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## The Challenges of Implementing Health Reform Through the Tax System

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Fundamental health reform proposals often envision a key role for the income tax system in achieving their goals. These goals include expanding coverage of health insurance, while containing the growth of medical costs. Health reform proposals may cap or eliminate the current exclusion for employer-provided health insurance, create new tax-based subsidies for health insurance, and use the Internal Revenue Service (IRS) to enforce individual or employer mandates. Since 2007, Massachusetts's Department of Revenue must enforce a mandate requiring individuals to obtain health insurance coverage, although other components of the state's health reform are administered by other agencies.

Using the IRS to achieve health reform goals could build on some of the strengths of the income tax system. First, the current income tax provides substantial subsidies for health care through the exclusion for employer-provided health insurance, the above-the-line deduction for health insurance purchased by self-employed workers, the itemized deduction for medical expenses, the tax preferences for contributions to medical savings accounts, and the refundable health coverage tax credit for certain dislocated workers. Health reform may affect individuals who currently do not benefit from these provisions, but many file income tax returns or pay payroll taxes. Further, the tax system already collects much information about individuals and employers, which could be used to target those most in need of assistance.

Health reform objectives also complement many tax policy goals. The goals of tax policy are to raise sufficient revenues to cover the costs of government through equitable, efficient, and simple means. Horizontal equity could be improved by treating those without access to employer-provided health insurance in the same manner as those with employer-provided health insurance. Limiting the tax preference for health insurance could reduce or remove an incentive to spend more on health care than is efficient.

However, conflict is also likely between health reform and other tax policy goals. Providing new subsidies for health insurance or enforcing an individual or employer mandate could add complexity to the tax system, as new filers enter the system, current filers attach new forms and schedules to their tax returns, insurers report information about health plans to both beneficiaries and the government, and the IRS absorbs millions of additional documents. At a time when the IRS is criticized for insufficient action on the tax gap and tax simplification and fundamental tax reform remains goals for many policymakers, new initiatives that would increase the complexity of the tax system may raise significant concerns.

The tax system faces several key challenges in implementing health reform. The first is whether the tax system can reach the targeted population – be it individuals and families or businesses and other employers – without placing undue burden on either taxpayers or the IRS. The second is whether the IRS can enforce either a mandate or eligibility rules for a subsidy, without causing noncompliance to increase or participation in subsidies – or more broadly the tax system – to fall. The third is whether the IRS can enforce mandates or pay out subsidies in a timely fashion, given the annual accounting structure of the income tax.

These challenges are not unique to the income tax system. Other agencies would also face similar challenges if asked to implement all or some portion of health reform. For policymakers, the decision may be two-fold: first, which agency can assimilate new responsibilities at minimal cost; and second, which trade-offs are acceptable if all objectives cannot be achieved.

#### I. A Profile of the IRS

The IRS is responsible for administering both individual and corporate income taxes, the estate tax, and various excise taxes. It also oversees pensions and tax-exempt organizations and their compliance with Internal Revenue Code provisions. The IRS processes over 140 million individual, corporate, and partnership income tax returns a year as well as over 1.5 billion information returns from employers and other third-parties. In total, the IRS collects over \$2 trillion dollars in taxes each year.

To achieve these goals, the IRS has a budget of \$11 billion in FY 2008, less than 1 percent of the total collected. Over 40 percent of the IRS budget (\$4.8 billion) funds enforcement activities, including audits and collections. The second largest item (\$3.7 billion or one-third of the total budget) is operations and support, including information technology systems. Taxpayer services, including taxpayer assistance and education, are funded at \$2.2 billion, or 19 percent of the budget.

