The Individual Mandate Tax Penalty

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ABSTRACT

In 2010, President Obama signed legislation that significantly altered the healthcare and health insurance markets in the United States. An integral part of that reform is the individual mandate, a provision that requires individuals to purchase and maintain healthcare insurance. Failure to maintain such coverage subjects an individual to a tax penalty. The Supreme Court recently heard oral arguments on the constitutionality of that provision in particular which, if found unconstitutional, could lead the Court to strike down the entire reform legislation.

Whichever way the Court rules, fundamental questions will remain. This article addresses the question of whether the use of a tax penalty to encourage taxpayers to do something that the government desires is normatively a good idea. Many commentators have contended that a tax penalty is economically equivalent to the current tax system’s use of deductions and credits to encourage behavior. This article argues that despite some similarity, there are major differences between the two that should lead Congress to consider whether the desirability of using this tax penalty approach in the future. This article also questions whether the use of the Internal Revenue Service to administer and enforce a penalty that has little to do with the correct baseline of income will have an effect on general tax compliance.

This article explores the individual mandate tax penalty in detail. It explains the mechanics of the tax penalty provision and points out several ambiguities in the provision that will likely require clarification. It also explores the issue of whether some of the problems in the healthcare system at which the mandate is aimed have been exaggerated. The author is skeptical of the extent of some of those problems and contends that the use of the tax penalty is inappropriate. The article concludes that Congress should reexamine the pros and cons and unintended consequences of using a tax penalty to induce behavior before going down a similar road.

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INTRODUCTION

Arguably President Obama’s key legislative success during his first term was the passage of an historic overhaul of the United States healthcare system.¹ Both at the time of its enactment and still today, one of the most discussed provisions of the Healthcare Reform Acts is the “individual mandate,” a provision that requires individuals to have healthcare insurance that provides “minimal essential coverage.”² Unless exempted, any individual that does not have such health insurance is subject to a tax “penalty” which is payable on the individual’s income tax return.³ The Code itself repeatedly refers to this imposition as a “penalty.” For convenience, I will refer to this imposition as an “insurance penalty.”

Some (including the attorney generals of several states) have argued that the healthcare bill in general and the individual mandate provision in particular are unconstitutional.⁴ The Supreme Court could decide the constitutionality of either the Healthcare Reform Acts as a whole or the

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¹ On March 23, 2010, President Obama signed into law the “Patient Protection and Affordable Care Act.” P.L. 111-148 (3/23/2010). Throughout this article, this law will be referred to as the “2010 Health Care Act.” On March 30, 2010, President Obama signed into law the “Health Care and Education Reconciliation Act of 2010.” P.L. 111-152 (3/30/2010). Throughout this article, this law will be referred to as the “2010 Health Care Reconciliation Act.” Together these two bills encompass the healthcare reform which some critics have referred to as Obamacare. Throughout this article, I will refer to the overall reform as the “Healthcare Reform Acts.”


³ Code § 5000A(b).

⁴ See Florida ex.rel. Att’y Gen. v. U.S. Dep’t Health & Human Servs., 648 F.3d 1235 (11th Cir. 2011). In that case, the 11th Circuit held that the individual mandate provision was beyond the scope of Congress’s powers. Other Circuits have upheld the provision. See Seven-Sky v. Holder, 661 F.3d 1 (D.C. Cir. 2011) and Thomas More Law Ctr. v. Obama, 651 F.3d 529 (6th Cir. 2011).
individual mandate alone this term. This article does not discuss the constitutionality issue. Instead, assuming the provision is valid, one question that this article addresses is whether it is appropriate to put this provision in the tax code and whether it is normatively a good strategy to utilize a penalty, enforced by the Internal Revenue Service, to force individuals to make a purchase that the government considers to be desirable and that does not directly involve the safety or well-being of others. This issue of the desirability of using a tax penalty (as opposed to either using a tax deduction or credit, or having another agency administer the penalty, or imposing a fee that is not designated as a penalty) will remain even if the Supreme Court holds that the individual mandate provision is unconstitutional.

It appears that this provision is the first to directly impose additional taxation on an individual for failure to purchase an item. Still,

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5 The Supreme Court will consider the constitutionality of the Healthcare Reform Acts via the case of Florida v. Dept. of Health & Human Serv., 648 F.3d 1235 (11th Cir. 2011), cert. granted, 80 U.S.L.W. 3198 and 3199 (2011). The reason that I use the term “could,” is that the Court could also decide that the Anti-Injunction Act and the Declaratory Judgment Act preclude review before the laws have been enforced. See Steve R. Johnson, The Anti-Injunction Act and the Individual Mandate, 133 TAX NOTES 1395 (2011).


There have also been several articles arguing that the provision is constitutional. See, e.g., David B. Rivkin, Jr., Lee A. Casey and Jack M. Balkin, A Healthy Debate: The Constitutionality of an Individual Mandate, 158 U. PA. L. REV. 93 (2009); Brian D. Galle, Conditional Taxation and the Constitutionality of Health Care Reform, YALE L.J. ONLINE (April 3, 2010).

7 There is some disagreement about whether the insurance penalty should be labeled a tax. This issue is discussed in Part II. Obviously, the insurance penalty has no resemblance to
some have questioned whether the provision is unique. This article will address the question whether deductions and credits in the current system are similar or even equivalent to a penalty system. I will also examine later whether provisions such as the social security tax are sufficiently comparable to the newly adopted insurance penalty that the latter is not a novelty in the tax law.

One of the questions this article addresses is whether the use of tax law to penalize people for not buying medical insurance imposes costs in adversely affecting taxpayers willingness to comply voluntarily with regular tax provisions. The author concludes that those costs plus the additional stress that the adoption of this provision places upon the administration of the tax system should have been weighed before the Internal Revenue Service was chosen as the agency to administer the program. While the availability of an already existing tax system makes it convenient to use that system to collect the penalty, if that convenience were weighed against the harm that might be imposed on the tax system, Congress might have chosen another approach. At least it would have been comforting to know that Congress had considered that issue before it acted rather than having gone forth blindly indifferent to those potential consequences.

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8 See Part IV.
9 See Part IV.
10 See Part V.
Part I of the article covers the mechanics of the individual mandate. It briefly describes the actual provision of the individual mandate that was added to the Internal Revenue Code and explains how that provision operates. As will be illustrated, the technical drafting of the Act is atrocious, and serious gaps and ambiguities abound.\textsuperscript{11} Part II of the article addresses the question of whether the penalty, despite its label, should actually be considered a tax. Several supporters of the Healthcare Reform Acts have attempted to characterize the individual mandate provision as a tax and this Part of the article will explore that contention. Part III describes the true purpose of the mandate. Part IV discusses the contention that the insurance penalty provision is neither unprecedented nor unique. Commentators have compared the insurance penalty to other tax provisions involving deductions and credits and have argued that there is no distinction between them. Part V discusses the main focus of this article – that is, whether a penalty is appropriate in this circumstance and, if so, whether the tax law should not have been chosen as the vehicle for applying the penalty. Part VI sets forth the article’s conclusions and suggestions.

I. THE MECHANICS OF CODE § 5000A\textsuperscript{12}

Section 5000A requires certain individuals, referred to as “applicable individuals,”\textsuperscript{13} to maintain “minimum essential coverage” for

\textsuperscript{12} Much of this Part derives from Jeffrey H. Kahn, The Operation of the Individual Mandate, \textit{supra} note 11.
each month after the close of the year 2013.14 Minimum essential coverage includes coverage under, among others, Medicare, Medicaid, plans purchased in the individual market and employer-sponsored plans.15 In any month in which the minimum essential coverage is not maintained for a taxpayer who is an applicable individual or for those of his dependents who are applicable individuals, the taxpayer will be subject to a “penalty.” The Code itself describes this imposition as a “penalty” throughout § 5000A.16 A taxpayer who has dependents is liable for any penalties imposed on those dependents; the Code does not expressly state whether the dependent also is liable to pay his penalty if the taxpayer fails to do so.17

Interestingly, failure to pay this penalty is not subject to any criminal prosecution or penalty, and the Service may not file any lien or levy any property in order to collect it.18 It appears that the sole way that the Service can collect the penalty from those who refuse to pay is to withhold any tax refund to which they might become entitled.

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13 Code § 5000A(a), (d).
14 Code § 5000A(a). Some individuals, such as a non-U.S. citizen present in the United States, are exempted from this requirement. Code § 5000A(d).
15 Code § 5000A(f).
16 E.g., Code § 5000A((b), (c), (e).
17 Code § 5000A(b)(3)(A). One ground for finding that such a dependent is relieved of liability is the contrast of the statutory provision dealing with dependents and the provision dealing with a spouse. Code § 5000A(b)(3)(A), (B). The dependent provision makes no mention of joint liability whereas the provision for spouses who file a joint return expressly provides for joint liability. The answer is far from clear.
18 Code § 5000A(g)(2).
The persons required to maintain essential coverage are referred to as “applicable individuals.”\textsuperscript{19} The Code provides a number of exemptions from characterization as an applicable individual, and persons who qualify for those exemptions are not required to purchase minimum essential insurance coverage.\textsuperscript{20} For example, certain persons who cannot afford coverage and persons who adhere to a religion whose tenants or teachings cause them to conscientiously oppose the benefits of insurance are exempt.

