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THE INCOME TAX AS INSURANCE:
THE CASUALTY LOSS AND MEDICAL EXPENSE DEDUCTIONS
AND THE EXCLUSION OF THE MEDICAL INSURANCE PREMIUMS

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ABSTRACT

Whether personal income tax deductions are appropriate refinements to the concept of income or unwarranted tax expenditures continues to be the subject of debate. The casualty loss and medical expense deductions are frequently justified on the ground that ability to pay is reduced by largely unavoidable expenditures or losses. This article reconsiders the question taking account of the availability of private insurance, which is in fact widespread for relevant losses in both areas. When individuals can insure, the second level of insurance implicit in the casualty loss and medical expense deductions distorts consumption choices and insurance decisions. In particular, individuals may be more exposed to losses because of tax deductions commonly believed to mitigate them. Given the option, individuals would prefer a regime that eliminated the deductions and offered correspondingly lower tax rates.

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I. Introduction

This article examines the appropriate tax treatment of losses to one's property and person. The federal income tax provides offsets for both: the former are allowed directly through the casualty loss deduction and the latter are allowed indirectly through the medical expense deduction and the exclusion from income of employer-provided medical insurance.¹

The approach and conclusions of this investigation differ from those of prior commentators. For the most part, those studying the appropriate base for the income tax have grounded their arguments in appeals to the Haig-Simons concept of income² or some substitute concept that serves a similar purpose: from the underlying concept, the appropriate treatment of particular items is derived based on arguments about what treatment is more faithful to the original definition. Stanley Surrey, who pioneered the tax expenditure movement embodying this approach, argued that personal deductions in the income tax are not

¹ This article considers only personal losses, so the former category excludes losses involving business and investment property, see *infra* notes 13 & 15, and the later is limited to medical costs (excluding, notably, lost wages, which are not taxed because they will not be earned). Also, it does not consider the tax treatment of tort recoveries and workers' compensation payments for personal injuries. See *infra* note 54.

² See H. Simons, *Personal Income Taxation* 49-50 (1938); Haig, *The Concept of Income -- Economic and Legal Aspects*, in *The Federal Income Tax* 1, 7 (R. Haig ed. 1921).

appropriate refinements to the concept of income, but instead are improper subsidies that disproportionately benefit the wealthy.³ This position has been challenged, notably by William Andrews, who claims that the medical expense deduction can be justified on the ground that the cost of medical treatment required to restore one's health reduces ability to pay.⁴ Others, such as Mark Kelman, have in turn criticized this position.⁵

This article does involve an appeal to definitions.⁶ It reflects a view that debates about definitions cannot give meaningful guidance to policy unless informed by the objectives underlying the definitions.⁷ Thus, the approach adopted here is

³ See, e.g., S. Surrey, *Pathways for Tax Reform: The Concept of Tax Expenditures* 21-23, 193 (1973).

⁴ See Andrews, *Personal Deductions in an Ideal Income Tax*, 86 *Harv. L. Rev.* 309, 331-43 (1972); see also Bittker, *Income Tax Deductions, Credits, and Subsidies for Personal Expenditures*, 16 *J. L. & Econ.* 193, 196-99 (1973); Epstein, *The Consumption and Loss of Personal Property Under the Internal Revenue Code*, 23 *Stan. L. Rev.* 454 (1971); Musgrave, *In Defense of an Income Concept*, 81 *Harv. L. Rev.* 44, 56-57 (1967); Stephan, *Federal Income Taxation and Human Capital*, 70 *Va. L. Rev.* 1357, 1385-1405 (1984).

⁵ See Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why they Fit Worse in a Far from Ideal World*, 31 *Stan. L. Rev.* 831, 858-79 (1979).

⁶ To be sure, rules of thumb, often embodied in concepts and definitions, can be useful in making everyday decisions. But when academic debate over important matters continues for decades, it is time to set aside aphorisms and substitute a more direct exploration.

⁷ Thus, for example, an income tax might be justified because it is better than the alternatives as a matter of efficiency and equity. For example, Andrews argues that the tax base should be defined in terms of what it is that society means to redistribute. See Andrews, *supra* note 4, at 326. But this can be determined only after stating the principles from which redistributive policies are derived.

As Thomas Griffith emphasizes, a convincing resolution of many tax policy debates can only be achieved by stating explicitly one's normative benchmark -- e.g., utilitarian or Rawlsian -- and determining what treatment best achieves the corresponding objectives. See Griffith, *Theories of Personal Deductions in the Income Tax*, 40 *Hast. L. J.* 343 (1989). Griffith offers an intentionally oversimplified examination of the medical expense deduction solely for the purpose of illustrating how differences in objectives may translate into different policy prescriptions. See *id.* at 385-94. While his illustration persuasively makes this point, his exclusion of ex ante considerations makes his account unconvincing with regard to what the

to evaluate directly the effects of possible tax rules on individuals' well-being. This requires examining individuals' consumption choices and insurance decisions, both of which are made before any loss occurs. Including insurance decisions in the analysis is particularly important. First, the most convincing rationales offered for the casualty loss and medical expense deductions implicitly appeal to notions relating to insurance. Second, insurance is widely available and frequently purchased both for medical expenses and major casualties, notably serious damage to one's home and car.

The analysis demonstrates that, if individuals make informed, rational decisions concerning consumption and the purchase of insurance,⁸ deductions for casualty losses and medical expenses are inefficient. An income tax without these provisions that adjusted rates to maintain the same ex ante distribution of after-tax income would improve the circumstances of all individuals.⁹ The deductions constitute a form of subsidy, the amount of which depends upon one's consumption and insurance decisions and thus distorts them. One distortion of particular interest arises because the deductions cover only uninsured losses. As a result, individuals may purchase less insurance than they would in the absence of the deductions, or forgo

appropriate treatment of medical expenses should be. Similar comments concerning the problems of deriving policy from definitions and another partial examination of the medical expense deduction can be found in Stiglitz & Boskin, *Impact of Recent Developments in Public Finance Theory on Public Policy Decisions*, 67 Am. Econ. Rev. 295 (1977).

⁸ These assumptions are addressed *infra* in note 83.

⁹ Thus, one need not adopt a particular view of distributive justice to resolve the issue as a matter of principle. See *supra* note 7.

insurance altogether, because additional purchases of private insurance require one to sacrifice the free partial insurance provided through the tax rules. When this occurs, individuals are more exposed to losses on account tax deductions nominally designed to mitigate them.

As the foregoing comments indicate, a focus on the effects of tax rules rather than their consistency with stipulated definitions may produce fresh insights and dramatically different conclusions. This is significant not only for the tax provisions under consideration, which collectively involve an outlay equivalent of nearly \$45 billion in the current fiscal year,¹⁰ but also for the study of tax policy more generally.

Another aspect of this study deserves emphasis: its explicit attention to uncertainty. Although the treatment of economic uncertainty is one of the most important features of a tax system, this subject has received scant attention in the legal literature.¹¹ The provisions for casualty losses and medical expenses both provide relief to individuals who experience unusually large losses that could not be anticipated with certainty in advance. It is this feature that turns out to be decisive in the analysis. While only personal losses are considered here,¹² this perspective is also relevant to

¹⁰ See *infra* page 31.

¹¹ Some exceptions include Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 Yale L.J. 1081, 1101-09 (1980), and J. Strnad, *Tax Depreciation and Risk* (1990) (manuscript available from author).

¹² See *supra* note 1.

investigating the appropriate tax treatment of business and investment losses.¹³

The article proceeds as follows. Parts II and III develop the analysis, moving from the effects of deductions on consumption choices to simple and then more complex effects on insurance decisions. For convenience of exposition, Part II emphasizes the casualty loss deduction and Part III emphasizes the medical expense deduction along with the exclusion from taxable income of employer-provided medical insurance, although much of the analysis in each Part is applicable to both deductions.¹⁴ Part IV discusses a variety of further issues, including the taxability of insurance proceeds, administrative factors, and distributional concerns. Part V offers a brief conclusion. Throughout, it is emphasized that all provisions of the tax code concerning these losses -- whether losses are deductible, whether insurance premiums are deductible, and whether insurance proceeds are taxable -- must be examined simultaneously, as the effects of one provision may offset or exacerbate those of another.