With limited resources for enforcement, the IRS relies on voluntary compliance, supported, in part, by audits and information reporting. In 2007, the IRS closed 1.3 million individual income tax audits, yielding an audit rate of slightly higher than 1 percent. For business returns (including Subchapter S and partnership returns), the audit rate was .66

percent.<sup>1</sup> Audits are supplemented by an information reporting program, which matches Forms W-2s and 1099s filed by employers and other payers of income to tax returns several months after the end of the filing season. Over 3.2 million taxpayers were contacted in 2006 due to discrepancies in income reporting, and another 1.3 million were contacted because they failed to file a return.<sup>2</sup>

One of the IRS's operating divisions oversees and examines employee plans, but its activities focus on ensuring compliance with the Internal Revenue Code provisions governing retirement plans. While the tax code also contains provisions regarding health plans, the Employee Plans Division does not have similar authority to audit health plans. Violations may be detected in examinations in the course of audits initiated by other IRS divisions, and employees can (with the assistance of the Labor Department) sue an employer if abuses are suspected.

Penalties for noncompliance can be substantial. Civil penalties are applied at a rate of 20 percent of the portion of the underpayment of tax resulting from certain types of misconduct (e.g., negligence; substantial understatement of income).<sup>3</sup> Fraud (which requires evidence of willful intent) carries penalties up to 75 percent and in some case, criminal penalties. Failure to file a return is considered a misdemeanor, carrying a fine of not more than \$25,000, imprisonment for not more than one year, or both. Penalties for violations of the tax laws governing health plans range from loss of the tax benefits for the entire plan if it contains non-health-related benefits to imposition of an excise tax if portability requirements are not met.

The IRS also dedicates resources for taxpayer education and assistance. These programs include publications, information notices, toll-free call centers, a web site, and taxpayer assistance centers. The IRS provides assistance for volunteer preparation sites for low-income and elderly taxpayers.

IRS compliance data provide some insight into the effectiveness of the current system. The gross "tax gap" is the difference between the amount of tax that taxpayers should pay under

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<sup>1</sup> [http://www.irs.gov/pub/irs-news/irs\\_enforcement\\_and\\_service\\_tables\\_fy\\_2007.pdf](http://www.irs.gov/pub/irs-news/irs_enforcement_and_service_tables_fy_2007.pdf)

<sup>2</sup> [http://www.irs.gov/pub/irs-soi/table\\_14\\_2006\\_dp.xls](http://www.irs.gov/pub/irs-soi/table_14_2006_dp.xls)

<sup>3</sup> The IRS imposed (after abatement) about 24.1 million civil penalties on individuals, totaling \$10.1 billion in FY 2006. Over half the penalties were for failure to pay. Less than 3 million civil penalties were imposed for delinquencies or fraud. [http://www.irs.gov/pub/irs-soi/table\\_17\\_2006\\_dp.xls](http://www.irs.gov/pub/irs-soi/table_17_2006_dp.xls)

the tax code and the amount they actually pay on time. In 2001, the gross tax gap was \$345 billion.<sup>4</sup> As a percentage of tax liability for tax year 2001, this represents a voluntary compliance rate of about 83.7 percent. These estimates, however, do not take into account taxes that were paid voluntarily but paid late or recoveries from IRS enforcement activities. Taking these factors into account, the “net tax gap” was an estimated \$290 billion in tax year 2001, resulting in a compliance rate of 86.3 percent.

Taxpayers incur costs complying with the tax code. The IRS relies on taxpayer’s assessing their own income tax liability, requiring individuals to learn about the tax law, obtain appropriate forms, keep records, determine their tax liability, and submit returns to the IRS. The IRS estimates that taxpayers will spend an average of 26.4 hours preparing their 2007 tax returns and \$207 on out-of-pocket expenditures (e.g., computer software, paid preparers). Costs vary, however, by the type of form used to prepare returns. (See Table 1.) In the self-assessment tax system, the most time-consuming task is record-keeping, with taxpayers spending an average of 15 hours just on record-keeping activities. These time and monetary estimates do not include costs incurred after filing a return (e.g., time spent responding to a deficiency notice from the IRS) or intangible costs, such as the anxiety taxpayers may feel in dealing with the IRS.

