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THE INDIVIDUAL MANDATE TAX PENALTY

Jeffrey H. Kahn*

In 2010, President Obama signed legislation that significantly altered the health-care 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 upheld the constitutionality of that provision under Congress's taxing power.

Despite the Supreme Court upholding the individual mandate, fundamental questions 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 bad policy. 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 reconsider the desirability of using a tax penalty approach in the future. This Article also considers 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 adverse 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 whether the extent of some of the problems in the healthcare system at which the mandate is aimed have been exaggerated. 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.

INTRODUCTION

Arguably, President Obama's key legislative success during his first term was the passage of a historic overhaul of the United States

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healthcare system.¹ Both at the time of its enactment and today, one of the most discussed provisions of the Healthcare Reform Acts is the “individual mandate,” a provision that requires most individuals to have healthcare insurance that provides “minimum 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 Internal Revenue Code (I.R.C.) itself repeatedly refers to this imposition as a “penalty.” For convenience, this imposition is hereinafter referred to as an “insurance penalty,” a “tax penalty,” or simply a “penalty.”

Some (including the attorney generals of several states) argued that the healthcare bill in general and the individual mandate provision in particular were unconstitutional.⁴ However, the Supreme Court upheld the constitutionality of the individual mandate as a valid exercise of Congress’s taxing power.⁵ This Article does not discuss the constitutionality of the mandate.⁶ Nor does it examine the merits and costs of the Healthcare Reform Acts. This Article does address whether it is appropriate to put the penalty provision in the tax code and whether normatively it is a good strategy to utilize a penalty, enforced by the Internal Revenue Service (Service), to pressure individuals to make a purchase that the government considers to be desirable. Although the Supreme Court resolved the constitutional issue, the question of the desirability of using a tax

1. On March 23, 2010, President Obama signed into law the Patient Protection and Affordable Care Act. Pub. L. No. 111-148, 124 Stat. 119 (2010). On March 30, 2010, President Obama signed into law the Health Care and Education Reconciliation Act of 2010. Pub. L. No. 111-152, 124 Stat. 1029. Together these two bills encompass the healthcare reform, which some critics have referred to as Obamacare, and some persons refer to the two acts in the singular as the Affordable Care Act (ACA). Throughout this Article, the overall reform will be referred to as the “Healthcare Reform Acts.”

2. See Patient Protection and Affordable Care Act § 1501, I.R.C. § 5000A(a) (2011).

3. *Id.* § 5000A(b).

4. Prior to the decision by the Supreme Court, there were mixed results. Compare *Florida v. U.S. Dep’t of Health & Human Servs.*, 648 F.3d 1235 (11th Cir. 2011) (holding that the individual mandate provision was beyond the scope of Congress’s powers), with *Seven-Sky v. Holder*, 661 F.3d 1 (D.C. Cir. 2011) (upholding the provision), and *Thomas More Law Ctr. v. Obama*, 651 F.3d 529 (6th Cir. 2011) (same).

5. *Nat’l Fed’n of Indep. Bus. v. Sebelius (NFIB)*, 132 S. Ct. 2566 (2012).

6. Prior to the Supreme Court decision, some professors argued that the mandate was unconstitutional. See, e.g., Randy E. Barnett, *Commandeering the People: Why the Individual Health Insurance Mandate is Unconstitutional*, 5 N.Y.U. J.L. & LIBERTY 581 (2010); Steven J. Willis & Nakku Chung, *Constitutional Decapitation and Healthcare*, 128 TAX NOTES 169 (2010). Others argued that the mandate was constitutional. See, e.g., Brian Galle, *Conditional Taxation and the Constitutionality of Health Care Reform*, 120 YALE L.J. ONLINE 27 (2010), <http://yalelawjournal.org/2010/5/31/galle.html>; David B. Rivkin, Jr., et al., *Debate, A Healthy Debate: The Constitutionality of an Individual Mandate*, 158 U. PA. L. REV ONLINE 93, 102 (2009), <http://www.pennlawreview.com/debates/index.php?id=23>.

penalty (in contrast to either using a tax deduction or credit, having another agency administer the penalty, or imposing a fee that is not designated as a penalty) continues to be a live issue.

It appears that the provision in question is the first to directly impose additional taxation on an individual for failure to purchase an item. Still, some have questioned whether the provision is unique—i.e., whether it is economically equivalent to providing a deduction or credit to encourage specified expenditures.⁷ This Article will question whether deductions and credits in the current system are equivalent or even similar to a penalty system. It will also examine whether provisions, such as the social security tax, are comparable to the newly adopted insurance penalty.

Additionally, this Article considers whether the use of tax law to penalize people for not buying medical insurance will adversely affect taxpayers' willingness to comply voluntarily with regular tax provisions, and concludes that it likely will. That harm, plus the additional stress that the adoption of this provision places upon the administration of the tax system, should have been weighed before the Service was chosen as the agency to administer the program. Although 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 the tax system may suffer, Congress may have chosen another approach. At least it would have been comforting to know that Congress had considered the issue before it acted, rather than having gone forth blindly indifferent to those potential consequences.⁸

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 I.R.C. and explains how that provision operates. As will be illustrated, the technical drafting of the

7. See discussion *infra* Part IV.

8. There is very little legislative history available for the Healthcare Reform Acts, and none of it suggests that Congress considered the possible harm to the overall tax system:

As a result of the unusual procedures used to enact the ACA, there is little definitive legislative history of the law. What exists is predominantly limited to Senate Floor debate of the ACA, and House and Senate floor debate of HCERA. No conference report exists. The Senate-passed version, which became law, was primarily the product of a melding of two Senate Committee bills by the Senate Democratic leadership. Of the two reporting Committees, the HELP Committee did not issue report language explaining the provisions. Although the Senate Finance Committee issued a report explaining provisions of the legislation reported from its Committee, it did not include actual legislative language in the report.

Katherine Hayes, *Overview of Policy, Procedure, and Legislative History of the Affordable Care Act*, 7 NAELA J. 1, 9 (2011).

Acts is atrocious, and serious gaps and ambiguities abound.⁹ Part II of the Article briefly discusses the Supreme Court decision upholding the individual mandate, focusing on the discussion of whether the mandate should be considered a tax or a penalty. Part III describes the 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 meaningful economic distinction between them. Part V discusses whether a penalty is appropriate in this circumstance and, if so, whether the tax law is a poor choice as the vehicle for applying the penalty. The Article ends with conclusions and suggestions.

I. THE MECHANICS OF I.R.C. § 5000A¹⁰

I.R.C. § 5000A requires certain individuals, referred to as “applicable individuals,” to maintain “minimum essential coverage” for each month after the close of the year 2013.¹¹ Minimum essential coverage includes coverage under, among others, Medicare, Medicaid, plans purchased in the individual market, and employer-sponsored plans.¹² 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.”¹³ The I.R.C. itself describes this imposition as a “penalty” throughout § 5000A.¹⁴ A taxpayer who has dependents is liable for any penalties imposed on those dependents; the I.R.C. does not expressly state whether the dependent also is liable to pay his penalty if the taxpayer fails to do so.¹⁵

9. See generally Jeffrey H. Kahn, *The Operation of the Individual Mandate*, 132 TAX NOTES 521 (2011).

10. Much of this Part derives from Jeffrey H. Kahn, *The Operation of the Individual Mandate*. *Id.*

11. I.R.C. § 5000A(a), (d) (2011). Some individuals, such as a non-U.S. citizen present in the United States, are exempted from this requirement. *Id.* § 5000A(d).

12. *Id.* § 5000A(f).