¹³ The income tax allows deductions for business and investment losses, subject to various limitations. See *infra* note 15. For an exploration of some issues raised by uncertain gains and losses in profit-making endeavors, see L. Kaplow, *Taxation and Risk Taking Revisited* (1991) (manuscript available from author).

¹⁴ The primary exception is that the exclusion for employer-provided medical insurance has no statutory analog for casualty losses. It would, however, be possible to make casualty insurance premiums deductible, producing the same effects.

II. The Casualty Loss Deduction

A. An Illustration

The casualty loss deduction is only relevant when the casualty affects an asset used for its owner's consumption; with business or investment assets, more general code provisions provide for the deductibility of losses.¹⁵ To examine the effect of the casualty loss deduction, consider a simple illustration. An individual contemplates buying a consumption good -- a yacht. The yacht has a potential useful life of one period. There is a 10% chance that the yacht will be destroyed by a storm at the beginning of the period. (For convenience, assume that there will not be another storm.)

Assume that the individual considers the following alternatives:

1. Purchase a yacht for 100. If it is destroyed by a storm, purchase another yacht for 100.¹⁶

¹⁵ I.R.C. §165(c), (h). There are important limits, including limits on the deductibility of capital losses, I.R.C. §1211, and on the ability to carry over operating losses, I.R.C. §172.

¹⁶ Given the structure of the example, it would be more appropriate for the purchase price of another yacht after the storm to be 111.11, assuming all yachts including those not yet sold are subject to the same probability of destruction by the storm. (Otherwise, since the storm is assumed to be at the beginning of the period, individuals would simply wait until just after the

2. Purchase a yacht for 100 and insurance for 10.
3. Rent a yacht for its useful life at a rental of 110.
(Because the rental agency is assumed to be responsible to replace the yacht if it is destroyed in a storm, which has a probability of 10%, it charges 110 rather than 100.)
4. Purchase a yacht, which is like a yacht except that it is indestructible, for 110.
5. Go to Europe for 110.

B. Effect of the Casualty Deduction
on Consumption Choices

To focus on behavioral effects uncomplicated by matters relating to insurance, begin with the case in which the individual is risk-neutral -- that is, indifferent to risk. First, assume that there is no income tax, or an income tax with no casualty loss deduction. The individual would value the first four options equally. Each provides a period of yachting at an expected cost of 110. The choice between these options and the European vacation will be determined by which yields greater utility. The individual's choice will be efficient, as there is no divergence between the private and social costs or benefits.

storm to purchase yachts for 100.) With this adjustment, the appropriate insurance premium would be 11.11, the rental price would be 111.11, and the price for yachts and the European vacation should be changed to 111.11. This complication is ignored in order to facilitate the exposition; the only effect on the analysis is to oversimplify slightly the measure of the extent of implicit insurance provided by a casualty loss deduction in this example.

Next, consider an income tax with a marginal rate of t and a full casualty loss deduction.¹⁷ The only effect is that option 1 is subsidized by $10t$: there is a 10% chance of losing 100, which would produce a deduction worth $100t$, and the individual, being risk-neutral, considers only the expected value. This leads to inefficient behavior if it induces the individual to choose option 1 when, but for the deduction, the European vacation would have been chosen because it yields greater utility.¹⁸ That is, a tax system with no deduction that adjusted tax rates to offset distributional effects would make individuals better off.¹⁹

The subsidy of option 1 will also induce the individual to choose it over options 2-4. As the example is now stated, this is unimportant because the first four options produce identical utility at identical cost. This will not, however, generally be the case. The different technologies (the yacht) and different methods of ownership (rental vs. outright purchase) may entail

¹⁷ For simplicity, the \$100 exclusion, I.R.C. §163(h)(1), 10% floor, I.R.C. §163(h)(2), requirement of itemization, I.R.C. §§62, 63, and 3% phase-out of personal deductions for high-income individuals, I.R.C. §68, as well as the possibility that a casualty loss may affect one's marginal rate, I.R.C. §1, are ignored.

¹⁸ More generally, when individuals can continuously vary the amount they spend on various consumption goods, such a subsidy will distort their behavior.

¹⁹ Obviously, if one does not adjust for the distributional effect, individuals can only be better off by being offered something for free that they may decline in whole or in part. The point of the distributional adjustment is to distinguish such an effect. Assume, for example, that each income class is given the choice ex ante between the casualty loss deduction or slightly lower rates, where the expected tax obligation in each regime is the same. See Griffith, *supra* note 7, at 360-63; see also Andrews, *supra* note 4, at 338-39. Because individuals would unanimously prefer the latter, no deduction is Pareto superior to a deduction. (Lower marginal tax rates may also reduce distortions in behavior, which would increase the degree of preference for a system with no deduction. See Feldstein & Friedman, *Tax Subsidies, The Rational Demand for Insurance and the Health Care Crisis*, 7 J. Pub. Econ. 155, 176 (1977).)

different costs and produce different levels of utility. For example, the yacht may cost only 108²⁰ or produce a more pleasurable experience, or the rental may be more convenient. As a result, the tendency of the subsidy to favor option 1 will distort these other choices as well.

C. Effect of the Casualty Deduction
on Insurance Decisions

Assume, more realistically, that the individual is risk-averse. Moreover, to simplify the analysis, assume that, aside from considerations of risk, the five options all yield identical utility.

Consider the individual's choice among the options when there is no income tax or an income tax without a casualty loss deduction. The individual would be indifferent among options 2-5 -- each costs 110 for certain and produces, by assumption, identical utility. With risk aversion, however, the individual would strictly prefer any of these to option 1 -- which produces the same utility in consumption at the same expected cost, but involves the individual bearing risk (the cost is 100 or 200 with probabilities of .9 and .1). This illustrates how "insurance" can take many forms: outright purchase (option 2), indirect purchase (3), choice of technology (4), or choice of a less risky activity (5). The individual's choice will be efficient.

²⁰ At a marginal tax rate of 30%, the subsidy would be worth 3, making the expected cost of option 1 -- purchasing a yacht without insuring -- only 107. As a result, option 1 would be chosen over the more efficient yacht, which costs 108.

Next, consider again an income tax with marginal rate t and a full casualty loss deduction. As before, the effect is to subsidize option 1, with the expected value of the subsidy being $10t$.²¹ But option 1 is still risky, although to a lesser extent since the tax deduction acts as insurance covering a portion of the loss equal to t : the individual now faces a loss of $100(1-t)$ with probability 10%.

Thus, depending on the level of t and the extent of the individual's risk aversion, either of two choices may be made: the individual may, as in the case with no deduction, purchase one of options 2-5 or instead purchase option 1, bearing the portion of risk not mitigated by the casualty loss deduction. Whenever the latter choice is made, the result is inefficient: assuming taxes are adjusted to offset distributional effects,²² individuals are worse off because of the existence of the deduction.

The inefficiency in this instance arises not from the nature of the consumption or the technology, but from the fact that the individual bears risk. The subsidy induces the individual to forgo insurance, leading to the ironic result that the free partial insurance embodied in the casualty loss deduction may encourage individuals to bear more risk than otherwise, because they may select an aggregate level of protection against risk

²¹ The subsidy of $10t$ arises because the tax system does not charge a premium for the implicit insurance it offers; an actuarially fair premium for coverage of t on a 100 loss that has probability 10% would simply equal $10t$.

²² See *supra* note 19.

that is less than if the free partial insurance were not offered.²³ The explanation is simple: the more insurance the individual obtains, the more of the tax code's insurance must be forfeited.²⁴ Since the tax code's insurance is free, one must make a greater incremental economic sacrifice than otherwise in order to obtain a more complete level of insurance coverage. The asymmetry is that the tax code's partial insurance is subsidized but the alternatives, involving more complete protection against risk (broadly construed to include options 2-5), are not.

Combining the effects noted in the preceding section with those here, the casualty loss deduction distorts choices of activity, technology, form of ownership, and exposure to risk. Note that this illustration confines private insurance choices to all-or-nothing, whereas in fact some technologies or consumption choices may involve varying levels of risk and individuals may purchase insurance coverage that is incomplete. The primary reason individuals might purchase partial insurance coverage (aside from distortions caused by the tax system²⁵) is to reduce

²³ This possibility is noted briefly in W. Vickrey, *Agenda for Progressive Taxation* 60-62 (1947).

²⁴ The deductions are only available for the portion of one's losses or expenses not covered by insurance. Even if this were not the case, choices that reduce the probability or magnitude of the loss would still involve sacrificing the tax code's insurance. Moreover, the subtle distortions in insurance decisions that arise in the case involving moral hazard would still occur. See *infra* p. 21.

²⁵ In the absence of moral hazard, the presence of a loss deduction will generally lead individuals to purchase partial coverage (leaving them exposed to some of the loss when the effects of their partial coverage and the casualty loss deduction are combined) if the tax rate is moderate or low, but no insurance if the tax rate is above some critical value that depends on individuals' risk preferences and the extent of the loss. See L. Kaplow, *Income Tax Deductions for Losses as Insurance* (1990) (Harvard Law School Program in Law and Economics Discussion Paper No. 83).

the costs of moral hazard. Part III addresses moral hazard in its discussion of the medical expense deduction, and the results are similar.

D. The Conventional Argument for the Deduction

The conventional argument takes an ex post perspective and considers whether it is appropriate to allow a deduction for an uninsured casualty loss.²⁶ Implicitly, this approach considers only option 1. A horizontal equity argument is made: as between two individuals of identical adjusted gross income, each of whom bought identical yachts and acquired no insurance, the one who suffers a casualty has less ability to pay than the one who did not, so a deduction should reflect this fact.²⁷ This rationale is essentially equivalent to a straightforward insurance approach that instead takes an ex ante perspective.²⁸ If one wished to provide fully equal treatment of these pre-casualty equals,²⁹ it would be necessary to provide a transfer from the fortunate to the unfortunate that compensated completely for the latter's losses. This is exactly what a complete insurance policy entered by all ex ante would accomplish -- and exactly what rational individuals would have purchased in the absence of a tax

²⁶ See, e.g., sources cited *supra* in note 4. This argument appears most often in connection with the medical expense deduction, which receives far greater attention. As noted in the introduction, the analysis of this Part is applicable to the medical expense deduction, and will not be repeated in Part III.

²⁷ Goode notes the prevalence of this attitude with regard to the medical expense deduction. See R. Goode, *The Individual Income Tax* 157-58 (1976).

²⁸ See Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 *Nat. Tax J.* 139, 145-46 (1989).

²⁹ The tax code's insurance only equalizes outcomes to the extent of t.

deduction. To accomplish this through the tax system instead, a 100% credit rather than a deduction would be necessary, with taxes on each income class raised sufficiently to cover the costs.³⁰

Once the connection between a tax break for casualty losses and insurance is made explicit, it is natural to adopt an ex ante perspective and consider directly the possibility that individuals may have purchased insurance or otherwise altered their behavior to take account of the riskiness of their consumption decisions.³¹ A 100% credit for uninsured losses, by subsidizing option 1, would be inefficient and would not make available anything individuals could not have obtained for themselves. Moreover, as the next Part demonstrates, even if direct insurance (rather than alternative technologies or consumption choices) is what individuals desire, providing it through the tax system in the form of a deduction or credit results in other distortions when one takes account of moral hazard.³²

³⁰ Griffith notes the potential desirability of a 100% credit when discussing the medical expense deduction from a utilitarian perspective, although he does not make the insurance comparison. See Griffith, *supra* note 7, at 394.

³¹ This perspective is considered briefly in R. Goode, *supra* note 27, at 154, and W. Vickrey, *supra* note 23, at 60-62.

³² When moral hazard is present, individuals optimally obtain partial insurance, so ex post there will be differences among ex ante equals. This raises the question of whether an ex ante or ex post equity perspective is appropriate. This investigation employs the ex ante perspective because it selects a Pareto superior policy, assuming one makes ex ante distributional adjustments. This reinforces the criticism in Kaplow, *supra* note 28, of conventional ex post horizontal equity notions: attaching any weight whatever to ex post horizontal equity violations in this instance would be unanimously rejected. Although it has been recognized that horizontal equity and utilitarianism sometimes conflict, see, e.g., Stiglitz, *Utilitarianism and Horizontal Equity: The Case for Random Taxation*, 18 J. Pub. Econ. 1 (1982), it is not thought that horizontal equity, as conventionally applied, might conflict with the Pareto principle.

III. The Medical Expense Deduction and the Exclusion of Medical Insurance Premiums

A. Issues for Analysis

The medical expense³³ and casualty loss deductions are parallel provisions addressing parallel problems.³⁴ Each

³³ I.R.C. §213. Because effects of flexible benefit plans are similar, they will not be considered explicitly. The primary difference is that such plans cover expenses up to a ceiling (chosen by the individual), whereas the medical expense deduction covers all expenses above a floor. (The combination might result in some individuals being fully protected against small losses, not at all protected against additional losses through some range, and partially protected against greater losses -- but at a decreasing rate, as large deductions would eventually reduce one's marginal rate.)

³⁴ Some of the analysis to follow is applicable to explicit government insurance, particularly Medicaid. Just as some individuals might reduce or forgo insurance coverage because a fraction of uninsured losses are borne by the government through the tax system, so individuals may forgo health insurance -- particularly for catastrophic events -- because of Medicaid. This incentive would presumably be greatest for low or moderate income individuals with few assets. By forgoing insurance, they are likely to save money. In the event of a serious medical problem, their small margin of income and assets would quickly be wiped out, at which time they would become eligible for Medicaid.

This argument concerning the incentive effects of Medicaid is broadly consistent with empirical evidence on medical insurance patterns in the United States. Low- and moderate-income individuals are disproportionately represented among the tens of millions who are uninsured. See Moyer, *A Revised Look at the Number of Uninsured Americans*, 8 Health Aff. 102, 105-08 (1989); Pauly, *Taxation, Health Insurance, and Market Failure in the Medical Economy*, 24 J. Econ. Lit. 629, 636-37 (1986). Moreover, firms with larger percentages of low-wage workers are less likely to offer insurance, and thus their employees are less likely to be insured. See Rossiter & Taylor, *Union Effects on the Provision of Health Insurance*, 21 Indus. Rel. 167, 173 (1982). Even among those poor families that do have private health insurance, the proportion without a limit on the amount of hospital expenditures they might have to pay is approximately 20% higher than the national average. See Farley, *Who are the Underinsured?*, 63 Health & Soc'y 476, 487-90 (1985). Finally, there is considerable turnover in the Medicaid population: in 1977, nearly 5 million individuals had Medicaid for part of the year and had no insurance (3.3 million) or other insurance (1.6 million) for the remainder of the year. This high level of turnover suggests that at least some individuals regard Medicaid as a readily available option in case they encounter large medical expenses. See Wilensky & Berk, *Health Care, The Poor, and The Role of*

provision allows individuals who itemize to take a deduction for uninsured losses above a floor representing a nontrivial percentage of adjusted gross income.³⁵ As a result, the analysis is largely the same.

Two aspects of medical expenses not considered in Part II are emphasized here. First, the tax code, in addition to allowing a deduction for medical expenses, also allows many individuals an indirect deduction for medical insurance premiums: employer-provided insurance is excluded from the measurement of an employee's gross income.³⁶ Second, the analysis in Part II did not address moral hazard. The level of medical expenditures is typically thought to be determined by individual behavior, both before an adverse event (smoking, taking up dangerous sports, nutrition) and afterwards (frequency and duration of contact with the medical system, types of practitioners used, diligence in adhering to prescribed treatment). Thus, it is common to emphasize moral hazard when considering medical care,³⁷ although moral hazard is surely relevant for casualty losses as well.³⁸

Medicaid, 1 Health Aff. 93, 94 (1982). A regime of compulsory insurance -- e.g., through national health insurance -- would not, of course, produce this sort of problem.

³⁵ The floor is currently 7.5% for medical expenses, I.R.C. §213(a), and 10% for casualty losses, I.R.C. §163(h)(2). Other details not central to the analysis are again ignored. See *supra* note 17.

³⁶ I.R.C. §106. See also *infra* note 42 (deductibility of medical insurance premiums). A provision that is currently set to expire at the end of 1991 allows self-employed individuals to deduct 25% of medical insurance premiums. I.R.C. §162(l)(1).

³⁷ Kelman emphasizes that illness is influenced by past behavior as a reason for denying a deduction for medical expenses, but his reasons are largely unrelated to those offered here. Rather, he raises the point to emphasize that voluntariness, combined with the tax system's tendency not to tax psychic income arising from the prior choices, undermines Andrews' argument for allowing a deduction. See Kelman, *supra* note 5, at 863, 868-71. Kelman does not explicitly state the normative principle from which it follows that a deduction should not be permitted.

This Part will analyze only the issues that arise from the possible deductibility³⁹ of insurance premiums and from the consideration of moral hazard. A complete analysis of the casualty loss and medical expense deductions can be obtained by combining the relevant portions of both Parts.

B. Analyzing the Different Tax Regimes

This section examines four possible regimes, each partially reflected in current law.⁴⁰ For the moment, it is assumed that, as under current law, insurance proceeds used to pay medical expenses are not taxable.⁴¹

1. Premium not deductible, uninsured expenses not deductible.
(This regime governs unemployed individuals who have expenses below the floor or do not itemize.)
2. Premium not deductible, uninsured expenses deductible.
(This describes unemployed individuals who itemize, with respect to expenses above the floor.⁴²)

³⁸ For example, before a storm hits, one can take more or less precautions to prevent damage to one's yacht, and after damage is done, more or less care may be spent in selecting who will perform the repairs. (Note that casualty losses are usually measured directly, by the loss incurred, while medical losses are measured by expenditures to correct them, although one could imagine valuing each in a different manner.)

³⁹ For convenience, the discussion will refer to the deduction of premiums rather than to the employer's payment of such premiums being excluded from income.

⁴⁰ The analysis will abstract from current law and consider each regime in its pure form -- ignoring, for example, that a loss may be deductible only to the extent it exceeds the floor.

⁴¹ I.R.C. §§104(a)(3), 105(b). The option of taxing such proceeds is considered in section IV.A.

⁴² While medical insurance premiums are deductible, for most individuals who itemize (typically middle and higher income individuals), the cost of health

3. Premium deductible, uninsured expenses not deductible.
(This includes employees with employer-provided insurance that covers losses that are below the floor or are not deductible because the individual does not itemize.)
4. Premium deductible, uninsured expenses deductible. (This describes employees with employer-provided insurance who itemize, with respect to expenses above the floor.)

In the first regime, which corresponds to the situation considered initially in Part II on casualty losses, individuals bear all of their losses and the full cost of any insurance. Assuming throughout this section that individuals are risk-averse, they would purchase insurance. Were it not for moral hazard, they would purchase complete coverage. In the presence of moral hazard, however, they would purchase partial coverage to maintain some incentive to control costs.⁴³ This is the second-best optimum in that, given available information, any alternative, whether involving more or less coverage, leaves individuals worse off.

In the second regime, as with the casualty loss deduction, the deductibility of uninsured losses is tantamount to free partial insurance. This free insurance distorts incentives due to moral hazard.⁴⁴ Moreover, it affects individuals' insurance

insurance would be mostly or totally under the floor. See R. Goode, *supra* note 27, at 159.

⁴³ See Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 Am. Econ. Rev. 941 (1963); Shavell, *On Moral Hazard and Insurance*, 93 Q. J. Econ. 541 (1979).

⁴⁴ Kelman notes that, if a medical expense deduction is to be allowed, it would be more appropriate to permit specified deductions for particular

decisions. The most straightforward effect is that each increment to the level of private insurance coverage requires one to forgo more of the free insurance offered through the tax code. This induces individuals to choose less coverage overall than they would in the first regime, as explored in section II.C. There are, however, two countervailing effects, described more fully in the discussion of the fourth regime: (1) the level of government insurance through the tax system may exceed the level of private insurance individuals would have purchased, and (2) some of the moral hazard effect of private insurance is externalized to the government, which may induce individuals to purchase greater aggregate levels of coverage.

The tendency to purchase less insurance in order to qualify for more of the government's free insurance will dominate when moral hazard is not very great, in which case individuals would purchase nearly complete coverage were it not for the deductibility of uninsured losses. (Thus, in the illustration in Part II where moral hazard was ignored, individuals purchased complete coverage when losses were not deductible, but might have forgone coverage if losses were deductible.) To compare individual welfare in the two regimes, it is appropriate, as noted previously, to adjust taxes to remove any distributional effects. When this is done, it is clear that welfare is lower in

ailments where the amount of the deduction does not depend on individuals' actual expenditures. See Kelman, *supra* note 5, at 876. His motivation is to separate the consumption dimension of some medical expenditures from their treatment aspect. Whatever the virtue of this result, such an approach has the desirable feature that it avoids ex post moral hazard. See Pauly, *supra* note 34, at 642. Presumably, this is one reason that public and private health insurance schemes have recently moved toward reimbursing providers based on treatment categories.

regime 2: the different aggregate level of protection against risk chosen in regime 2⁴⁵ could have been chosen in the undistorted system, regime 1, but was rejected because it yielded less utility.

In the third regime, because insurance premiums are deductible but uninsured losses are not, insurance is subsidized. Thus, individuals purchase a greater level of coverage than they would otherwise prefer.⁴⁶ As compared with regime 1, they are purchasing protection against risk that is not worth the added social cost when one accounts for the increase in moral hazard,⁴⁷ but this inefficient choice is nonetheless made because of the subsidy.⁴⁸

⁴⁵ By coincidence, for some individuals, the two tendencies may precisely offset so that their welfare in regimes 1 and 2 would be equal.

⁴⁶ See Pauly, *supra* note 34, at 641. Farley and Wilensky estimated that a family paying the average amount of premiums (\$987) with no tax benefit and subject to the average tax rate (31%) would spend an additional \$132 if the tax subsidy applied to the entire premium. Farley & Wilensky, *Household Wealth and Health Insurance as Protection against Medical Risks*, in *Horizontal Equity, Uncertainty, and Economic Well-Being* 323, 337 (M. David & T. Smeeding eds. 1985). Feldstein & Friedman, *supra* note 19, estimated large effects of the tax subsidy on the level of health insurance purchased (in particular, on coinsurance rates -- the portion of expenses individuals would remain responsible to pay), implying large welfare losses. See also Feldman & Dowd, *A New Estimate of the Welfare Loss of Excess Health Insurance*, 81 *Am. Econ. Rev.* 297 (1991) (providing recent large estimates of welfare loss; not deriving how much excess insurance may result from the tax system). Other studies are surveyed in Pauly, *supra*, at 638, who indicates that, at the time of his writing, the tax subsidy was sufficiently large to make the after-tax cost of insurance protection negative for many workers (i.e., the after-tax cost of premiums was less than the expected payments).

⁴⁷ If the incentive to purchase insurance is insufficient due to other distortions, see, e.g., *supra* note 34 and *infra* note 83, some subsidy of insurance may be desirable, although there is no reason for believing that the subsidy should take the form or have the magnitude of the current exclusion for medical insurance premiums.

⁴⁸ The fact that much employer-provided insurance covers 100% of very small losses illustrates this effect. For example, some dental policies cover only expenses up to \$1000. See Phelps, *Tax Policy, Health Insurance, and Health Care*, in *Market Reforms in Health Care: Current Issues, New Directions, Strategic Decisions* 198, 209 (J. Meyer ed. 1983). Given the moral hazard and administrative costs involved, combined with the small amount of risk, it seems plausible that such policies are a product of the tax system. See *id.*

In the fourth regime, in which both premiums and uninsured losses are deductible, it might appear that there is no distortion of the insurance decision⁴⁹ -- i.e., that the distortions in regimes 2 and 3 precisely offset. For each unit of protection, one pays a premium. The unit of protection only effectively shields one against $1-t$ units of the loss (because t of the loss was otherwise covered by the tax system), but that unit of protection costs only $1-t$ because the premium is deductible.

This argument, however, is incomplete. First, regime 4 will be inefficient to the extent the level of partial insurance implicit in the tax code, considered alone, exceeds the level individuals would have chosen in regime 1.⁵⁰ Second, regardless of whether the tax code's implicit insurance coverage exceeds the level individuals would otherwise select, the existence of implicit government insurance that does not entail charging a premium results in what might be called a two-stage moral hazard problem,⁵¹ noted briefly in the discussion of regime 2. To

at 209-13; Pauly, *supra* note 34, at 644. Group plans, most of which are employer-provided and thus subsidized by the exclusion of employer-paid premiums from income, are also far more likely than individual plans to have coverage for dental care, physician office visits, prescription drugs, and medical equipment, while they are far less likely to have deductibles of more than \$100. See P. Farley, *Private Health Insurance in the United States* 46-47, 63-64 (1986). In addition, individuals may use flexible benefit plans to pay in full for small items not covered by their insurance or excluded by the deductible.

⁴⁹ The distortion in choice of activity or technology discussed in Part II would still exist. Thus, for example, purchasing a yacht for 100 and insurance for 10 would be cheaper than purchasing an indestructible yacht for 108 if the insurance premium were deductible at a 30% marginal tax rate.

⁵⁰ With top marginal rates near 30%, this is much less likely than when top marginal rates were 70%, or even higher.

⁵¹ See Kaplow, *Incentives and Government Relief for Risk*, 4 J. Risk & Uncertainty 167 (1991).

understand this effect, note initially that each increment of protection entails further moral hazard. This moral hazard, in turn, increases the aggregate expected loss, which is insured partially by private insurance and partially by the tax system through the deduction. Thus, the additional moral hazard effect increases the expected costs of both insurance systems. For private insurance, this increase will be reflected in the individual's premium. But the tax system charges no premium, so this aspect of the increased expected cost will not be taken into account by the individual. As a result, the level of aggregate coverage the individual would choose in this regime will tend to be higher than the level of private insurance the individual would have bought in regime 1, in which the individual received the full benefit of insurance but bore the full cost. In regime 1, the individual purchased insurance coverage up to the point where an infinitesimal increase in coverage produced a risk-spreading benefit just equal to the incentive cost (reflected in the premium). Here, that same incremental increase produces the same risk-spreading benefit but at less cost to the individual. As a result, regime 4 is inefficient.

In sum, all regimes except regime 1 -- no deductibility of premiums or uninsured losses -- are inefficient relative to the second-best optimum. Thus, the conclusion of Part II that a deduction for losses is inefficient continues to hold when considering a wider array of regimes and taking account of how moral hazard affects individuals' insurance decisions.

IV. Discussion and Extensions

This Part considers a range of issues that further illuminate the analysis of Parts II and III. The preceding discussion considered the deductibility of losses or expenses and of insurance premiums. Section A examines the additional and related question of the taxability of insurance proceeds. Another perspective on the deductions for casualty losses and medical expenses is introduced in section B, which considers the possibility of taxing the implicit gain taxpayers realize when a loss that might have occurred does not in fact occur. A central point in the analysis is that the tax deductions for casualty losses and medical expenses are profitably viewed as a form of implicit insurance. Section C compares this implicit insurance with ordinary private insurance from an administrative perspective to see what can be learned from some notable differences in how these systems operate. Section D emphasizes how the approach here differs from that common in the literature and examines distributional concerns that arguably are addressed by the casualty loss and medical expense deductions.

A. Taxability of Insurance Proceeds

The discussion in Parts II and III took as given the current rule that insurance proceeds to cover casualty losses or medical

expenses typically are not taxable, unless they reimburse previously deducted amounts.⁵² Often this treatment is said to be justified because, if the proceeds were taxable, there would be an offsetting deduction in any event. Given all the limits on the casualty loss and medical expense deductions,⁵³ this is not true in many instances. More important for present purposes, however, one can hardly rely on this rationale to the extent the justification for the offsetting deductions is placed in question.

Instead, it is useful to emphasize the prior payment of an insurance premium and make an analogy to the notion of basis.⁵⁴ Begin by recalling the first regime considered in Parts II and III:⁵⁵ premiums were not deductible, losses not deductible, and insurance proceeds not subject to tax. Now compare an alternative that differs only with respect to the treatment of insurance: premiums are deductible and proceeds are included in income.⁵⁶ Both systems would be nondistorting with regard to an

⁵² See *supra* note 41 (medical insurance); I.R.C. §123 (allowing deduction of insurance payments for living expenses during loss of occupancy caused by casualty; nullifying court decision holding such insurance proceeds taxable). If proceeds exceed the adjusted basis of an asset and are not reinvested (i.e., so that the nonrecognition rule of I.R.C. §1033 does not apply), the gain is taxable.

⁵³ See, e.g., *supra* note 17 (casualty deduction).

⁵⁴ See I.R.C. §§1011, 1012. Because the argument in this section depends on the prior payment of an insurance premium, it is inapplicable to tort and workers' compensation recoveries, which are excluded from income. I.R.C. §§104(a)(1), (2).

⁵⁵ One could also consider modifications to the other regimes, but this would yield few additional insights.

⁵⁶ Except for the timing of the deduction for the premium -- a complication ignored here -- this is equivalent to a system that views the premium as an investment in a financial asset, with realization at the time proceeds are received or at the expiration of the policy.

individual's ex ante decision to purchase actuarially fair insurance (i.e., insurance for which the premium just equals the expected recovery under the policy). The former system fails to recognize gain when one receives a large payment and fails to allow a loss deduction when no payment is made (i.e., when one has good luck, and thus in hindsight would rather not have purchased the insurance). The basis can be seen as the premium, and it, on average, just equals the proceeds. With the latter system, because the premium is deducted, the basis is zero. As a result, neutrality would require taxing the receipt of proceeds. It would appear that individuals should be indifferent between these two systems.

To analyze this further, consider the case in which there is no moral hazard.⁵⁷ With the former system, individuals purchase full insurance coverage. The occurrence of a loss does not produce any fluctuation in actual income or after-tax income. With the latter system, the possibility of a loss means that even individuals purchasing full coverage experience a fluctuation in their after-tax income: when a loss occurs, their after-tax income is lower by the amount of the loss (which equals the amount of the insurance proceeds) times the tax rate. Thus, although the latter scheme is equivalent to the former on an expected value basis, the latter involves the individual bearing some risk because the tax system effectively erases a fraction of the insurance policy (the fraction equaling the tax rate). In

⁵⁷ It would be straightforward to demonstrate that the analysis also applies when individuals purchase partial insurance coverage because of moral hazard.

principle, individuals could gross up their level of insurance coverage to offset this effect.⁵⁸ For example, if the tax rate were one-third, they could purchase coverage for 150% of their loss. After paying tax on the proceeds, they would be just whole. The premium would be 50% higher than with the former system, but since the entire premium is deductible, the after-tax cost of the premium would be the same as with the former system.

At this point, it appears that the latter regime, by allowing deductibility of premiums and taxing insurance proceeds, results in a wash. To avoid the administrative costs of accounting for all this, it would be better simply to adopt a system that ignores insurance altogether.

There are, however, some additional differences. The existence of progressive rates makes the latter system less generous because the average tax rate on the proceeds would exceed the rate applicable to the deduction of the premium; the net effect would be to tax, and thereby discourage, the purchase of insurance. On the other hand, the latter system is more generous with regard to any load paid on the insurance policy (i.e., the amount in excess of the expected recovery to cover

⁵⁸ This possibility, as well as the close relationship between whether insurance proceeds should be taxed and whether premiums should be deductible, is noted by Daniel Halperin. See D. Halperin, Valuing Personal Consumption -- Cost vs. Value and the Impact of Insurance (1989) (unpublished manuscript available from author). He also suggests another perspective: individuals who purchase insurance along with an asset subject to casualty loss have, in effect, purchased a different asset. The loss is the insurance company's, not theirs, and the proceeds can be seen as flowing to the seller of the replacement asset. Following the illustration in Part II, one might say that the insurance company is like a lessor that has promised to make an asset available regardless of whether a casualty occurs. The lessee suffers no casualty loss and receives no payments.

costs of administering the policy), because the load is deductible. The above analysis suggests that this generosity would be inefficient, as it amounts to a subsidy for the insured activity (e.g., yachting).⁵⁹ Finally, the former system may be more efficient because the latter requires individuals to purchase insurance that depends on their future tax bracket, which may be uncertain and create additional incentive problems, particularly with coverage that nominally exceeds 100%.⁶⁰ In conclusion, a system that ignores insurance rather than taxing proceeds and allowing premiums to be deducted seems optimal.⁶¹

B. Exclusion of "Gains"

Daniel Halperin,⁶² paralleling an earlier suggestion of William Vickrey,⁶³ argues that the casualty loss deduction is defective because it is asymmetric: it allows a deduction for losses but does not include in income what might be termed

⁵⁹ See W. Vickrey, *supra* note 23, at 61. For medical insurance, the nature of the subsidy is less apparent in the case where moral hazard is insignificant. Yet the load is a real cost of the insurance; it is more efficient that it be fully taken into account when individuals make insurance decisions. To the extent all individuals would acquire insurance, paying the same load, the distributional consequences would be insignificant, but there may be efficiency consequences if the level or type of insurance purchased depended on the after-tax cost of the load.

⁶⁰ In the example with 150% coverage, if one's tax rate unexpectedly declined, one would stand to profit by having one's asset destroyed. This possibility introduces another element of moral hazard, which in turn affects the level of insurance coverage individuals would obtain. This problem and the other noted in the text might be mitigated if the amount to be paid under the insurance policy were to depend on one's actual tax bracket, determined *ex post*. Such a policy, however, would introduce an additional moral hazard element with regard to one's taxable income (e.g., timing one's realizations of capital gains would affect the amount of insurance coverage).

⁶¹ A system that taxed proceeds and did not allow premiums to be deducted would inefficiently discourage the purchase of insurance.

⁶² See D. Halperin, *supra* note 58, at 25-28.

⁶³ See W. Vickrey, *supra* note 23, at 61.

"casualty gains." The idea is that one purchases an asset only if its expected value equals or exceeds its price. If, in the event of a casualty, its value is less than the price paid, it must be that one expects the value to exceed the price if there is no casualty.⁶⁴ That is, when there is no casualty, one possesses an asset worth more than what one paid. Thus, the argument goes, if casualty losses are deductible, casualty gains should be taxable.

To illustrate, consider the yacht purchase example in Part II. One might say that, when there is no storm, there is a casualty gain of 10: the individual secured an asset worth 110 -- the cost of rental or other alternatives that guaranteed the ability to engage in yachting for the period -- for a price of only 100. Taxing this gain of 10 at the rate t yields a tax due of $10t$, precisely offsetting the subsidy previously identified as arising from the deduction.⁶⁵

It is useful to consider the relationship between the idea that casualty gains are excluded and the analysis here.⁶⁶ One can view the yacht purchaser as consisting of two personalities:

⁶⁴ The reasoning also applies to the medical expense deduction: good health ex post is better than the average level of health that would have been anticipated ex ante.

⁶⁵ As presented in the text, the numbers do not fully add up, because taxable income of 10 with probability .9 and a tax deduction of 100 with probability .1 leaves one with an expected (net) deduction of 1, and thus an expected subsidy of 1t. But if one adjusted the example to be complete, as described in note 16, the casualty gain would be 11.11 rather than 10, so the (net) expected deduction and subsidy would be zero.

⁶⁶ Although for many purposes Halperin adopts an ex ante perspective and often discusses the effect of tax provisions on the purchase of insurance, he does not systematically examine the effects of different regimes as is done here; nor does he offer an explicit criteria for evaluating the effects.

one is in the business of purchasing yachts to rent and the other is the lessee and user of yachts.⁶⁷ The former stands to have a profit of 10 if there is no storm and a loss of 100 if there is (because the yacht must be replaced, to rent to the other personality). Standard, uncontroversial, tax accounting for this business would show both the profit (the "casualty gain") and any casualty loss. The lessee/user pays the purchaser/lessor the market rental, which is not deductible and thus results in no tax consequences, regardless of whether there is a casualty.⁶⁸ One might argue, therefore, that the correct treatment of the single individual -- the purchaser/user -- should be the sum of the treatment of these two hypothetical persons.

With regard to the activity choices discussed in Part II and the insurance choices addressed in Parts II and III, the effect of allowing the casualty loss deduction while taxing casualty gains appears to be largely the same as that of allowing no deduction and failing to tax gains. Since measuring gains (which involves assessing the ex ante probability of losses that did not occur during the tax year) would be administratively costly and often nearly impossible,⁶⁹ as Halperin emphasizes, it seems

⁶⁷ Since the example involves only one period, where the asset is fully expired at the completion, the issue of excluding imputed rent from the tax base does not arise. See D. Bradford & U.S. Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform 89* (2d ed. 1984); R. Goode, *supra* note 27, at 154-55.

⁶⁸ See *supra* note 58.

⁶⁹ See W. Vickrey, *supra* note 23, at 61. In addition to various assets used in different ways, one must also consider medical expenses. In all instances, any attempt at valuation would inevitably involve predictable errors, which would reintroduce some asymmetry. Ignoring both losses and gains avoids the problem entirely. (Such valuations are implicit in insurance contracts, in that voluntarily paid premiums reflect expected losses and thus implicitly

simpler to disallow a deduction for casualty losses. Because the prospective gains and losses that are ignored accrue to the same individual, typical problems of tax arbitrage do not arise.⁷⁰

There remains, however, an important difference between a regime that ignores losses and gains and one that involves deducting losses and taxing gains: the latter amounts to compulsory partial insurance (to the extent of one's marginal tax rate) while the former does not. Thus, the latter regime is subject to the insurance distortion arguments presented in section III.B addressed to a regime that allowed a casualty loss deduction and a deduction for insurance premiums (regime 4).⁷¹ First, if the marginal tax rate exceeds the level of insurance that otherwise would be optimal (recall that, with moral hazard, optimal insurance is partial), inefficient overinsurance would result. Second, as individuals purchase more private insurance, some of the moral hazard is externalized to the government and consequently ignored. Thus, in addition to administrative considerations, there is a conceptual basis for believing that a system that would allow no deduction is more efficient than one

measure the casualty gain. See *infra* p. 32 (discussing administrative differences between direct insurance and tax deductions.).

⁷⁰ Of course, with progressive rates, the gain and loss would not all enter at the same rate, and to the extent the individual could influence the timing of such gains and losses, some manipulation would be possible.

⁷¹ Regime 2 entailed a tendency to underinsure in aggregate because increasing one's level of private insurance involved forgoing some of the free insurance implicit in the tax code. With regime 4, this problem was avoided because the deduction for the premium on private insurance just offset this effect. For the regime that taxes casualty gains, the tax on casualty gains is in essence the insurance premium for the government's insurance, so the government insurance is not free. In all these regimes, however, one is subject to the more subtle distortions in insurance coverage that arise when moral hazard is present.

that would allow a casualty deduction while taxing casualty gains.

C. Administrative Differences between Private Insurance and
Implicit Insurance Through the Tax System

The discussion in Parts II and III assumed that both private insurance and implicit government insurance through tax deductions were simple and costless to administer. Considering administrative costs and practices further illuminates the question of the appropriate tax treatment.

First, the existence of tax deductions for losses that may also be partially insured results in duplication of effort. Second -- perhaps in part because of such duplication, in part because the level of government insurance is often modest, and in part because of limited enforcement resources -- the government spends far less effort on claims administration than do private insurance companies. A taxpayer simply writes a number on a tax return and receives a check (implicitly -- in practice, a refund may be larger or the tax due may be smaller). Rarely will there be an audit, examination of receipts, or analysis of the nature of the expense. This is striking when one considers that the medical expense deduction involves an outlay equivalent exceeding \$3 billion for fiscal year 1991 and the exclusion of employer insurance payments, far less subject to abuse, exceeds \$40 billion.⁷²

⁷² Office of Management and Budget, Budget of the United States Government, Fiscal Year 1991 A-72 (1990).

There are other, more subtle differences.⁷³ Notably, private insurance involves tailoring coverage and setting premiums to account for moral hazard and activity choices.⁷⁴ Thus, with medical insurance, categories of expenditures more subject to moral hazard have higher coinsurance rates (i.e., individuals contribute a greater percentage of such costs). Casualty insurance is more expensive for types of assets subject to greater risks. For example, auto collision and theft coverage is more expensive for fancier cars and fire insurance is more expensive for wooden structures. Although limits on administrative resources and a desire to keep the tax system relatively simple could explain why government definitions do not make such distinctions,⁷⁵ this is unlikely. Instead, such distinctions are not made because the tax code does not purport

⁷³ Differences in administrative costs have other ramifications. For example, as discussed at page 26, private insurance policies involve load charges that reflect real costs, whereas the administrative costs of implicit tax code insurance are not charged to the insured. Another cost difference is that the tax code's insurance is more comprehensive: as one enters a new activity, one need not write a separate insurance policy. For major casualties, however, such as those involving a home or car, the administrative cost is likely to be small relative to the stakes involved. Moreover, individuals may obtain liability coverage in any event, and casualty coverage would often be available in the same policy.

⁷⁴ In addition, individuals with different risk preferences can choose different levels of insurance coverage. The tax system's insurance is at a stipulated level. Moreover, this rate is greater the higher is one's income, and individuals with little income receive no insurance through the tax system. Yet risk aversion is thought to be greater for those with lower incomes.

⁷⁵ The tax code's definition of casualty, I.R.C. §165(c)(3), refers to losses "from fire, storm, shipwreck, or other casualty, or from theft," and interpretations of "other casualty" emphasize suddenness. The apparent attempt is to distinguish probabilistic, substantial decreases in value from gradual, anticipated declines -- wear and tear -- which should not be deductible because they are consumption. If one wished to appeal to definitions, one could simply note that probabilistic consumption is still consumption. For example, assume houses were destroyed by floods for certain once every 100 years rather than with probability 1% every year, or through erosion by a certain 1% annually. Clearly, behavior will be distorted if the tax code allows deductions for any of these causes of decreased value.

to be involved in the insurance business. There is no legal basis for excluding or reimbursing at a lower rate casualty losses and medical expenses that taxpayers actually incur because of incentive considerations.⁷⁶

In addition, existing tax rules may influence efforts aimed at controlling costs of the medical care system. Cost control efforts have received increasing attention from insurance companies and the government with respect to Medicaid and Medicare, and concerns for cost control have been important in the expansion of Health Maintenance Organizations and other innovations in the marketplace. Medical system cost control, however, does not have similar prominence on the agenda of the Internal Revenue Service or the tax-writing committees of Congress, despite the tens of billions of revenue cost incurred annually for medical care through the tax system.⁷⁷ Employer-provided insurance is the lion's share of these costs, so the tax coffers may benefit indirectly as a result of private cost control efforts. Nevertheless, the fact that a significant fraction of the benefit of such efforts accrues to the government rather than directly to the purchasers of insurance coverage blunts insurers' incentives to limit health care costs.

⁷⁶ There are some narrow statutory exceptions, such as that for cosmetic surgery. I.R.C. §213(d). More generally, when marginal rates are relatively modest, as they are currently, incentive effects may be correspondingly low. Nevertheless, a 30% subsidy is hardly a trivial matter, and the level of the subsidy does not vary with the extent of the incentive problem.

⁷⁷ Tax expenditures for the exclusion and deduction of health insurance premiums in 1982 constituted about 10% of private health insurance expenditures. See Pauly, *supra* note 34, at 638.

D. Comments on the Literature and Distributional Concerns

The preceding discussion indicates that allowing deductions for casualty losses and medical expenses distorts activity choices and insurance decisions. In particular, the implicit insurance offered through the tax code may result in individuals securing less aggregate protection against risk than they would in the absence of the deductions. Given a choice, individuals would prefer a tax code without such deductions and with correspondingly lower rates. In principle, it would be possible to distribute the revenue savings in a manner that made all taxpayers better off.⁷⁸

One noteworthy aspect of this analysis is that, unlike most commentary on these issues, none of it requires one to define "income" or "consumption." Instead, the discussion focuses exclusively on the plausible effects of alternative regimes on behavior. Any conclusions about tax policy that emerge depend on how one assesses these consequences. After the analysis is complete, one could, for example, deem medical expenses to be "consumption" or not, but this would merely restate one's conclusion in less straightforward terms.⁷⁹ Moreover, it would

⁷⁸ As a practical matter, this generally would not be possible. It would not be administratively feasible, for example, to identify which individuals at a given income level engage in more casualty-prone activities. That some individuals would be worse off as a result of such a tax reform is not necessarily an argument against it, as there is no obvious basis for suggesting that individuals who prefer more risky activities should be entitled to pay less taxes.

If the revenue savings were not distributed to income groups in proportion to their current benefits but rather more evenly, the effect would be progressive. Currently, the exclusion for medical insurance premiums and the medical expense deduction -- the bulk of the revenue involved -- favor wealthier families. See Feldstein & Friedman, *supra* note 19, at 176 & n.143.

reopen debate about what one really means by "income" or "consumption" without illuminating the underlying reasons for preferring one tax treatment over another.⁸⁰

The investigation here also differs from much (not all) of the literature by adopting an ex ante rather than an ex post perspective. Instead of focusing on whether one who has suffered a loss deserves more generous treatment than one who does not, it considers the situation prevailing at the time individuals make decisions that influence the likelihood and extent of their losses as well as the degree to which they will be compensated. This perspective is important for two reasons. First, ex post tax treatment has important effects on ex ante behavior that are relevant in assessing various tax regimes. Second, the ex ante perspective is relevant to considerations of equity. In particular, through their insurance decisions and activity choices, individuals may reduce or eliminate their exposure to losses. There is good reason to view differently losses voluntarily borne by individuals who accepted a gamble and would have benefited financially if they experienced a more favorable outcome.⁸¹ Moreover, in the context examined here, all

⁷⁹ In commenting on his argument that the medical expense deduction is justified as a refinement to the concept of income, Andrews states that his point involves "recognizing that the notion of consumption as a base for personal taxation may rationally be elaborated differently than it is for other purposes." Andrews, *supra* note 4, at 337. Once the term becomes a term of art, however, it serves only to communicate accepted understandings, not as a basis for illuminating new contexts, because any presumption that one may draw upon familiar applications of the term is rejected.

⁸⁰ This point should not be understood as a claim that using definitions, as with income or consumption, is necessarily wrong. Reasoning from definitions, concepts, and other proxies is often useful. As emphasized in the introduction, however, the existence of continued controversy itself seems sufficient to justify examining foundations. See *supra* note 6. How often and when this is appropriate cannot be stated simply.

individuals would in principle choose to be governed by a regime without deductions if they could.⁸² It is not clear what principle of distributive justice would refuse to honor this choice.⁸³

There is, however, an important reservation concerning distribution: what if individuals have ex ante differences beyond their control? One might imagine such differences to be insignificant for most casualty losses, but there are important differences in medical condition that affect one's future medical

⁸¹ This point is suggested in Bittker, *Comprehensive Income Taxation: A Response*, 81 Harv. L. Rev. 1032, 1035 (1968), and D. Bradford, *Untangling the Income Tax* 168 (1986).

⁸² See also *supra* note 32 and accompanying text (discussing horizontal equity).

⁸³ One might view differently losses that were "voluntarily" borne by individuals who made uninformed or irrational decisions to forgo insurance. A moderate paternalistic perspective might favor attempting to produce the result such individuals would have achieved had they chosen properly from the standpoint of their own welfare. In this instance, compulsory insurance at the level informed individuals would have chosen is preferable to deductions for a number of reasons. First, it provides the right level of protection, rather than the partial protection involved in a loss deduction that depends on one's tax bracket, status with regard to itemizing, and the like. Second, it avoids distorting activity choices that influence the extent of expected losses and thus the level of insurance premiums (if such activities can be observed by insurance companies and used in setting premiums). Moral hazard from the insurance itself may be unavoidable. One danger of a compulsory scheme is in setting the level of required coverage too high -- particularly if the scheme must, of necessity, apply to a large portion of individuals who are well-informed and thus who would make sensible decisions if not compelled to act differently.

Another aspect of imperfect consumer choice may involve ex post decisions. For example, some individuals may be reluctant to seek medical care because they underestimate its value. This may arise because individuals do not appreciate the value of treatment or because treatment -- such as for substance abuse -- may involve positive externalities. A subsidy may help offset such a tendency. Nevertheless, a subsidy may be most important for lower cost, preventive expenses, which would be under the floor of the current deduction. Moreover, to the extent that the existence of a medical expense deduction (in contrast to the exclusion for employer-provided insurance) discourages the purchase of insurance, it might be seen as less desirable than suggested by the discussion in the text. Finally, an optimal subsidy scheme would presumably be directed to particular actions for which individuals underestimate social value rather than broad categories of expenditure, and it would not offer greater benefits to the wealthy while excluding the poor and unemployed or self-employed (who now receive only a 25% deduction, see *supra* note 36).

expenses. Even these differences would not be important if all could purchase insurance at the same rates and adverse selection were not a serious problem.⁸⁴ Those having access to fairly comprehensive group medical insurance through employers or professional organizations may face little difficulty in this respect.

If, instead, some individuals are unable to obtain medical insurance except at very high rates because innate observable factors indicate that they are more prone to health problems,⁸⁵ one may wish to take this into account in determining the appropriate distribution of income, and thus in determining the appropriate tax base. To avoid distorting insurance and other decisions of such individuals, it would generally be more efficient to offer direct subsidies or, if through the tax system, special deductions or credits that depend on status rather than actual events. Thus, for example, an additional tax deduction for the blind might be more efficient than subsidizing particular purchases they make.⁸⁶ If such alternatives were too administratively costly and if innate health differences were substantial, one might allow a medical expense deduction and a

⁸⁴ It is not apparent that these are significant practical problems for medical insurance markets. For a discussion of insurer practices making adverse selection less likely, see Pauly, *supra* note 34, at 649-54. As he suggests, if the tax subsidy were removed, employers might offer a greater range of choices to employees, which could make adverse selection more serious than it currently is.

⁸⁵ In practice, it will often be difficult to determine whether a particular health risk is attributable to innate factors or prior voluntary choices, as emphasized by Kelman, *supra* note 5, at 863, 868. For example, a middle-aged individual may face high medical insurance costs because of a life of smoking or poor nutritional habits.

⁸⁶ See *supra* note 44.

deduction for medical insurance premiums (particularly for non-employer-provided insurance, where premium differences would be the greatest) as a second-best alternative. Yet it might be more efficient to pursue other health policies, such as insurance taxes and subsidies⁸⁷ or national health insurance.⁸⁸

⁸⁷ Cf. Crocker & Snow, *A Simple Tax Structure for Competitive Equilibrium and Redistribution in Insurance Markets with Asymmetric Information*, 51 S. Econ. J. 1142 (1985) (even if government cannot determine which insurance purchasers are subject to more risk, it may tax and subsidize different types of insurance policies to effect redistribution among groups subject to different risks).

⁸⁸ By analogy, the case for an income tax to reduce variations in labor income arising from uncertainty that is anticipated is relatively weak, see L. Kaplow, *A Note on Taxation as Social Insurance for Uncertain Labor Income*, (1990) (Harvard Law School Program in Law and Economics Discussion Paper No. 84), while that for reducing variations in future labor income arising from unmeasurable innate differences in ability stands independently, see Stern, *Optimum Taxation with Errors in Administration*, 17 J. Pub. Econ. 181 (1982). The argument in the context of medical expenses is, however, more precarious. Individuals with poorer innate health will face substantially higher insurance premiums only if insurance companies can determine at modest cost who such individuals are. But if this determination is in fact feasible, there is less of a case for using medical expense deductions for uninsured expenses and other indirect policies rather than direct subsidies to benefit such individuals. Cf. Crocker & Snow, *The Efficiency Effects of Categorical Discrimination in the Insurance Industry*, 94 J. Pol. Econ. 321-44 (1986) (demonstrating that it is more efficient for government to allow categorical discrimination supplemented by direct redistribution than forbid categorical discrimination when cost of categorization is sufficiently low).

V. Conclusion

This investigation has considered many aspects of the casualty loss and medical expense deductions. The perspective adopted here emphasizes that both deductions are, in essence, an odd sort of free, partial, quasi-compulsory insurance: for no explicit premium (except higher taxes generally), some individuals (those who itemize) receive partial coverage (for losses above a floor) at a level equaling their tax rate (and thus higher for the more wealthy) for qualifying losses (where the portion of losses one insures directly are not qualifying). Focusing on individuals' ex ante decisions, the effect of these deductions is to distort behavior. Most obviously, activities are subsidized to an extent that increases with the risk of loss involved. Moreover, insurance decisions are distorted. One possibility is that individuals might reduce their coverage or forgo insurance entirely, so that they will not sacrifice the free partial insurance offered by the tax system. In such cases, individuals bear more risk as a result of their being offered some free insurance. More subtle distortions that take into account moral hazard and its effect on insurance coverage were also considered.

The approach adopted here differs from most of the previous literature on these personal deductions by focusing entirely on the effects of various regimes on behavior and how these effects might be evaluated, ignoring the perplexing questions of how "income" and "consumption" should be defined. Moreover, it illustrates the need to consider simultaneously whether losses or expenses are deductible, premiums are deductible, insurance proceeds are taxable, and implicit gains are taxable, as changes in one provision may offset or exacerbate the effects of another.

This investigation, however, has one important element in common with much of the prior literature: it takes an ideal perspective. That is, the analysis considers what deductions should be permitted in an ideal income tax, abstracting from many administrative considerations and ignoring second-best complications, such as those pertaining to the medical system. Moreover, the reasoning about individual behavior was only occasionally supported by empirical evidence concerning the magnitude of effects.⁸⁹ As a result, the hypothesized

⁸⁹ The primary reason these effects may not be substantial is the currently low (by historical standards) marginal tax rates. For example, with a 30% marginal tax rate, a deduction may be insufficient to induce many individuals to reduce their insurance coverage very significantly. By contrast, when marginal rates were 70%, large effects were more likely. (A 30% rate still constitutes a substantial disincentive to undertake activities to reduce the level of one's losses.) Moreover, even at a 30% rate, the exclusion of medical insurance premiums may have a significant effect on the level of coverage individuals purchase, as reflected in the breadth of coverage. See *supra* note 48.

Ultimately, to the extent effects are small because of low marginal tax rates or the fact that many individuals do not itemize, any justification for the deductions is correspondingly reduced. In particular, if one favored the deductions as fall-back insurance for lower-income individuals, low marginal rates (zero for the poor) combined with the fact that few lower-income individuals itemize may be decisive considerations against the provisions, at least in anything like their current form. (That lower-income individuals are less familiar with tax rules and thus less likely to respond to the incentives they create also would be of little relevance; it is rational for such

inefficiency of the casualty loss and medical expense deductions and the exclusion of medical insurance premiums is an important but not decisive consideration in assessing reform of these provisions. It should be noted, however, that the existing rules are unlikely to be among the more efficient policy responses to problems with the medical system and imperfections regarding insurance purchases.⁹⁰ In this regard, it is interesting that some other developed countries with similar tax systems employ parallel tax rules,⁹¹ while others do not.⁹²

individuals to know little of the casualty and medical deductions since they are unlikely to benefit significantly from them in any event.) Conversely, much of the benefit of the deductions is concentrated on a modest portion of taxpayers: those in upper brackets, who itemize, and who are most likely to experience large uninsured losses because of the nature of their activities and decisions not to insure.

⁹⁰ See, e.g., *supra* sections IV.C & IV.D and notes 34, 78, 83 & 88.

⁹¹ In Japan, individuals may deduct uninsured casualty losses and medical expenses above a floor and subject to a maximum, but not insurance premiums. See Tax Bureau, Ministry of Finance, *An Outline of Japanese Taxes 1988* 51 (1988). Germany allows deduction of health insurance premiums and "extraordinary financial burdens." See H. Gumpel, J. Rudden, K. Ramin & P. Gumpel, *Taxation in the Federal Republic of Germany* 2/2.4, 6/1.10a n.54, 6/1.7b (2d ed. 1987). Canada allows a tax credit for medical expenses above a floor. See Price Waterhouse, *Individual Taxes: A Worldwide Summary* 49 (1990). South Korea allows a deduction for medical insurance premiums and for expenses above a floor and up to a maximum amount. See *id.* at 178.

⁹² Notable exceptions include France and the United Kingdom, which do not permit deductions for casualty losses, medical expenses, or medical insurance. See Price Waterhouse, *supra* note 91, at 106, 340.