

# TAXING PAIN AND SUFFERING

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*Every year, billions of dollars are awarded as compensation for pain and suffering. A hard question—one that has vexed courts, legislators, and academics alike—is how we should tax them (if, indeed, we should tax them at all). In this Note, I articulate a new answer. If we take seriously the value of equality between injured people and uninjured people, we ought to tax compensatory damages for pain and suffering.*

*In Part I, I criticize an influential approach to the taxation of compensatory damages for pain and suffering. This approach appeals to various intuitive normative principles to justify exempting pain and suffering damages from tax. I argue that these principles are estranged from their normative foundations. Such principles are intuitive because they seem to embody an ideal of equality between injured people and uninjured people. But, as I show in Part I, equality does not always justify exempting pain and suffering damages from tax. Sometimes, a well-designed tax on pain and suffering damages serves equality better than an exemption does.*

*In Parts II and III, I determine which tax regime best respects the ideal of equality between the injured and the uninjured, giving that value neither too little nor too much weight. Following the optimal tax literature, I divide the work into two parts. First, I determine which tax policies would be best under the assumption that no one modifies their behavior in anticipation of tax consequences. To do this, I formulate an appropriate social welfare function, I estimate the relevant parameters, and I simulate optimal tax rates. I then consider whether the resulting taxes should be modified in light of behavioral responses that we should expect in the real world.*

*I conclude that we should tax some, and likely many, compensatory damages for pain and suffering—and we should do so at rates that increase with damages. Perhaps counterintuitively, this tax scheme is the best way of balancing the competing demands of creating well-being and distributing it equally.*

INTRODUCTION .....	508
I. INADEQUATE NORMATIVE FRAMEWORKS .....	513
A. <i>Losses and Gains</i> .....	514
B. <i>In Lieu Of</i> .....	518
II. A COMPREHENSIVE APPROACH TO TAXING PAIN AND SUFFERING .....	521
A. <i>A Comprehensive Approach to Equality</i> .....	522

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1.	<i>An Argument for Equality Between the Injured and the Uninjured</i> .....	522
2.	<i>The Atkinson Social Welfare Function</i> .....	524
B.	<i>Simulation of Optimal Tax Rates</i> .....	526
1.	<i>Model</i> .....	526
2.	<i>Results</i> .....	529
3.	<i>Discussion</i> .....	532
C.	<i>Provisional Policy Implications</i> .....	534
III.	IMPLEMENTING AN OPTIMAL TAX .....	534
A.	<i>Efficiency</i> .....	535
1.	<i>The Tax Base</i> .....	537
2.	<i>The Rate Structure</i> .....	538
B.	<i>Tax Avoidance</i> .....	539
1.	<i>Trials</i> .....	540
2.	<i>Settlements</i> .....	541
C.	<i>Summing Up</i> .....	543
	CONCLUSION .....	543

## INTRODUCTION

In 2008, Erin Andrews, a famous sportscaster, stayed at a Marriott in Nashville.<sup>1</sup> Michael Barrett tracked her down, rented the room next to hers, and modified her door’s peephole so that he could film her naked.<sup>2</sup> He then put the video on the internet, where it likely will remain, in some form, until the end of civilization.<sup>3</sup> Approximately 16.8 million people had seen the video by the time Andrews brought Barrett and two hotel companies to trial.<sup>4</sup> The video “ripped [her] apart.”<sup>5</sup> A psychologist testified that she had post-traumatic stress disorder (PTSD).<sup>6</sup> And, as her lawyer put it, “this is a

<sup>1</sup> See Daniel Victor, *Erin Andrews Awarded \$55 Million in Lawsuit over Nude Video at Hotel*, N.Y. TIMES (Mar. 7, 2016), <https://www.nytimes.com/2016/03/08/business/media/erin-andrews-awarded-55-million-in-lawsuit-over-nude-video-at-hotel.html>. I was alerted to this example and to salient facts about it by Scott Hershovitz, *The Search for a Grand Unified Theory of Tort Law*, 130 HARV. L. REV. 942, 953, 963–64 (2017) (reviewing ARTHUR RIPSTEIN, *PRIVATE WRONGS* (2016)).

<sup>2</sup> See Suzannah Gonzales & Fiona Ortiz, *Jury Awards Erin Andrews \$55 Million in Lawsuit over Nude Video*, REUTERS (Mar. 7, 2016), <https://www.reuters.com/article/us-tennessee-andrews-stalking-verdict/jury-awards-erin-andrews-55-million-in-lawsuit-over-nude-video-idUSKCN0W92IL>; see also Hershovitz, *supra* note 1, at 953.

<sup>3</sup> Gonzalez & Ortiz, *supra* note 2.

<sup>4</sup> Alex Johnson, *Erin Andrews Tearfully Testifies Stalker’s Nude Videos ‘Ripped Me Apart,’* NBC NEWS (Feb. 29, 2016), <https://www.nbcnews.com/news/us-news/sportscaster-erin-andrews-testifies-nude-videos-case-n528061>.

<sup>5</sup> *Id.*

<sup>6</sup> Harriet Sokmensuer, *Erin Andrews Has ‘Mild PTSD’ from Secretly Filmed Nude Tape, Psychologist for Defense Testifies*, PEOPLE (Mar. 2, 2016), <http://people.com/crime/>

PTSD for which there is no ‘post.’”<sup>7</sup> “I’ll always have to go get treatment for this,” she said.<sup>8</sup> “I’ll always need to talk to somebody about this. Because this will always be on the Internet. . . . There will always be a reminder. Every . . . single . . . day.”<sup>9</sup> To compensate for her injuries, a jury awarded Andrews \$55 million.<sup>10</sup>

Even if Barrett and his codefendants pay in full, Andrews won’t see close to this amount. Pursuant to a limited exception for physical injuries, compensatory damages are subject to the federal income tax.<sup>11</sup> It’s impossible to know exactly how much of Andrews’s damages the IRS will claim; but if they are taxed at the top marginal rate, the state’s share will be \$20,350,000.<sup>12</sup>

Should we tax damages like these: compensatory damages for pain and suffering?<sup>13</sup> It is important to get this question right, and not just out of fairness to people like Erin Andrews. Billions of dollars likely are awarded for pain and suffering every year.<sup>14</sup> Since so much money changes hands through these damages, we risk considerable distributive injustice if we don’t tax these damages properly—if we tax them too much or, indeed, if we don’t tax them enough.

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psychologist-testifies-erin-andrews-has-mild-ptsd; *see also* Hershovitz, *supra* note 1, at 963–64.

<sup>7</sup> Harriet Sokmensuer, *Erin Andrews ‘Living a Nightmare,’ Says Lawyer in Closing Statement of \$75 Million Civil Trial over Leaked Nude Video*, PEOPLE (Mar. 4, 2016), <https://people.com/crime/erin-andrews-trial-lawyer-says-sportscaster-is-living-a-nightmare>; *see also* Hershovitz, *supra* note 1, at 964.

<sup>8</sup> Michael McCarthy, *Heartbroken Erin Andrews Admits What Hurts Most About Peephole Scandal*, SPORTING NEWS (Mar. 1, 2016), <http://www.sportingnews.com/other-sports/news/erin-andrews-lawsuit-peeephole-fox-sports-espn-75-million-civil-lawsuit-michael-david-barrett/12y5r2wwqi5zz19hkszulk4w0t>.

<sup>9</sup> *Id.*

<sup>10</sup> Victor, *supra* note 1; *see also* Hershovitz, *supra* note 1, at 963.

<sup>11</sup> *See* I.R.C. § 104(a)(2) (2012) (exempting “damages (other than punitive damages) received . . . on account of personal physical injuries or physical sickness” from taxation); *id.* § 61(a) (including “all income from whatever source derived,” unless specifically exempted by another provision).

<sup>12</sup> The top marginal tax rate on individuals is currently 37%. *See* I.R.C. § 1 (West Supp. 2017).  $\$55,000,000 * 0.37 = \$20,350,000$ .

<sup>13</sup> I will sometimes refer to these damages as “pain and suffering damages,” for brevity. I use “pain and suffering damages” as a residual category, which contains all those damages left after economic damages, medical expenses, and lost wages have been factored out. For a similar definition, *see* Steven P. Croley & Jon D. Hanson, *The Nonpecuniary Costs of Accidents: Pain-and-Suffering Damages in Tort Law*, 108 HARV. L. REV. 1785, 1789 n.11 (1995).

<sup>14</sup> It is difficult to find a reliable yearly estimate of the total amount of pain and suffering damages awarded in the United States. In 2010, one team of researchers found that noneconomic damages cost \$2.4 billion (in 2008 dollars) to healthcare providers alone. *See* Michelle M. Mello et al., *National Costs of the Medical Liability System*, 29 HEALTH AFF. 1569, 1570 (2010). The total amount of pain and suffering damages awarded across the entire tort system is likely considerably higher than this figure.

Courts and legislatures have tied themselves into knots attempting to address this issue. Before 1996, compensatory damages were excludable if they were received “on account of personal injuries or sickness,”<sup>15</sup> a standard which the Department of the Treasury interpreted to be satisfied if the damages originated in “tort or tort type rights.”<sup>16</sup> Sculpting the contours of this formless standard produced a pile of litigation, including two Supreme Court cases in four years.<sup>17</sup> Afterwards, in 1996, Congress amended the Internal Revenue Code to exempt all damages received “on account of personal physical injuries or physical sickness” and to tax all other compensatory damages at ordinary rates.<sup>18</sup> The hope was that this amendment would clarify the law.<sup>19</sup> But the 1996 amendment spawned its own interpretive challenges and some baffling results. In the recent case of *Collins v. Commissioner*, for example, the plaintiff was subjected to a racially hostile work environment and received damages to compensate both for emotional trauma and for ensuing physical symptoms.<sup>20</sup> The Tax Court held that his \$85,000 in damages for emotional distress was fully taxable.<sup>21</sup> The emotional distress, after all, caused the physical injury, and not the other way around.<sup>22</sup> Had it been the other way around—had a physical injury caused Collins’s emotional distress—those \$85,000 would have been completely tax exempt.<sup>23</sup>

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<sup>15</sup> I.R.C. § 104(a)(2) (1994).

<sup>16</sup> 26 C.F.R. § 1.104-1(c) (1995).

<sup>17</sup> See *Comm’r v. Schleier*, 515 U.S. 323, 327 (1995) (holding that money received in settlement of claim under the Age Discrimination in Employment Act was not excludable under I.R.C. § 104(a)(2)); *United States v. Burke*, 504 U.S. 229, 242 (1992) (holding that damages for unlawful discrimination under Title VII of the Civil Rights Act were not excludable under I.R.C. § 104(a)(2)).

<sup>18</sup> See I.R.C. § 61(a) (2012) (including all income “from whatever source derived” unless specifically exempted); Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605(a)(2), 110 Stat. 1755, 1838 (providing the language exempting such damages).

<sup>19</sup> See H.R. REP. NO. 104-586, at 143 (1996) (praising the amendment for providing “a bright-line standard which avoids prospective litigation”).

<sup>20</sup> See *Collins v. Comm’r*, No. 16245-15S, 2017 WL 4015039, at \*1–2 (T.C. Sept. 11, 2017).

<sup>21</sup> *Id.* at \*4.

<sup>22</sup> See *id.*

<sup>23</sup> See Robert W. Wood, *Taxing Emotional Distress and Physical Sickness: Chicken or Egg?*, 157 TAX NOTES 1635, 1636 (2017) (“[The tax treatment of Collins’s settlement] might have been different if his physical sickness came first, producing emotional distress.”); see also H.R. REP. NO. 104-586, at 143–44 (“If an action has its origin in a physical injury or physical sickness, then all damages . . . that flow therefrom are treated as payments received on account of physical injury or physical sickness . . .”).

Few tax scholars would say that the law's current approach to the taxation of pain and suffering damages is the best it could be.<sup>24</sup> But there is little agreement about what, exactly, is the best alternative.<sup>25</sup>

In this Note, I articulate a new approach to the taxation of damages for pain and suffering. I claim that we should evaluate possible tax schemes by considering their effects on the total amount of well-being and how equally well-being is distributed between injured people and uninjured people.<sup>26</sup> I then estimate which tax policies would be best under this standard. To do this, I first formulate an appropriate social welfare function and simulate which tax rates would maximize this function.<sup>27</sup> Second, I consider whether such ideal tax policies need to be modified in light of behavioral responses that we should expect in the real world. I conclude that we should tax some, and likely many, pain and suffering damages—and at rates that increase with damages.