13. See *id.* § 5000A(b).

14. See, e.g., *id.* § 5000A(b), (c), (e).

15. See *id.* § 5000A(b)(3)(A). One ground for finding that such a dependent is not jointly liable is to contrast the dependent provision, which makes no mention of joint liability, with the comparable provision for spouses that file a joint return on whom the I.R.C. expressly imposes joint liability. Compare *id.*, with *id.* § 5000A(b)(3)(B). The express imposition of joint liability in one provision and the lack of a mention in the comparable provision

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.¹⁶ 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.¹⁷

The I.R.C. 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.¹⁸ For example, incarcerated individuals and persons who adhere to a religion whose tenets or teachings cause them to conscientiously oppose the benefits of insurance are exempt.¹⁹

In addition to the characterization as an applicable individual exemption, the I.R.C. exempts certain applicable individuals from the penalty.²⁰ 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.²¹ 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.²²

To provide relief for short-term gaps in coverage, the I.R.C. does not impose a penalty if a person fails to have the minimum essential coverage for a continuous period of less than three months.²³ Such a continuous period can consist of months that fall within two calendar years.²⁴ If there is more than one such continuous period in a

for dependents suggests that there is not joint liability in the latter case. The answer is far from clear.

16. *Id.* § 5000A(g)(2).

17. *See Questions and Answers on the Individual Shared Responsibility Provision*, IRS, <http://www.irs.gov/uac/Questions-and-Answers-on-the-Individual-Shared-Responsibility-Provision> (last updated Sept. 24, 2013).

18. I.R.C. § 5000A(d)(2)–(4), (e).

19. *See id.* § 5000A(d)(2), (4).

20. *Id.* § 5000A(e).

21. *Id.* § 5000A(e)(5).

22. *Id.* § 36B. Medicaid was also expanded to cover more individuals and families. 42 U.S.C. § 1396a(a)(10)(A)(i)(VIII) (2006).

23. *See* I.R.C. § 5000A(e)(4).

24. *Id.* § 5000A(e)(4)(B)(i).

calendar year, only the first such period qualifies for the exclusion.²⁵ If the continuous period lasts for three months or more, then there is no exception to the imposition of the penalty.²⁶

Subject to a limitation described below,²⁷ 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.²⁸ If the taxpayer files a joint return, then the taxpayer and the spouse are jointly liable for “such penalty.”²⁹ 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.³⁰ The definition of “household income” is described later in this Article.³¹

The flat dollar amount is determined by reference to an “applicable dollar amount” that is established in the I.R.C.³² The flat dollar amount for each applicable individual is equal to the sum of the applicable dollar amounts for that individual and for others who are not clearly identified in the statute.³³ 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.”³⁴ Obviously, there needs to be a modifying limitation on the word “individuals” in that provision to clarify 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

25. For example, if a taxpayer did not have appropriate insurance coverage for the months of January and November in one calendar year, but did have coverage for all other months of that year, this exception would apply only to exclude the penalty for the January month. It would apply the penalty for November even though the total lack of coverage during the year was two months. *See id.* § 5000A(e)(4)(B)(iii).

26. *Id.* § 5000A(e)(4). Note that no exemption is provided for any month during the period. That is, once the taxpayer exceeds three months, the penalty applies to all such months, not just the months in excess of three. *Id.* § 5000A(e)(4)(B)(ii). Also note that Congress delegated authority to the 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. *See id.* § 5000A(e)(4)(B).

27. *See infra* text accompanying note 49.

28. I.R.C. § 5000A(c). A dependent of a taxpayer is a person who comes within the definition set forth in I.R.C. § 152.

29. *Id.* § 5000A(b)(3)(B). The provision is unclear as to what “such penalty” refers to in cases with joint returns. *See Kahn, supra* note 9, at 526.

30. I.R.C. § 5000A(c)(2).

31. *See infra* text accompanying notes 43–46.

32. I.R.C. § 5000A(c)(2)(A), (3).

33. *Id.* § 5000A(c)(2)(A)(i).

34. *Id.*

adequate health insurance coverage,³⁵ but the Service's future construction may be different. For the year 2016, the applicable dollar amount will be \$695.³⁶ If an individual is under the age of eighteen at the beginning of a month, the individual's applicable dollar amount for that month will be reduced by fifty percent.³⁷

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 taxpayer will be \$57.92. After 2016, this amount will be adjusted for cost of living.³⁸

Although 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.³⁹ Consequently, a taxpayer's flat dollar amount for the year 2016 cannot exceed \$2,085.⁴⁰

After computing the flat dollar amount for the monthly penalty, one must calculate the percentage on the taxpayer's household income for the monthly penalty to determine which figure is larger. To calculate the percentage of household income variable for 2016, the taxpayer multiplies modified family income by 2.5 percent.⁴¹ Modified family income is the excess of the taxpayer's "household income" over "the amount of gross income specified in section 6012(a)(1)"⁴²—i.e., the minimum amount of income that requires a taxpayer to file a tax return. "Household income" is the sum of a

35. As shown later, 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.

36. I.R.C. § 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 ninety-five dollars, and the amount for 2015 is \$325. *Id.* § 5000A(c)(3)(B). The flat dollar amount can be greater than the \$695 applicable dollar amount for 2016 because it will include the applicable dollar amount for each of the taxpayer's dependents who are subject to the penalty. *See id.* § 5000A(c)(2)(A). For years after 2016, the applicable amount will be adjusted for changes in the cost of living. *Id.* § 5000A(c)(3)(D).

37. *Id.* § 5000A(c)(3)(C).

38. *Id.* § 5000A(c)(3)(D).

39. *Id.* § 5000A(c)(2)(A)(ii).

40. Of course, the taxpayer's actual penalty could be higher because the percentage of income variable could be greater than this maximum flat dollar amount.

41. I.R.C. § 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 one percent, and for 2015 it will be two percent. *Id.*

42. *Id.* § 5000A(c)(2)(B).

modified amount of the adjusted gross income⁴³ of the taxpayer⁴⁴ and each dependent of the taxpayer who qualifies the taxpayer for an exemption deduction under I.R.C. § 151⁴⁵ and who is required to file a tax return.⁴⁶ I.R.C. § 6012 is the provision that requires taxpayers to file a tax return unless their gross income does not exceed a certain amount.⁴⁷ For example, for joint filing taxpayers, that amount is equal to twice the personal exemption amount listed in I.R.C. § 151(d), plus the standard deduction for joint filing taxpayers.⁴⁸

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.⁴⁹ It is currently unclear exactly how that average will be determined. However, in a letter to Senator Olympia Snowe, Douglas Elmendorf (Director of the Congressional Budget Office (CBO)) stated that the CBO estimated that, in 2016,

43. 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 I.R.C. § 911. *Id.* § 5000A(c)(4)(C).

44. 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 9, at 526.

45. 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. I.R.C. § 151(d). 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.

46. *Id.* § 5000A(c)(4)(A), (B). A taxpayer can qualify for an exemption deduction for his spouse if a joint return has not been filed, the spouse has no gross income, and the spouse is not the dependent of another person. *Id.* § 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. *Id.* § 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) would be included in a taxpayer’s household income.

47. *Id.* § 6012(a).

48. *Id.* § 6012(a)(1)(A)(iv).

49. *Id.* § 5000A(c)(1)(B). The Healthcare Reform Acts provide four levels of coverage (Bronze, Silver, Gold and Platinum) depending on the benefits provided under the plan. Patient Protection and Affordable Care Act § 1302(d)(1), 42 U.S.C. § 18022(d)(1) (2006). It is unclear whether this limitation is applied monthly or annually. *See Kahn, supra* note 9, at 527.