In addition to the exemption from being characterized as an applicable individual, the Code exempts certain applicable individuals from the penalty.\textsuperscript{21} Along with four specific exemptions from the penalty, there is a general provision exempting applicable individuals for whom the government determines that their purchase of coverage would be a hardship. The Healthcare Reform Acts also established federal tax credits for insurance premiums paid by individuals and families with household income between 133 percent and 400 percent of the federal poverty line.\textsuperscript{22}

To provide relief for short-term gaps in coverage, the Code does not impose a penalty if a person fails to have the minimum essential coverage for a continuous period of less than three months. Such a continuous period can consist of months that fall within two calendar years. If there is more than one such continuous period in a calendar year,

\textsuperscript{19} Code § 5000A(a), (d).
\textsuperscript{20} Code § 5000A(d)(2)-(4), (e).
\textsuperscript{21} Code § 5000A(e).
\textsuperscript{22} Code § 18081. Medicaid was also expanded to cover more individuals and families. Code § 1396a(a)(10)(A)(i)(VIII).
only the first such period qualifies for the exclusion. If the continuous period lasts for three months or more, than there is no exception to the imposition of the penalty.

Subject to a limitation described below, the annual amount of the penalty is equal to the sum of the “monthly penalty amounts” that the taxpayer incurs for each month that the taxpayer, or any dependent of the taxpayer who is an applicable individual, is not in compliance with coverage. If the taxpayer files a joint return, the taxpayer and the spouse are jointly liable for “such penalty.” The monthly penalty amount is one-twelfth of the greater of either (1) a fixed “flat dollar amount” or (2) an amount based on a percentage of the taxpayer’s household income. The definition of “household income” is described later in this article.

The flat dollar amount is determined by reference to an “applicable dollar amount” that is established in the Code. The flat dollar amount for each applicable individual is equal to the sum of the applicable dollar

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23 For example, if a taxpayer did not have appropriate insurance coverage for the months of January and December in one calendar year, but does have coverage for every other month of that year, this exception would apply only to exclude the penalty for the January month. It would apply the penalty for December even though the total lack of coverage during the year was two months. Code § 5000A(e)(4).
24 Code § 5000A(e)(4). Note that no exemption is provided for any month during the period. That is, once you exceed three months, the penalty applies to all such months, not just the months in excess of three. Code § 5000A(e)(4)(B). Also note that Congress delegated authority to Treasury to issue regulations on how to apply the penalty when the continuous period of less than three months includes months in more than one taxable year. Id.
25 See text accompanying note 45, infra.
26 Code § 5000A(c). A dependent of a taxpayer is a person who comes within the definition set forth in Code § 152.
27 Code § 5000A(b)(3)(B). The provision is unclear as to what “such penalty” refers to in cases with joint returns. See Kahn, supra note 11.
28 Code § 5000A(c)(2).
29 See note 32, infra.
amounts for that individual and for others who are not clearly identified in
the statute. The statute describes the flat dollar amount of a taxpayer for a
month as the “sum of the applicable dollar amounts for all individuals with
respect to whom such failure occurred during such month...”\textsuperscript{30} Obviously,
there needs to be a modifying limitation on the word “individuals” in that
provision. Which individuals have their applicable dollar amounts added
to the taxpayer’s? By referring to other subsections of the statute, it seems
clear that the reference is to dependents of the taxpayer who are applicable
individuals and who failed to have adequate health insurance coverage;\textsuperscript{31}
but we will have to await the Service’s construction to learn if that is
correct. For the year 2016, the applicable dollar amount will be $695.\textsuperscript{32} If
an individual is under the age of 18 at the beginning of a month, the
individual’s applicable dollar amount for that month will be reduced by 50
percent.\textsuperscript{33}

For a taxpayer who has no dependents, the flat dollar amount will
be equal to the applicable dollar amount, and so will be $695 for the year
2016. Thus, in 2016, the monthly flat dollar penalty amount for such a

\textsuperscript{30} Code § 5000A(c)(2)(A)(i).
\textsuperscript{31} As we will see, this is contrasted with the fact that the household income of a taxpayer
includes the income of all dependents who are required to file an income tax return
regardless of whether they are applicable individuals who are not in compliance with the
mandate.
\textsuperscript{32} Code § 5000A(c)(3)(A). Although $695 is the applicable dollar amount, it is not fully
phased in until 2016. The applicable dollar amount for 2014 is $95 and the amount for
2015 is $325. The flat dollar amount can be greater than the $695 applicable dollar
amount for 2016 since it will include the applicable dollar amount for each of the
taxpayer’s dependents who are subject to the penalty. See Code §§ 5000A(c)(2)(A) and
(c)(3)(C). For years after 2016, the applicable amount will be adjusted for changes in the
cost-of-living. Section 5000A(c)(3)(D).
\textsuperscript{33} Code § 5000A(c)(3)(C).
taxpayer will be $57.92. After 2016, this amount will be adjusted for cost of living.\(^\text{34}\)  

While the total flat dollar amount of an individual who has such dependents is the cumulative total of the applicable dollar amounts of all of them, there is a ceiling on the size of the flat dollar amount for the year; it cannot exceed three times the amount of the applicable dollar amount.\(^\text{35}\) Consequently, a taxpayer’s flat dollar amount for the year 2016 cannot exceed $2,085.\(^\text{36}\)  

To calculate the percentage of household income variable (recall that the penalty is the greater of those two figures) in 2016, the taxpayer multiplies an amount calculated by using a modified family income figure by 2.51 percent.\(^\text{37}\) The modified family income is the excess of the taxpayer’s “household income” over “the amount of gross income specified in section 6012(a)(1)”\(^\text{38}\) – i.e., the minimum amount of income which requires a TP to file a tax return. “Household income” is the sum of a modified amount of the adjusted gross income\(^\text{39}\) of the taxpayer and each dependent of the taxpayer who qualifies the taxpayer for an

\(^{34}\) Code § 5000A(c)(3)(D).

\(^{35}\) Code § 5000A(c)(2)(A)(ii).

\(^{36}\) Of course, the taxpayer’s actual penalty could be higher since the percentage of income variable could be greater than this maximum flat dollar amount.

\(^{37}\) Code § 5000A(c)(2)(B). Similar to the flat dollar amount, this rate is not fully phased in until 2016. For 2014, the rate will be 1.0 percent and for 2015, it will be 2.0 percent. Code § 5000A(c)(2)(B)(i) and (ii).

\(^{38}\) Code § 5000A(c)(1)(B).

\(^{39}\) It is “modified” adjusted gross income because it takes the taxpayer’s adjusted gross income and adds any tax-exempt interest and any foreign income that was exempted under Code § 911. Code § 5000A(c)(4)(C).

\(^{40}\) There is some ambiguity as to whether, in the joint return context, the taxpayer includes the entire amount of gross income reported on the joint return or whether some allocation is required. See Kahn, supra note 11.
exemption deduction under Code § 151 and who is required to file a tax return. Section 6012 is the provision that requires taxpayers to file a tax return unless their gross income does not exceed a certain amount. For example, for joint filing taxpayers, that amount is equal to twice the personal exemption amount listed in Code § 151(d) plus the standard deduction for joint filing taxpayers.

Thus, the monthly penalty amount will be one-twelfth of the greater of those two calculations: (1) the flat dollar amount or (2) the percentage of modified income amount. There is one final limitation on the amount of the penalty. The amount of penalty paid in a taxable year cannot exceed “the national average premium for qualified health plans which have a bronze level of coverage” for the taxpayer’s family size. It is currently unclear exactly how that average will be determined although, in a letter to Senator Olympia Snowe, Douglas Elmendorf (Director of the

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41 When the taxpayer’s income exceeds a threshold amount by more than $122,500 ($61,250 for married taxpayers filing separate returns), the taxpayer will not be allowed any exemption deduction. In such circumstances, there is a question whether the taxpayer’s household income will include the income of any dependents whose income exceeds that threshold amount.

42 Code § 5000A(c)(4)(A), (B). A taxpayer can qualify for an exemption deduction for his spouse if a joint return is not filed and the spouse has no gross income and is not the dependent of another person. Code § 151(b). Note that an applicable individual whose household income is less than the amount required to file a return is not subject to a penalty. Code § 5000A(e)(2). Note also that the modified adjusted gross income of a dependent who is required to file a tax return is included in the taxpayer’s household income regardless of whether the dependent incurred a penalty. It would seem therefore that the modified adjusted gross income of even such a dependent who is not an applicable individual (such as a person who has a religious objection to insurance) will be included in a taxpayer’s household income.

43 Code § 6012(a).


45 Code § 5000A(c)(1)(B). The Healthcare Reform Acts provide four levels of coverage (Bronze, Silver, Gold and Platinum) depending on the actuarial benefits provided under the plan. 2010 Healthcare Act § 1302.