That conclusion might be surprising; it might seem obvious that pain and suffering damages should not be taxed. In Part I, I show that

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<sup>24</sup> The tax policy literature contains two main camps, both of whom find something to criticize in the current law. One camp alleges that *all* pain and suffering damages should be taxed. See, e.g., Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143, 180–88 (1992); Thomas D. Griffith, *Should “Tax Norms” Be Abandoned? Rethinking Tax Policy Analysis and the Taxation of Personal Injury Recoveries*, 1993 WIS. L. REV. 1115, 1130–34. The other camp alleges that *no* pain and suffering damages should be taxed. See, e.g., William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 331–34 (1972); Jennifer J.S. Brooks, *Developing a Theory of Damage Recovery Taxation*, 14 WM. MITCHELL L. REV. 759, 769–73 (1988); Laura Sager & Stephen Cohen, *Discrimination Against Damages for Unlawful Discrimination: The Supreme Court, Congress, and the Income Tax*, 35 HARV. J. ON LEGIS. 447, 449 (1998). Both of these positions are at odds with current law, which excludes such damages when, but only when, they originate in a physical injury. See *supra* notes 11–23 and accompanying text.

<sup>25</sup> See *supra* note 24 (describing main camps in the scholarly literature); see also Griffith, *supra* note 24, at 1118 (reporting the lack of scholarly consensus).

<sup>26</sup> I use “welfare” and “well-being” interchangeably.

<sup>27</sup> Social welfare functions are normative rankings of possible social states based on how much well-being there is and how that well-being is distributed. See MATTHEW D. ADLER, *WELL-BEING AND FAIR DISTRIBUTION: BEYOND COST-BENEFIT ANALYSIS*, at xiv (2012). Social welfare functions are commonly used to evaluate tax policy. See, e.g., LOUIS KAPLOW, *THE THEORY OF TAXATION AND PUBLIC ECONOMICS* (2011) (evaluating many facets of tax policy by appeal to a utilitarian social welfare function); Lily L. Batchelder, *What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax*, 63 TAX L. REV. 1, 2, 5, 11 (2009) (evaluating inheritance taxation by appeal to a social welfare function); Jacob Goldin & Zachary Liscow, *Beyond Head of Household: Rethinking the Taxation of Single Parents*, 71 TAX L. REV. 367, 369 (2018) (evaluating the taxation of single parents by appeal to a utilitarian social welfare function); Griffith, *supra* note 24, at 1122 (evaluating the taxation of damage awards by appeal to a utilitarian social welfare function). Though tax policy analysts typically use a utilitarian social welfare function—i.e., one that accords normative significance only to the *total* amount of well-being—this is by no means necessary. See ADLER, *supra*, at xiv (explaining that social welfare functions need not be utilitarian); Batchelder, *supra*, at 6 n.18 (same).

these appearances deceive. First, I argue that the most plausible foundation for this anti-tax intuition is the value of equality between the injured and the uninjured. Second, I demonstrate that a tax exemption sometimes can *increase* inequality between the injured and the uninjured. By concentrating the tax burden on uninjured people, a full exemption for pain and suffering damages can make uninjured people worse off than those injured people who receive compensation—so worse off, indeed, that there is more inequality between the two classes of people than there would be if pain and suffering damages were taxed. The value that most plausibly justifies the anti-tax intuition, then, does not actually justify that intuition. The upshot of this discussion is that the demands implied by the value of equality between the injured and the uninjured are complex. Accordingly, if we believe in this value—as I do—we should analyze these demands concertedly.

In Parts II and III of this Note, I perform that analysis. To make the problem tractable, I divide the work into two steps.<sup>28</sup> First, in Part II, I adopt the simplifying assumption that people do not adjust their behavior in response to tax policy, and I determine which tax rates on pain and suffering damages would produce an optimal distribution of well-being under this assumption. Second, in Part III, I discuss whether and how the policy conclusions of Part II ought to be modified in light of anticipated behavioral responses.

In Part II, I describe which taxes on pain and suffering damages are best under static conditions. To determine this, I first outline a new normative framework for the tax treatment of pain and suffering damages. This framework has two main virtues. First, it is explicitly derived from plausible premises. Second, it allows us to derive precise policy implications. I propose that we should think about how to tax pain and suffering damages by evaluating two outcomes of possible policies: (a) the total amount of welfare and (b) how equally that welfare is distributed between the injured and the uninjured. I then use this framework to estimate optimal tax policies. I describe a social welfare function, known as the Atkinson social welfare function, that gives some degree of normative weight to total welfare and some weight to its equal distribution; I estimate the relevant parameters; and I simulate optimal tax rates. The tentative upshot is that we should tax some, and likely many, pain and suffering damages—and we should do this at rates that increase with damages.

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<sup>28</sup> This division is common in tax policy analysis. See, e.g., KAPLOW, *supra* note 27, at 315–44 (analyzing optimal tax policies with respect to families in this way); Goldin & Liscow, *supra* note 27, at 390–410 (same); Griffith, *supra* note 24, at 1130–35 (analyzing optimal taxes on pain and suffering damages in this way).

In Part III, I discuss whether and how this tax scheme should be modified in light of potential behavioral responses to it. Two concerns are paramount: efficiency and opportunities for tax avoidance. I argue that these considerations have two implications. First, the maximum tax rate might need to be lower than the top rates described in Part II. Second, a tax on pain and suffering damages received might need to be paired with a corresponding deduction for pain and suffering damages paid. But neither efficiency nor tax avoidance should cause us to retreat from taxing pain and suffering damages according to the structure I describe. This tax is the best way of balancing the competing demands of increasing the total amount of well-being and distributing it equally.

## I

### INADEQUATE NORMATIVE FRAMEWORKS

To think about the proper tax treatment of pain and suffering damages, we need a normative framework: a set of principles that specify what ought to be done in various circumstances. The two most prominent frameworks in the tax literature appeal to intuitive moral principles—principles which, I suspect, many thoughtful people would use to approach this issue if pressed. The first approach, made prominent by William Andrews, alleges that compensatory damages for pain and suffering are not truly a *gain*, for they serve only to neutralize a previous *loss*.<sup>29</sup> Being injured and then receiving pain and suffering damages is like handing over one dollar and getting four quarters in return. By neither exchange is one made better off; accordingly, one's tax burden should not be increased by either. The second approach, which appears to have influenced the 1996 Tax Reform Bill,<sup>30</sup> appeals to the so-called “in lieu of” principle, according to which damages should not be taxed if they “compensate for loss of a right that would otherwise have been enjoyed tax free.”<sup>31</sup> Since one is not taxed on, say, the joy of playing the piano, one should not be taxed on damages which compensate for losing that joy.

Though intuitive, the principles to which these approaches appeal are not *basic*—that is, if they are true, that is so because some deeper

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<sup>29</sup> See Andrews, *supra* note 24, at 334, 336.

<sup>30</sup> The Report of the House Committee on Ways and Means justifies the physical/non-physical distinction by appealing to the “in lieu of” principle. See H.R. REP. NO. 104-586, at 143 (1996) (“Damages received on a claim not involving a physical injury or physical sickness are generally to compensate the claimant for lost profits or lost wages that would otherwise be included in taxable income.”).

<sup>31</sup> Sager & Cohen, *supra* note 24, at 449 (quoting 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 5.6, 5-43 (1986)).

normative proposition implies them.<sup>32</sup> In this Part, I argue that the “losses and gains” principle and the “in lieu of” principle sit shakily on their normative foundations. The most plausible explanation for both principles—an ideal of equality between the injured and the uninjured—does not actually imply these principles. Thus, to determine the optimal tax treatment of pain and suffering damages, we should bypass these tempting but misleading principles. We should, instead, directly analyze how to respond to the value of equality between the injured and the uninjured. I take up this more constructive task in Parts II and III. In Part I, I do the prior and necessary critical work.

### A. *Losses and Gains*

The intuition behind the losses and gains argument is best conveyed through an example. Compare Erin Andrews to another sportscaster (call him “Eric Andrews”) whose ordinary income is equal to hers.<sup>33</sup> Erin travels to Nashville, suffers a gross invasion of her privacy, and receives \$55 million in compensatory damages. Eric does not. On the (cheery) assumption that Erin’s damages are enough to make her just as well off as Eric, equality between them has been preserved. But if we then *tax* Erin on her damages, we undermine equality between the two. The greater the tax, the lower Erin sinks below Eric’s level. So we ought not to tax Erin’s damages at all. That is the only way to minimize inequality between the injured and the uninjured.

One way to resist this argument would be to reject the value of equality between the injured and the uninjured.<sup>34</sup> That is not my take; I think that this value is defensible.<sup>35</sup> Rather, the chief mistake of the losses and gains argument is that it misunderstands which *policies* preserve equality between the injured and the uninjured.<sup>36</sup> Even if we maximally cared about equality between the injured and the uninjured, we would not always exempt pain and suffering damages from tax. So the losses and gains argument is unsound: We cannot infer,

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<sup>32</sup> See generally Ketan H. Ramakrishnan, *The Collapse of Deontology* (Jan. 23, 2017) (unpublished term paper, New York University) (on file with New York University Law Review) (distinguishing between basic and derivative normative truths).

<sup>33</sup> I use “ordinary income” to refer to income other than pain and suffering damages.

<sup>34</sup> Thomas Griffith takes this approach. See Griffith, *supra* note 24, at 1130–34 (evaluating policies with the utilitarian social welfare function, which does not accord any weight to how equally well-being is distributed).

<sup>35</sup> See *infra* Section II.A.1.

<sup>36</sup> This is not the only mistake that it makes. As I claim below, the taxation of pain and suffering damages forces us to make tradeoffs between total welfare and its equal distribution, and it is a mistake to assign lexical priority to equality (as the losses and gains argument does). See *infra* note 64 and accompanying text.



from the fact that tort victims have suffered a loss, that their pain and suffering damages ought to be wholly exempt from tax.

My argument for this claim proceeds in two steps. First, I will show that, because of the declining marginal utility of consumption, taxing  $n$  dollars from someone who receives pain and suffering damages reduces her welfare by less than does taxing  $n$  dollars from someone who does not receive such damages. Second, I will show that this fact implies a surprising consequence: Even if we maximally cared about equality between the injured and the uninjured, we sometimes would tax pain and suffering damages.

It is commonplace that an additional dollar means much more to a homeless person than it does to Jeff Bezos—or, more generally, that each additional dollar tends to improve a person's welfare by less than the last one.<sup>37</sup> This is the declining marginal utility of consumption. Because of the declining marginal utility of consumption, pain and suffering damages significantly differ from other types of compensatory damages such as lost wages and medical expenses.<sup>38</sup> Lost wages and medical expenses simply *replace* lost consumption. By contrast, pain and suffering damages attempt to ameliorate some welfare loss with *additional* consumption. Thus, the welfare consequences of taxing pain and suffering damages differ from those of taxing other forms of damages (or taxing other forms of income, for that matter). Taxing  $n$  dollars from someone who receives pain and suffering damages reduces her welfare by less than taxing  $n$  dollars reduces the welfare of someone who does not receive such damages.

To see this, consider a simple numerical example. We are concerned with two people: Injured and Uninjured. They have the same pre-tax and pre-injury income: \$100,000. Injured then is hurt and receives \$200,000 in pain and suffering damages from a third party (the tortfeasor). Injured now has \$300,000 in pre-tax income compared to \$100,000 in the hands of Uninjured.<sup>39</sup> Whatever money they have after tax, they consume for themselves, spending it on food, clothes, opera tickets, NASCAR races, and the like. The two people have identical utility functions, which have two inputs: (a) the size of the person's injury (zero for Uninjured) and (b) the number of dollars

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<sup>37</sup> But see Sarah B. Lawsky, *On the Edge: Declining Marginal Utility and Tax Policy*, 95 MINN. L. REV. 904 (2011) (posing counterexamples to the claim that money always has diminishing marginal utility).

<sup>38</sup> William Andrews, in his exposition of the losses and gains argument, makes the mistake of conflating the two. See Andrews, *supra* note 24, at 331–34.

<sup>39</sup> This example assumes that the injury does not affect the injured person's income on the year. It assumes, among other things, that Injured does not have to pay attorneys or does not suffer some reduction of his earnings capacity. These assumptions are unrealistic, but they are made solely for simplicity. My argument does not require them to be true.

they consume.<sup>40</sup> Assume that the consumption term of the utility function exhibits diminishing marginal returns<sup>41</sup>—for concreteness, suppose that the utility derived from consumption is the square root of consumption—and also assume that damages are fully compensatory, such that the welfare gained from consuming the damages equals the welfare lost from the injury.<sup>42</sup> The situations of Injured and Uninjured are reflected in Table 1.

TABLE 1

	Ordinary Income	Damages	Pre-Tax Income	Welfare from Consumption	Welfare Loss from Injury	Injury-Adjusted Welfare
Injured	100,000	200,000	300,000	548 <sup>43</sup>	-231 <sup>44</sup>	316
Uninjured	100,000	0	100,000	316 <sup>45</sup>	0	316

Now compare the effects of a \$10,000 tax levied on Injured to a \$10,000 tax levied on Uninjured. If Injured pays the tax, his welfare declines to 307 units.<sup>46</sup> If Uninjured pays the tax, his welfare declines to 300 units.<sup>47</sup> In other words, the same tax hits Uninjured harder than it hits Injured, and the reason for this is the declining marginal utility of consumption. Even though Injured and Uninjured reached the same level of welfare before tax, Injured got there by consuming much more than Uninjured—by consuming his damage award to make up for his injury. Because Uninjured consumes less than Injured, his marginal utility is higher. Thus, a tax of  $n$  dollars causes a greater loss to Uninjured than it does to Injured.

This implies that an exemption for pain and suffering damages can sometimes *aggravate* inequality between the injured and the uninjured. If we assume—as is standard in the evaluation of tax bases<sup>48</sup>—that the government must raise the same amount of revenue under various tax regimes, an exemption has the effect of shifting

<sup>40</sup> In this Note, I use utility functions to represent persons' well-being. See ADLER, *supra* note 27, at xiv (using utility functions in the same way).

<sup>41</sup> Or, more formally, that it is strictly concave.

<sup>42</sup> Mathematically: Let  $I$  be the welfare loss from an injury,  $W$  be the amount of Injured's ordinary income,  $P$  be the amount of Injured's pain and suffering damages, and  $U$  be Injured's utility. Then  $U(P + W) - I = U(W)$ .

<sup>43</sup>  $\sqrt{200,000 + 100,000} \approx 548$

<sup>44</sup>  $\sqrt{200,000 + 100,000} - \sqrt{100,000} \approx 231$

<sup>45</sup>  $\sqrt{100,000} \approx 316$

<sup>46</sup>  $\sqrt{300,000 - 10,000} - 232 \approx 307$

<sup>47</sup>  $\sqrt{100,000 - 10,000} = 300$

<sup>48</sup> See, e.g., KAPLOW, *supra* note 27, at 23 (stating the assumption of revenue neutrality).

some tax burden from those who get the exemption to those who do not. Moreover, as I have shown, a marginal dollar of tax hurts the uninjured worse than it does the injured. Thus, it is possible for an exemption to be *too* generous to the injured. Under an exemption regime, the uninjured can be worse off than the injured. And, crucially, the inequality between the two under the exemption regime can be *worse* than the inequality that results when pain and suffering damages are included in the tax base.

To see this, reconsider the example of Injured and Uninjured. Assume that the government must hit a constant revenue target. (Suppose, for concreteness, that this target is \$100,000.) The government makes two choices. First, whether to include or exclude pain and suffering damages from the tax base. Second, what rate at which to tax all income in the base.

TABLE 2

	Other Income	Damages	Pre-Tax Income	Taxable Income	Post-Tax Income	Welfare from Consumption	Welfare Loss from Injury	Injury-Adjusted Welfare
Injured	100,000	200,000	300,000	300,000	225,000	474	-232	242
Uninjured	100,000	0	100,000	100,000	75,000	274	0	274
Total	200,000	200,000	400,000	400,000	300,000	748	-232	516
Difference								32

TABLE 3

	Other Income	Damages	Pre-Tax Income	Taxable Income	Post-Tax Income	Welfare from Consumption	Welfare Loss from Injury	Injury-Adjusted Welfare
Injured	100,000	200,000	300,000	100,000	250,000	500	-232	268
Uninjured	100,000	0	100,000	100,000	50,000	224	0	224
Total	200,000	200,000	400,000	200,000	300,000	724	-232	492
Difference								46

Suppose that the government decides to tax pain and suffering damages. This means that it has to levy a 25% tax.<sup>49</sup> These policies

<sup>49</sup> Since the tax base is \$400,000 and the revenue target is \$100,000, the tax rate must be 25%.  $\frac{\$100,000}{\$400,000} = 0.25$ .

produce the results depicted in Table 2. Since we are solely concerned with inequality of welfare, the important results are in the final column. Uninjured is better off than Injured by 32 units of well-being. This is unsurprising; qualitatively, it is the result that we would intuitively expect from reflecting on cases like that involving the two sportscasters, Erin and Eric Andrews.

But now suppose that the government decides to exclude pain and suffering damages. Since the tax base has shrunk, it must raise tax rates to 50% to hit its revenue target.<sup>50</sup> These policies produce the results depicted in Table 3. Now *Injured* is better off than Uninjured. And, crucially, the difference between the two is *greater* than the difference that we observed when pain and suffering damages were taxed. Now there are 46 units worth of difference between the two, not just 32.

These examples were constructed by making several assumptions, some of which are unrealistic. (Most strikingly, the ratio of injured people to uninjured people is not 1:1.) But my assumptions need not be realistic in order for my points to hold. My first point is that the ideal of equality between the injured and the uninjured accounts for *all* of the intuitive appeal of the argument involving losses and gains. This point can be confirmed by reflecting on the merely hypothetical case of Injured and Uninjured. In that case, equality counts against an exemption. Does the fact that Injured has suffered a loss lend any independent support for an exemption? It seems not. To be sure, Injured's loss may bear on the ideal policy by means of affecting equality between the two, perhaps making some middle ground between an exemption and full taxation (i.e., taxing pain and suffering damages at a preferential rate) most preferable. But if the policy space is limited to (a) full taxation and (b) an exemption, the fact of loss seems totally irrelevant once equality is already accounted for. My second point is that a sounder approach to the taxation of pain and suffering damages would focus explicitly on the effects of policies on the distribution of welfare between the injured and the uninjured. As we have seen, the relationships between policies and distributions are not as obvious as one might first think.

### B. *In Lieu Of*

Let us now consider the in lieu of principle, according to which damages should not be taxed if they “compensate for loss of a right

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<sup>50</sup> Since the tax base is \$200,000 and the revenue target is \$100,000, the tax rate must be 50%.  $\frac{\$100,000}{\$200,000} = 0.50$ .

that would otherwise have been enjoyed tax free.”<sup>51</sup> Unfortunately, the normative underpinnings of this principle are hard to identify. After examining three of the strongest candidates, I suggest that the only foundation that withstands critical scrutiny is the same ideal of equality between the injured and the uninjured that underlies the argument involving losses and gains. As we just saw, though, this value does not imply that pain and suffering damages should always escape tax. Thus, even fans of the in lieu of principle would do better to refocus their attention on equality itself and examine its implications explicitly.

The first and perhaps the most obvious support for the in lieu of principle is the (in)famous tax norm of horizontal equity.<sup>52</sup> There are two main articulations of what horizontal equity amounts to. Perhaps the most precise one is that if two people earn the same amount of income, they ought to pay the same amount in tax.<sup>53</sup> Alternatively, we might construe horizontal equity as a vaguer injunction to treat like cases alike.<sup>54</sup> From this interpretation of the norm, the in lieu of principle follows so long as we make the auxiliary assumption that uninjured people and injured people who receive compensatory damages are alike in the relevant sense.

Interpreted narrowly, horizontal equity does not support the in lieu of principle. Comparisons of people who receive compensatory damages and people who do not are simply outside of horizontal equity’s scope, for these two classes of people do not earn the same amounts of income.

Moreover, there are two problems with invoking the broad interpretation of horizontal equity to support the in lieu of principle. The first is that horizontal equity is not a highly compelling candidate for being a basic normative truth—a normative proposition, like the principle that each of us has reason to avoid pain, that we could reason-

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<sup>51</sup> Sager & Cohen, *supra* note 24, at 449 (quoting 1 BITTKER & LOKKEN, *supra* note 31, at ¶ 5.6, 5-43).

<sup>52</sup> For a locus classicus, see R.A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 45 (1967), which states that horizontal equity demands that “people in equal position should pay equal amounts of tax.”

<sup>53</sup> See, e.g., Harvey S. Rosen, *An Approach to the Study of Income, Utility, and Horizontal Equity*, 92 Q.J. ECON. 307, 307 (1978) (“As traditionally defined, horizontal equity is the notion that . . . ‘people in equal positions should be treated equally’ . . . . Customarily, ‘equal positions’ are defined in terms of some observable index of ability to pay such as income, expenditure, or wealth.” (citation omitted)).

<sup>54</sup> See Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT’L TAX J. 139, 140 (1989) (“Most generally, and most commonly, [horizontal equity] is said to require the equal treatment of equals.”); Musgrave, *supra* note 52, at 45 (“[P]eople in equal position should pay equal amounts of tax.”).

ably accept even if it lacked a deeper explanation.<sup>55</sup> Thus, the appeal to horizontal equity only pushes our explanatory inquiry back one level and does not make much progress in doing so. We now need an explanation of why we should care about horizontal equity. Second, and more importantly, we need some explanation of why uninjured people and injured people who receive compensatory damages are *alike*, in the relevant sense. There are many seemingly relevant distinctions between the two: one is injured, the other is not; one has much more income than the other; one is much further out on her utility curve than the other. Why, in spite of all this, ought they receive the same tax treatment? One answer, perhaps implicit in the thoughts of those who would invoke horizontal equity, is the value of equality between the injured and the uninjured. But if that is the answer, we would do better to bypass horizontal equity and examine the implications of such equality explicitly.

A second possible foundation for the in lieu of principle is a principle of self-ownership, according to which each person has a package of moral rights—such as the right to direct one's body as one sees fit so long as one does not violate the rights of others—that constitutes moral ownership of herself.<sup>56</sup> This package of rights implies that parts of our bodies cannot be forcefully redistributed even when doing so leads to a better distribution overall.<sup>57</sup> By extension, this thought goes, it would be wrong to tax people on the harmless disposition of their bodies, and to tax them on income which compensates for the loss of enjoyment of rights of self-ownership. Thus, self-ownership independently explains both why the enjoyment of certain activities (such as playing the piano for fun) should not be taxed and why damages which compensate for the loss of those activities should not be taxed.

The main problem with this argument is that its crucial first inference—moving from the claim that parts of our bodies cannot be redistributed to the claim that income derived from our bodies cannot be

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<sup>55</sup> For this example of a plausibly basic normative truth, see Ramakrishnan, *supra* note 32, at 6, 8–9.

<sup>56</sup> See Kasper Lippert-Rasmussen, *Against Self-Ownership: There Are No Fact-Insensitive Ownership Rights over One's Body*, 36 PHIL. & PUB. AFF. 86, 86 (2008) (providing this definition of the self-ownership principle).

<sup>57</sup> One prominent argument for this point involves a thought experiment in which it is possible to painlessly and effectually redistribute one eye from each sighted person to each blind person. See ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 206 (1974) (originating the thought experiment). This policy would make visual capabilities more equally distributed and would have no negative side-effects. So, if distributions are better to the extent that they are equal, the policy would lead to a better distribution. Nonetheless, many philosophers believe that it would be wrong to redistribute eyes even in such idealized circumstances. See, e.g., G.A. COHEN, SELF-OWNERSHIP, FREEDOM, AND EQUALITY 70 (1995); NOZICK, *supra*, at 206.

redistributed—is unwarranted.<sup>58</sup> First, I would note that the upshot of this inference is a rather sweeping libertarianism. Labor income, after all, is derived from our bodies; thus, this argument implies that it cannot be taxed.<sup>59</sup> Second, and more importantly, as many philosophers have pointed out, the inference in question is invalid. One’s body and income derived from one’s body are two quite different things. Even if portions of the former cannot be taken away in the name of distributive justice, this does not imply much about the latter.<sup>60</sup>

The third and final possible foundation for the in lieu of principle is the familiar ideal of equality between the injured and the uninjured. I agree that this is a genuine value.<sup>61</sup> But, as we saw in the previous section, it does not confer unqualified support for exempting pain and suffering damages. We would do better to examine more closely why this form of equality might matter and what it might demand.

## II

### A COMPREHENSIVE APPROACH TO TAXING PAIN AND SUFFERING

I have argued that, *if* one finds the losses and gains argument and the in lieu of argument intuitively compelling, one ought to redirect one’s attention towards explicitly analyzing which policies best promote equality between the injured and the uninjured. This claim is unsatisfying in two respects. First, there is that “if”: Some might not be

<sup>58</sup> One might also object—as many philosophers have—to the principle of self-ownership itself. *See, e.g.*, Lippert-Rasmussen, *supra* note 56, at 87 (arguing that the principle of self-ownership is false); Liam Murphy, *Purely Formal Wrongs* 24 (Oct. 11, 2018) (unpublished manuscript) (on file with author) (“The idea of self-ownership, in my view, is one of the worst wrong turns in the history of moral and political thought.”).

<sup>59</sup> Indeed, that is Robert Nozick’s famous argument *for* a rather sweeping libertarianism in *Anarchy, State, and Utopia*. *See* NOZICK, *supra* note 57, at 169 (“Taxation of earnings from labor is on a par with forced labor.”).

<sup>60</sup> *See, e.g.*, COHEN, *supra* note 57, at 67–91; MICHAEL OTSUKA, LIBERTARIANISM WITHOUT INEQUALITY (2003); Ronald Dworkin, *What is Equality? Part 2: Equality of Resources*, 10 PHIL. & PUB. AFF. 283, 312 (1981) (calling the inference in question “a series of nonsequiturs”). Otsuka’s left-libertarianism potentially has some nuanced implications for the taxation of pain and suffering damages. Otsuka distinguishes between what one produces *solely* with one’s body—which he illustrates with the thought experiment of a person who weaves clothes from his own hair—and what one produces by acting upon external resources. The former, Otsuka thinks, cannot be redistributed in the name of equality; the latter can. *See* OTSUKA, *supra*, at 19–39. Otsuka’s argument, if sound, might imply that some pain and suffering damages may be redistributed and others cannot. The damages which can are those which compensate for the loss of enjoyment of external resources, such as playing the piano. The damages which cannot are those which compensate for the felt experience of pain.

<sup>61</sup> *See infra* Section II.A.1.

moved by the intuitive appeal of examples such as that of the two sportscasters; or, even if they are, they might want some assurance that the appeal is not illusory. Second, I have said nothing about what equality between the injured and the uninjured might demand.

In this Part, I address these shortcomings. In Section II.A, I offer an argument for why equality between the injured and the uninjured matters, and I claim that the demands of such equality can be modelled by applying the Atkinson social welfare function to the well-being of injured and uninjured people with identical ordinary income. In Section II.B, the centerpiece of this Part and indeed this Note, I develop a model of the optimal taxation of pain and suffering damages, and I simulate optimal tax rates within this model. In Section II.C, I discuss provisional policy implications from this simulation.

### A. *A Comprehensive Approach to Equality*

#### 1. *An Argument for Equality Between the Injured and the Uninjured*

I begin with the claim that we sometimes ought to prefer a distribution of economic resources which spreads welfare more equally to a distribution which produces more welfare overall.<sup>62</sup> We ought to prefer a society in which everyone is decently comfortable to one in which a few are ecstatic and many are miserable, even if there is somewhat more well-being overall in the unequal society.<sup>63</sup> To be sure, there ought to be a limit on this preference for equality. If the costs in total welfare are too great, we ought not to accept them.<sup>64</sup> But

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<sup>62</sup> See, e.g., Thomas Nagel, *Equality*, in *THE IDEAL OF EQUALITY* 60–80 (Clayton Matthew & Andrew Williams eds., 2002) (outlining a canonical egalitarian theory of distributive justice, according to which both total welfare and its equal distribution ought to be accorded some normative weight); Derek Parfit, *Equality or Priority?*, in *THE IDEAL OF EQUALITY*, *supra*, at 81 (outlining a canonical prioritarian theory of distributive justice, according to which the well-being of the worse-off is accorded extra normative weight). Both of these theories converge on the claim that we sometimes ought to prefer a distribution of economic resources which spreads welfare more equally to a distribution which produces more welfare overall.

<sup>63</sup> Cf. Nagel, *supra* note 62, at 75–76. Nagel describes an analogous thought experiment, in which a parent must decide between living in one of two locations. *Id.* at 75. The first location is better for one of the parent's children, the one who is relatively worse off before the move. *Id.* The second location is better for the other of the parent's children, the one who is relatively better off before the move. *Id.* Nagel's intuition is that the parent ought to choose the location which is better for the relatively worse-off child. *Id.* at 76.

<sup>64</sup> See, e.g., Michael Otsuka, *Luck, Insurance, and Equality*, 113 *ETHICS* 40, 46 (2002) (criticizing Ronald Dworkin's theory of equality of resources for implying that we ought to trade *any* amount of total welfare for an arbitrarily small gain in equality).



nor is equality a mere tiebreaker, relevant only for those rare cases in which two distributions contain equal amounts of well-being.<sup>65</sup>

That is a claim about the distribution of welfare across societies as a whole. Why, one might ask, does it imply anything about the distribution of welfare between injured people and uninjured people? One might imagine a two-tiered society in which all tort victims are absurdly wealthy and only destitute people avoid accidents. It would seem odd to say, in the name of equality, that we ought to redistribute from the latter to the former.

The answer to this question, and the link between equality *simpliciter* and equality between the injured and the uninjured, is an institutional division of labor. We could design our taxes on compensatory damages for pain and suffering with an eye towards producing the optimal amount of equality of welfare overall, taxing rich plaintiffs more than we do poor plaintiffs. But, to adapt a point made famously by Louis Kaplow and Steven Shavell, it is more efficient to divide the redistributive labor into two separate tasks.<sup>66</sup> The first is to realize

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<sup>65</sup> As it is under a welfarist version of the Pigou-Dalton Principle, according to which, “[a] transfer of well-being, from a better-off to a worse-off individual, which leaves everyone else unaffected, and which leaves the initially better-off individual still at least as well off, yields a better outcome.” ADLER, *supra* note 27, at 308.

<sup>66</sup> See Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667 (1994). Kaplow and Shavell’s argument is known as the “double distortion argument.” For this term, see Lee Anne Fennell & Richard H. McAdams, *The Distributive Deficit in Law and Economics*, 100 MINN. L. REV. 1051, 1061 n.29 (2016); Richard S. Markovits, *Why Kaplow and Shavell’s “Double-Distortion Argument” Articles Are Wrong*, 13 GEO. MASON L. REV. 511, 516 (2005); Zachary Liscow, Note, *Reducing Inequality on the Cheap: When Legal Rule Design Should Incorporate Equity as Well as Efficiency*, 123 YALE L.J. 2478, 2480 (2014). In short, the argument claims that taxes on labor income dominate other legal instruments as a means of distributing wealth between rich and poor. In other words, labor income taxes score better than other instruments on one dimension of assessment, and at least as good on all others. A well-designed labor income tax, they point out, can achieve whatever distribution of wealth between rich and poor that any given alternative legal instrument can achieve. In doing so, it will indeed distort choices about labor and leisure, and these distortions are a drag on efficiency. But other redistributive legal instruments will *also* distort labor-leisure choices, to the exact same degree as a labor income tax with the same distributive consequences. Moreover, those alternative instruments also distort choices about the primary behavior that they regulate. This is also a drag on efficiency. All told, then, the labor income tax’s one distortion is better than the alternative instrument’s two.

Kaplow and Shavell’s argument has attracted many critics. See, e.g., Christine Jolls, *Behavioral Economics Analysis of Redistributive Legal Rules*, 51 VAND. L. REV. 1653 (1998) (arguing that people do not respond to the labor-leisure distortions embedded in legal rules as strongly as they do to those distortions embedded in the income tax); Chris William Sanchirico, *Deconstructing the New Efficiency Rationale*, 86 CORNELL L. REV. 1003 (2001) (limiting the double distortion argument to legal rules that are explicitly conditional on income, and also to cases where multiple distortions do not offset each other); Liscow, *supra* (describing conditions under which legal rules are more efficient than the income tax as an instrument of redistribution).

equality between the rich and the poor. It is most efficient to give this task solely to a comprehensive tax on labor income.<sup>67</sup> Yet even if we have reached the optimal level of equality between the rich and the poor, tort accidents will still create inequalities between the injured and the uninjured. We ought to care about this inequality just as we ought to care about inequalities of welfare in other guises. For this second task, it is best to use a tax on pain and suffering damages.

Ideally, then, we would evaluate possible tax treatments of pain and suffering damages by considering their effects on the distribution of well-being among injured and uninjured people with the same amounts of ordinary income. In evaluating such distributions, we would assign some amount of weight to equality and some amount of weight to total welfare.<sup>68</sup>

## 2. *The Atkinson Social Welfare Function*

How should we do this? Some tools ripe for the task are inequality-averse social welfare functions. Social welfare functions, as a general matter, are normative rankings of possible social states based on how much well-being there is and how that well-being is distributed.<sup>69</sup> *Inequality-averse* social welfare functions sometimes rank more equal distributions of welfare over less equal ones, even when the total amount of well-being is held constant—or, potentially,

<sup>67</sup> See Kaplow & Shavell, *supra* note 66, at 677.

<sup>68</sup> In claiming that we should give some weight to total welfare and some weight to its equal distribution, it might seem that I am taking a controversial position in one of the more prominent debates in the recent philosophical literature on distributive justice. This debate concerns the “currency” of egalitarian justice: How should we measure relative advantage—in terms of welfare, opportunities for welfare, resources, or something else? See, e.g., JOHN RAWLS, *A THEORY OF JUSTICE* 90–95 (1971) (defending a particular conception of resources, which Rawls calls “primary goods”); Richard J. Arneson, *Equality and Equal Opportunity for Welfare*, 56 *PHIL. STUD.* 77 (1989) (defending opportunities for welfare); G.A. Cohen, *On the Currency of Egalitarian Justice*, 99 *ETHICS* 906 (1989) (same); Ronald Dworkin, *What is Equality? Part 1: Equality of Welfare*, 10 *PHIL. & PUB. AFF.* 185 (1981) [hereinafter *Equality of Welfare*] (criticizing welfare); Dworkin, *supra* note 60 (defending resources). My position, though, is less controversial than it might first seem. The primary objection to equality of welfare appeals to claims about responsibility: Under certain conditions, it is reasonable to hold people responsible for the fact that their preferences are relatively hard to satisfy. See Dworkin, *Equality of Welfare*, *supra* at 234–35 (articulating the responsibility objection); T.M. Scanlon, *Justice, Responsibility, and the Demands of Equality*, in *THE EGALITARIAN CONSCIENCE* 70, 75–77 (Christine Sypnowich ed., 2006) (refining the objection by appealing to reasonableness). In the policy setting I am exploring, the people whose preferences are relatively difficult to satisfy are the injured. And those preferences are hard to satisfy precisely *because* they are injured. It would be unreasonable to hold them responsible for this fact. Thus, even if one believes that resources or opportunities for well-being are the proper currency of egalitarian justice—as I do—one should be relatively comfortable with evaluating the equal distribution of *welfare* in this setting.

<sup>69</sup> See ADLER, *supra* note 27, at xiv.

even when gains in equality come at the expense of some total welfare. I suggest that we use a particular kind of inequality-averse social welfare function known as the Atkinson social welfare function.<sup>70</sup> The form of the Atkinson social welfare function is<sup>71</sup>:

$$S = \frac{\sum_{i=1}^N u_i(x)^{1-\gamma}}{1-\gamma}$$

$S$  is the amount of social welfare for a particular social state,  $N$  is the number of people in that state,  $u_i(x)$  is the utility function of person  $i$ , and  $\gamma \geq 0$  is a measure of inequality-aversion.

The Atkinson social welfare function has several attractive properties. I will focus on just three which are particularly relevant for our purposes. First, any positive change in one person's well-being implies that social welfare is increased, provided that no one else's well-being decreases.<sup>72</sup> Thus, the Atkinson social welfare function does not imply that we should turn down an opportunity to make one person better off at the expense of no one else; and it would have us prefer more total well-being to less.<sup>73</sup> But, second, this social welfare function need not be indifferent as to *who* receives benefits. So long as  $\gamma > 0$ , social welfare is improved more significantly by an additional unit of welfare for a worse-off person than it is by an additional unit of welfare for a better-off person.<sup>74</sup> Third, the Atkinson social welfare function gives us a flexible framework for *weighing* the relative importance of total well-being and its equal distribution. Those relative weights are reflected in  $\gamma$ .<sup>75</sup> At one extreme ( $\gamma = 0$ ), the social welfare function assigns no weight to equality, simply preferring social states insofar as they have more total well-being.<sup>76</sup> At the other extreme, as  $\gamma$  approaches infinity, the Atkinson social welfare function is a maxim social welfare function, ranking social states primarily by how

<sup>70</sup> See Anthony B. Atkinson, *On the Measurement of Inequality*, 2 J. ECON. THEORY 244 (1970) (proposing the Atkinson social welfare function).

<sup>71</sup> For this attractive statement of the Atkinson social welfare function, see ADLER, *supra* note 27, at 378.

<sup>72</sup> See *id.* at 310–11 (stating the separability axiom, according to which any positive change in one person's well-being implies that social welfare is increased, provided that no one else's well-being decreases); *id.* at 311–12 (stating that the Atkinson social welfare function satisfies the separability axiom).

<sup>73</sup> Accordingly, the Atkinson social welfare function avoids at least one version of the so-called "Levelling Down Objection" to certain theories of distributive justice. See Parfit, *supra* note 62, at 98–99 (describing the Levelling Down Objection); see also Larry Temkin, *Equality, Priority, and the Levelling Down Objection*, in THE IDEAL OF EQUALITY, *supra* note 62, at 126 (defending one such theory against the Levelling Down Objection).

<sup>74</sup> ADLER, *supra* note 27, at 378.

<sup>75</sup> *Id.* at 307 (describing  $\gamma$  as an inequality-aversion parameter).

<sup>76</sup> Thus, the Atkinson social welfare function with  $\gamma = 0$  is the utilitarian social welfare function.

they treat the worst-off person within them and using total well-being solely as a tiebreaker.<sup>77</sup> Thus, with the Atkinson social welfare function, we can simulate optimal policies for a wide range of degrees of inequality-aversion.

## B. Simulation of Optimal Tax Rates

### 1. Model

Here is the model under its baseline assumptions. All people share the same utility function over consumption:  $u_i(c) = \ln(c_i)$ . There is one period of time. At the beginning of the period, a portion of the population,  $\alpha$ , is stricken with a tort injury. This causes them to suffer a flat welfare loss ( $I$ ). All people then earn the same amount of ordinary income ( $W$ ). Then all victims of tort injuries receive enough damages ( $P$ ) to make them indifferent (pre-tax) between being injured and being uninjured. That is, they receive  $P$ :  $[u(P + W) - I] = u(W)$ . Finally, damages are taxed at a rate  $r_p$  and ordinary income is taxed at a rate  $r_w$ . Tax rates are set so as to maximize social welfare, given a revenue constraint ( $Pr_p + Wr_w = R$ ). Social welfare is determined according to the Atkinson social welfare function:

$$S = \frac{\alpha[u((1-r_p)P+(1-r_w)W)-I]^{1-\gamma}}{1-\gamma} + \frac{(1-\alpha)[u((1-r_w)W)]^{1-\gamma}}{1-\gamma}$$

The first term describes the inequality-weighted welfare of injured people; the second term describes that of uninjured people. All parameters aside from tax rates are exogenous.

This is a highly stylized model, and I should defend some of its more unrealistic assumptions.

*Injuries Are Flat Losses.* I have assumed that injuries are flat losses. Two objections might be raised to this assumption. First, one might object that the model does not account for how some tort injuries linger; recall Erin Andrews's lawyer, who claimed that she had a PTSD for which there is no "post."<sup>78</sup> But temporally extended injuries can be modeled as flat losses. All the hurt, over many years, is packed into  $I$ . The second objection is that modeling injuries as flat losses does not capture how some injuries change tort victims' utility functions; it does not capture "state-dependent utilities."<sup>79</sup> Perhaps, for

<sup>77</sup> See Jason Furman, Should Policymakers Care Whether Inequality Is Helpful or Harmful for Growth? 10–11 (Dec. 11, 2017) (unpublished manuscript) (on file with author).

<sup>78</sup> See *supra* note 7 and accompanying text.

<sup>79</sup> See Alan Schwartz, *Proposals for Products Liability Reform: A Theoretical Synthesis*, 97 YALE L.J. 353, 362, 364 (1988) (noting the possibility that injury victims have state-dependent utilities); see also W. Kip Viscusi, *Empirical Analysis of Tort Damages*, in

example, someone gets injured, loses the ability to pursue various pastimes that he did before, and takes up other hobbies instead. If these hobbies are more expensive—say an injured runner takes up opera—the injured person will receive less welfare from each dollar of future consumption.<sup>80</sup> True, modeling injuries as flat losses rules out this possibility. But accounting for state-dependent utilities would not change my results in a significant way. If anything, tort injuries tend to reduce victims' abilities to enjoy future consumption.<sup>81</sup> This means that their marginal utility is lower. If damage awards are adjusted upwards accordingly, that would imply that pain and suffering damages should be taxed to an even greater extent.<sup>82</sup>

*Equal Ordinary Incomes.* I have assumed that everyone earns the same amount of ordinary income to focus on inequalities between the injured and the uninjured. This is warranted given the optimal division of labor between some taxes which address economic inequalities (such as the tax on labor income) and the tax on pain and suffering damages, which addresses inequalities between the injured and the uninjured.<sup>83</sup>

*Equal Injury Size.* I have assumed that all tort victims suffer equally grave injuries. This was a concession to tractability. However, the optimal tax rates for varying sizes of injuries were estimated by varying  $P$ .

One other assumption was dropped in subsequent simulations:

*Fully Adequate Compensation.* In subsequent simulations, I estimated what optimal taxes would be if tort victims do not receive enough damages to make them indifferent between being injured and not being injured. This was simulated by adding a measure of adequacy of compensation,  $C \geq 1$ .  $P$ , the amount of pain and suffering damages, was set at  $P: [u(P + W) - I] = \frac{u(W)}{C}$ . Thus, the higher the value of  $C$ , the less adequate the victim's compensation.

I based my estimates of the values of the empirical parameters on estimates made by the Bureau of Justice Statistics (BJS) and the Internal Revenue Service (IRS). I should flag up-front that my estimates are imprecise, for at least two reasons. First, the BJS and IRS estimates on which they are based were made at only one point in time. I did not confirm that the BJS and IRS estimates were represen-

RESEARCH HANDBOOK ON THE ECONOMICS OF TORTS 460, 468–69 (Jennifer Arlen ed., 2013) (producing modest empirical evidence that serious injuries lower the marginal utility of consumption).

<sup>80</sup> See Schwartz, *supra* note 79, at 364.

<sup>81</sup> See Viscusi, *supra* note 79, at 468–69.

<sup>82</sup> See *infra* Section II.B.3 (making this argument).

<sup>83</sup> I defend this division of labor above. See *supra* notes 66–68 and accompanying text.

tative of broader trends. Second, I had to make several assumptions to infer the values of the parameters in my model from the parameters estimated by the BJS and the IRS. Many of these assumptions are questionable.

Despite this imprecision, we can still learn from the policy simulation I conducted. The point of the simulation is not to derive the exact tax rates that are optimal under the conditions that we face today. It is rather to demonstrate qualitative trends in the optimal taxation of pain and suffering damages under *realistic* circumstances. For this purpose, ballpark estimates of the relevant parameters suffice, so long as the observed trends hold up to substantial variation in the values of the parameters. To check this, I simulated optimal tax rates under a range of alternative values of the empirical parameters.

Here is how I estimated the empirical parameters. BJS estimates that in 2005, 140,929 tort suits reached a disposition in state court, and, in FY 2002–03, 98,786 tort suits did so in federal district court, for a total of 239,715.<sup>84</sup> Assuming that no person filed more than one suit, this means that approximately 0.08% of the population suffered an injury that gave rise to a putative tort action.<sup>85</sup> Hence  $\alpha$  was set at 0.0008. When I turned to estimating  $P$ , I encountered a significant limitation: BJS only collects data on damages awarded at trial, not in settlements. Without a principled method of estimating settlements from data on damages awarded at trial, I assumed that the damages awarded at trial were representative of those agreed to in settlements. After adjusting BJS's 2002–03 statistic to 2005 dollars and taking a weighted average of the median awards in state and federal courts, I arrived at \$100,485.<sup>86</sup>  $P$  was set to this value.  $W$  was set at the average

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<sup>84</sup> LYNN LANGTON & THOMAS H. COHEN, BUREAU OF JUSTICE STATISTICS, CIVIL BENCH AND JURY TRIALS IN STATE COURTS, 2005 at 9 (2005), <https://www.bjs.gov/content/pub/pdf/cbjtsc05.pdf> [hereinafter BJS STATE] (reporting the state court figures); *Tort, Contract and Real Property Trials*, BUREAU JUST. STAT., <https://www.bjs.gov/index.cfm?ty=tp&tid=451#federal> [hereinafter BJS FEDERAL] (last visited Jan. 15, 2019) (reporting the federal district court figures). Though these are the most recent estimates that are publicly available, they do come with some significant limitations. They are dated, they come from different years, and they do not subdivide cases by damages sought. I assumed that all cases sought pain and suffering damages.

<sup>85</sup> The U.S. population in 2005 was 296.4 million people, and in 2003 it was 290.8 million people. U.S. CENSUS BUREAU, POPULATION DISTRIBUTION IN 2005, at 1, <https://www.census.gov/population/pop-profile/dynamic/PopDistribution.pdf> (reporting the figure for 2005); U.S. CENSUS BUREAU, POPULATION PROFILE OF THE UNITED STATES 1 (2003) (reporting the figure for 2003). This yields an average of 293.6 million people.

<sup>86</sup> To adjust the federal median damage upward for inflation, I performed the following calculations. The median federal damage award in FY 2002–03 was \$201,000. See BJS FEDERAL, *supra* note 84. The consumer price index in January 2003 was 181.7, and the consumer price index in January 2005 was 190.7. See BUREAU OF LABOR STATISTICS, CONSUMER PRICE INDEX: JANUARY 2003, at 1 (Feb. 21, 2003), <https://www.bls.gov/>

individual's Adjusted Gross Income in 2005, \$58,842.<sup>87</sup> Finally, to arrive at  $R$ , the average individual's tax burden, I multiplied \$58,842 by 12.65%, the average individual's federal income tax rate in 2005.<sup>88</sup> Thus,  $R$  was set at \$7444.

I also had to make assumptions about the value of inequality-aversion ( $\gamma$ ), a wholly ethical parameter that reflects how much extra weight we ought to accord to the well-being of the worse-off.<sup>89</sup> Following Adler et al., when I needed to specify a value of  $\gamma$ , I used values within the range of 0 and 3.<sup>90</sup> The value of 0.5 reflects a low degree of inequality-aversion, 2.5 reflects a high degree of it, and 1.5 is the central estimate.

## 2. Results

I first simulated optimal tax rates under the baseline assumptions.<sup>91</sup> This yielded an important result: Even at extremely high degrees of inequality-aversion—degrees of inequality-aversion that few people would accept—the optimal tax rate on pain and suffering far exceeds that on ordinary income (Figure 1).

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news.release/archives/cpi\_02212003.pdf; BUREAU OF LABOR STATISTICS, CONSUMER PRICE INDEX: JANUARY 2005, at 1 (Feb. 23, 2005), [https://www.bls.gov/news.release/archives/cpi\\_02232005.pdf](https://www.bls.gov/news.release/archives/cpi_02232005.pdf).  $\frac{\$201,000}{181.7} * 190.7 \approx \$210,956$ .

To construct a weighted average of state and federal damage awards, I performed the following calculations. First, I needed to calculate the median damages awarded in state court. In 2005, the median final award in state tort cases decided at a jury trial was \$24,000, and the median final award in state tort cases decided at a bench trial was \$21,000. *See* BJS STATE, *supra* note 84, at 3. There were 18,404 jury trials and 8543 bench trials. Thus, the overall median state damage award was  $\left(\$24,000 * \frac{18,404}{26,947}\right) + \left(\$21,000 * \frac{8543}{26,947}\right) \approx \$23,049$ . Second, I constructed a weighted average of the median state damage award and the inflation-adjusted median federal damage award:

$$\left(\$23,049 * \frac{140,929}{239,715}\right) + \left(\$210,956 * \frac{98,786}{239,715}\right) \approx \$100,485.$$

<sup>87</sup> I arrived at this figure via the following calculations. In 2005, approximately 124,673,000 individuals filed tax returns. *See* ERICA YORK, TAX FOUND., SUMMARY OF THE LATEST FEDERAL INCOME TAX DATA, 2017 UPDATE tbl.2 (Jan. 17, 2018), <https://taxfoundation.org/summary-federal-income-tax-data-2017>. Meanwhile, taxpayers reported a total of \$7.336 trillion of adjusted gross income. *Id.* at tbl.3.  $\frac{\$7,336,000,000,000}{124,673,000} \approx \$58,842$ .