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.⁵⁰

II. A TAX? A PENALTY? DOES IT MATTER?

There is a question of 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 I.R.C. and its payment with an individual’s federal income tax return.⁵¹ However, the original House bill referred to the penalty and used the term “tax” fourteen times.⁵² 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.”

This issue of whether the individual mandate was a tax or a penalty became the key question in the Supreme Court decision. Once a majority of the Court determined that Congress did not have the power under the Commerce Clause to impose the mandate,⁵³ the mandate could only be saved with Congress’s taxing power.⁵⁴

Prior to determining the constitutionality of the provision, the Court first had to determine whether it even had authority to consider the question.⁵⁵ The Anti-Injunction Act bars any litigation that attempts to restrain “the assessment or collection of any tax.”⁵⁶ The permitted procedure to challenge a tax requires the taxpayer to pay the tax and then sue the government for a refund.⁵⁷ Because no

50. Letter from Douglas W. Elmendorf, Dir., Cong. Budget Office, to Olympia Snowe, U.S. Senator (Jan. 11, 2010), *available at* http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/108xx/doc10884/01-11-premiums_for_bronze_plan.pdf.

51. *See supra* text accompanying note 14.

52. Affordable Health Care for America Act, H.R. 3962, 111th Cong. § 501(a) (2009); *see also* Willis & Chung, *supra* note 6, at 181.

53. Nat’l Fed’n of Indep. Bus. v. Sebelius (*NFIB*), 132 S. Ct. 2566, 2593 (2012). Justices Ginsburg, Breyer, Kagan, and Sotomayor would have upheld the provision under the Commerce Clause. *Id.* at 2609 (Ginsburg, J., concurring in part, concurring in the judgment in part, and dissenting in part). They joined Chief Justice Roberts in upholding the provision under the taxing power. *Id.* at 2600. Justices Scalia, Kennedy, Thomas, and Alito would have struck down the mandate. *Id.* at 2642 (Scalia, Kennedy, Thomas, Alito, JJ., dissenting).

54. Congress may “lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States.” U.S. CONST. art. 1, § 8, cl. 1.

55. *NFIB*, 132 S. Ct. at 2582–84.

56. Tax Anti-Injunction Act, I.R.C. § 7421(a) (2006).

57. “[The Anti-Injunction Act’s] language could scarcely be more explicit The Court has interpreted the principal purpose of this language to be the protection of the Government’s need to assess and collect taxes as expeditiously as possible with a minimum of pre-enforcement judicial interference, ‘and to require that the legal right to the disputed

individual would be obliged to pay the individual mandate penalty until 2014, the Supreme Court could have held that the Anti-Injunction Act barred a decision until that time.

The Court, however, held that the mandate was a penalty, and not a tax, for purposes of the Anti-Injunction Act.⁵⁸ The Court stressed that Congress called the mandate a “penalty” and held that this label was determinative for purposes of the Anti-Injunction Act.⁵⁹ Thus, the Court held that the Anti-Injunction Act would not bar consideration of whether Congress had the constitutional authority to impose the individual mandate.⁶⁰

One might think that this determination would also settle the constitutional question of whether the taxing power authorizes Congress to create the individual mandate—that is, if the mandate was a penalty for purposes of the Anti-Injunction Act, then it must also be a penalty, and thus cannot be a tax, for purposes of the Constitution. However, Chief Justice Roberts, authoring the majority opinion, stated that while what Congress called the mandate was determinative for purposes of the Anti-Injunction Act, it was not determinative for purposes of the Constitution.⁶¹ Thus, the Court would look beyond the mere label to determine whether the mandate was a penalty or tax for purposes of the Constitution.⁶²

Chief Justice Roberts determined that, for constitutional purposes, the mandate should be considered a tax.⁶³ There are some obvious considerations that support that conclusion. For example, the penalty that is set out in the I.R.C., is enforced by the Internal Revenue Service, and is payable on an individual’s federal income tax return.⁶⁴ 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.⁶⁵ Justice Roberts also noted

sums be determined in a suit for refund.’” *Bob Jones Univ. v. Simon*, 416 U.S. 725, 736 (1974) (quoting *Enochs v. Williams Packing & Navigation Co.*, 370 U.S. 1, 7 (1962)).

58. *NFTB*, 132 S. Ct. at 2582–84.

59. *Id.* at 2583.

60. *Id.* at 2584.

61. *Id.* at 2594.

62. *Id.* (“It is of course true that the Act describes the payment as a ‘penalty,’ not a ‘tax.’ But while that label is fatal to the application of the Anti-Injunction Act . . . it does not determine whether the payment may be viewed as an exercise of Congress’s taxing power. It is up to Congress whether to apply the Anti-Injunction Act to any particular statute, so it makes sense to be guided by Congress’s choice of label on that question. That choice does not, however, control whether an exaction is within Congress’s constitutional power to tax.”).

63. *Id.* at 2595.

64. *Id.* at 2594.

65. *Id.*

that the provision has “the essential feature of any tax: it produces at least some revenue for the Government.”⁶⁶

Chief Justice Roberts noted that although the mandate clearly:

aims to induce the purchase of health insurance, it need not be read to declare that failing to do so is unlawful. Neither the Act nor any other law attaches negative legal consequences to not buying health insurance beyond requiring a payment to the IRS. The Government agrees with that reading, confirming that if someone chooses to pay rather than obtain health insurance, they have fully complied with the law.⁶⁷

Essentially, Chief Justice Roberts viewed the mandate as a choice between purchasing insurance and paying more in federal taxes. Chief Justice Roberts therefore did not view the mandate as an absolute requirement to purchase insurance. He noted that Congress itself predicted that many millions of people would be subject to the penalty for failing to purchase insurance, and he wrote that he did not believe that Congress would so willingly acknowledge the creation of several million “outlaws.”⁶⁸ To the contrary, as the Article will discuss later, labeling those who fail to comply with the mandate as “outlaws” is a major objective of the penalty provision.

In their dissent, Justices Scalia, Kennedy, Thomas, and Alito argued that the majority opinion was simply rewriting the statute.⁶⁹ Essentially, they said that because Congress called it a penalty, it should be considered a penalty, and not a tax, for purposes of the Constitution.⁷⁰ Countering some of the points discussed in the opinion written by Chief Justice Roberts, the dissent noted that (1) other penalties are collected by the Internal Revenue Service,⁷¹ (2) the mandate is also administered by the Department of Health and Human Services, and (3) it is not unusual for penalties to vary based on ability to pay.⁷²

66. *Id.* 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.

67. *Id.* at 2596–97. This ignores the psychological consequences of being subject to a “penalty.” See *infra* Part IV.C.

68. *NFTB*, 132 S. Ct. at 2597.

69. *Id.* at 2655 (Scalia, Kennedy, Thomas, Alito, JJ., dissenting).

70. *Id.*

71. The dissent used I.R.C. § 527(j) (penalty for failure to make campaign finance disclosures) as an example. *Id.* at 2654.

72. *Id.*

For purposes of this Article, it makes no difference that the Supreme Court ultimately determined that the insurance penalty is a tax. 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 as part of the overall tax system. The Supreme Court's decision has bolstered the perception that the mandate is part of the tax system. However, some questions remain: is it a good idea to use a tax penalty—as opposed to credits and deductions⁷³—to encourage a behavior, and will the penalty system have an adverse effect on taxpayer compliance?

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 insurance companies' practice of turning down individuals for coverage based on prior medical history and to prevent insurance companies from cancelling coverage for policyholders who become seriously ill.⁷⁴ 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.⁷⁵ 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 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 do not require outlays, i.e., the

73. In common parlance, these two choices may be referred to as the choice between sticks and carrots. See, e.g., Brian Galle, *The Tragedy of the Carrots: Economics and Politics in the Choice of Price Instruments*, 64 STAN. L. REV. 797, 799 (2012).

74. Subject to limited exceptions, which do not include preexisting medical conditions, insurers must accept any employer or individual that applies for health insurance coverage. 42 U.S.C. § 300gg-1 (2006). Insurers may not adjust premiums for prior medical conditions. *Id.* § 300gg-4(b)(1). Insurers may not have annual or lifetime limits on benefits. *Id.* § 300gg-11. Finally, insurance companies may not cancel any coverage other than for fraud. *Id.* § 300gg-12.

75. KENNETH S. ABRAHAM, *DISTRIBUTING RISK* 1 (1986).

healthy people.⁷⁶ 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.⁷⁷ 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 because 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 because their premiums would be high enough to cover any medical expenses they would be likely to incur.⁷⁸ Insurance companies could not survive long in that environment.

This situation arises because of what is referred to as adverse selection.⁷⁹ As described in an amici curiae 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

76. See Lawrence O. Gostin & Elenora E. Connors, *Health Care Reform in Transition: Incremental Insurance Reform Without an Individual Mandate*, 303 JAMA 1188, 1188 (2010).

77. In fact, under this scenario, it is probably incorrect to describe the product as “insurance” because insurance involves the coverage of some risk. Instead, each purchaser has the certainty of receiving disbursement from the insurer.

78. See Gostin & Connors, *supra* note 76, at 1188–89. In effect, such insureds would not purchase actual insurance coverage; they would merely prepay to the insurer the amount of their anticipated medical expenses.

79. See DAVID M. KREPS, *A COURSE IN MICROECONOMIC 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.”).

individuals despite preexisting conditions could become unsustainable.⁸⁰

Congress enacted the individual mandate in an attempt to avoid the adverse selection problem and nudge the healthy into the health insurance pools.⁸¹ The mandate accomplishes this by tilting the balance heavily towards buying health insurance for the vast majority of people. Individuals who purchase sufficient health insurance are exempt from the penalty. If the amount of the penalty is close to or greater than the cost of the insurance, then 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, because 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.⁸²

Note that the penalty need not be equal to the cost of the insurance to induce the individual to purchase it. The effect of excluding the penalty from 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.⁸³

80. Brief Amici Curiae of the March of Dimes Found. et. al. in Support of Motion to Dismiss at 3, *Virginia v. Sebelius*, 702 F. Supp. 2d 598 (E.D. Va. 2010).

81. See Ezra Klein, *How Does the Individual Mandate Work?*, WASHINGTON POST (Mar. 25, 2010, 11:55 AM), 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.").

82. If the individual ends up paying the penalty, the amount paid is not directly transferred to private insurance companies. While the penalty itself does not benefit insurance companies, the Acts provide an indirect benefit to them. Government subsidies will be paid indirectly to the insurance companies because the Healthcare Reform Acts created a federal tax credit for premiums paid to such companies by certain individuals and families. See I.R.C. § 36B (2006).

83. 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. If the individual does not buy insurance, he or she will pay \$300 to the government and receive nothing in return; if the person buys insurance, he or she will avoid the penalty, pay the insurance company \$500, and receive insurance. Because the person will pay at least \$300

IV. IS THE MANDATE UNPRECEDENTED? (IS THE TAX PENALTY
REALLY THE SAME AS A CREDIT?)

As noted above, this provision appears to be the first of its kind to impose an additional federal income tax amount for failure to purchase a product or service. However, some have questioned whether it is truly unprecedented or whether the I.R.C. already imposes additional taxation on individuals for failure to spend money a certain way in the same manner as the shared responsibility tax penalty.⁸⁴

For example, Professor Len 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).⁸⁵

The gist of this argument is that the government creates financial incentives to engage in certain behavior, and the form of the incentives is irrelevant. But, there are reasons why the penalty tax is not the same as a deduction or credit, and though there are also similarities, the differences matter. These differences include: (1) the penalty is an overall tax increase while a deduction or credit would involve an overall tax decrease; (2) different distributional consequences arise from the two systems; (3) there are different psychological responses to the systems; and (4) the systems have different effects on overall tax compliance. These differences are sufficient to raise the issue of whether a penalty was the optimal means of implementing the mandate. The following Sections discuss each of these differences.⁸⁶

whether he or she does or does not buy insurance, the person will buy insurance as long as the \$500 health insurance is worth \$200 to the individual.

84. 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.”).

85. Len Burman, *Health Mandate: It's Just a Tax Break in Disguise*, CNNMONEY (Apr. 14, 2010, 6:59 AM), http://money.cnn.com/2010/04/14/pf/taxes/health_insurance_mandate/index.htm (ellipsis in original).

86. The last difference is discussed *infra* Part V.D.

A. Tax Increase v. Tax Decrease

When discussing whether the penalty is financially equivalent to deductions or credits, commentators focus on the viewpoint of the individual taxpayer.⁸⁷ It is clear that, without offsetting adjustments, they are not equivalent from the viewpoint of the government or taxpayers as a whole. Granting a deduction or credit decreases government revenue; imposing a penalty increases it.⁸⁸ Without a corresponding reduction of taxes, the penalty is an additional burden on taxpayers. Similarly, focusing on the taxpayers' position as a whole, the overall liability of taxpayers would be reduced with deductions or credits and would not be reduced with a penalty.

B. Different Distributional Consequences

As noted above, superficially the two systems (i.e., a deduction/credit versus a tax penalty) appear similar when one focuses on financial consequences to taxpayers.⁸⁹ Take for example the charitable contribution deduction and compare two tax systems. Under the first system, assume the government imposes a twenty percent flat tax rate on all income and 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 deduct the donated \$10,000, leaving *A* with taxable income of \$40,000. *A*'s tax liability is \$40,000 x twenty 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 twenty 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 more disposable income remaining than *A*. After making the contribution, *A* enjoys whatever value he or she derived from the charitable donation and has \$32,000 of income left to use for purchasing whatever

87. See Burman, *supra* note 85.

88. The Congressional Budget Office expects the insurance penalty to raise an average of approximately eight billion dollars a year over the 2017–2022 period. BANTHIN ET. AL., CONG. BUDGET OFFICE, PAYMENTS OF PENALTIES FOR BEING UNINSURED UNDER THE AFFORDABLE CARE ACT (2012), available at http://cbo.gov/sites/default/files/cbofiles/attachments/09-19-12-Indiv_Mandate_Penalty.pdf.

89. See also JOEL SLEMMROD & 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.”).

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.

Using a penalty system without providing a deduction for charitable contributions could achieve the same result by subjecting taxpayers to a tax penalty for not making a required charitable donation. Assume the penalty is calculated as a percentage of income, similar to the way in which it is calculated in the new healthcare law, and that it is imposed on any taxpayer who does not donate at least \$10,000 to charity. Because this system does not allow taxpayers to deduct charitable contributions, the tax rate can be lower than it was under the first system. For *A* to pay the same income tax amount as in the hypothetical above, the tax rate would be set at sixteen percent, rather than twenty percent. Because the system does not allow deductions for charitable contributions, *A*'s taxable income is \$50,000. *A*'s tax liability is \$50,000 x sixteen percent, or \$8,000. This is the same tax liability that *A* had in the first hypothetical where *A* was allowed a deduction for charitable donations, but the tax rate was higher. Without consideration of the tax penalty provision, *B*'s tax liability would also be \$8,000 because *B* has the same gross income as *A*. To impose an overall liability on *B* equal to *B*'s liability under the deduction system, the tax penalty for failure to make a donation must be set at four percent of income.