It is unclear whether this limitation is applied monthly or annually. See Kahn, supra note 11.
CBO) stated that the CBO estimated that, in 2016, annual premiums for Bronze plans would probably average between $4,500 and $5,000 for individuals and between $12,000 and $12,500 for family policies.\footnote{Letter from Douglas W. Elmendorf, Director, Congressional Budget Office, for Senator Olympia Snowe. Available at http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/108xx/doc10884/01-11-premiums_for_bronze_plan.pdf}

II. IS THE PENALTY A TAX AND DOES IT MATTER?

Of course, one could question whether the mandate for a payment truly is a “tax” rather than a penalty. As noted above, Congress repeatedly referred to the mandate as a “penalty,” not a tax, despite its inclusion in the Internal Revenue Code and its payment with an individual’s federal income tax return. However, the original House bill referred to the penalty and used the term “tax” fourteen times.\footnote{H.R. 3962, Affordable Health Care for America Act, section 501(a), 111th Cong., 1st Sess. See also Steven J. Willis & Nakku Chung, Constitutional Decapitation and Healthcare, 128 TAX NOTES 169, 181 (2010).} On account of political realities, the Senate version was passed by the House which referred to the mandate’s imposition only as a penalty and avoided the use of the term “tax.”

There are grounds for finding that, despite the congressional avoidance of the term, the mandate’s imposition is truly a tax. In fact, supporters of the Healthcare Reform Acts have attempted to bolster their argument that the law is constitutional by referencing Congress’s power to tax (which, although still subject to some limitation, is broader than the power granted under the commerce clause).\footnote{See Brief for Petitioners, Department of Health and Human Services v. Florida, 52-62.} There are some obvious considerations that
support the conclusion that it should be considered a tax. For example, the “penalty” is set out in the Internal Revenue Code, enforced by the Internal Revenue Service and is payable on an individual’s federal income tax return.\textsuperscript{49} Also, one of the elements for determining the amount of the penalty is the taxpayer’s adjusted gross income, a concept used in the federal income tax system.

Professor Jenson, in a piece discussing the constitutionality of the mandate under the taxing power granted to Congress, argues that the penalty, despite some similarity, is not a tax.\textsuperscript{50} First, as mentioned, the statute never uses the term tax and only refers to the exaction as a penalty. Of course, as Professor Jenson acknowledges,\textsuperscript{51} this fact alone is not enough. Congress could label it anything it chooses; but, if it meets the general definition of a tax, it should be considered a tax.

Professor Jenson counters by noting that the general characteristics that commentators raise to attempt to classify the mandate as a tax apply equally to penalties or other forms of payment to the government that no one would consider a tax.\textsuperscript{52} For example, as Professor Jenson notes,\textsuperscript{53} the Internal Revenue Service is also in charge of collecting interest and

\textsuperscript{49} Id. at 52 (“The practical operation of the minimum coverage provision is as a tax law. It is fully integrated into the tax system, will raise substantial revenue, and triggers only tax consequences for non-compliance.”) See also Edward D. Kleinbard, \textit{Constitutional Kreplach}, 128 TAX NOTES 755, 760 (2010).

\textsuperscript{50} Erik M. Jenson, \textit{The Individual Mandate and the Taxing Power}, 134 TAX NOTES 97 (2012). See also Steven J. Willis & Nakku Chung, \textit{Oy Yes, the Healthcare Penalty is Unconstitutional}, 128 TAX NOTES 725, 729-31 (2010).

\textsuperscript{51} Id. at 98.

\textsuperscript{52} Id.

\textsuperscript{53} Id.
penalties imposed on taxpayers.\textsuperscript{54} No one considers these payments a form of taxation.

Others have argued that the fact that the provision will raise revenue that will be contributed to the general fisc supports the conclusion that the provision should be considered a tax.\textsuperscript{55} Counter to this point is the fact that, although it is predicted that the provision will raise some money, the main goal of the provision is not to raise revenue, but instead to encourage people to purchase adequate health insurance. In fact, the government’s ultimate purpose would be met if no person was subject to the penalty. Also, many transfers to the government, including payments that are clearly true penalties and not a tax payment, also raise revenue that is contributed to the general fisc. That point alone cannot be dispositive.

Surprisingly, Professor Jenson ignores one element that provides strong support that mandate penalty should be considered a tax and that is the fact that the amount of the penalty can be based on the amount of the taxpayer’s adjusted gross income.\textsuperscript{56} At the very least, this supports the conclusion that the mandate is a bit of a hybrid, somewhere between a normal penalty and a true tax.

For purposes of this paper, it makes no difference whether the Supreme Court ultimately determines that the insurance penalty is a tax or is not. On account of its enforcement by the Internal Revenue Service and its payment on an individual’s federal income tax return, most will view it

\textsuperscript{54} See, e.g., Code § 6601.
\textsuperscript{55} See Petitioner’s Brief, supra note 48, at 52.
\textsuperscript{56} See Part I, supra.
as part of the overall tax system. As discussed in Part V, this perception could have an effect on attitudes toward compliance with federal income tax law. Even if the Supreme Court rules that the mandate is unconstitutional, the normative issue remains whether it is a good idea for Congress to use a tax penalty to encourage behavior rather than to use the current system of deductions and credits.\textsuperscript{57}

III. THE PURPOSE BEHIND THE MANDATE

Why did Congress enact the penalty to seek to force people to purchase insurance? The answer is quite straightforward.

Two of the goals of the healthcare reform were to disallow the practice by insurance companies to turn down coverage for individuals based on prior medical history and to prevent insurance companies cancelling coverage for policyholders who become seriously ill.\textsuperscript{58} However, if those were the only changes that Congress made, the insurance industry likely would not survive for very long. Insurance, in general, is about spreading risks among a large group of people. That is, a large number of people put money into a pool that is held by an insurance company. In the health insurance model, most of the people in the pool will not suffer major medical problems and thus will not receive a significant amount of payout.

\textsuperscript{57} In common parlance, these two choices may be referred to as the choice between sticks and carrots. See, e.g., Brian Galle, \textit{The Tragedy of the Carrots Economics and Politics in the Choice of Price Instruments}, \textit{Stanford Law Rev.} (2012).

\textsuperscript{58} Subject to limited exceptions, which does not include preexisting medical conditions, insurers must accept any employer or individual that applies for health insurance coverage. 42 U.S.C. § 300gg-1. Insurers may not adjust premiums for prior medical conditions. 42 U.S.C. § 300gg-2. Insurers may not have annual or lifetime limits on benefits. 42 U.S.C. § 300gg-11. Finally, insurance companies may not cancel any coverage other than for fraud. 42 U.S.C. § 300g-12.
from the insurance company. However, some individuals will have a serious illness and the pool’s aggregate premiums will cover those expenses. Thus, the premiums of the entire pool, both the healthy and the sick, cover the medical expenses of the sick.

This arrangement only works if there are enough individuals in the pool who pay premiums but don’t require outlays, i.e., the healthy. If a person knows that an insurance company cannot refuse to cover him at any time, that person may not buy insurance until he actually incurs an injury or illness that will cause him to incur medical expenses. That is, a healthy person will have little incentive to purchase health insurance unless and until he actually becomes ill. Thus, the pool, instead of being made up of both the healthy and sick, would instead consist largely of those who require outlays from the insurance company. Obviously, if this were so, premiums would skyrocket since the insurance company would know that the pool of coverage is skewed towards the unhealthy. In that event, even many of the sick would have little incentive to buy insurance since their premiums would be high enough to cover any medical expenses they would be likely to incur. Insurance companies could not survive long in that environment.

59 In fact, under this scenario, it is probably incorrect to describe the product as “insurance” since insurance involves the coverage of some risk. Instead, each person is purchasing the actual medical coverage.
60 Id.
This situation arises because of what is referred to as adverse selection.61 As described in an amici curae brief in the Virginia lawsuit challenging the healthcare reform:

This phenomenon of adverse selection is severely aggravated when the government prohibits insurers from denying coverage outright to consumers with disabilities or preexisting conditions, Pub. L. No. 111-148, §2704. By itself, this prohibition would give consumers sharply increased economic incentives to refrain from purchasing insurance until they become seriously ill or injured – knowing that at that point insurers would be barred from turning them away. Congress recognized that, under such circumstances, premiums for insurance would rise so sharply that the requirement to accept individuals despite preexisting conditions could become unsustainable.62

Congress enacted the individual mandate in an attempt to avoid the adverse selection problem and nudge the healthy into the health insurance pools.63 The mandate accomplishes this by essentially taking away the choice of whether an individual will purchase a certain level of health insurance. Individuals who purchase sufficient health insurance are exempt from the penalty. If the amount of the penalty is close to or greater

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61 See David M. Kreps, A Course in Microeconomics Theory 626-27 (1990) (“Assume a particular good comes in many different qualities. If in a transaction one side but not the other knows the quality in advance, the other side must worry that it will get an adverse selection out of the entire population. The classic example of this is in life/health insurance. If premiums are set at actuarially fair rates for the population as whole, insurance may be a bad deal for healthy people, who then will refuse to buy. Only the sick and dying will sign up. And premium rates must then be set to reflect this.”)