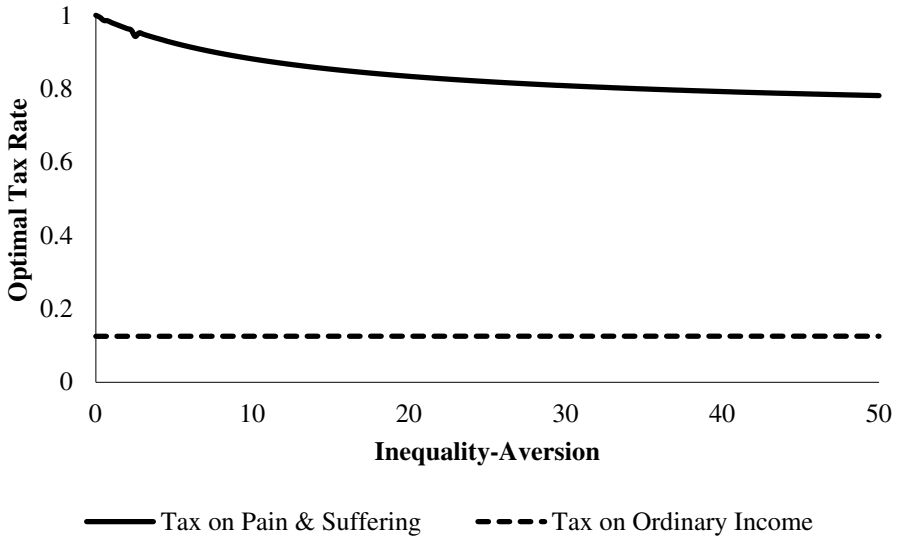
<sup>88</sup> *Id.* at tbl.8.

<sup>89</sup> *See* Matthew Adler et al., *Priority for the Worse-Off and the Social Cost of Carbon*, 7 NATURE CLIMATE CHANGE 443, 444 (2017) (describing the parameter capturing the degree of priority for individuals with lower well-being as a “pure ethical parameter”).

<sup>90</sup> *See id.*

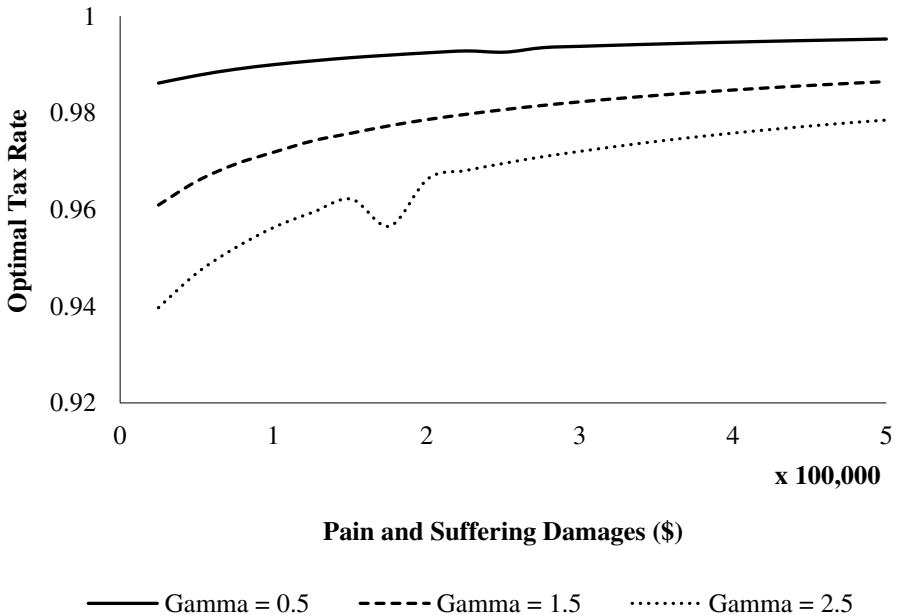
<sup>91</sup> Optimal tax rates were simulated using MATLAB's `fmincon` function. The `fmincon` function finds the minimum of a nonlinear multivariable function, subject to constraints. *See* `fmincon`, MATHWORKS, <https://www.mathworks.com/help/optim/ug/fmincon.html> (last visited Jan. 2, 2019). In conducting the simulation, my objective was to find the *maximum* of the social welfare function. Using `fmincon` accordingly required a small transformation of the social welfare function. Let  $SWF$  be the social welfare function. I directed `fmincon` to minimize  $- (SWF)$ , subject to a revenue constraint.

FIGURE 1: OPTIMAL TAX ON OI AND P&S (BASELINE ASSUMPTIONS)



One might have thought that optimal tax rates would decline as injuries get worse. This was not the case. As injuries become worse, the optimal tax on pain and suffering damages slightly *increases* (Figure 2).

FIGURE 2: OPTIMAL TAX ON P&S OVER SIZE OF INJURY





Optimal taxes change if damages are not fully compensatory. First, if damages are not fully compensatory, the optimal tax rate on pain and suffering damages falls more quickly as a function of inequality-aversion (Figure 3). Second, if damages are not fully compensatory, the *structure* of an optimal tax schedule changes. Tax rates still should increase as injuries become worse (and, accordingly, damage awards become greater). But no longer should they start high and gradually become even higher. Rather, an optimal tax schedule would have a tripartite structure. There would be: (a) an exemption threshold; (b) a phase-in range; and (c) a high maximum tax rate. The size of the exemption threshold, the rapidity of the phase-in, and the height of the maximum rate depend on inequality-aversion (Figure 4).

FIGURE 3: OPTIMAL TAX ON P&S IF UNDERCOMPENSATION

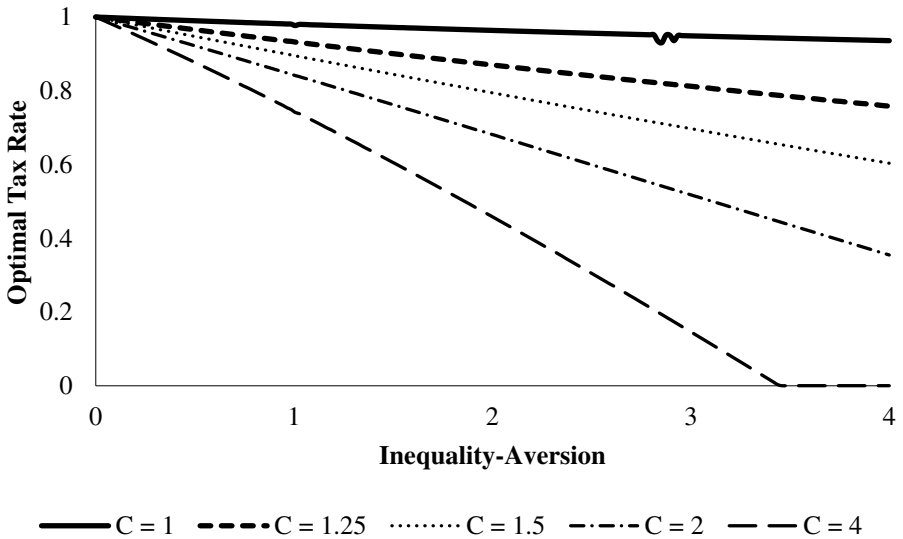
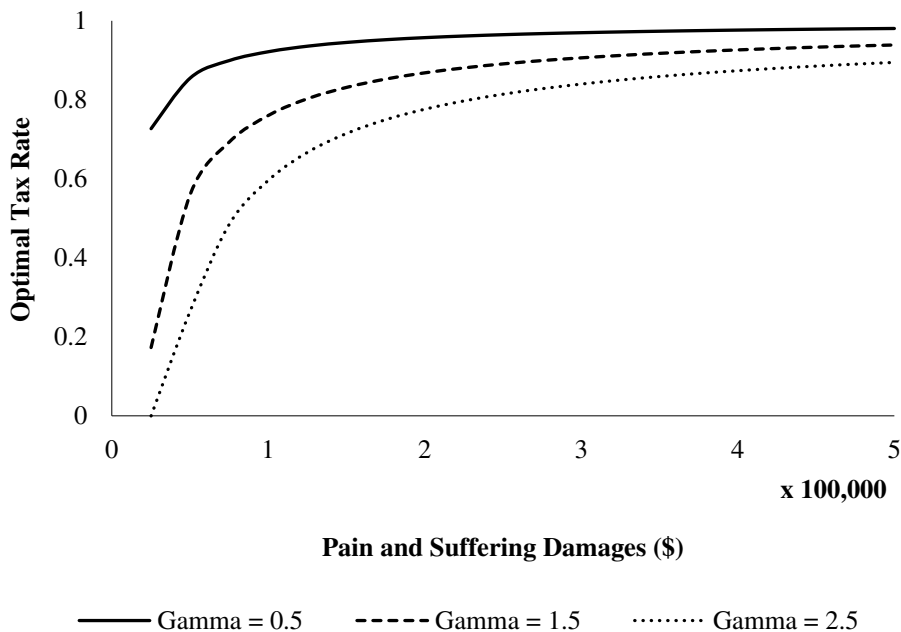


FIGURE 4: OPTIMAL TAX ON P&S OVER DAMAGE SIZE IF  $C = 2$ 

There were two null findings. First, variations in income ( $W$ ) did not affect optimal tax rates. Second, variations in the number of injured people ( $\alpha$ ) did not affect optimal tax rates substantially until an unrealistically large proportion of people (~10%) suffered tort injuries in a single period.

### 3. Discussion

What could explain these results? I suspect that they are being driven by two propositions which we originally encountered in Part I, combined with a third, intuitive one.

*Proposition 1:* Placing  $n$  dollars of the tax burden on uninjured people rather than injured people decreases total welfare.

This, as we saw, straightforwardly follows from the assumption that injured people have lower marginal utility than uninjured people.<sup>92</sup>

*Proposition 2:* An overly generous tax treatment of pain and suffering damages can increase inequality of welfare between the injured and the uninjured.

<sup>92</sup> See *supra* Section I.A.

In Part I, I suggested that this proposition also follows from the declining marginal utility of consumption, and I demonstrated it with the hypothetical case of Injured and Uninjured.<sup>93</sup>

*Proposition 3:* If damages are inadequately compensatory, there is pre-tax inequality of welfare between the injured and the uninjured.

Proposition 3 is implied by the fact that injured people are worse-off than uninjured people, before taxes, whenever damages fail to fully offset the welfare loss from their injuries.

These three propositions offer a satisfying explanation of the results. The first two conspire to explain optimal tax rates under the baseline assumptions (Figure 1). When inequality-aversion is low, our decisionmaking ought to be dominated by consideration of total welfare. Since—per Proposition 1—injured people have lower marginal utility than uninjured people, the tax rate on pain and suffering damages accordingly should be high. Yet even as we become more inequality-averse, and our decisionmaking becomes more dominated by consideration of equality, we still must be careful not to provide injured people with an overly favorable tax treatment. For doing so—per Proposition 2—would aggravate *inequality* by making the injured better off than the uninjured. Thus, even at extremely high levels of inequality-aversion, the optimal tax rate on pain and suffering damages remains high—indeed, higher than the optimal tax rate on ordinary income (Figure 1).

Propositions 1 and 2 also explain why optimal tax rates on pain and suffering damages should be an increasing function of damages (Figure 2). As damages get larger, marginal utility decreases; accordingly, both total welfare and equality speak more strongly in favor of a high tax rate on those damages.

The third proposition—relating to pre-tax inequality of welfare—helps to explain Figures 3 and 4. Now, total welfare and equality pull in two opposite directions. Per Proposition 1, maximizing total welfare entails a high tax rate on pain and suffering damages; per Proposition 3, realizing an equal distribution entails a low rate. Thus, as we become more averse to inequality, the optimal tax rates on pain and suffering damages decline relatively quickly—and more quickly insofar as pre-tax inequalities of welfare increase (Figure 3). However, as the size of the damage award increases, two things happen—both consequences of the diminishing marginal utility of consumption. First, placing the tax burden on uninjured people rather than injured people sets back total well-being to a greater extent. Second, and perhaps less intuitively, any given quantity of tax on pain and suffering

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<sup>93</sup> See *supra* Section I.A.

damages sets back *equality* of well-being to a lesser extent. If damages are under-compensatory, there is pre-tax inequality between the injured and the uninjured. But taking \$1 from a plaintiff who receives a \$1,000,000 award diminishes his well-being to a much smaller extent than taking \$1 from a plaintiff who receives a \$100 damage award. Accordingly, a tax on the former does not aggravate inequality as much as a tax on the latter. Thus, as damage awards increase, higher taxes on pain and suffering damages are called for—even if plaintiffs are not fully compensated (Figure 4).