Thus, *B* would have \$8,000 in "regular tax liability" (i.e., \$50,000 x sixteen percent) plus a \$2,000 (\$50,000 x four percent) tax penalty because *B* did not donate \$10,000 to charity. *B*'s total tax liability would be \$10,000, just as it is in the first hypothetical.

However, there are several defects to the argument that the penalty is justified because of a purported economic equivalency. One problem is that the economic equivalence itself unravels when one examines the two structures a bit closer. The second problem is that even if there were economic equivalency, there is another element of the penalty that makes it objectionable, and that element is not present with the deduction or credit.

As to the first problem, the hypotheticals above proved exact economic equivalence assuming each taxpayer earned \$50,000 and was 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 sixteen percent rate for general income plus a four percent tax penalty rate.⁹⁰

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 because the tax savings depend on the taxpayer's marginal tax rate. To maintain the economic equivalence between the deduction and a tax penalty, the government would have to set a lower rate for the penalty on higher bracket taxpayers to account for the fact that the rate will be multiplied by 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 be formidable and would add considerable complexity to tax forms and administration.

The government could use a refundable tax credit, instead of a deduction, to avoid the marginal bracket issue.⁹¹ 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.⁹² Adding a surtax to a taxpayer that is washed out by a credit of equal or nearly equal amount is a nullity or a circuitous route to imposing a penalty on the people who do not purchase health insurance, and it should be regarded as such by the courts and policymakers. 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 with the penalty system, and so demonstrates that a penalty is no different

90. Using the deduction model, A's income tax would be \$14,000 ($\$70,000 \times$ twenty percent). B's income tax would be \$16,000 ($\$80,000 \times$ twenty percent). Using the tax penalty model, A's income tax would be \$12,800 ($\$80,000 \times$ sixteen percent), which is \$1,200 less than under the deduction model. B's income tax would be the same as the deduction model, \$16,000 ($(\$80,000 \times$ sixteen percent) + $(\$80,000 \times$ four percent)). 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.

91. A tax credit is deducted from a taxpayer's tax liability whereas 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. 2011).

92. See Sullivan, *supra* note 84 (maintaining that Congress could have adopted this approach and thereby obtained identical equivalence to the insurance penalty).

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.

Instead of using the surtax method, which makes the true purpose of the credit obvious, 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 to imposing a penalty, it is more likely to be sustained by courts and policymakers because it is much less obviously a subterfuge for imposing a tax penalty. The problem is that it will be very difficult to design a structure that will exactly duplicate the current tax penalty provision, which is based on either a flat amount or a percentage of income but is 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 do not 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,⁹³ which 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.

C. Psychological Response Differences

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. As noted by Professor Burman, since the government already

93. A graduated credit would be one that increases in size the more income a taxpayer has. The current tax system has no such credit, although it has many credits that phase out as a taxpayer's income increases. *See, e.g.*, I.R.C. § 21 (dependent care credit).

uses deductions and credits to affect behavior, why not use a penalty for a similar purpose?⁹⁴ While there is some force to that argument, there are counter considerations.

Not every deduction or credit's purpose is the subsidization of an investment or an activity.⁹⁵ There is no dispute, however, that many deductions and credits serve that function.⁹⁶ Because the I.R.C. already has provisions that are used for non-neutral reasons (i.e., reasons that have nothing to do with an accurate measurement of net income), and because there is some economic similarity between deductions or credits and tax penalties, should it matter whether the government's intervention is in the form of a deduction or credit on the one hand, or a penalty on the other?

It should. The psychological impact of subsidization is very different from the psychological impact of penalization. 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 the purchase of a hybrid car. By providing a deduction or credit, the government effectively shares the cost of the expenditure.⁹⁷ For example, if a taxpayer is in the twenty 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 attributable to 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 and credits differently from tax penalties. In the credit and deduction case, a taxpayer is not required to buy anything. A deduction or credit reduces the economic cost of the expenditure to

94. Burman, *supra* note 85.

95. An example of a deduction that is not designed to subsidize expenditures is the ordinary business deduction under I.R.C. § 162, which is an element of net income measurement. An example of a credit that is not designed as a subsidy is the credit allowed by I.R.C. § 21 for certain dependent care expenses. This credit is neutralizing a tax bias against a second spouse's employment that arises because of the exclusion of implied income from the tax base. See Douglas A. Kahn, *A Proposed Replacement of the Tax Expenditure Concept and a Different Perspective on Accelerated Depreciation*, 41 FLA. ST. U. L. REV. (forthcoming 2014) (manuscript at 8–9), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2205288.

96. A clear example is the \$7,500 credit provided for purchasing a qualified plug-in electric car such as the Chevy Volt. See I.R.C. § 30D.

97. Whether or not one views this as a subsidy from the government is a separate issue. See, e.g., David I. Walker, *Suitable for Framing: Business Deductions in a Net Income Tax System*, 52 WM. & MARY L. REV. 1247, 1247–48 (2011); see also Douglas A. Kahn & Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical View*, 54 TAX NOTES 1661 (1992). There is no question that, by providing a deduction or credit, the government is reducing the cost of the expenditure.

the taxpayers, but the decision to make that expenditure feels 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 concludes instead that the reduced cost of the expenditure is not sufficient for him to make that purchase.

By way of analogy, suppose a 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.

There is an argument that the sofa sale is not perfectly analogous to the tax credit or deduction for health insurance. When a buyer chooses not to purchase a discounted sofa, he suffers no direct or indirect loss from that decision. One could argue that, by contrast, when a taxpayer chooses not to buy health insurance for which a tax subsidy is available, he may feel that he will directly pay more in taxes (since he does not get the subsidy), or he will indirectly pay more because other taxpayers will receive a subsidy when they buy insurance (perhaps requiring the taxpayer to pay more in taxes to cover the subsidy loss).

As to the first contention, if a credit is offered to anyone who purchases insurance, those who do not purchase it have decided that the reduced cost of the insurance (via the tax subsidy) is not sufficient to make it something they are willing to buy. Since the "bargain" is offered to everyone, if the taxpayer determines not to buy the insurance even at the bargain price, then the taxpayer will likely view himself as shrewd rather than harmed. In this sense, it is similar to the person considering the purchase of the sofa.

As to the second contention, there are political restraints on the extent to which taxes can be raised. Still, if a subsidy is used and tax revenues are reduced, then it may result in reduced government spending or more borrowing by the government. Any increased borrowing will be a burden borne by all citizens, including those who received the credit. Thus, it will be spread throughout a massive system. It is unlikely that a taxpayer will perceive the granting of a tax credit as causing an increase in his individual tax burden, even if the credit does increase that burden. Indeed, there are numerous credits currently in the tax system, and it does not appear that most taxpayers regard them as increasing their tax burden. In the end, regardless of whether the analogy is perfect, it reflects the perception of the public that the credit is merely a reduction of the

cost of an item, and their choice is to buy it at the lower price or not.