## II. Reaching and Identifying the Targeted Population

The decision to use the tax system to provide subsidies or to enforce a mandate must first address questions regarding the IRS’s ability to reach the targeted population. Although many individuals and employers have ongoing contact with the IRS, a significant number do not. Among those who do file, an additional number have no income tax liability and could not benefit from many types of tax benefits. Targeting raises another set of issues. Policies that recognize differences in ability-to-pay among individuals or businesses will result in targeted subsidies or exemptions from mandates. A challenge is to prevent less sympathetic entities – whether they are business or families – from reorganizing in order to claim subsidies or avoid the mandate. Another challenge is to create eligibility rules that do not discourage eligible individuals from applying for subsidies.

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<sup>4</sup> The estimates of underreporting of individual income and self-employment taxes were derived from preliminary analysis of the 2001 National Research Program (NRP). Most of the other estimates are projections derived from older compliance studies.

Reaching Non-Filers. The first challenge of implementing health reform through the tax system is reaching non-filers. An advantage of using the tax system to achieve health reform goals is that most individuals and couples already file individual tax returns. The Joint Committee on Taxation (2008) estimates that 136 million individual income tax returns will be filed in 2008.<sup>5</sup> However, 28 million tax units, headed by nondependents, do not have any reason under current law to file income tax returns. Their incomes are not above the filing thresholds, nor do they file to receive refunds of overwithheld income taxes or refundable tax credits.

*New Filing Requirements for Individuals.* For the estimated 28 million tax units who will not file tax year 2007 returns, compliance with a mandate or claiming a subsidy could impose the costs of filing a tax return. The IRS is currently urging some of these individuals (in particular, the elderly) to file a Form 1040A return in 2008 in order to obtain stimulus payments. On average, a taxpayer is expected to spend an average of 10 hours and \$72 completing the relatively simple Forms 1040A and 1040EZ.<sup>6</sup> Adding new filers to the tax system may also increase IRS administrative costs, as expenditures on taxpayer services and processing rise.

Compliance costs could be reduced if individuals, filing solely to comply with health reform provisions, did not have to complete an entire tax return. However, creating a separate short form for non-filers requires relatively simple rules. Moreover, the IRS may find it difficult to reach individuals with whom they have little, if any, contact. During the 2007 filing season, the IRS created a short form – the Form 1040-TZ – for non-filers who wanted to claim a one-time rebate for telephone excise taxes paid between 2003 and 2006. The minimum value of the rebate was \$30, increasing with the number of exemptions and the amount paid in excise taxes. The Form 1040-TZ required only the taxpayer's name, address, and social security number. No other information was necessary to claim the minimum rebate. Relative to the total number of

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<sup>5</sup> This estimate does not take into account additional returns that may be filed in order to obtain stimulus rebates. The estimate includes returns with negative adjusted gross income and dependent filers. It also does not include those who evade filing requirements. Using information from W-2s and 1099s, the IRS identified 7.9 million cases in 2005 where it appeared an individual should have filed a return but did not. With limited resources, the IRS currently follows up with less than a third of these cases (GAO, 2007).

<sup>6</sup> <http://www.irs.gov/pub/irs-pdf/i1040ez.pdf>

non-filers, utilization of the Form 1040-T was low: As of October 2007, over 700,000 Form 1040EZ-T's were filed, even though most low-income households have telephone service.<sup>7</sup>

*Share Administrative Responsibilities.* Alternatively, a strategy could be designed that recognizes and accommodates the differences between the filing and non-filing populations. Among low-income individuals, those who have earnings tend to file returns. Low-income earners file because they meet at least one of the following conditions:

- Their income is above the filing thresholds, which are roughly 80 percent of the poverty thresholds (see Table 2);
- They have more than \$400 of self-employment income;
- They must file to obtain a refund of overwithheld income taxes; or
- They are eligible to claim either the earned income tax credit (EITC) or the refundable portion of the child tax credit, both of which require earnings to qualify.

