any other important tax policy question.[133]

Horizontal equity generally is defined as the principle that "individuals who are in equal positions should bear an equal tax

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131.   Rawls favored inheritance and gift taxes and restrictions on bequests in order to prevent concentrations of power which might undermine liberty and equal opportunity. *Id.* at 277.

132.   Rawls discusses tax policy briefly in A THEORY OF JUSTICE. He suggests an income tax with a minimum guaranteed income and flat marginal rates. He also suggests the use of taxes to break up concentrations of wealth. *Id.* at 277-80.

133.   The tax concept of horizontal equity has influenced the analysis of other legal problems. *See, e.g.,* Robert D. Cooter & Thomas S. Ulen, *An Economic Case for Comparative Negligence,* 61 N.Y.U. L. REV. 1067, 1095-96 (1986).

burden."[134]   The problem is that all individuals are alike in some respects and different in others.[135]   The principle of horizontal equity cannot determine which differences justify different tax treatment.

Horizontal equity arguments in the personal injury literature have involved a wide range of analogies, including comparisons of the tax treatment of personal injury recoveries to the taxation of involuntary conversions of property,[136] the exclusion from the tax base of "imputed

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134.   STANLEY S. SURREY ET AL., FEDERAL INCOME TAXATION: CASES AND MATERIALS 46 (1986). Horizontal equity is also commonly defined in the tax literature as the principle of placing the same tax burden on taxpayers who have the same "income." Under this view, tax-favored receipts such as the interest on municipal bonds are paradigm cases of horizontal equity violations. *See, e.g.,* LEWIS D. SOLOMON & JEROME M. HESCH, FEDERAL INCOME TAXATION: PROBLEMS, CASES AND MATERIALS 41 (1987). Proponents of horizontal equity generally do not explain if horizontal equity should be defined with respect to the total tax burden or if a separate horizontal equity calculation should be made for local, state and federal taxes. *See* Walter Hettich, *Reforms of the Tax Base and Horizontal Equity,* 36 NAT'L TAX J. 417, 422-24 (1983).

Economists frequently have defined horizontal equity as the principle that the utility orderings of taxpayers should not be changed by the imposition of a tax or, in the context of tax reform, that the reform should leave utility ordering unchanged. *See, e.g.,* Martin Feldstein, *On the Theory of Tax Reform,* 6 J. PUB. ECON. 77 (1976); Martin Feldstein, *Compensation in Tax Reform,* 29 NAT'L TAX J. 123 (1976). These scholars have developed various measures of the "horizontal inequity" of tax regimes which deviate from this norm. *See, e.g.,* Mervyn A. King, *An Index of Inequality: With Applications to Horizontal Equity and Social Mobility,* 51 ECONOMETRICA 99-115 (1983); Robert Plotnick, *The Concept and Measurement of Horizontal Equity,* 17 J. PUB. ECON. 373 (1982); Harvey S. Rosen, *An Approach to the Study of Income, Utility, and Horizontal Equity,* 92 Q.J. ECON. 307 (1978). The scholars do not explain, however, why it is desirable to maintain pre-tax or pre-reform utility orderings. For a persuasive criticism of this literature, see Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle,* 42 NAT'L TAX J. 139 (1989).

135.   Even proponents of the horizontal equity principle admit that it often is difficult to determine which individuals are similarly-situated. Nevertheless, they continue to make horizontal equity claims and argue that the concept remains valuable as a tax policy tool. *See, e.g.,* RICHARD A. MUSGRAVE & PETTY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 232-33 (1985); SURREY ET AL., *supra* note 134, at 46; Michael J. Graetz, *Legal Transitions: The Case for Retroactivity in Income Tax Revision,* 126 U. PENN. L. REV. 47, 79 (1977).

Other scholars have noted the ambiguity of the horizontal equity principle, but have proposed equally vague norms. Professor Thuronyi, for example, argues that the norms of horizontal equity and Haig-Simons income are based on a more general "fairness" norm and then contends that tax policies should be evaluated directly on the fairness criterion. Unfortunately, Thuronyi's fairness principle is no better defined than the concepts it is intended to replace. *See* Victor Thuronyi, *The Concept of Income,* 46 TAX L. REV. 45 (1990).

136.   *See* Cochran, *supra* note 8, at 46-47; Frolik, *supra* note 8, at 20-21.

income" from good health,[137] and the taxation of the voluntary sale of body parts.[138]   The problem with horizontal equity as a criterion for judging tax policy is similar in each case. Consider the application of the horizontal equity principle to the following three taxpayers:

(1) Alice, who earns $50,000 in wages and suffers no injury.

(2) Bob, who earns $50,000 in wages, is injured, and receives damages of $10,000 which precisely compensate him for pain and suffering.

(3) Carol, who earns $60,000 in wages and suffers no injury.

Should Bob be considered equal to Alice, or to Carol? Horizontal equity does not tell us the answer. Rather, the correct comparison depends on which of the following normative principles one finds attractive.

Principle one: Individuals should be taxed in accordance with their utility levels.

Principle two: Individuals should be taxed in accordance with their monetary income.

It is necessary to choose one of these principles *before* one can determine which of the two taxpayers are "equal." If principle one is adopted and utility levels provide the basis for comparison, then Bob is in the same position as Alice, since the welfare he gets from the extra $10,000 of income exactly matches the welfare loss from his pain and suffering. Such "utility level" horizontal equity is implicit in arguments that pain and suffering damages should be tax exempt because they replace imputed income from good health which otherwise would be received tax-free.[139]   More broadly, utility level horizontal equity underlies arguments for the exclusion of damages on the ground that such damages do not constitute gain.

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137.   *See* Brooks, *supra* note 4, at 763-73; Cochran, *supra* note 8, at 48-49; Yorio, *supra* note 8, at 713-14 (damages intended to compensate for losses that the taxpayer would have enjoyed tax-free should also be tax-free).

138.   *See* Frolik, *supra* note 8, at 23-28.

139.   *See* United States v. Kaiser, 363 U.S. 299, 311 (1960) (Frankfurter, J., concurring); Brooks, *supra* note 4, at 761, 769-75; Henry, *supra* note 8, at 728; Yorio, *supra* note 8. The unanimous view would seem to be against taxing compensation that would not have been taxable. Andrews implies such a "utility level" horizontal equity comparison in his defense of the medical deduction on the grounds that it might be desirable in theory (although impractical) to tax imputed income from good health. Andrews, *supra* note 126, at 335-36.

On the other hand, if principle two is adopted and cash income levels are the basis for comparison, then Bob is in the same position as Carol because each has an income of $60,000. "Cash income level" horizontal equity underlies the view that an individual who receives damages for the tortious invasion of personal rights should be taxed like an individual who voluntarily sells personal rights (such as privacy rights) because both have reduced those rights to cash.[140]

Horizontal equity is of no help in deciding which comparison is the correct one. Moreover, horizontal equity analysis obscures the underlying principle of decision. Utility level horizontal equity implies that "individuals should be taxed on the basis of their utility levels," while income level horizontal equity implies the principle that "individuals should be taxed according to their level of cash income." It is interesting to note that although horizontal equity arguments implying taxation according to utility levels or cash income levels are common in the tax literature, few, if any, commentators explain why a tax structure based on either principle would be desirable. This is not surprising because neither tax base is appealing. Taxation according to cash income levels would ignore differences in needs.[141] Taxation according to utility levels would require taxing non-monetary factors which affect utility, such as good health and a cheerful disposition. Neither tax base is consistent with any widely-held ethical theory.

Many of the objections raised here to the use of horizontal equity arguments in forming tax policy would apply to a wide range of equality arguments.[142] Equality arguments are particularly inappropriate in the evaluation of tax policy, however, because no feasible tax system can avoid assigning different tax burdens to individuals with identical

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140.   See Frolik, supra note 8, at 21; Cochran, supra note 8, at 46-47. Income level horizontal equity may also be implied by the argument that personal injury recoveries should be taxed like involuntary conversion of property where the damages are not reinvested.