63 See Ezra Klein, How Does the Individual Mandate Work?, http://voices.washingtonpost.com/ezra-klein/2010/03/how_does_the_individual_mandat.html (“The theory behind the mandate is simple: It’s there to protect against an insurance death spiral. Now that insurers can’t discriminate based on preexisting conditions, it would be entirely possible for people to forgo insurance until, well, they develop a medical condition. In that world, the bulk of the people buying insurance on the exchanges are sick, and that makes the average premiums terrifically expensive. The mandate is there to bring healthy people into the pool, which keeps average costs down and also ensures that people aren’t riding free on the system by letting society pay when they get hit by a bus.”)
than the cost of the insurance, the individual is likely to choose to purchase the insurance rather than to pay the penalty. This is likely to be especially true for high income taxpayers for whom the penalty will be greater. The government’s hope is that since the individual is going to spend the money one way or the other, the individual will choose to acquire health insurance rather than pay a tax penalty for which he receives nothing in return.64

Note that the penalty need not be nearly equal to the cost of the insurance to induce the individual to purchase it. The effect of waiving the penalty for those who purchase the insurance is to make the actual cost to the individual the difference between the premium and the penalty that the individual otherwise would have had to pay. An individual who might not have been willing to pay the premium for the insurance may be willing to pay that differential.65

IV. IS THE MANDATE UNPRECEDENTED?

As noted above, this provision appears to be the first of its kind that imposes an additional federal income tax amount for failure to purchase a product or service. However, some have questioned whether it is truly

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64 If the individual ends up paying the penalty, the amount paid is not directly transferred to private insurance companies. However, government subsidies will be paid indirectly to the insurance companies since the Healthcare Reform Acts created a federal tax credit for premiums paid to such companies by certain individuals and families. See Code § 18081.

65 For example, assume that health insurance costs $500 and the government imposes a penalty of $300 on any individual who does not acquire mandated health insurance coverage. As long as the “$500” health insurance is worth $200 to the individual, he or she will purchase the insurance. That is, if the individual does not buy health insurance, he or she will pay $300 and get nothing in return. Since the individual will pay $300 regardless of his or choice, the only decision to make is whether it is worth it to pay the additional $200 to get an item in return.
unprecedented or whether the Code already imposes additional taxation on individuals for failure to spend money a certain way in the same manner as the shared responsibility tax penalty.66

For example, Professor Leonard Burman argued that the individual mandate penalty is nothing new. He stated:

Our tax returns are full of implicit mandates with huge penalties – in the form of lost credits and deductions – for noncompliance. The government wants us to donate to charity, own a home, save for retirement, adopt a child, buy a hybrid car…If we don’t, we pay more tax (a penalty).67

If Professor Burman is correct, then the imposition of the tax penalty should raise little, if any, concern other than the question of the merits of the health reform itself. One could argue whether the health reform is good policy, but the structure of utilizing a tax penalty would be beyond dispute since Congress could have achieved the same result by using a deduction or credit.68

While one can question whether it is desirable to utilize the tax system to carry out external programs, there is no doubt that many provisions in the Code serve that function.69 That fact does not exculpate

66 See, e.g., Martin A. Sullivan, If Mandate is Struck Down, Are Tax Incentives Next?, 135 TAX NOTES 14 (2012) ("The only difference between the mandate and your common tax incentive is that Congress framed the incentive as a tax penalty instead of a tax break….A tax penalty and a tax incentive have the same economic impact on affected and unaffected individuals.").


68 Of course, one could still contend that it would be better to use a credit or deduction rather than the tax penalty. See Galle, supra note 57.

69 Many have used the tax expenditure budget to classify provisions that are not a natural part of the income tax system and thus should be evaluated the same way as a direct expenditure is. STANLEY SURREY & PAUL MCDANIEL, TAX EXPENDITURES (1985). The author does not agree with such classifications. See Jeffrey H. Kahn, Personal Deductions – A Tax “Ideal” or Just Another “Deal”?", 2002 M.S.U.-D.C.L. 1. See also
the medical insurance penalty from criticism. The objection to utilizing taxes to carry out other programs is not universal. It is generally recognized that the tax system can be the most efficient means of carrying out some programs, and so the added burden on the operation of the system is outweighed by the administrative benefit of using it for the desired purpose.70 Those who raise this issue merely wish Congress to limit the use of the tax system for such purposes and to utilize other approaches when they are feasible and not unduly burdensome. Nevertheless, if the medical insurance penalty is equivalent to a tax deduction or credit, then there would be much less for this article to discuss.

There are reasons why the penalty tax is not the same as a deduction or credit. There also are similarities, and the question is whether the differences matter. In the view of the author, the differences are sufficient to raise a serious issue as to whether a penalty was an appropriate means of implementing the mandate. There is an implicit recognition by Congress that a penalty is different from the deduction or credit approach. Otherwise, why would Congress have broken from uniform past practice and chosen to use a penalty rather than the normal deduction or credit approach? This suggests that Congress believed that a penalty provision

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Douglas A. Kahn & Jeffrey S. Lehman, Tax Expenditures Budgets: A Critical View, 54 TAX NOTES 1661 (1992). However, some provisions clearly serve only a programmatic purpose.

70 See, e.g., David A. Weisbach and Jacob Nussim, The Integration of Tax and Spending Programs, 113 YALE L.J. 955 (2004).
would have a very different impact; and, when examined closely, Congress was correct in taking that view.

As noted above, superficially the two systems (i.e., a deduction/credit versus a tax penalty) appear similar, especially when one focuses on financial consequences. 71 Take for example the charitable contribution deduction and compare two tax systems. Under the first system, assume a 20 percent flat tax rate on all income and the government allows taxpayers to fully deduct any charitable contributions. A and B both earn $50,000 and have no deductions other than charitable deductions. A donates $10,000 to charity while B donates nothing. A begins with gross income of $50,000 but is able to fully deduct the donated $10,000 leaving A with taxable income of $40,000. A’s tax liability is $40,000 x 20 percent or $8,000. B has no deduction so B’s taxable income is the full $50,000. B’s tax liability is $50,000 x 20 percent or $10,000. Thus, even though A and B had the same gross income, B paid $2,000 more in income taxes because he did not donate anything to charity.

Of course, as a consequence of the contribution, B has the ability to consume more than A. After making the contribution, A has $32,000 of income left to use for purchasing whatever goods or services A may desire. Because B did not give away any of his income, B has $40,000 of income left after taxes to use for purchasing whatever goods or services B may desire. The reduced tax burden that A obtained came with a price tag.

71 See also Joel Slemrod & Jon Bakija, TAXING OURSELVES 88-89 (4th Ed. 2008) (“The point is that we are all in the tax game together, and what is a privilege to one group of people ends up being a penalty to everyone else through higher tax rates.”)
We could achieve the same tax result using a penalty system without providing a deduction for charitable contributions and instead impose a mandate, subject to a tax penalty, on taxpayers that required charitable donations. Since this system does not allow taxpayers to deduct charitable contributions, the overall tax rate can be lower than it was under the first system where a deduction was allowed. In order to have A pay the same income tax amount as the first hypothetical above, the overall tax rate will be set at 16 percent. Since the system does not allow any deductions for charitable contributions, A’s taxable income is $50,000. A’s tax liability is $50,000 x 16 percent or $8,000. This is the same tax liability amount that A had in the first hypothetical where A was allowed a deduction for charitable donations but the overall tax rate was higher. Without consideration of the tax penalty provision, B’s tax liability would also be $8,000 since B has the same gross income as A.

To achieve the same tax results as the first hypothetical, however, assume that the government imposes a tax penalty on any taxpayer who does not donate at least $10,000 to a charity. The penalty amount is calculated, similar to the one in the new healthcare bill, as a percentage of income. To get the same results as above, we need merely set the tax penalty percentage at 4 percent. Thus, B would have $8,000 in “regular tax liability” (i.e., $50,000 x 16 percent) plus a $2,000 ($50,000 x 4 percent) tax penalty since B did not donate $10,000 to charity. Thus, B’s total tax liability would be $10,000, just as it is in the first hypothetical.
Since economically the two are the same in this hypothetical, does that answer the question whether a penalty provision, as a normative matter, is a good idea? That is, since Congress could have reached the same economic result using a deduction or credit for purchasing health insurance, is there really any issue as to whether the individual mandate is appropriate for the tax code? One problem is that the economic equivalence unravels when one examines the two structures a bit closer.

For example, the hypotheticals above proved exact economic equivalence assuming each taxpayer earned $50,000 and were subject to a flat rate of taxation. Of course, in the real world, not everyone earns exactly $50,000 and our system imposes graduated rates of taxation on taxpayers. So, for example, if instead of $50,000, the two taxpayers earned $80,000, the economic equivalence would not work using the same 16 percent rate for general income plus a 4 percent tax penalty rate.\footnote{Using the deduction model, A’s income tax would be $14,000 ($70,000 x 20%). B’s income tax would be $16,000 ($80,000 x 20%). Using the tax penalty model, A’s income tax would be $12,800 ($80,000 x 16%) which is $1,200 less than under the deduction model. B’s income tax would be the same as the deduction model, $16,000 (($80,000 x 16%) + ($80,000 x 4%)). To reach exact economic equivalence, the general rate would have to be raised to 17.5 percent while the tax penalty rate would be lowered to 2.5 percent.}

The structure becomes more complex when graduated rates are introduced and the two taxpayers have different amounts of income. A deduction is worth more to those in higher brackets since the tax savings depend on the taxpayer’s marginal tax bracket. To maintain similar economic consequences between the deduction and a tax penalty, one would have to structure a lower rate for the mandated penalty on higher
bracket taxpayers to account for the fact that the rate will be multiplied times a higher income figure. The penalty would also have to take into account the larger benefit of a deduction to those in higher tax brackets. The task of designing a formula for equating penalties with deductions would strain even the most sophisticated computers.