A penalty is not viewed in the same light as a tax subsidy. As noted previously, the I.R.C. makes a point of characterizing the payment required of the non-insured as a penalty.⁹⁸ A governmental penalty carries with it the connotation that the person is a wrongdoer.⁹⁹ If an individual fails to make a charitable contribution, and thus gets no deduction, that individual is not thereby made to feel as if he or she is a wrongdoer. On the other hand, if the government were to impose a penalty on those who do not make a specified amount of charitable contributions, the citizens who fail to contribute would be identified as bad citizens. The use of the penalty system in the Healthcare Reform Acts is designed to induce guilt in those who do not purchase sufficient medical coverage.¹⁰⁰ One of the major objections, then, to the use of the penalty provision is that it is inappropriate for the government to mark as miscreants those who chose not to invest in projects that the government likes.¹⁰¹

There is another reason why the government believes 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.¹⁰² For example, if a ticket for the Super Bowl would cost \$1,000, an individual might not be willing to pay that amount to obtain the ticket. But, if the individual were given a ticket to the Super Bowl, he might refuse an offer of \$1,000 to purchase it. It might seem that if the ticket is not worth \$1,000 to him, he would

98. See *supra* Part I.

99. As is true with many words, the term “penalty” has different meanings in different contexts. Imposed by a government, it means “a punishment fixed by law for a crime” or “disadvantage, suffering, handicap, etc. imposed upon an offender, as a fine or forfeit.” See WEBSTER’S NEW UNIVERSAL UNABRIDGED DICTIONARY 1324 (Jean L. McKechnie ed., 2nd ed. 1979).

100. Cf. James Andreoni et al., *Tax Compliance*, 36 J. ECON. LIT. 818, 850–52 (1998).

101. Chief Justice Roberts appears to have focused only on negative *legal* consequences rather than the detrimental psychological effects of being subject to a penalty. See *Nat’l Fed’n of Indep. Bus. v. Sebelius (NFIB)*, 132 S. Ct. 2566, 2597 (2012). Chief Justice Roberts writes, “Neither the Act nor any other law attaches negative legal consequences to not buying health insurance, beyond requiring a payment to the IRS. The Government agrees with that reading, confirming that if someone chooses to pay rather than obtain health insurance, they have fully complied with the law.” *Id.* This statement ignores the basic facts that we normally do not subject people who have “fully complied with the law” to a penalty and that persons who are penalized by the government are widely considered to have been punished for a wrongful act or omission.

102. This phenomenon is referred to as the “endowment effect.” See Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, in *ADVANCES IN BEHAVIORAL ECONOMICS* 55, 56–57 (Colin F. Camerer et al. eds., 2004).

be willing to sell it for \$1,000. Yet, that is not necessarily so because he will regard the opportunity to obtain cash differently from parting with cash. That is, the loss of one's wealth is felt more deeply than the declining of an opportunity to increase it.¹⁰³

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 notion is far from true. There is no actual fund. The fund is a paper figure and does not represent any actual assets.¹⁰⁴ No one who pays into the social security system has any rights (contractual or otherwise) to receive any benefits.¹⁰⁵ The government could legally cut off all of a person's social security benefits,¹⁰⁶ although it would be a political disaster to do that. The social security tax is just that, a tax like any other, and it is not a purchase of contractual rights.

The degree to which an individual internalizes the guilt associated with a penalty will vary depending upon how heinously the event that triggered the penalty is regarded. Offenses that are *malum in se* are considered more heinous than those that are *malum prohibitum*. Even within the classification of *malum prohibitum*, some acts have greater moral implications than others.¹⁰⁷ If an individual willfully fails to pay his income tax liability, then that can be seen as harming taxpayers who thereby may have to pay a greater tax or receive fewer governmental benefits. Accordingly, a willful failure to pay or a willful avoidance of an income tax can be seen as moral turpitude. That is not to say that it is on the same level of turpitude as an act of violence, but it is certainly frowned upon by most of the public.

To what extent would the public consider the failure to buy health insurance an act of moral turpitude? To those who take seriously the government's contention that the failure to purchase

103. See *id.*

104. See Richard L. Kaplan, *Top Ten Myths of Social Security*, 3 ELDER L.J. 191, 192–94 (1995).

105. See *Flemming v. Nestor*, 363 U.S. 603, 610 (1960).

106. See *Bowen v. Pub. Agencies Opposed to Soc. Sec. Entrapment*, 477 U.S. 41, 51–53 (1986); *Richardson v. Belcher*, 404 U.S. 78, 80 (1971).

107. Of course, an act ordinarily regarded as heinous can be considered laudatory under special circumstances. For example, the willful killing of a human being is typically considered a heinous act. In certain circumstances, however, such as a mercy killing, some persons regard it as laudatory.

health insurance imposes a cost on the persons who do buy insurance and on those who incur medical expenses, the wrongfulness is comparable to that of willfully not paying one's income tax liability. Regardless of whether the failure to buy health insurance should be so regarded, it is the actual perception of the act that creates the internalizing of guilt. In any event, the government's hope of inducing compliance with the individual mandate must depend upon the anticipation that most of the public will regard the imposition of the penalty as a reflection of the moral turpitude involved in failing to comply with the mandate.¹⁰⁸

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 desirable to use a tax penalty in this way. One reason that Congress may have chosen to use a tax penalty is that the I.R.C. already provides a deduction for payment of health insurance premiums. Medical expenses, including insurance premiums paid for health insurance coverage,¹⁰⁹ are deductible but only to the extent that such expenses exceed ten percent of a taxpayer's adjusted gross income.¹¹⁰ Assuming a taxpayer's medical expenses exceed ten percent, the excess amount is 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 health 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

108. See Josh Bowers & Paul H. Robinson, *Perceptions of Fairness and Justice: The Shared Aims and Occasional Conflicts of Legitimacy and Moral Credibility*, 47 WAKE FOREST L. REV. 211, 217 (2012) (“[A] criminal law can stigmatize only if it has earned moral credibility with the community it governs. That is, for conviction to trigger community stigmatization, the law must have earned a reputation with the community for accurately reflecting the community's views on what deserves moral condemnation.”).

109. I.R.C. § 213(d)(1)(D) (2011).

110. *Id.* § 213(a), (f). For years prior to 2017, the floor will be 7.5 percent of adjusted gross income 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. *Id.* § 213(f).

the counteracting force that encourages some taxpayers to self-insure. The medical expense deduction 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.¹¹¹ Thus, a taxpayer who is eligible to use the medical expense deduction may be more willing to self-insure because the government will share in any medical costs that such a taxpayer incurs.

While these two concepts seem to affect the taxpayer's decision to purchase health insurance, the limitations that apply to the medical expense deduction likely make it so that relatively few taxpayers are able to deduct any medical expenses at all.¹¹² The limitations therefore diminish, if not eliminate altogether, the cost-sharing element of the deduction for health insurance premiums. However, 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.¹¹³

B. Is the Imposition of a Penalty an Undesirable Choice?

Given that other options were available, it is worth considering whether the choice to use a penalty was the optimum one. The focus here is not on whether it is proper to impose a fee on the uninsured but whether that fee is correctly imposed in the form of a penalty. It is useful to consider whether the usual purposes for imposing a pecuniary penalty apply. The classic use of a pecuniary penalty is to punish undesirable behavior.¹¹⁴ The government deems a certain behavior wrong and punishes those who engage in

111. *See id.* § 213(d).

112. In 2009, there were 140,494,127 individual income tax returns filed. Only 10,090,297 of those returns (or approximately seven percent) claimed a deduction for medical expenses. *See Internal Revenue Serv., 2009 INDIVIDUAL INCOME TAX RETURNS* 19 tbl.1, 38 tbl.3 (2011), available at <http://www.irs.gov/pub/irs-soi/11infallbulincome.pdf>.

113. A tax increase or a reduction of governmental expenditure could offset any decrease in government revenue, though the political reality is that neither of those is likely.

114. *See supra* note 99.

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: (1) the person is a “free rider,” and so, despite not acquiring health insurance, the person will still receive some free medical care if she becomes ill; or (2) the person is engaging in adverse selection and will defer purchasing health insurance until she actually needs it.¹¹⁵

Upon further inspection, the free rider problem appears to be grossly exaggerated, and there is a serious question as to whether a penalty is the proper remedy for adverse selection. Each is now considered separately.

1. The Free Rider Issue

It is not the non-purchase 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.¹¹⁶ 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.¹¹⁷

Not only is the free rider argument inapplicable to such persons, but the current design of the penalty in the Acts is at odds with that argument since the penalty is graduated based on an individual’s income level for the year.¹¹⁸ Normally in criminal law, the worse the

115. See Nicholas Bagley & Jill R. Horwitz, *Why It’s Called the Affordable Care Act*, 110 MICH. L. REV. FIRST IMPRESSIONS 1, 3 (2011), <http://www.michiganlawreview.org/assets/fi/110/bagleyhorwitz.pdf>.

116. 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 do 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, *Free Rider: A Justification for Mandatory Medical Insurance Under Health Care Reform?*, 109 MICH. L. REV. FIRST IMPRESSIONS 78, 81 (2011), <http://www.michiganlawreview.org/assets/fi/109/kahn.pdf>.

117. Uninsured individuals directly pay over one-third of medical expenses they incur. Brief of Economic Scholars as Amici Curiae Supporting Defendants-Appellees at 12, *Thomas More Law Ctr. v. Obama*, 651 F.3d 529 (6th Cir. 2011) (No. 10-2388).

118. I.R.C. § 5000A(c)(2)(B) (2011).

behavior, the greater the penalty 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, then it would seem that the opposite is true because those at lower income levels who do not buy insurance but do receive medical care pass on their expenses, while those at higher income levels do not.

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.”¹¹⁹ Under that definition, this person constitutes a free rider.

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 the term pejoratively. For them, the term conjures an image of parasites obtaining medical care for which they choose not to pay.¹²⁰ Contrary to that picture, most of the public do not have a negative view of the impecunious.¹²¹ In fact, the Healthcare Reform Acts’ penalty provision itself reflects that view by not imposing a penalty on any individual who cannot afford insurance.¹²² In addition, as previously noted, the Healthcare Reform Acts include provisions to provide subsidies for some individuals for whom health insurance premiums would be a burdensome sacrifice.¹²³ 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 hence will technically remain free riders.

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 uninsured individuals that might fit the negative connotation of a free rider.

119. N. GREGORY MANKIW, *PRINCIPLES OF MICROECONOMICS* 222 (1998).

120. *See* Kahn & Kahn, *supra* note 116.

121. It is a common view that the poor deserve sympathy rather than condemnation. Many times, poverty is not necessarily the fault of the poor. *See* Sara Sternberg Greene, *The Broken Safety Net: A Study of Earned Income Tax Credit Recipients and a Proposal for Repair*, 88 N.Y.U. L. REV. 515, 544 (2013); *see also* JOSEPH STEIN, *FIDDLER ON THE ROOF* 21 (1964) (“I realize of course it’s no shame to be poor, but it’s no great honor either.”).

122. Patient Protection and Affordable Care Act § 1501, I.R.C. § 5000A(e)(1) (2011).

123. *See* Patient Protection and Affordable Care Act § 1401, I.R.C. § 36B.

In the absence of empirical evidence that this group is made up of a significantly large number of people, there is a question of whether the group is large enough to justify the enactment of such a large-scale change in the healthcare industry. That decision rests on value judgments over which reasonable people can disagree.

Aside from the size of the problem, however, there is an issue as to whether this group truly presents a free-riding problem. Prior to the enactment of the Healthcare Reform Acts, there were severe limits as to how much free medical care an individual could receive.¹²⁴ Thus, if uninsured individuals became seriously ill and tried to acquire health insurance, they would find that it either would be prohibitively expensive or would not cover preexisting conditions. Those persons, therefore, would be taking a substantial risk by not acquiring health insurance because there are limits on the amount of free medical care 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, non-pecuniary form. They are not simply receiving the benefit of a good they did not pay for. 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 insurance can decide not to buy insurance until expensive medical services are needed because the insurer cannot deny coverage for a reason other than fraud.¹²⁵ These provisions of the Healthcare Reform Acts create the adverse selection problem described above.¹²⁶ The program would fail if that problem were not resolved, which justifies the Healthcare Reform Acts imposing a price for non-coverage in order to induce the purchase of health insurance. It might even justify having a graduated price to reflect the different utility of money to those who have more of it. Yet, this

124. Emergency Medical Treatment and Active Labor Act (EMTALA), 42 U.S.C. § 1395dd (2006).

125. See Patient Protection and Affordable Care Act § 1201, 42 U.S.C. § 300gg-2(b)(2).

126. See *supra* Part III.

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 should not 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.¹²⁷ The insurance penalty provision serves that goal. It imposes a price on an individual for failing to acquire adequate health insurance. However, 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.¹²⁸ 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 incurring a penalty for 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,¹²⁹ 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 because it is determined by the amount of adjusted gross income that a person has, is set out in the tax code, and is administrated by the Internal Revenue Service.¹³⁰ 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

127. 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.

128. See *supra* text accompanying notes 98–101.

129. See *supra* text accompanying notes 16–17.

130. See *supra* text accompanying notes 63–66.

of increasing the cost of not having insurance without subjecting the individual to the sanction of being identified as a wrongdoer.¹³¹

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 the factory that pollutes. Without some penalty, it is rational for the factory owner to pollute because 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.¹³² 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 the situation before and after the adoption of the Healthcare Reform Acts.

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 that 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.¹³³

As previously noted, that problem has been grossly exaggerated. Over a third of medical expenses incurred by the uninsured are

131. A penalty is imposed by a government for committing an unlawful and wrongful act. See *supra* note 99. 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.

132. See, e.g., 33 U.S.C. §§ 1311(a), 1319(d) (2006) (imposing a penalty on those who illegally discharge pollutants).

133. See Brief of Economic Scholars as Amici Curiae Supporting Petitioners at 13–15, Nat'l Fed'n of Indep. Bus. v. Sebelius (*NFIB*), 132 S. Ct. 2566 (2012) (No. 11-398); see also Bagley & Horwitz, *supra* note 115.

paid for directly by such individuals.¹³⁴ Some 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 exclude many such persons from the mandate and provide a subsidy for the others to help them purchase insurance.¹³⁵ The cost of those persons' medical needs is still passed on to others under the Acts. 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, so only that minority group can be thought of as approaching the situation of a polluter. Yet, even that group is in a significantly different position from a polluter.

First, 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 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.¹³⁶

134. Brief of Economic Scholars as Amici Curiae Supporting Defendants-Appellees, *supra* note 117.

135. See I.R.C. §§ 36B, 5000A(e)(1) (2011).

136. 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, but that is a subject for another time and debate.

The question that arises is whether an individual's decision to refrain from purchasing medical insurance harms those who do purchase it. The contention that harm is imposed is based on focusing on the group of people who do not purchase insurance (the "non-purchasing group") rather than on a single individual who makes that choice. The "harm" can take place only if, when including the non-purchasing group in the pool, the non-purchasing group would pay a premium that is greater than the value that they would receive. In other words, considering the effect *ex post*, the non-purchasing group would receive a smaller amount of medical benefits than they paid in premiums. On examination, it is clear that that contention has no merit.

Applying the law of large numbers and making various assumptions about the pricing of the premiums, if the non-purchasing group is large enough, then their premiums will be just adequate to provide the medical benefits they receive—that is, they are in the same position as the purchasing group and so none of their premiums would affect the amount of premiums to be paid by the purchasing group.

If the non-purchasing group is not large enough to provide reasonable expectations that the medical benefits they would receive will comport with the actuarial evaluation of a large group's medical costs, then it is possible that *ex post* the non-purchasing group will incur a smaller amount of medical expenses. Thus, the premiums they would have paid would have reduced the premium cost of the purchasing group. However, it is equally possible that *ex post* the non-purchasing group will incur larger medical expenses and will cause an increase in the premium cost of the purchasing group. In other words, it is just as likely that the inclusion of the non-purchasing group in the pool would increase the costs of the purchasing group as it is that they would reduce those costs.