Low-income filers with earnings also tend to have little, if any, contact with agencies providing means-tested assistance (Holtzblatt and McCubbin, 2004). In contrast, nearly all legitimate non-filers are low-income individuals with little or no attachment to the work force. (See Table 3.) Many, especially the elderly and those with children, also receive social security benefits or means-tested assistance (Cilke, 1998).

Many health reform proposals would build on the current patchwork of tax benefits and transfer programs, targeting different subsidies or mandate requirements – each administered by a different agency – to specific populations. Recent Bush Administration proposals to expand eligibility for health insurance tax subsidies would not cover individuals who receive other forms of government-subsidized health insurance (e.g., Medicare and Medicaid). Massachusetts exempts individuals with incomes below the poverty level from having to comply with the

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<sup>7</sup> <http://www.irs.gov/pub/irs-soi/06tp16tb.xls>. In 2007, 95 percent of households had telephone service, and among those with incomes below \$20,000, the telephone subscription rate was about 93 percent. About 6 million households did not have telephone service. [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DOC-279997A1.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-279997A1.pdf) Utilization of the rebate was low across-the-board. Through March 23, 2007, only about 69 percent of filers claimed the excise tax rebate, while utilization among non-filers was less than 2 percent. (GAO, 2007)

From the preliminary data, it is not obvious whether low-income individuals filed the longer tax return in order to claim a larger credit or did not claim the telephone excise rebate at all – either because a \$30 credit still was not sufficient to make up for the costs of completing and submitting the form or due to lack of knowledge about the rebate.

mandate to purchase health insurance.<sup>8</sup> This patchwork approach may effectively exempt most of the non-filers from having to file a return in order to comply with a mandate or obtain subsidies, but it does not eliminate the need for close coordination between agencies to ensure that individuals do not escape the mandate or receive overlapping benefits. Still, reaching non-filers under age 65 without children would be difficult, because many may not be eligible for transfers under the current system.

A second approach would allow individuals to apply for the same subsidy or demonstrate compliance with a mandate through more than one agency. For workers, the point-of-contact could be the IRS, while low-income non-workers could choose to interact with either the Social Security Administration or state welfare agencies. Coordination between the tax and transfer systems would require the development of new information systems and ways of dealing with individuals whose status change during the year. While there is little precedent in the United States for operating a single mandate or benefit program jointly through the tax and transfer systems, other countries – most notably New Zealand – have been developing coordination systems to provide family benefits to different populations through more than one agency (Johnson, 2005).<sup>9</sup>

*Reaching Other Non-Filers.* Among employers, filing requirements vary by type of organization. Private businesses generally must file income tax returns. However, state and local governments do not file income tax returns. While tax-exempt organizations file annual forms with the IRS, the Form 990 is largely aimed at showing compliance with the rules governing their tax-exempt status. Like other employers, state and local governments and tax-exempt organizations file quarterly and annual forms reporting amounts of income and payroll taxes withheld for employees. Implementing an employer mandate or subsidies for certain types of employers could build on the withholding system or require new form and filing requirements for entities outside the income tax system.

Income Tax Liability. A second challenge of a tax-based health reform is providing assistance to individuals or firms who have little or no income tax liabilities. The tax value of

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<sup>8</sup> In 2007, Massachusetts residents are not required to file a return if their income is less than \$8,000, which is below the poverty levels for all family types.

<sup>9</sup> In 2003, roughly one-third of Family Support recipients in New Zealand received their payments entirely through the tax system, one-third through the welfare system, and one-third through both agencies at different points during the year.

deductions, exclusions, and nonrefundable tax credits is limited to the amount of a taxpayer's income tax liability. However, many low-income taxpayers do not have any income tax liability.