One could use a refundable tax credit, instead of a deduction, to avoid the marginal bracket issue. For the credit to be useful to low income individuals, it would have to be refundable. For example, Congress could add a surtax of a specified dollar figure to all taxpayers earning more than a certain amount of income. It could then also provide a tax credit, equal to the surtax, for any taxpayer that purchases health insurance. This method, however, is obviously just a circuitous route to imposing a penalty on the people who do not purchase health insurance and should be regarded as such by the courts, policymakers and any reasonable person. Adding a surtax to a taxpayer which is washed out by a credit of equal or nearly equal amount is a nullity and would be seen as such. After eliminating the surtax and the credit for those who purchase insurance, one is left with nothing more or less than a penalty for those who have the surtax and do not receive the credit. Those who state that the surtax and credit device achieves economic equivalence and so

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73 A tax credit is deducted from a taxpayer’s tax liability while a tax deduction is deducted from the taxpayer’s income. Therefore, each dollar of tax credit provides a full dollar of benefit to the taxpayer whereas the benefit of each dollar of a deduction depends on the taxpayer’s marginal tax bracket. DOUGLAS A. KAHN & JEFFREY H. KAHN, FEDERAL INCOME TAX 669 (6th Ed.).

74 See Martin A. Sullivan, supra note 65, maintaining that Congress could have adopted this approach and thereby obtained identical equivalence to the insurance penalty.
demonstrates that a penalty is no different from tax credits ignore the time-honored concept of substance versus form. The very equivalence of the two approaches demonstrates that both are penalties. If it is invalid to impose a penalty directly, it will be equally invalid to use a surtax and credit system to impose a penalty indirectly.

If instead of using the surtax method, which makes it obvious what the true purpose of the credit is, could Congress increase the tax rates at certain levels and then provide a credit for purchasing health insurance? While that is just another circuitous route for imposing a penalty, it is more likely to be sustained by courts and policymakers since it is much less obviously a subterfuge for imposing a tax penalty. The problem is that it will be very difficult, or even impossible, to design a structure that will duplicate the current tax penalty provision, which you will recall is based on either a flat amount or a percentage of income but subject to a ceiling of the average annual premium amount for a certain level of health insurance. The rate increase would have to kick in at the lower level of tax brackets (excluding those taxpayers who are exempt from the mandate requirement because they don’t have enough income) in order to ensure that it reaches the persons to be covered. Even a nominal raising of tax rates of those in the lower tax brackets would invoke strong political opposition. To make the tax credit equal to the additional tax raised by the
increase in rates, there would have to be a graduated credit\textsuperscript{75}; and that would make obvious that the purported credit system is actually a disguised penalty system. If there are valid objections to the system, they will apply regardless of the form employed. If the objections center on the public’s perception of the system, then disguising it could answer those complaints but only if the disguise is successful.

Supporters of the penalty system might respond that they do not need to show that a tax penalty is the exact economic equivalent of a deduction. For purposes of their contention, they might argue that the two are similar enough that they should be treated the same. Since, as noted above by Professor Burman, we already use deductions and credits to affect behavior, why not use a penalty for a similar purpose? While there is some force to that argument, there are counter considerations.

Not every deduction or credit constitutes a subsidization of an investment or an activity. There is no dispute, however, that many deductions and credits serve that function.\textsuperscript{76} Since the Code already has provisions that are used for nonneutral reasons (i.e., reasons that have nothing to do with an accurate measurement of net income) and since there is some economic similarity between deductions or credits and tax penalties, should it matter whether it is in the form of a deduction, credit or a penalty?

\textsuperscript{75}A graduated credit would be one that increases in size the more income that a taxpayer has. The current tax system has no such credit although it has many credits that phase out the more income that a taxpayer has. See, e.g., Code § 21 (Dependent care credit).

\textsuperscript{76}A clear example is the $7,500 credit provided for purchasing a qualified plug-in electric car such as the Chevy Volt. Code § 30D.
The psychological impact of adopting a subsidization of doing something is very different from the impact of imposing a penalty. It is useful to review what a deduction or credit actually does. Essentially, a deduction or credit reduces the cost of an expenditure, whether it be a charitable contribution, a medical expense or a hybrid car. By providing a deduction or credit, the government shares the cost of the expenditure.\textsuperscript{77} For example, if a taxpayer is in the 20 percent marginal tax bracket, then he or she knows that a $10,000 deductible expense will only cost the taxpayer a net of $8,000 (i.e., the $10,000 expense minus the $2,000 in tax savings as provided by the $10,000 deduction). In a sense, the government shares the cost of that expenditure by allowing the taxpayer to save $2,000 in taxes because of the expense.

This helps explain why, psychologically, taxpayers view deductions or credits and tax penalties very differently. In the deduction case, a taxpayer is not required to buy anything. A deduction or credit merely reduces the economic cost of the expenditure to the taxpayers, but the decision to make that expenditure is completely voluntary. If a taxpayer determines not to make the expenditure, he or she does not view the increased amount in tax as a “penalty.” The taxpayer merely concluded that the reduced cost of the expenditure was not sufficient for him to make that purchase. The argument has been made that a deduction or credit that is provided for

\textsuperscript{77} Whether or not one views this as a subsidy from the government is a separate issue. See, e.g., David I. Walker, \textit{Suitable for Framing: Business Deductions in a Net Income System}, 52 \textit{WILLIAM & MARY L.R.} 1247 (2011). See also Kahn & Lehman, \textit{supra} note 69. There is no question that, by providing a deduction or credit, the government is reducing the cost of the expenditure.
programmatic purposes is the same as a direct expenditure by the government. That view is at the base of the several tax expenditure budgets that the government promulgates. Under that view, a taxpayer should no more feel penalized by not obtaining a deduction or credit then he is by the government’s using his taxes to do something that benefits others and does not benefit that taxpayer.

By way of analogy, consider the situation where a retail furniture store has a weekend sale in which it offers to sell a $900 sofa for $450. Those individuals who do not wish to buy the sofa even at the reduced price do not consider themselves penalized by the store for not providing them with the financial benefit enjoyed by those who take advantage of the sale.

A penalty is not viewed in the same light. As noted previously, the Code make a great point of characterizing the payment required of the non-insured as a “penalty.” A penalty carries with it the connotation that the person is a wrong-doer. If an individual fails to make a charitable contribution and so gets no deduction, that individual is not thereby made to feel as if he or she is a bad person. On the other hand, if the government were to impose a penalty on those who do not make a specified amount of charitable contributions, that would identify those persons who fail to contribute as bad citizens. The use of the penalty system in the medical reform act is designed to induce guilt in those who do not purchase

78 See Part I.
sufficient medical coverage.\footnote{See, e.g., James Andreoni, Brian Erard & Jonathan Feinstein, \textit{Tax Compliance}, 36 JOURNAL OF ECON. LIT. 818, 850-51 (1988).} One objection then to the use of the penalty provision is the view that it is inappropriate for the government to mark as miscreants those who chose not to invest in projects that the government likes.

There is another reason why the use of a penalty has a more compelling impact than would a credit or deduction. There is a different psychological impact to having dollars taken from a person than there is to not giving him additional dollars.\footnote{This phenomenon is referred to as the “endowment effect.” See Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, \textit{Experimental Tests of the Endowment Effect and Coase Theorem}, in ADVANCES IN BEHAVIORAL ECONOMICS 55, 56-7 (Colin F. Camerer, George Loewenstein & Matthew Rabin eds. 2004).} For example, if a ticket for the Super Bowl would cost $1,000, I would not be willing to pay that to obtain it. But, if I had a ticket to the super bowl, I would refuse an offer of $1,000 to purchase it from me. It might seem that if the ticket is not worth $1,000 to me, I might be willing to sell it for a $1,000. But that is not necessarily so because I will regard the opportunity to obtain cash differently from parting with cash.

Is the penalty system any different from the social security tax system? Is that tax a mandate to require persons to save for their retirement? Of course, one difference is that the insurance penalty encourages a taxpayer to purchase a product from a private company whereas social security payments must be made to the government. Also, while the social security taxes are sometimes described as a payment into
a retirement fund, that is far from true. There is no actual fund. References to a fund are to a paper figure and do not represent any actual assets. No one who pays into the social security system has any rights (contractual or otherwise) to receive any benefits. The government could legally cut off all of a person’s social security benefits; although it would be a political disaster to do that. The social security tax is just that; it is a tax like any other and is not a purchase of contractual rights.

Congress could have chosen to establish a national health system or a national medical insurance system to be run by the government. Congress could have imposed a tax to pay for that program. There were political obstacles to adopting that approach, and the Healthcare Reform Acts were probably chosen as a second best solution for many of those who supported it in Congress and the administration. Having chosen a different approach which entails the use of a penalty system, the program has to withstand the objections that apply to that system.

The choice of a penalty seems to rest partly on the policy of imposing an internalized stigma on those who do not purchase medical insurance. Presumably, Congress determined that there would be greater compliance with its plan to have most of the public insured than if they had chosen an incentive system instead. It is likely that more people will feel required to make that expenditure since there is not only the lost dollars of the penalty provision but also the internalized stigma of being subject to a penalty.\footnote{Note the stigma is entirely internal since there will be no public listing of those taxpayers who are subject to the mandate tax penalty. This can be compared to public...}
It is interesting to note that Congress may have had qualms about using a penalty system. As noted above, the statute provides that the Internal Revenue Service may not impose any penalty or levy on taxpayer’s property for a failure to pay the penalty. The likely reason for that prohibition is concern that enforcing the penalty will generate strong political opposition. The Service has stated that the only recourse it has (other than sending nastily worded letters) is to withhold refunds from taxpayers who refuse to pay. If compliance turns out to be poor (an unlikely event), this prohibition is almost certain to be eliminated.

Thus, a careful strategic taxpayer could still engage in adverse selection with regard to health insurance. That is, a taxpayer could refuse to purchase health insurance and refuse to pay the penalty as long as he or she structures his or her taxes in such a way that he or she does not have any refunds forthcoming. If enough taxpayers engage in this behavior, the risk pool for health insurance would again be threatened and changes would likely take place.

It is unlikely that significant numbers of taxpayers will pursue that course of action. First, even without the threat of liens or levies, many
taxpayers will pay the penalty voluntarily. One need only look at the United State’s high compliance rate and yet low audit rate to show that many taxpayers voluntarily pay the taxes that they owe. Second, as noted above, if enough taxpayers should avoid the penalty in that manner, it is likely that Congress would change the rule and allow the Service to enforce the penalty with the same tools it has for other tax underpayments.  

What this suggests is that the tax penalty mandate system is quite different from our normal use of deductions and credits. Whether, as a normative matter, the penalty tax is a bad idea is a separate issue and that is discussed in detail below. However, the above discussion shows that the differences between the penalty tax and our current deduction and credit system are sufficient for the former to be characterized as a novel approach.

V. IS THE TAX PENALTY A GOOD IDEA?

A. It’s Not the Only Option

Whether or not one views the penalty as a departure from the traditional tax system, there is still the separate question of whether it is a good idea to use a tax penalty in this way. One reason that Congress may have chosen to use a tax penalty is that the Code already provides a

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85 Ezra Klein, How Does the Individual Mandate Work?, http://voices.washingtonpost.com/ezra-klein/2010/03/how_does_the_individual_mandat.html (“And what happens if you don’t buy insurance and you don’t pay the penalty? Well, not much. The law specifically says that no criminal action or liens can be imposed on people who don’t pay the fine. If this actually leads to a world in which large numbers of people don’t buy insurance and tell the IRS to stuff it, you could see that change.”)
deduction for payment of health insurance premiums. Medical expenses, including insurance premiums paid for health insurance coverage, are deductible but only to the extent that such expenses exceed 7.5 percent of a taxpayer’s adjusted gross income Assuming a taxpayer’s medical expenses exceed 7.5 percent, the excess amount is also classified as an itemized deduction and therefore does not benefit the majority of taxpayers who use the standard deduction. Thus, the usefulness of the medical expense deduction in encouraging taxpayers to purchase health insurance is severely offset by the number of limitations that apply to that deduction.

To the extent that a taxpayer’s payment of a medical insurance premium is deductible, that will reduce the cost of purchasing the insurance coverage. While that might seem to encourage some taxpayers to purchase insurance, the availability of the deduction has the counteracting force that encourages some taxpayers to self-insure. The medical expense deduction also allows a deduction for the cost of actual medical expenses thereby reducing the cost of such expenses to those taxpayers who can use the deduction. Thus, a taxpayer who is eligible to use the medical expense deduction may be more willing to self-insure since the government will share in any medical costs that such taxpayers incur.

86 IRC § 213(d)(1)(D).
87 IRC § 213(a). This floor will be increased to 10 percent of a taxpayer’s adjusted gross income for years beginning after 2012. For years prior to 2017, the 7.5 percent of adjusted gross income floor will remain in place for taxpayers who are at least sixty five years of age or who have a spouse who is at least sixty five years of age.
While these two concepts seem to counteract on the taxpayer’s decision to purchase health insurance, the fact is that the limitations that apply to the medical expense deduction likely make it so relatively few taxpayers\textsuperscript{88} are able to deduct any medical expenses at all. The limitations thus diminish, if not eliminate altogether, the cost-sharing element of the deduction for health insurance premiums, but they also reduce, if not eliminate, the cost-sharing aspects for actual future medical expenses thereby increasing the value of having medical insurance.

It is not true that Congress had to use a tax penalty merely because the traditional method of providing a deduction has been ineffective in inducing a significant number of persons to purchase health insurance. It is quite clear that the current system could have been altered either by reducing the limitation on deductions or by providing a credit for health insurance premiums to encourage taxpayers to acquire adequate health care coverage.

\textit{B. Is the Imposition Properly Called a Penalty?}

Another question is whether it is appropriate to use a penalty, even with all its negative connotations, in these circumstances. The focus here is not on whether it is proper to impose a fee on the uninsured, but whether that fee is correctly characterized as a penalty. It is useful then to consider whether the usual purposes for imposing a pecuniary penalty apply. The classic use of a pecuniary penalty is to punish undesirable behavior. The

\textsuperscript{88} In 2009, there were 140,494,127 individual income tax returns filed. Only 10,090,297 of those returns (or approximately 7 percent) claimed a deduction for medical expenses. See http://www.irs.gov/pub/irs-soi/11infallbulincome.pdf.
government deems a certain behavior wrong and punishes those who engage in that behavior by imposing a penalty or fine. The goal of the penalty is to deter that behavior.

In the instant situation, what is the bad behavior that the government is penalizing? Supporters of the healthcare reform would argue that the failure to purchase health insurance is bad behavior for two reasons - either because the person is a “free-rider” (that is, despite not acquiring health insurance, the person will still receive some free medical care if she becomes ill) or because the person is engaging in adverse selection (that is, the person will defer purchasing health insurance until she actually needs it).

Upon further inspection, the free-rider problem appears to be grossly exaggerated, and there is a serious question whether a “penalty” is the proper remedy for adverse selection. Let us consider each of those problems separately.

1. The Free-Rider Issue

It is not the nonpurchase of health insurance that causes the alleged free-rider problem but the receipt of free medical care. Consider three categories of people with different amounts of wealth who are uninsured.

First, there is the wealthy individual who can afford to buy insurance (that is, can afford to pay the insurance premiums) and can also afford to pay for any medical care that is required. That person will be
required to pay for any medical services she receives.\textsuperscript{89} Clearly, that person is not a free-rider. If a person is sufficiently wealthy to self-insure, there is little justification for the government to require her to purchase health insurance.\textsuperscript{90}

Not only is the free-rider argument inapplicable to such persons, but the current design is even more incongruous since the penalty may be graduated based on an individual’s income level for the year. Normally, the worse the behavior, the greater the penalty that is imposed. Yet, those with higher income levels who decline to purchase insurance are not engaging in worse behavior than those at lower levels. If the free rider argument is the justification for the penalty, it would seem that the opposite is true.

Second, consider the circumstances of a low income individual who cannot afford to pay for medical care (but, to an extent, will still receive it if required) and also cannot afford to purchase health insurance. Economists define a free-rider as anyone “who receives the benefit of a good but avoids paying for it.”\textsuperscript{91} Under that definition, this person constitutes a free-rider.

\textsuperscript{89} If it is true that hospitals do not collect amounts owed from people who could afford to pay and thus some in this group may receive medical care for which they did not pay, that is a problem with the hospital collection process, it is not a free-loading issue. See Douglas A. Kahn & Jeffrey H. Kahn, \textit{Free Rider: A Justification for Mandatory Medical Insurance Under Health Care Reform?}, 109 MICH. L. REV. FIRST IMPRESSIONS 78, 81 (2011).

\textsuperscript{90} Over one-third of medical expenses incurred by uninsured individuals are paid directly by such individuals. Brief for Economic Scholars in Support of Appellees as Amici Curiae, Thomas More Law Center v. Barack Hussein Obama, 16 (6th Cir. 2011) (No. 10-2388).

\textsuperscript{91} N. GREGORY MANKIW, \textit{PRINCIPLES OF MICROECONOMICS} 222 (1998).
However, that is not how the term is understood by the general public, nor is it how the term is used by supporters of the healthcare reform, who use that term pejoratively. For them, the term conjures an image of parasites obtaining medical care for which they choose not to pay.92 Contrary to that picture, most of the public do not have a negative view of the impecunious. In fact, the Healthcare Reform Act’s penalty provision itself reflects that view by not imposing a penalty on any individual who cannot afford insurance. In addition, as previously noted, the Healthcare Reform Acts also include provisions to provide subsidies for some individuals for whom health insurance premiums would be a burdensome sacrifice.93 Even if individuals in this low-income group are considered free-riders, the healthcare reform does nothing to solve that “problem.” Individuals in this group will still receive free medical care and so will remain free-riders under that broad use of the term.

The final uninsured category is economically situated between the previous two. Those persons can afford to pay medical insurance premiums but may not be able to afford the medical expenses that would arise from a major illness or other health issue. This is the one group of uninsureds that might fit the negative connotation of a free-rider.