### C. Provisional Policy Implications

My simulation suggests that some, likely many, pain and suffering damages should be taxed. It also suggests that the tax rate on these damages should increase along with the amount of them that a person receives. Such a tax could be implemented in our statutory scheme by establishing a substantive tax on pain and suffering damages in § 1 of the Internal Revenue Code. This tax would be distinct from the others currently levied in § 1 as its base would only include pain and suffering damages, not one's taxable income.<sup>94</sup> Thus, it would be analogous to the tax on capital gains,<sup>95</sup> although the tax rate would also be a function only of one's pain and suffering damages instead of one's taxable income.<sup>96</sup>

The structure of this new tax would depend upon an empirical question: whether damages are fully compensatory. If they are, then the tax rate should begin high and gradually become even higher.<sup>97</sup> If they are not, then a tripartite schedule is called for.<sup>98</sup> There should be (a) an exemption threshold; (b) a phase-in range; and (c) a high maximum tax rate. Since it seems likely that damages are at least somewhat under-compensatory—few plaintiffs are indifferent between receiving damages and avoiding their injury altogether—the tripartite scheme seems more likely to be the correct one.

## III

### IMPLEMENTING AN OPTIMAL TAX

The simulation of Part II estimated optimal tax rates under a crucial (and unrealistic) assumption: that people do not modify their behavior in response to anticipated tax burdens. This assumption was

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<sup>94</sup> See, e.g., I.R.C. § 1(c) (2012) (imposing tax liability on an individual's "taxable income").

<sup>95</sup> See *id.* § 1(h) (imposing a separate tax rate on a base of net capital gains).

<sup>96</sup> The capital gains rate increases along with the taxpayer's taxable income. See *id.*

<sup>97</sup> See *supra* Section II.B.2.

<sup>98</sup> See *supra* Section II.B.2.

useful, because it allowed us to focus on the complex distributive issues involved in taxing pain and suffering damages.<sup>99</sup> But tax policy in the real world needs to account for how taxes affect behavior.

In this Part, I buttress the conclusions of Part II by bringing two important behavioral considerations—efficiency and tax avoidance—back into the picture. I argue that efficiency and tax avoidance do not undermine the case for some positive tax rates on pain and suffering damages. Nor do they decisively modify the structure of an ideal tax on pain and suffering damages. Rather, efficiency and tax avoidance have two implications. First, the maximum tax rate might need to be lower than the top rates described in Part II. Second, a tax on pain and suffering damages received might need to be paired with a corresponding deduction for pain and suffering damages paid.

### A. *Efficiency*

Even when we don't pay them, taxes have costs. Suppose that, in the absence of a tax on apples, you would buy one apple for \$1.00. This is a mutually beneficial exchange for both you and the grocer. Let us also assume that there are no externalities—that is, all the harms and benefits to others of your buying the apple are already reflected in the price. Two people benefit, and no one loses; society is better off for your trade. But now suppose that the government taxes apple purchases at 50%. If apples cost \$1.50 (post-tax), you would rather buy an orange at \$1.00, and you do. Though you do not pay the apple tax, it hurts you: You now have to settle for your second choice (an orange at \$1.00) rather than your first (an apple at \$1.00). The tax has *distorted* your behavior. To the extent that such distortions are inefficient—to the extent that they curb socially beneficial behavior—they ought to be eliminated. This is a basic lesson of public economics.<sup>100</sup>

Our first question is: would a tax on pain and suffering damages, with the structure I have sketched, be inefficient? The answer is “yes.” Since one's tax burden would be a function of one's choices—including the decision to file a tort claim, to hire attorneys (and at what cost), to seek  $x$  dollars in damages rather than  $y$  dollars, to seek pain and suffering damages rather than lost wages—the tax would distort these choices, and these distortions would cause deadweight loss.<sup>101</sup> But the same is true of virtually all taxes currently on the

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<sup>99</sup> See *supra* Part II.

<sup>100</sup> See, e.g., JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 621 (2016) (describing how taxes cause deadweight loss—a measure of the inefficiency of taxation caused by surplus lost and not recaptured in the form of tax revenues).

<sup>101</sup> See *id.*

books and also those which are seriously considered as policy possibilities. Many taxes that scale with economic outcomes, such as income taxes, consumption taxes, and wealth taxes, distort labor decisions.<sup>102</sup> Some taxes—such as excise taxes and taxes on capital income—distort labor decisions and then other decisions as well.<sup>103</sup> Indeed, the only taxes that do not distort behavior at all are lump-sum taxes, which are generally rejected based on the very property that makes them so efficient: their unavailability.<sup>104</sup>

So our question should not be: Would a tax on pain and suffering damages be inefficient? It should rather be: Would a tax on pain and suffering damages be *so* inefficient as to alter the conclusions of Part II? More precisely:

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<sup>102</sup> For a classic source, see J.A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175, 175 (1971), for a discussion about how income taxes influence labor decisions; *see also* Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413, 1417–18, 1426–27 (2006) (discussing how consumption taxes and wealth taxes distort labor decisions).

<sup>103</sup> The locus classicus for this point is A.B. Atkinson & J.E. Stiglitz, *The Design of Tax Structure: Direct Versus Indirect Taxation*, 6 J. PUB. ECON. 55 (1976). In that paper, Atkinson and Stiglitz argue in favor of comprehensive consumption taxes, as opposed to excise taxes on particular types of consumption. Comprehensive consumption taxes distort decisions about labor and leisure. Excise taxes do that, and then also distort decisions about *how* to consume. To use an example discussed above, if the state taxes apples but not oranges, people will face the same anti-labor and pro-leisure pressures as under a comprehensive consumption tax, *along with* a pressure to consume oranges but not apples. For this gloss on the Atkinson-Stiglitz argument, and for further explanation of these distortion effects, see Bankman & Weisbach, *supra* note 102, at 1423–24. Atkinson and Stiglitz's basic idea has since been adopted in other contexts as well. For example, some tax scholars argue that a comprehensive consumption tax would be better than a comprehensive income tax that raises the same amount in revenue, because such a consumption tax distorts only labor-leisure decisions, while an income tax distorts *both* labor-leisure decisions and decisions about whether to consume now or save for the future. *See, e.g., id.*

<sup>104</sup> For the efficiency of lump-sum taxation, see Mirrlees, *supra* note 102, at 201. The two forms of lump-sum taxation most frequently discussed are the poll tax and the endowment tax. The poll tax, or head tax, is typically rejected because it is insensitive to one's earning ability, and thus is highly regressive. *See, e.g.,* Griffith, *supra* note 24, at 1159 ("A head tax would be considered unfair under almost any ethical theory . . ."). The endowment tax, meanwhile, is typically rejected because it is insensitive to one's *actual* earnings, and thus puts undue pressure on the talented to take the most remunerative jobs available to them. *See, e.g.,* Erick J. Sam, *Endowment Taxation and Equality of Resources*, 22 FLA. TAX REV. 243, 269–71 (2018) (outlining the structure of this objection); *see also* David Hasen, *Liberalism and Ability Taxation*, 55 TEX. L. REV. 1057, 1061 (2007) (arguing that endowment taxation is inconsistent with liberalism); *cf.* Kristi A. Olson, *The Endowment Tax Puzzle*, 38 PHIL. & PUB. AFF. 240 (2010) (articulating a puzzle about this objection to the endowment tax—namely, that it seems to impugn other taxes as well—and providing a solution); Lawrence Zelenak, *Taxing Endowment*, 55 DUKE L.J. 1145 (2006) (providing an overview of the endowment tax debate from both utilitarian and liberal egalitarian perspectives).

- (1) Would a tax on pain and suffering damages be so inefficient that pain and suffering damages should be excluded from the tax base altogether?
- (2) Would a tax on pain and suffering damages be so inefficient that we ought to depart from tax schedules with the structure that I have proposed?

The answer to both these questions, I argue, is “no.” If anything, efficiency bolsters the case for taxing pain and suffering damages. And though efficiency may compel us to modify certain aspects of the tax regime proposed in Section II.C—we might have to lower the maximum rate, and we might have to add a deduction to defendants for pain and suffering damages paid—it should not require us to abandon a tax whose rate increases with damages.

### 1. *The Tax Base*

For two reasons, it is plausible that taxing pain and suffering damages is more efficient than excluding them from the tax base altogether.

First, as a general matter, one should expect a tax code to become less efficient when it exempts certain categories of labor income from taxation. The reason for this is a “double distortion”-type argument.<sup>105</sup> Let us once again adopt the standard assumption that all tax systems under comparison must raise the same amount in revenue.<sup>106</sup> Now suppose, for illustration, that one tax system taxes all labor income at a flat rate; the other tax system taxes all labor income at a flat rate, except for income from carpentry. Since both tax codes raise the same amount of revenue from labor, they will distort labor-leisure decisions to the same extent. But the carpentry exemption also distorts decisions about *how* to labor—now people face tax-based pressure to earn their income from woodworking. By implication, we should expect a full exclusion for pain and suffering damages to make the tax code, if anything, *less* efficient than a code which taxes pain and suffering damages. An exclusionary regime would distort not just labor-leisure decisions, but also decisions about *how* to labor. One would now face tax pressure to spend time on one’s case, as opposed to working one’s day job.<sup>107</sup> Even if the distortionary effect of this pressure is small because people tend not to respond to it, whatever distortions are wrought by an exclusionary regime will be larger than

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<sup>105</sup> See *supra* note 66 (highlighting the use of “double distortion”-type arguments). The main inspiration for this argument comes from Atkinson and Stiglitz, *supra* note 103.

<sup>106</sup> See *supra* note 48 and accompanying text.

<sup>107</sup> Alternatively, if the benefit of the exemption gets allocated in equilibrium to plaintiffs’ lawyers, one would instead face pressure to join the plaintiff’s bar.

those caused by a regime which taxes pain and suffering damages to some extent.

Second, it is generally more efficient to tax goods or factors that are relatively *inelastic*—i.e., whose demand or supply varies less according to their price.<sup>108</sup> Moreover, it is plausible that the supply of tort litigation is more inelastic than the supply of much other labor. There is ample evidence that many tort plaintiffs are not motivated solely by money; sometimes, they seek to tell their side of the story, to vindicate their rights, or simply to exact revenge.<sup>109</sup> Of course, many people also get noneconomic rewards from their work. But it is plausible that, on the margin, taxes are a stronger deterrent to working an extra hour at one's day job than they are to working an extra hour on one's own lawsuit.

## 2. *The Rate Structure*

It is harder to say, from the armchair, how efficiency affects the optimal *structure* of a tax on pain and suffering damages. This is hard for two reasons. First, assessing the efficiency of specific portions of various possible rate structures is hard to do solely with theoretical models; many of the claims which one would want to make need to be justified empirically. Second, since the optimal tax rate is a function not just of the tax's efficiency, but also of its distributive effects, making claims about the optimal rate structure would require making difficult trade-offs between efficiency and equality.

That said, I suspect that accounting for efficiency would affect the optimal rate structure in the following ways. First, the effects outlined in the previous subsection would persist. Insofar as the supply of tort litigation is inelastic, the optimal rate structure would not be affected by efficiency concerns.<sup>110</sup> On the other hand, the exemption threshold would likely incentivize some people to earn income from tort litigation rather than by other means. We would need to quantify exactly how large this distortion is, and whether it is large enough to outweigh the inequality that results from taxing the worse off. Second, it is possible that the supply of tort litigation is sufficiently elastic that we might be able to raise more revenue with lower top tax rates than the ones described in Part II. Third, asymmetric taxes could have a desta-

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<sup>108</sup> See F.P. Ramsey, *A Contribution to the Theory of Taxation*, 37 *ECON. J.* 47, 58–59 (1927) (explaining why it is more efficient to tax inelastic goods or factors).

<sup>109</sup> See Frank B. Cross, *In Praise of Irrational Plaintiffs*, 86 *CORNELL L. REV.* 1, 19–23, 19 n.107 (2000) (outlining several nonpecuniary reasons why tort plaintiffs sue).

<sup>110</sup> If anything, we might be inclined to tax pain and suffering damages *more* heavily, for there would be efficiency gains from taxing them rather than more elastic forms of income, and these gains could be redistributed to the worthiest claimants.



bilizing effect on the strategic dynamics of litigation.<sup>111</sup> If plaintiffs must pay taxes on the damages they receive and defendants cannot deduct the damages they pay, defendants stand to lose more, after-tax, than plaintiffs stand to win. Thus, for any given injury, a rational defendant will invest more in attorneys, expert witnesses, and the like, than a rational plaintiff. This will make defendants more likely to prevail, reducing the expected payoff to plaintiffs. Thus, an asymmetric tax could make rational plaintiffs even less willing to bring suits than a symmetric one at the same rate. One solution to this would be to allow defendants to deduct pain and suffering damages. Though there is no sound distributive case for such a deduction, it might be necessary to preserve the integrity of the tort system once a tax on pain and suffering damages is introduced.