Adverse selection is not a factor here. The situation is one where the insurance company is not obliged to accept applicants who are unhealthy. They can refuse coverage or charge a larger premium to reflect the additional risk that the applicant poses. To the extent that an applicant may successfully hide information about poor health, that is as true for people in the purchasing group as in the non-purchasing group.

There is another consideration here. Assume, contrary to actual facts, that somehow it was possible to predict that a non-purchasing group would incur smaller medical costs *ex post*. If that were the case, then the inclusion of that group into the pool would reduce the premium cost of the purchasing group. But in what sense has

the purchasing group been harmed by the refusal of the non-purchasing group to overpay for the medical insurance they receive? The refusal to subsidize another's costs may be seen as reducing the latter's assets, but it is a strange use of the term to say that they have harmed others. If John refuses to give money to a beggar, the beggar is poorer for not receiving those alms, but there would be few people who would say that John has harmed the beggar. If that constitutes harm, then everyone who fails to contribute to any worthy organization can be said to have harmed the people who benefit from that organization's work. Even if the word "harm" can be applied there, it would not be the kind of harm that would warrant imposing a fine on the non-donor.

Even as to those uninsured who 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.¹³⁷ 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.¹³⁸ Hence, 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,¹³⁹ 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 from illness and mortality. The young very likely overly discount the possibility that they might need medical

137. See Jedediah Purdy & Neil S. Siegel, *The Liberty of Free Riders: The Minimum Coverage Provision, Mill's "Harm Principle," and American Social Morality*, 38 AM. J.L. & MED. 374, 386 (2012).

138. See *supra* text accompanying note 124.

139. 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.

services before they are ready to purchase insurance.¹⁴⁰ The decision of the young to forego insurance may very well be rational. Even if it is not rational, 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.

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. Even if it is not a sensible decision, people are generally not punished for making poor choices that do not involve affirmative action causing injury to others.¹⁴¹

There is another important distinction. The polluter's injury to others comes from actions that the polluter has taken. For example, a polluter manufactures an item where the manufacturing process dispenses pollution into the environment, adversely affecting 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 uninsured individuals' decisions not to purchase insurance did harm to others, it is an unusual step to punish people for choosing not to buy something.

If someone chooses not to purchase a manufactured item, then there will be negative consequences for others. The owner of the item will be deprived of the profit from the sale that did not take place. The manufacturer will sell fewer of its products and 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.

140. See Tom Baker & Peter Siegelman, *Tontines for the Invincibles: Enticing Low Risks into the Health-Insurance Pool with an Idea from Insurance History and Behavioral Economics*, 2010 Wis. L. REV. 79, 96–97 (2010).

141. Concededly, the sentence above reflects a libertarian viewpoint. There are state and local laws that impose fines for failure to take certain precautions against harms, such as not wearing a seatbelt or a helmet. Whatever one thinks of the appropriateness of such laws, it is not likely that violators consider themselves (or are considered by others) to be bad people.

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.¹⁴² 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.¹⁴³ 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.¹⁴⁴ However, there remains the question of whether the method chosen by the government (the Individual Mandate and the penalty) is an appropriate vehicle. This question will be discussed below.

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 the industry is subject to scrutiny. The government can use tax revenues to support an industry. The government can use deductions and credits to encourage consumers to purchase an industry's products (an incentivizing carrot as contrasted to a prodding 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, it becomes a matter of concern and warrants especially careful scrutiny, like that given to direct expenditures, because, unlike the subsidy, the penalty carries with it a negative characterization. The material below examines 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, a national insurance program to which all must belong, or a national insurance program to which 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.¹⁴⁵ The problem is not so much with what Congress

142. Patient Protection and Affordable Care Act § 1201, 42 U.S.C. § 300gg-3(a) (2006).

143. See *supra* text accompanying notes 79–81.

144. There is a question whether the size of the penalty is adequate for that purpose.

145. See JULIUS B. RICHMOND & RASHI FEIN, *THE HEALTH CARE MESS: HOW WE GOT INTO IT AND WHAT IT WILL TAKE TO GET OUT* 79 (2007).

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. The Acts compound that problem by using a penalty to enforce the mandate. While the use of a penalty may more effectively cause 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.¹⁴⁶ One concern is whether the manner in which the Healthcare Reform Acts operate 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 tax penalty? Could it order people to purchase a minimum amount of life insurance?¹⁴⁷ 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.¹⁴⁸ In fact, not everyone does require major medical treatment during his or her 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 concept is established that the government can dictate what are considered to be personal choices, it might 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

146. One objection to the Healthcare Reform Acts is that while they addressed some existing healthcare problems, they did little or nothing to deal with the spiraling costs of medical care, which many consider to be the most important of their problems. See Douglas A. Kahn & Jeffrey H. Kahn, *The Unaffordable Health Act: A Response to Professors Bagley and Horwitz*, 110 MICH. L. REV. FIRST IMPRESSIONS 16, 22 (2011) (citing David Brooks, *Death and Budgets*, N.Y. TIMES, July 15, 2011, at A23).

147. Justice Scalia asked if the government could force everyone to exercise because that would improve health and reduce medical expenses. See Transcript of Oral Argument at 42, Nat'l Fed'n of Indep. Bus. v. Sebelius (*NFIB*), 132 S. Ct. 2566 (2012) (No. 11-398).

148. See Brief of Economic Scholars as Amici Curiae Supporting Petitioners, *supra* note 133, at 7.

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 anyone with the same smoking status and in the same rating area.¹⁴⁹ The actuarial cost of providing insurance to the elderly is much greater than the actuarial cost of providing insurance to the young and healthy because the elderly are more prone to illnesses. The ceiling that the Healthcare Reform Acts imposes 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 imposes redistribution of wealth. Taxpayers will not receive the same 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 in addition to 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.¹⁵⁰ 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 the Acts 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. In addition, there is the matter

149. Patient Protection and Affordable Care Act § 1201(4), 42 U.S.C. § 300gg(a)(1) (2006).

150. See Bagley & Horwitz, *supra* note 115, at 6; Transcript of Oral Argument, *supra* note 147, at 57–59.

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 raise the resentment of many people.¹⁵¹

What effect may the Healthcare Reform Acts have on the tax system? The United States relies heavily on voluntary compliance. 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 that 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.

It is doubtful 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 (because the administrative system is already in place), it does not seem that Congress sought to balance those advantages with the costs.

Relatedly, as a former Service commissioner under Presidents Kennedy and Johnson and founder of the Caplin & Drysdale law firm said:

151. See *supra* Part V.C.

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.¹⁵²

Thus, in this circumstance, not only was the use of a tax penalty a bad idea, but the concept of using the tax system should be carefully considered before being utilized in this manner in the future.

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. Although 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. A major purpose of this Article is to disclose the detriment to the administration of the tax system that results from using a tax penalty as the means of implementing the health care insurance program. This information could influence subsequent reforms of the health care system and the question of whether a penalty should be used to implement other programs in the future. The impact on the tax system by using the Internal Revenue Service to collect the penalty and of including the mandate in the I.R.C. 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.

152. Jeremiah Coder, *The New IRS: Expanding the Mission?*, 128 TAX NOTES 576, 579 (2010) (quoting Mortimer Caplin).

It is likely that the Acts will be amended from time to time as problems are discovered. When those reexaminations take place, one hopes that the reformers will give consideration to substituting a different means of implementing the goals of the Acts.