Income tax thresholds vary with taxpayers' characteristics and have increased over time as Congress has expanded the standard deduction, personal exemptions, and various tax credits. Prior to the enactment of the Tax Reform Act of 1986, the tax threshold hovered near the poverty line. Since then, expansions of child-related tax benefits and marriage penalty relief have increased the income tax threshold for couples with children to roughly twice the poverty level (see Figure 1). In 2007, a married couple with two children does not incur any income tax liability until their income exceeds 204 percent of poverty – up from 86 percent in 1986.<sup>10</sup>

For taxpayers without children, the tax threshold has not risen as rapidly (see Figure 1). Because childless individuals did not benefit from the expansions of the child-related tax benefits, the tax threshold continues to hover near the poverty threshold. Only the extension of a small EITC to very low-income workers without qualifying children lifted the tax threshold slightly in 1994.

Refundable tax credits are required to provide assistance to individuals or employers who do not have any income tax liabilities. Refundable tax credits are not limited by the amount of the taxpayer's income tax liability, meaning that an individual with little or no income tax liability can receive the full benefit of the credit.

Some have expressed concern that refundability encourages noncompliance. McCubbin (2001) finds that the EITC overclaim rate for claimants with income or self-employment tax liabilities was over three times higher than for those who received the entire credit as a refund, suggesting that taxpayers might be more likely to claim the EITC to avoid a tax liability than to generate a refund.<sup>11</sup>

Targeting. As automated data systems become more sophisticated and unique identifiers (e.g., the social security number in the United States) become more prevalent, universal benefits or mandate requirements that do not vary with income or the size of a family or business entity become easier to administer. But costs and equity considerations may override simplicity concerns.

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<sup>10</sup> Figure 1, and the accompanying text, assumes that income is derived solely from wages.

<sup>11</sup> McCubbin (2001) also finds that decreases in balances due have a slightly larger impact on compliance than do increases in refunds. However, she cannot reject the hypothesis that an increase in the tax refund and a decrease in the balance due have the same effect on compliance.

*Targeting Individuals.* An advantage of using the tax system to promote health reform goals is that the income tax already collects information that could be used to target needs-based subsidies or exemptions from a mandate. The individual income tax adjusts for differences in ability-to-pay based on family size, with the taxpayer receiving additional exemptions for children and other dependents. In addition, taxpayers are eligible for a standard deduction, which varies with marital status or, if unmarried, with the presence of children or other relatives in the household. The definition of income is fairly broad, although means-tested government benefits and certain interest income are exempt from taxation.

Thus, tax filers already provide information on the first page of the tax return that would be required to target benefits based on income and family status. Taxpayer-reported information is supplemented by independent information reports about many different types of income. And in the past decade, the IRS has begun using third-party data sets to systemically verify the existence, age, and to some extent, relationship and residency of children claimed for exemptions and other tax benefits.<sup>12</sup>

The information available through the tax system may make it easier to implement new policies that use income and family characteristics to distinguish among taxpayers based on ability-to-pay. Massachusetts exempts individuals from the health insurance mandate if they cannot afford insurance, with affordability depending, in part, on adjusted gross income and filing status.

Nonetheless, targeting social policy through the tax system may present a new set of targeting challenges. Massachusetts also exempts individuals from the mandate for other reasons, including “sincerely-held” religious beliefs and personal hardship. The latter includes homelessness, large medical expenses, natural disaster, or unanticipated large expenses as a result of domestic violence or the sudden responsibility for the care of an elder parent.<sup>13</sup> With

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<sup>12</sup> The IRS receives the DM-1 file from the Social Security Administration (SSA), containing the names, social security numbers, and dates of birth for all social security number holders. In addition, the IRS also receives another SSA file called Kidlink, which links the social security numbers of children and at least one of their parents. The file generally contains information only for children who received social security numbers after 1998. The IRS also has access to the Federal Case Registry of Child Support Orders.