One question is whether the number of people in this group is large enough to justify the enactment of such a large-scale change in the

92 See Kahn & Kahn, supra note 89, at 81.
93 See Code § 18081.
healthcare industry. Aside from that, however, there is an issue as to whether this group truly presents a free-riding problem.

Prior to the enactment of the Healthcare Reform Act, there were severe limits as to how much free medical care an individual could receive. Thus, if uninsured individuals who become seriously ill and tried to acquire health insurance, they would find either that it would be prohibitively expensive or would not cover preexisting conditions. Those persons, therefore, would be taking a substantial risk by not acquiring health insurance since there are limits on the amount of free medical care that is available. While such persons will receive medical care to stabilize their condition, they will not receive free long-term treatment for serious illnesses. Also, to the extent that they have the means to pay for part of their care, they will be required to do so.

Given the costs that this group can suffer by being uninsured, it may be more accurate to view them as paying for their decision in a meaningful nonpecuniary form. An additional reason for not characterizing their behavior as reprehensible is described in Part V(B)(3).

2. The Adverse Selection Issue

Under the Healthcare Reform Acts, a person who could otherwise afford it can decide not to buy insurance until expensive medical services are needed since the insurer cannot deny coverage other than for fraud and preexisting conditions. These provisions of the Healthcare Reform Act create the adverse selection problem described above. The program would
fail if that problem were not resolved. That necessity justifies the Healthcare Reform Acts’ imposing a price for noncoverage in order to induce the purchase of health insurance, and it might even justify having a graduated price to reflect the different utility of money to those who have more of it. But this additional price is not a “penalty” for bad behavior. Rather, it is an imposition to change rational market decisions. Moreover, as noted later, there were other options for dealing with that problem that might have been preferable.

An individual who engages in adverse selection is acting rationally. If the insurance system allows her to get medical coverage at any time at premium rates that do not take into account her medical condition, it makes financial sense for her to wait until she has a medical condition before purchasing insurance.

That does not mean that society shouldn’t deter that behavior. As noted previously, the entire system would fail if steps were not taken to discourage adverse selection. How then should the government prevent this behavior? One simple answer is to increase the cost for not purchasing insurance.\footnote{There is a question as to whether the government can validly impose a cost for not purchasing an item when the urgency for that purchase is created by the government itself. I do not discuss that question in this article.} The insurance penalty provision serves that goal. It imposes a price on an individual for failing to acquire adequate health insurance. But the characterization of that price as a “penalty” does more than merely add a financial burden. The use of that term imposes an additional cost of internalized guilt for purportedly behaving badly. The author believes that
it is inappropriate to use an implicit sanction for bad behavior to induce people to purchase insurance.

Should a person who engages in rational behavior be subjected to a pejorative characterization by imposing a penalty on that behavior? As noted above, the term penalty has a psychological effect on individuals that is different from other methods of increasing costs. Since Congress chose to make the penalty unenforceable,\footnote{See Part I.} it may have relied on that psychological coercion as the means to inducing compliance.

Instead of a penalty, the exaction could have been labeled a tax. That would have been a more neutral term. As previously noted, tax can be seen as an appropriate name for the requirement since it is determined by the amount of adjusted gross income that a person has, is set out in the tax code, and is administered by the Internal Revenue Service. Regardless of whether the imposition can properly be regarded as a tax, that designation would not condemn the taxpayer’s behavior. Calling it a tax would meet the goal of increasing the cost of not having insurance without subjecting the individual to the sanction of being identified as an evil person.\footnote{As noted in Part II, supporters of the Healthcare Reform Acts have argued that the penalty should be considered a tax in order to support Congress’s authority in creating the tax penalty.}

This attempt to increase the cost of an otherwise rational behavior is not unique to the health care area; nor is it unusual to designate the imposed cost as a penalty. Economists and government policymakers are
often concerned about externalities and use penalties to force individuals to internalize the costs that they are imposing on others. The classic example of this is, of course, the factory that pollutes. Without some penalty, it is rational for the factory owner to pollute since the cost of that pollution is imposed on someone else and avoiding the cost of reducing pollution increases profits. So, a penalty for pollution is imposed to force factory owners to reduce or eliminate the pollution that they otherwise would impose on others. It is appropriate to characterize the imposition of that cost as a penalty because the active conduct of the factory owners harms others, and that violates a moral obligation.

Is the situation of medical insurance comparable to the pollution problem? Does a person’s decision not to purchase insurance harm others? If so, is the nature of the manner in which that harm is imposed significantly different from the classical pollution problem so that it does not violate any moral obligation? To answer those questions, it is necessary to look at two different situations – the situation before the adoption of the Healthcare Reform Acts and the situation afterwards.

3. Prior to the Adoption of the Acts.

The government and some commentators contend that, even before the adoption of the Acts, a person’s failure to purchase insurance harmed others by raising the cost of insurance premiums which priced some people out of the market. The reason that premiums were increased was because the cost of medical care was raised to pass on the cost of treating
people who had no medical insurance and who could not pay for their treatment.

As previously noted, that problem has been grossly exaggerated. Over a third of medical expenses incurred by the uninsured are paid for directly by such individuals.\textsuperscript{97} A considerable portion of the other expenses are likely imposed on individuals who also could not afford to purchase medical insurance. It cannot be said that those people are voluntarily passing on a cost to others. Rather, they are persons of need. In recognition of that, the Healthcare Reform Acts excludes many such persons from the mandate and provides a subsidy for the others to help them purchase insurance. The cost of those persons medical needs are still passed on to others under the Act. Those who are exempted from the mandate will pass their medical expenses on to taxpayers or to those who pay for their services, and the others will pass on part of the cost of their premiums to the taxpayers. Only those who could afford to pay premiums without incurring a hardship can be said to have chosen to pass on their unpaid medical expenses to others, and so only that minority group can be thought of as approaching the situation of a polluter. But even that minority group is in a significantly different position from a polluter.

First, you will recall that it is not the absence of premium payments from the uninsured that affects the costs of those who purchase insurance. If the uninsured did purchase insurance, their premiums would

\textsuperscript{97} Brief for Economic Scholars in Support of Appellees as Amici Curiae, Thomas More Law Center v. Barack Hussein Obama, 16 (6th Cir. 2011) (No. 10-2388).
equal the actuarial cost of insuring them, and so there would be no surplus to reduce the premiums of others. There would be a problem if the number of people purchasing insurance were not large enough to provide confidence that the actuarially determined estimates of payouts for that group would be realized. That problem does not exist. The number of people purchasing insurance is more than sufficient to permit the insurers to provide coverage, and that is why insurance is readily available.

The problem caused by that minority of the uninsured arises if and when they become ill and need medical services. If they fail to pay the full cost of the services they receive, the shortfall is passed on to those who pay for medical services. Those who could afford insurance but deferred purchasing it until later in life when they are older but still healthy have not affected anyone’s cost of medical services. They will be charged the actuarial cost of the coverage they acquire. The only group who will affect the medical costs of others are those who could afford insurance and do incur significant medical expenses that they are unable to pay. The method chosen by the government to prevent that consequence is to penalize all who do not purchase insurance they could afford even though many of those persons would not have passed on any costs to others. As a matter of policy, it might have been better to have chosen a method that penalized only those who actually caused a problem,98 but that is a subject for another time and debate.

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98 For example, the government could require such persons to pay the unpaid balance of their expenses plus interest when and if they obtain the funds to make payments. The
Even as to those uninsured who do incur medical expenses they cannot pay, one must consider the reason they did not purchase insurance to determine if they are in a comparable position to a polluter. The assumption advanced by the supporters of the penalty system is that those persons consciously relied on the availability of free medical services in deciding not to purchase insurance. This assumption appears to be based on speculation rather than on empirical data. There are good reasons to doubt the correctness of that assumption. As noted previously, the quality and extent of the medical services that are available for free are far less than the services that the insured can receive. So, persons who declined insurance in reliance on free coverage would be accepting a significant risk as to the quality of services that would be available to them. The existence of that element of risk reduces the likelihood that many of the uninsured based their decision on the expectation that free services would be available. Moreover, it is likely that many of the uninsured in that minority class are young. Speculating as to why many of the young do not purchase insurance, it seems likely to be a product of two factors.

The young typically do not have large amounts of disposable income, and so the payment of premiums would be a burden. Moreover, the young are notoriously optimistic and believe themselves to be immune

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99 Some young persons are covered by their parents’ insurance and some are covered by insurance provided by their employers. The uninsured young are those not covered by such plans and who do not choose to purchase insurance on their own.
from illness and mortality. The young very likely overly discount the possibility that they might need medical services before they are ready to purchase insurance. The decision of the young to forego insurance may very well be rational; but, even if it isn’t, it is a product of poor judgment. It is one thing to punish bad behavior and quite another to punish the young for poor judgment, even assuming that it is poor judgment.

The minority of uninsured who cause an increase in costs to others are in a very different position from polluters. The polluter knows that he is imposing harm on others and does nothing to prevent it. The uninsured simply made a judgment that the value of insurance coverage was not worth what it would cost him at this time of his life. That may be a sensible decision even if the likelihood of needing future medical services were accurately determined; but, even if not a sensible decision, people are not punished for making poor choices which do not involve affirmative action that causes injury to others.

There is another important distinction. The polluter’s injury to others comes from action that the polluter has taken. For example, a polluter manufactures an item where the manufacturing process dispenses pollution into the environment which adversely affects others. The wrong that is punished by the healthcare penalty is one of inaction rather than an affirmative act. The uninsured choose not to purchase an item. Even if one were to conclude that the uninsured’s decision not to purchase insurance
did harm to others, it is a novel step to punish people for choosing not to buy something.

If someone chooses not to purchase a manufactured item, that will have negative consequences to others. The owner of the item will be deprived of the profit from the sale that did not take place. The manufacturer will have fewer of its products sold and so may have to reduce its pool of employees. Some employees may lose their employment. Consumers are not held responsible for the harm others suffer because the consumers refrained from purchasing certain goods. This all goes to show that it is inappropriate to impose a penalty, as contrasted with a tax, for a failure to purchase insurance.

4. Subsequent to the Adoption of the Acts

When effective, the Healthcare Reform Acts will require insurers to provide insurance regardless of preexisting medical conditions. As previously noted, if left unchecked, that would lead to an adverse selection problem in which only the sick would purchase insurance, and the industry would soon collapse. If the health reform program is to succeed, it is necessary that the government take steps to prevent adverse selection. The penalty arguably serves that purpose.\textsuperscript{100} There remain the questions of whether the method chosen by the government (the Individual Mandate and the penalty) is valid, and whether, if valid, it is an appropriate vehicle. I will discuss the latter question below.

\textsuperscript{100} There is a question whether the size of the penalty is adequate for that purpose.
C. The Inappropriateness of Using a Penalty.

If the government wishes to support an industry for the public good, it may do so. But the manner in which the government supports that industry is subject to scrutiny. The government can use tax revenues to support an industry and has done so. The government can use deductions and credits to encourage consumers to purchase an industry’s products (a carrot as contrasted to a stick). When the government chooses to support an industry by adopting a penalty (i.e., a stick) to punish those who do not purchase its products, that becomes a matter of concern and warrants careful scrutiny. I will examine below whether the manner in which the government structured its program in the Healthcare Reform Acts was undesirable.

Congress could have adopted a national health program to which all must belong or a national insurance program to which all must belong or to whom all who do not have a minimum level of insurance must belong. Those programs could have been financed with taxes. It seems likely that the supporters of the Healthcare Reform Acts would have preferred to adopt one of those choices but lacked the political support to take that route. The problem is not so much with what Congress sought to accomplish but how it went about implementing its program. The Individual Mandate offends libertarians who resent being required to purchase something even when they might wish to make that purchase. Even those who are not libertarians may chafe at being told to purchase an item. That problem is compounded by the Acts’ using a penalty to enforce
the mandate. While the use of a penalty may be more effective in causing individuals to internalize the cost of their not purchasing insurance, it is inappropriate to characterize those who do not purchase insurance as miscreants.

Governmental paternalism is not unusual, and many such programs exist. There is little dispute that medical care is in great need of reform, and that it is legitimate for the government to address that problem. One concern is whether the manner in which the Healthcare Reform Acts operate, if validated, will set a precedent that opens the door to other governmental mandates overriding personal choices. If the government determines that it is in the national interest that the newspaper industry should thrive, can it mandate that everyone purchase newspapers or be subjected to a penalty? Could it order people to purchase a minimum amount of life insurance? After all, everyone will die. The supporters of the Healthcare Reform Acts argue that medical care differs from other items because everyone becomes ill at some time in life. In fact, not everyone does require major medical treatment during their life, but everyone does die.

While there are political limitations on what the government is likely to do, the public as well as the courts should be aware that once the

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101 One objection to the Healthcare Reform Acts is that while they addressed some of the healthcare problems that exist, they did little or nothing to deal with the spiraling costs of medical care which many consider to be the most important of its problems.

102 Justice Scalia asked if the government could force everyone to exercise since that would improve health and reduce medical expenses. See also Transcript of Oral Argument at 407, Department of Health and Human Services v. Florida, __ S. Ct. ___ (2012).
concept is established that the government can dictate what are considered to be personal choices, it may be encouraged to broaden its reach. If the political process is one of the checks on abusive use of governmental power, it is especially important that the public consider the ramifications of the manner in which this program is implemented. The history of the expansion of the federal government’s use of its power over the last eighty years does not inspire confidence that the government will exercise restraint in utilizing this precedent.

There is another aspect to the design of the program that is likely to cause resentment. The Healthcare Reform Acts place a ceiling on the amount of premium that insurers can charge an insured. The maximum premium cannot be greater than three times the lowest premium the insurer charges.\textsuperscript{103} The actuarial cost of providing insurance to the elderly is much greater than to the young and healthy because the elderly are more prone to illnesses. The ceiling that the Healthcare Reforms Acts impose results in requiring insurers to provide premiums for the elderly that are substantially less than the actuarial cost of providing insurance coverage for them. The only way that the insurers can make up for that shortfall is to charge the young much higher premiums than their actuarial cost. The consequence of this shifting of the cost of the insurance is to require the young to subsidize the premiums paid by the elderly.

It is a necessary element of an income tax system that it will impose redistribution of wealth. Taxpayers will not receive the same

\textsuperscript{103} 2010 Health Care Act § 1201.
dollar amount of benefit from the government that they pay to the government in taxes. Some will receive more, and some will receive less. Even taxpayers who are aware of that redistribution generally accept it. However, the young, who will often find it burdensome to pay insurance premiums, may bristle at having to subsidize the elderly as well as paying for the cost of their own insurance coverage.

Some supporters of the program (and Justice Ginsburg) have proposed that the young should not mind subsidizing the elderly because they will be subsidized in turn later when they become elderly. The young could look at their subsidization of the elderly as a kind of down payment on their own expenses. Perhaps some youths will find that prospect convincing, but there are a number of countervailing considerations. There is considerable opposition to the Healthcare Reform Acts, and they may not be in existence when the young could hope to be subsidized. Even if the Healthcare Reform Acts remain in force, the provisions may be modified to eliminate a subsidy for the elderly. Some young may not live long enough to qualify for that subsidy. Also, there is the matter of the time value of money. The dollars that the young pay now to subsidize the elderly are worth more than the present value of the same number of dollars that might be received many years in the future. Moreover, dollars have different utility values depending upon how many one has and what expenses one needs to incur. The utility of dollars to the young usually

will be higher than to the elderly. Requiring the young to use their dollars to subsidize others when their dollars have the highest utility may not seem a good bargain to them.

D. Should the Penalty be Part of the Tax System?

Leaving aside the question of the use of the penalty for a moment, consider whether it was a mistake to utilize the tax system to administer it. While the program can be seen as providing financing to grant insurance to all who desire it, the manner in which it is conducted appears to force people to purchase something that they may not want. As previously noted, the paternalistic appearance of the mandate and the imposition of a penalty raises the rankles of many people.

What effect may the Healthcare Reform Acts have on the tax system? The United States relies heavily on voluntary compliance, and the country can be rightly proud of its compliance level. The question is whether adding a controversial social program to the income tax system will have a negative impact on the public's view of the tax system and thereby affect compliance. Moreover, it imposes a significant burden on the Internal Revenue Service to administer the program. Anger over the imposition of a tax penalty is likely to attach to the tax system which is associated with it. The fact that there are a large number of persons who dislike the health reform program increases the risk that their anger will spill over to the agency administering the mandate.
I am not suggesting that the tax system will suffer greatly because of its relationship to this program, but it is an added burden on an agency that already is heavily loaded. While there are obvious advantages to using the tax system to enforce the mandate (since the administrative system is already in place), it does not seem that Congress sought to balance those advantages with the costs.

Related to that point, let me quote Mortimor Caplin, a former IRS commissioner under Presidents Kennedy and Johnson and founder of the Caplin & Drysdale law firm:

I'm a critic of new chores continuously imposed on the IRS to police social and economic policies. The IRS has become the easy way out. Its resources are spread thinly, and its employees face issues totally unrelated to tax backgrounds and skills.105

VI. CONCLUSION

There are obvious benefits and costs associated with the adoption of the health reform program, which establishes an insurance scheme providing near universal coverage. Congress weighed those competing attributes and decided to adopt the program. To finance the program, Congress chose to use the individual mandate and to require the young to subsidize the premiums of the elderly. To enforce the mandate, Congress adopted a penalty provision that is administered by the Internal Revenue Service. While the advantages of utilizing a penalty, rather than adopting a credit or deduction system, are obvious, the costs are more subtle and

require some inquiry and thought to bring them into view. The purpose of this paper is to disclose those costs. The impact on the tax system of using the Internal Revenue Service to collect the penalty and of including the mandate in the Internal Revenue Code adds to the cost of imposing a penalty. The potential injury to the perception of the tax system might well make it worthwhile to utilize another agency to collect the penalty even though that would increase the cost of administration.

Alternatively, Congress might replace the individual mandate with a carrot of a refundable credit that is reduced as income rises. While a credit system will not achieve the same result as the mandate, it would serve much of the function of that program and would be far more acceptable to the public.