141.   Income-based horizontal equity also ignores the capitalization of tax benefits. The benefits of tax exempt bonds, for example, largely vanish when their lower yield is take into account. See Boris I. Bittker, Equity, Efficiency and Income Tax Theory: Do Misallocations Drive Out Inequities?, 16 SAN DIEGO L. REV. 735 (1979).

142.   The criticisms here of horizontal equity as a normative principle are similar to those raised by Westen against equality as a normative principle. Peter Westen, The Empty Idea of Equality, 95 HARV. L. REV. 537 (1982). The Westen article has generated an active debate. See, e.g., Steven J. Burton, Comment on "Empty Ideas": Logical Positivist Analyses of Equality and Rules, 91 YALE L.J. 1136 (1982); Erwin Chemerinsky, In Defense of Equality: A Reply to Professor Westen, 81 MICH. L. REV. 575 (1983); Anthony D'Amato, Is Equality a Totally Empty Idea, 81 MICH. L. REV. 600 (1983); Kent Greenawalt, How Empty is the Idea of Equality, 83 COLUM. L. REV. 1167 (1983); Kenneth L. Karst, Why Equality Matters, 17 GA. L. REV. 245 (1983).

opportunity sets, but varying tastes.[143] This can be seen by considering two individuals with identical endowments but different preferences for leisure and consumption. The individual who works harder will have a higher income and will pay more in taxes. This difference would appear to violate horizontal equity because the two individuals, who are identical in all respects other than their tastes for leisure, will be taxed differently. This sort of "inequity" can be avoided only by a lump sum tax such as a "head tax"—which would assign the same tax burden to each individual, regardless of income, needs or ability—or an "ability tax"—which would tax an individual's ability to earn income rather than the individual's actual earnings. A head tax would be considered unfair under almost any ethical theory, while an ability tax would be impossible to administer and would raise serious liberty issues.[144]

D. Sympathy and Other "Non-Tax" Rationales

Commentators sometimes conclude that although no "tax principle" can support the exclusion of personal injury recoveries, the exclusion might be supported on "non-tax" grounds, such as sympathy for the victim. It has been suggested that Congress may simply have intended the personal injury exclusion to be humanitarian relief.[145] One commentator, for example, contended that although no tax principle can support a tax exemption for recoveries for loss of earnings and for pain and suffering, Congress determined that "the victim is more to be pitied than taxed" and thus "[t]he great social feeling engulfs tax logic."[146]

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143.   Joseph Stiglitz, *Taxation, Risk Taking and the Allocation of Investment in a Competitive Economy, in* STUDIES IN THE THEORY OF CAPITAL MARKETS 320 (Michael C. Jensen ed., 1972).

144.   An ability tax is impossible to administer because individuals would have an incentive to conceal their talents. It raises liberty issues because highly talented individuals would be assessed a heavy tax burden regardless of their actual earnings and thus would be precluded from working at low-paying jobs. *See* Alan Gunn, *The Case for an Income Tax,* 46 U. CHI. L. REV. 370, 381-82, 399-400 (1979); Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World,* 31 STAN. L. REV. 831, 841-42 (1979).

145.   *See, e.g.,* Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983); Epmeier v. United States, 199 F.2d 508, 511 (7th Cir. 1952) (money received as insurance payment intended to combat the ravages of disease or accident); Huddell v. Levin, 395 F. Supp. 64, 87 (D.N.J. 1975) ("A societal purpose would be served by benefiting innocent victims of tortious conduct"), *vacated on other grounds,* 537 F.2d 726 (3d Cir. 1976); Downey v. Commissioner, 97 T.C. 150 (1991); Hall v. Chicago and N.W. Ry. Co., 125 N.E. 2d 77, 86 (Ill. 1955) (jury should not mitigate damages of plaintiff by reason of income tax exclusion); Harnett, *supra* note 8, at 626-27.

146.   Harnett, *supra* note 8, at 627.

The sympathy rationale is sometimes tied to concerns of administrative convenience. If proper tax principles were followed, it is argued, some portion of personal injury recoveries, such as those for lost wages and punitive damages, would be taxable, while other portions, such as those for medical expenses and, perhaps, pain and suffering, would be received tax-free. Although similarly difficult allocations may be required for business damages,[147] since the tax treatment of the recovery depends on the nature of the underlying claim, some argue Congress believed that for personal injury recoveries "the injured party, who has suffered enough, should not be further burdened with the practical difficulty of sorting out the taxable and nontaxable components of a lump-sum award."[148]

Tax scholars are split on whether sympathy for the victim can justify a tax exemption for personal injury recoveries. Some simply reject the sympathy argument, maintaining that tax principles require the taxation of personal injury recoveries and that the tax system should be run entirely by such principles. Others reject the sympathy justification on horizontal equity grounds, arguing that personal injury awards should be taxed because no deduction is permitted for uncompensated personal injury losses,[149] and that allocations between taxable and nontaxable amounts are required for other hardship payments.[150]

Other commentators accept the sympathy rationale, but only for recoveries for medical expenses or pain and suffering.[151] It is unclear whether these writers believe that sympathy alone would justify the exemption, however, since they tend to believe that these recoveries would be exempt on "tax principles" as well. Few, if any, scholars have argued that sympathy for the victim could justify a tax exemption for lost wages or punitive damages.

In one important respect, "sympathy" arguments in the personal injury tax literature are similar to "tax principle" arguments: no reference is made to general ethical norms. More important, the separation of normative principles into tax and non-tax principles suggests that tax policies should be made by one set of norms and other policies should be made by a different set. It is hard to see why ethical principles should be so segregated.

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147.   *See* Morris, *supra* note 8, at 744; Yorio, *supra* note 8, at 708.

148.   *Roemer*, 716 F.2d at 696.

149.   *See* Cochran, *supra* note 8, at 52; Burke & Friel, *supra* note 8, at 42-44 (personal injury recoveries should be taxed and a deduction should be established for specified physical handicaps).

150.   Frolik, *supra* note 8; Henry, *supra* note 8.

151.   *See* Chapman, *supra* note 8, at 428; Morris, *supra* note 8, at 748; Blackburn, *supra* note 8, at 690.

V. CONCLUSION

This Article has argued that traditional tax norms like horizontal equity and the ideal tax base should be abandoned as tools for tax policy analysis because they are not grounded in any more general ethical theory. To be sure, the policy conclusions reached under traditional tax norms are often sensible. Indeed, the conclusions reached under traditional tax analysis with respect to the proper tax treatment of lost wage recoveries and medical expenses generally are similar to the results reached under the model in Part II.

This is not surprising. The widespread support for traditional tax norms would not exist if the norms were not, in most cases, consistent with broader ethics. The Haig-Simons tax base, for example, often provides a good measure of an individual's economic well-being and, with appropriate adjustments for differences in needs, might well be adopted as a tax base under a utilitarian or Rawlsian ethic. Treating equal individuals equally would be appropriate under any ethical principle; the difficulty with horizontal equity is that it cannot tell us which individuals are equal.

The policy results reached under traditional tax norms are not always the same, however, as those reached under broader ethics. The analysis of pain and suffering damages in the model in Part II under an *ex ante* Pareto superiority norm, for example, led to quite different conclusions than those reached by some commentators using traditional tax norms.

The treatment of personal injury recoveries is secondary, however, to the central theme of this Article: policy makers should abandon special tax norms in tax analysis and instead adopt a two-step procedure. First, they should determine the likely consequences of alternative tax rules. Second, they should evaluate those consequences under explicitly-stated general ethical principles.