<sup>13</sup> Hardship exemptions are also available for taxpayers who are 30 days behind in their rent or mortgage payment, have received an eviction notice, or received a shut-off notice for utilities. Death of a spouse or family member can qualify an individual for a hardship exemption. Hardship exemptions are also extended to individuals who can show that the purchase of health insurance would deprive the individual of food, shelter, clothing, or other necessities,

the possible exception of natural disasters, these criteria are invisible to the Massachusetts tax authorities and require the establishment of documentation requirements and an appeals system. Restricting eligibility for subsidies based on immigration status, which is also largely invisible to the IRS, would also be difficult to implement.<sup>14</sup>

In some instances, the tax rules defining income and family status may be at odds with health policy objectives. For example, the tax unit may not coincide with the health insurance unit. Until recently, each of the five child-related tax benefits used a different definition of child, provoking concerns about complexity and taxpayer compliance burdens (Holtzblatt and McCubbin, 2003). Since 2005, a taxpayer generally is not eligible for these benefits unless he or she lives with a child for over half the year.<sup>15</sup> Modifying the residency tests for purposes of a health subsidy could extend assistance to some noncustodial parents and other nonresident relatives who purchase health insurance for children, but it could also restore some of the complexity of pre-2005 tax law, including additional lines of instructions and reporting requirements.

Health reform proposals raise unique hurdles in defining and determining eligibility. The first hurdle is to determine whether the potentially eligible individual actually has health insurance coverage. A second hurdle may be to prevent double-dipping by individuals eligible for more than one government benefit or to confirm that someone is exempted from the mandate because of coverage in another program. A third hurdle may be to determine if the individual's health insurance coverage meets certain minimum standards. Another hurdle is presented if policymakers take preemptive actions to try to prevent erosion of employer coverage, for example by denying eligibility to those whose employers offered insurance until recently (six

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large family. There is also a "miscellaneous" category, with individuals who do not meet any of these criteria having the option of presenting their own case as to why purchasing health insurance would be a hardship.

<sup>14</sup> The IRS does not have access to immigration records. Even if the IRS had such access, the data would be difficult for the IRS to use because it generally would not contain the social security numbers of immigrants. Without the social security numbers, the IRS could not link the immigration records to tax returns. Limited information is available from another source. From Social Security Administration records, the IRS can determine if an individual was authorized to work in the United States at the time he or she initially received the social security number or subsequently updated his or her records.

<sup>15</sup> A noncustodial parent can claim certain benefits -- the dependent exemptions and child tax credits -- but only if the custodial parent waives his or her rights.

months, in the case of the Massachusetts mandate). None of this information is currently available on a national large-scale basis.

*Targeting Employers.* Similar targeting issues arise for employer mandates or subsidies. Some health reform proposals provide preferential treatment for small businesses and their employees. Subsidies may be designed to compensate the employees of small businesses for their lack of access to larger purchasing pools for health insurance. Subsidies for small businesses may also be proposed to offset the additional administrative costs incurred by employers to provide health insurance to their workers. The challenge, as with families, is defining small businesses in a manner that is consistent with both tax policy and health reform goals.

Unfortunately, there is no commonly accepted definition of small business for government programs. The Small Business Administration uses industry-specific measures, relying on either counts of employees or average annual receipts.<sup>16</sup> The IRS targets small businesses for special services and enforcement activities, using type of income (i.e., partnership, corporation) and amount of assets (\$10 million or less) to identify these taxpayers. Hawaii and Massachusetts target small businesses for preferential treatment under their health reform plans, using counts of full-time employees.<sup>17</sup>

The IRS currently does not have sufficient information to target subsidies based on the size of a business's workforce. Quarterly and annual reports on withholding taxes contain some information on the number of employees,<sup>18</sup> although these reports do not distinguish between employees based on full- or part-time status or temporary or permanent status. The counts also

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<sup>16</sup> For example, a book store is defined as a small business if it has gross receipts of \$6.5 million, while a department store is considered small with gross receipts of \$25 million. Mines are generally considered small with fewer than 500 employees. Among manufacturers, the size standard varies, ranging from 500 to 1,000 employees depending on the product. [http://www.sba.gov/idc/groups/public/documents/sba\\_homepage/serv\\_sstd\\_tablepdf.pdf](http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sstd_tablepdf.pdf)

<sup>17</sup> In Hawaii, subsidies are provided to employers with fewer than 8 employees, while Massachusetts exempts employers with 10 or fewer employees from the mandate and offers subsidies to those with 50 or fewer employees. Typically, only full-time employees are included in these counts; Massachusetts further excludes independent contractors and seasonal and temporary employees. The Hawaii employer mandate exempts individuals who work fewer than 20 hours a week, while Massachusetts counts only full-time equivalent employees – those who work at least 35 hours a week – toward the mandate. Independent contractors, seasonal employees, and temporary employees are not considered full-time employees for purposes of the Massachusetts employer mandate.

<sup>18</sup> The Form 941, which employers file quarterly reporting payments of withholding taxes, includes a box for the number of employees. Form W-2s could be matched (using the employer identification number) and aggregated for each unique employer identification number to derive counts of employees.

show the total number of employees over a period of time (a quarter or a year); thus a small firm with high turnover might appear to have many employees. Some employers may report withholding data at the establishment level, while others may report at the firm level.

There are two alternatives to basing a tax subsidy for small businesses on employee characteristics. The first is to use gross receipts, which is already collected and monitored by the IRS (even tax-exempt organizations report gross revenues on their annual reports to the IRS). The second may be to turn to other agencies to administer a subsidy or employer mandate based on employee size. In Hawaii and Massachusetts, the state agencies that administer labor laws, including minimum wage and overtime rules, also enforce employer mandates.

Confusion, Avoidance, and Evasion. Targeting can create incentives for avoidance and evasion activities. Confusion over complicated targeting rules may lead to unintentional errors. IRS studies of compliance, particularly EITC compliance, provide insight into the relationship between targeting and avoidance and noncompliance. Another challenge, then, is to design eligibility rules in a way to minimize confusion, avoidance, and evasion.

EITC errors are primarily associated with targeting criteria, particularly those for which reliable information is not readily available such as the presence of a child in the household and self-employment income. Another large source of errors is misreporting of filing (or marital) status. Many taxpayers claim to be single or head-of-household filers when they are, in fact, still legally married and required to file a joint return reporting their spouse's income. However, there is no national registry of marital status, making it difficult for the IRS to independently verify if an individual is married or single.<sup>19</sup>

Complicated eligibility rules may lead to some of the errors in reporting marital status. The tax code allows some married taxpayers to file as heads of households if they meet a three-part complicated test: they must be living apart from their spouse for the past six months of the year; they must provide over half the costs of the household in which they and their dependent child reside; and they must have lived with their dependent son or daughter for over half the year. It is possible that some well-intentioned taxpayers misunderstand these rules and mistakenly believe they qualify to file as unmarried. By filing as unmarried and omitting their estranged spouse's income, they appear to be eligible for the EITC.

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<sup>19</sup> The IRS is testing alternative means to better detect questionable claims of filing status, using either a combination of statistical methods and data from either tax records or commercial sources. (IRS, 2005; IRS, 2007).

Targeted benefits like the EITC phase out as income rises, causing marginal tax rates and marriage penalties to increase. Because the EITC phase-out thresholds for joint filers are not equal to twice the corresponding amounts as for unmarried filers, marriage penalties also occur. Marriage penalties also arise because the amount of the EITC does not increase proportionately with the number of children.

By increasing marginal tax rates and marriage penalties, phase-outs may create incentives for avoidance and evasion. Much of the empirical research finds an association between higher marginal tax rates and noncompliance (McCubbin, 1999).<sup>20</sup> Some taxpayers may avoid marriage penalties by remaining unmarried, delaying a wedding, or arranging a divorce-of-convenience.<sup>21</sup> Others may intentionally evade marriage penalties by misreporting their marital status and filing returns as single or head-of-households.<sup>22</sup>

Similarly, the design of a subsidy for health insurance or exemptions from mandates could give rise to confusion, avoidance, or evasion. A health reform proposal that provides taxpayers with a one-size-fits-all family subsidy could encourage misreporting of marital and other family characteristics for couples with more than one child. Businesses, as well as

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<sup>20</sup> The impact of marginal tax rates has been debated. Allingham and Sandmo (1972) find that the effect is ambiguous, depending on whether an income or substitution effect dominates. A higher tax rate lowers after-tax income, making taxpayers more risk-averse and thus more willing to comply. However, a higher tax rate also increases the return to noncompliance. Yitzhaki (1974) finds that if the penalty is proportional to the amount of tax evaded (as it is in the United States and Israel), then noncompliance declines as the tax rate increases (because the expected value of consumption falls). Sandmo (2005, pg. 647) notes that while Yitzhaki's finding eliminates ambiguity, it also goes against "most people's intuition about the connection between the marginal tax rate and the amount of evasion, and also against much empirical evidence." Sandmo concludes that the simple model of tax compliance may be too simple, and that the tax evasion decision should be studied in the context of a model of labor supply.

<sup>21</sup> Alm and Whittington (1995) find a small negative correlation between the aggregate marriage rate and the marriage tax. Alm and Whittington (1997a, 1997b, and 1999) find a small effect of marriage penalties on increasing the probability of delaying marriage until the following year, increasing the probability of divorce from the first marriage for women, and decreasing the probability of entering the first marriage for women. When examining how the transfer or tax system each affects the decision of marital separation and how the two effects interact, Dickert-Conlin (1999) shows that controlling for the transfer penalty increases the effect of tax penalty on marital separation. This result suggests that previous work may have underestimated the effect of the marriage tax on marital separation by not taking into account the interdependence between the tax penalty and the transfer penalty.

<sup>22</sup> While the impact of marriage penalties on misreporting filing status has not been as thoroughly investigated as its impact on marital decisions, the EITC compliance data provide some evidence that evasion occurs. When the IRS determines that an individual should have filed as married, he or she is given a choice to file as married filing separately or jointly with his or her spouse. In the tax year 1999 EITC compliance study, about \$600 million in overclaims in the tax year 1999 EITC compliance was attributable to individuals who, after detection, refiled jointly with their spouses, meaning that they could locate them and cooperate on a combined return (Holtzblatt and McCubbin, 2004).

families, may respond to tax incentives that favor one form of organization over another. Larger firms may find it advantageous to reorganize (or appear to reorganize) as smaller businesses, if subsidies are large enough to compensate for the costs of restructuring. It is possible, however, that a requirement that taxpayers must use the subsidy for health insurance may limit the type of avoidance and evasion activities observed with a more fungible tax credit, like the EITC, particularly if reporting requirements are (or appear to be) stringent.

Simplification and Participation. Participation rates for government benefit programs vary immensely. Nearly all eligible individuals claim social security benefits, while food stamp participation rates among eligible households approach 60 percent (Wolkwitz, 2007). Within the tax system, participation rates vary as well – with between 75 and 86 percent of eligible EITC claimants receiving the credit with participation rates for the health coverage tax credit appearing to be much lower (Holtzblatt and McCubbin, 2004, Dorn, 2008).

Individuals will claim subsidies when the costs of applying are less than the value of the benefits. Costs include time, out-of-pocket expenditures, and intangibles, such as the stigma that individuals may feel applying for benefits. Increasing benefits to offset the costs of applying may be an effective strategy to increase participation,<sup>23</sup> but budget constraints and other policy considerations may limit application of this approach.

Simplifying eligibility rules can not only eliminate incentives for noncompliance, but can also make it easier for eligible individuals to claim benefits. