Revisiting the *Kaczkowski* Court Rule on Discounting Lost Future Earnings

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The effect of a decision on calculating lost future earnings, handed down in the 1980 Pennsylvania Supreme Court case *Kaczkowski v. Bolubasz*, grows costlier and harder to justify with each passing year.

Who pays the overvalued damage awards flowing from the court's outdated decision? We all do, of course, through higher insurance premiums and the cost of products and services.

The time is long overdue to reverse the ruling and reinstate present-value discounting in Pennsylvania. The "total offset method," for which the court opted instead, has served only to artificially inflate, by millions of dollars, damages awarded in personal injury and death cases.

How? By dictating that lost future earnings be determined without taking into account the impact of the discount factor—the "time value of money."

The discount factor—which requires consideration of inflation and risk-free interest rates—recognizes that a dollar invested today is worth more than a dollar received in the future. (Several other factors need to be considered as well, including wage increases, fringe benefits, the probabilities of not achieving earnings in a given year or work-life expectancy.)

Discounting future cash flows is a fundamental accounting and financial concept, used in business valuations, pensions and other actuarial practices in Pennsylvania. Discounting also makes good common sense; a dollar received today is worth more than that same dollar received years into the future because it can be invested.

The reason given by the court for abandoning the practice? "Future inflation shall be presumed equal to future interest rates with these factors offsetting," it stated, "so that the impact of inflation will be reflected without specifically submitting question to jury."

But that was 20 years ago. Economic conditions are vastly different today, as is the relationship between inflation and investment interest rates. In the intervening years, inflation and investment interest rates have been more predictable and less volatile, a fact which flies in the face of the court's logic and lends further support to the argument for restoring present-value discounting.

Pennsylvania is today the exception, not the rule. Virtually every state in the U.S. recognizes the time value of money in determining damages and allows future earnings to be reduced by a discount factor. In addition, federal courts, circuit courts of appeal and several longstanding acts all accept that future damages should be reduced to present value.

Even Alaska, which *Kaczkowski* cited as a model for adopting the total offset method, had by 1988 recognized that damages should be reduced to their present value. Further proof of its reversal in thinking can be found in a 1992 ruling in which the court stated: "The clear purpose of the provision was to bring Alaska in line with other states which reduce future economic awards to present value."

While the *Kaczkowski* ruling might have made sense in 1980 due to unusual circumstances —the economy in the preceding years had experienced roller-coaster inflationary and interest-rate changes—it makes none whatsoever today.

That's why it's time to revisit the past to understand how the case came to be decided and to review its findings in light of the inflation and interest-rate picture in the intervening years.

LOOKING BACKWARD

Long before *Kaczkowski* came to pass, Pennsylvania had been discounting future damages at 6 percent, a rate mandated back in 1922. By 1980, inflation was running at 13.5 percent while the statutory discount rate remained unchanged.

The result was, to say the least, unusual: a negative discount rate of 7.5 percent (6 percent less 13.5 percent). This negative value turned conventional financial wisdom upside down, making it impossible to recognize the time value of money. This, understandably, led the court to believe future rates could not be predicted with any degree of certainty.

The court did, however, recognize the importance of the effects of inflation and

worker productivity on wage increases. It also believed an individual's income would likely rise during his or her lifetime. The question, though, was by how much?

The court considered three approaches to estimating future earnings — traditional, middle ground and evidentiary, based on the earlier Alaska court ruling—and opted for the third. The court said predicting prospective interest rates is as difficult as forecasting inflation. The adopted total offset method included wage increases for productivity but ignores the impact of inflation.

Given that inflation is a component of both salary increases and the discount rate, the court reasoned that inflationary increases would "offset" interest rate increases, nullifying the discount factor and reducing it to zero.

Asserting that no method of measuring damages can assure absolute accuracy, the court ruled that where a variance exists, "it will be in favor of the innocent victim and not the tortfeasor who caused the loss."

NUMBERS DON'T LIE

By the mid-1980s, the gap between inflation and interest rates had narrowed considerably, making both a lot easier to forecast. Government monetary policy changed, too, with the emphasis on reducing inflation and thinking globally. Much of the uncertainty about inflation and interest rates that was present in 1980 is gone in 2000, although there will always be a component of uncertainty.

The numbers directly refute the court's finding that inflation and interest rates cannot be predicted with any certainty, or that inflation is greater than interest rates, resulting in a negative discount rate.

Furthermore, applying a present-value discount rate to a future income stream, annuity or stream-of-cash receipts is a basic financial concept. This concept was no less valid in 1980.

Kaczkowski is, in fact, silent on the issue of applying a discount factor in the case of business valuations or in calculating pension amounts. Presumably, where deemed appropriate, present-value discounting was used in 1980 in these cases just as it is today—but not in personal injury cases.

AN EXAMPLE

A simple example serves to illustrate the important difference between applying and not applying a discount factor. The discount rate is determined by subtracting inflation from the interest rate, then applying a discount factor. The discount rate is determined by subtracting inflation from the interest rate, then applying that rate to the gross dollar amount of future earnings. The lower the discount rate, the higher the calculated amount.

Say I.M. Hert incurred a $300,000 earnings loss, estimated at $30,000 a year for 10 years. Under current law, he would receive the lump sum, which he could then invest to earn interest. Therefore, he would earn more than the original award.

If the $300,000 were to be discounted to the present value using a government security, say a three-year Treasury bill at a rate of 5.14 percent, less inflation (by not deducting inflation, the future cash stream would have to be increased for inflation to account for the loss of purchasing power) to total $251,905, a difference of $48,095 from the original $300,000. Hert would still receive $300,000 but over the course of 10 years, because the $251,905 would be invested, earning interest.

The selection of a risk-free discount rate and the resulting financial calculations are typically made in a vacuum. They are based on the assumption that a "prudent" person would opt for a lower investment risk and thus expect a lower return. Yet it's hardly realistic to assume someone would invest all $300,000 in three-year Tbills or other government securities.

Rather, common sense and business reality indicate that Hert would be more likely to diversify his investments and, in so doing, earn returns that might well overcompensate him for his loss. Despite that, almost all loss estimates are discounted based on a conservative fixed interest rate.

It remains unclear why, in the face of all this evidence, Pennsylvania continues to ignore the fundamental concept of present value discounting, which recognizes the time value of money.

The lone holdout state should revise its thinking and follow Alaska's example once again. Pennsylvania must face up to the fact that the economic conditions that seemed to justify the total offset method disappeared years ago.

Changing the law, by restoring present value discounting, will not only save insurance companies, companies and ultimately the consumer millions but will also bring Pennsylvania in line with the present and establish a law that makes good common and financial sense. It's time to go back to the future.

CONSIDER THE FOLLOWING INFLATION AND GOVERNMENT INTEREST-RATE FIGURES WHICH REFUTE ARGUMENTS THAT INFLATION AND INTEREST RATES CAN NOT BE PREDICTED AND THAT INFLATION IS GREATER THAN INTEREST RATES:

Year	Inflation	3-year T-Bill Interest Rate	Discount Rate
1998	1.60	5.14	3.31
1997	2.30	6.10	2.90
1996	3.00	5.99	2.15
1985	3.60	9.64	4.12
1984	4.30	11.90	5.62
1983	3.20	10.45	5.75

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