### B. Tax Avoidance

The structure of an optimal tax on pain and suffering damages likely would differ from the structure of the federal income tax currently levied on individuals. The maximum tax rate would be higher.<sup>112</sup> Moreover, if damages are under-compensatory, the maximum rate would phase in more quickly than the rate on ordinary income,<sup>113</sup> and the exemption threshold could be narrower or wider.<sup>114</sup>

Thus, if we were to graft such a tax on pain and suffering damages onto our current tax code, we would create several opportunities for the classic tax planning strategy of rate arbitrage.<sup>115</sup> On the one hand, if pain and suffering damages are taxed at a preferential rate or excluded altogether, plaintiffs will angle for a mixture of damages that includes more of *them*, even if the total damage award is constant or,

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<sup>111</sup> In this respect, asymmetric taxes would function like nonmutual issue preclusion—i.e., issue preclusion which may be used by plaintiffs against defendants, but not vice versa. Nonmutual issue preclusion “may lead the defendant to invest disproportionately in the first case,” so as to stave off issue preclusion in all cases that follow. See DAVID L. SHAPIRO, CIVIL PROCEDURE: PRECLUSION IN CIVIL ACTIONS 112 (2001).

<sup>112</sup> Compare the top marginal rate on individuals (thirty-seven percent), I.R.C. § 1 (West Supp. 2017), to those suggested *supra* Figure 2 and Figure 4. Even if the rates suggested by Figures 2 and 4 are adjusted downwards to accommodate efficiency concerns, they would still likely be higher than thirty-seven percent.

<sup>113</sup> Compare the tax brackets in I.R.C. § 1 (West Supp. 2017) to those suggested *supra* Figure 4.

<sup>114</sup> Compare the standard deduction in I.R.C. § 63 (West Supp. 2017) to the exemption ranges *supra* Figure 4.

<sup>115</sup> Rate arbitrage involves “converting” income from a category taxed at a relatively higher rate to one which is taxed at a relatively lower one. See, e.g., Joseph E. Stiglitz, *The General Theory of Tax Avoidance*, 38 NAT’L TAX J. 325, 325, 328 (1985) (describing various methods of tax rate arbitrage).

indeed, smaller. Meanwhile, defendants will be happy (or at least indifferent) to go along, for they will pay fewer (or at least no more) damages than they would have paid otherwise. Conversely, if pain and suffering damages are taxed at a *higher* rate than other damages, the plaintiff will have an incentive to seek more medical expenses, lost wages, and the like; and defendants will be willing to go along. The game, in short, is to shift damages to categories that are tax-preferred.

There are three potential effects of this tax avoidance strategy. First, if the overall damage award is held constant, the plaintiff will be overcompensated. Second, if the overall damage award declines, taxpayers will effectively pay some damages on behalf of the defendant. Finally, if the damage award declines (but not by a sufficiently large amount), *both* of these effects will happen. The plaintiff will receive, net of taxes, a larger damage award than he is owed. Meanwhile, the defendant will pay fewer damages than he ought, and taxpayers will pick up the rest of the tab.

People do not always engage in tax arbitrage, even when that game can be played. Sometimes, taxpayers do not know about the game, or do not know enough to play it well. Sometimes, the economic costs of playing the game (as manifested in lawyers, accountants, or in foregone opportunities) outweigh the benefits. Sometimes too there are social or legal sanctions.

In this context, though, it seems overly optimistic to hope that ignorance, economics, or social sanctions will clamp down on the game. The game is relatively simple, easy enough for litigators on both sides of the bar to learn quickly. Moreover, marginal transaction costs for playing it are small (as both sides have already hired lawyers, and no one needs a tax specialist to guide them through the details), and shifting damage awards forecloses no economic opportunities. Finally, it seems unlikely that social sanctions would provide much of a deterrent, as many damages are given out in private settlements, and even in public trials it can be hard for outsiders to tell whether damages have been shifted or whether they accurately reflect the plaintiff's injuries.

The best hope, then, for clamping down on rate arbitrage is legal sanctions backed up by enforcement. There are two contexts in which we must evaluate how well legal sanctions will work: trial and settlement. These contexts need to be treated separately because potential enforcement mechanisms operate differently in each.

### 1. *Trials*

At trial, juries can constrain the benefits of shifting damages from tax-burdened to tax-favored categories of damages. Juries are sup-

posed to evaluate claims for damages independently.<sup>116</sup> Thus, it is impossible (at least in theory) to relent on one category of damages in return for a greater amount in another. If one has a claim for \$500,000 of pain and suffering damages and a claim for \$200,000 of medical expenses, one cannot ask the jury for just \$400,000 of pain and suffering damages so long as it awards \$300,000 for medical expenses in return. To be sure, it is possible that juries are illicitly influenced by considerations of total damage size, such that asking for fewer damages in one category will make them more inclined to award more damages in another. But, in the absence of evidence that juries are so influenced, it seems reasonable to hope that juries can clamp down on rate arbitrage.<sup>117</sup>

## 2. Settlements

The vast majority of tort suits do not go to trial.<sup>118</sup> Many are settled. And the settlement process provides a friendlier arena for tax

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<sup>116</sup> See Ronen Avraham, *Putting a Price on Pain-and-Suffering Damages: A Critique of the Current Approaches and a Preliminary Proposal for Change*, 100 NW. U. L. REV. 87, 90 (2006) (providing background on jury determinations of pain and suffering damages in the tort system).

<sup>117</sup> Alternatively, one might worry that juries introduce a separate problem to the administration of a tax on pain and suffering damages. The worry is that juries will “gross up” their damage awards: that they will increase the gross amount of pain and suffering damages so that, after tax, the plaintiff receives the amount of money that the jury intended. Suppose, for example, that the jury believes that a plaintiff is entitled to \$100,000 of pain and suffering damages, and such damages are taxed at a 20% rate. If the jury wants the plaintiff to receive \$100,000, it could award the plaintiff \$125,000 ( $\$125,000 * 0.8 = \$100,000$ ). If pain and suffering damages paid are not deductible to defendants, grossing up will mean that the tax on pain and suffering damages is borne entirely by defendants. The defendant, in my example, would pay an extra \$25,000, which is then collected by the government after it passes to the plaintiff. Meanwhile, if damages paid are deductible, the tax on pain and suffering damages will have no effect at all. In my example, the defendant would pay an excess \$25,000, which is then collected in tax—but would also subsequently receive a deduction worth \$25,000. Thus, the transfers would net to \$0.

Courts could mitigate this concern. The Restatement (Second) of Torts provides that the “amount of an award of tort damages is not augmented or diminished because of the fact that the award is or is not subject to taxation.” RESTATEMENT (SECOND) OF TORTS § 914A (AM. LAW INST. 2007). Pursuant to this, courts could prohibit the introduction of evidence concerning the tax treatment of damages. Moreover, without being explicitly asked to gross up damages and without being guided through those calculations, it seems unlikely that juries would perform a gross-up. See Gregg D. Polsky & Dan Markel, *Taxing Punitive Damages*, 96 VA. L. REV. 1295, 1306 (2010) (reporting that “jurors are not currently tax aware,” even though punitive damages are taxed).

<sup>118</sup> See Marc Galanter, *The Vanishing Trial: An Examination of Trials and Related Matters in Federal and State Courts*, 1 J. EMPIRICAL LEG. STUD. 459, 463 (2004) (reporting that 2.2% of tort cases in U.S. district courts went to trial in 2002); see also John H. Langbein, *The Disappearance of Civil Trial in the United States*, 122 YALE L.J. 522, 524–26 (2012) (reporting a severe decrease in the number of civil cases going to trial in the United States over the course of the past century).

games. As we have seen, both parties have something to gain from inaccurately allocating damages across damage categories.<sup>119</sup> Moreover, and crucially, there is frequently no impartial observer to check these awards for accuracy. Though judges do have the authority to review settlements in a handful of areas, typically where the parties are thought not to adequately represent the interests at stake,<sup>120</sup> they are free to settle on their own terms.<sup>121</sup> To be sure, the IRS could always challenge fishy damage awards after the fact, in a separate legal action for tax evasion. But the Service's resources are limited, and any inquest into the proper allocation of damage awards will be fact intensive.

There are three possible solutions to this problem. One would be a move towards across-the-board judicial review of settlements. The enforcement costs of this move, though, would be high, to say nothing of the more uncertain, but nonetheless real, accuracy costs incurred whenever a judge rejects a meritorious settlement offer. A second solution would be to rely on IRS enforcement. Though the IRS's resources are limited, it could develop a method for determining which settlement offers look the most suspicious on the basis of the information contained in a tax return. And this would not be aberrational: The IRS regularly does enforce fact-intensive provisions of the tax code.<sup>122</sup> Moreover, in other contexts, an extremely small audit rate has produced very large rates of tax compliance.<sup>123</sup> A third possibility, mentioned earlier, would be to allow defendants to deduct the damages that they pay. This would provide plaintiffs and defendants with

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<sup>119</sup> See *supra* Section III.B.

<sup>120</sup> See Sanford I. Weisburst, *Judicial Review of Settlements and Consent Decrees: An Economic Analysis*, 28 J. LEG. STUD. 55, 56 (1999).

<sup>121</sup> *Id.* at 55.

<sup>122</sup> For one example, consider the multifactor tests for determining whether compensation is reasonable under I.R.C. § 162(a) (2012). See, e.g., *Heitz v. Comm'r*, 75 T.C.M. (CCH) 2522, 2525 (1998) (using seven factors); *Foos v. Comm'r*, 41 T.C.M. (CCH) 863, 878–79 (1981) (using twenty-one factors), *rev'd*, 196 F.3d 833 (7th Cir. 1999). For another, consider the multifactor test for determining whether loans from corporations to shareholders ought to be treated as dividends. See, e.g., *Busch v. Comm'r*, 728 F.2d 945, 948 (7th Cir. 1984) (listing eight factors); *Dolese v. United States*, 605 F.2d 1146, 1153 (10th Cir. 1979); *Alterman Foods, Inc. v. United States*, 505 F.2d 873, 877 n.7 (5th Cir. 1975). These multifactor tests are sometimes criticized for being too indeterminate. See, e.g., *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 834–38 (7th Cir. 1999) (criticizing the use of multifactor tests for determining whether compensation is reasonable). But the IRS is capable of enforcing these standards.

<sup>123</sup> The IRS estimates an 81.7% voluntary compliance rate, even though the audit rate for individuals is just over 1%. IRS, TAX GAP ESTIMATES FOR YEARS 2008–2010, at 2 (2016) (reporting compliance rate); Joshua D. Blank, *Collateral Compliance*, 162 U. PA. L. REV. 719, 731 (2014) (reporting audit rate).

cross-cutting tax incentives, eliminating the opportunity for collusive settlements.

### C. *Summing Up*

In the absence of empirical evidence, the analysis of this section has had to be cautious. But four tentative conclusions can be drawn. First, the ideal tax rate on pain and suffering damages would sometimes be positive and would be an increasing function of damages.<sup>124</sup> Second, these claims hold even after accounting for behavioral responses. Third, the optimal maximum tax rate on pain and suffering damages is likely lower than the high figures described in Part II. Fourth, we might need to pair a tax on pain and suffering damages received with a deduction for pain and suffering damages paid, so as to maintain the integrity of the tort system and to prevent tax avoidance.

### CONCLUSION

The proper taxation of pain and suffering damages has perplexed courts, legislators, and academics alike. In this Note, I have articulated a new approach to this issue, one which evaluates policies by their effects on how much welfare there is and how equally welfare is distributed. I have argued that some, and likely many, pain and suffering damages ought to be taxed—and at rates that increase with damages.

Before setting policy in the real world, we would need to address some further issues. We would need to more precisely determine several empirical parameters, including: how fully tort victims are compensated, how greatly taxes deter litigation, and how much rate arbitrage we should expect under this proposed scheme. We would also need to answer a normative question: To what extent should we trade welfare for equality, and vice versa? This Note, however, has articulated a framework within which these further efforts can be made.

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<sup>124</sup> Strictly speaking, the function is *nondecreasing*, since the optimal tax schedule might include an exemption threshold.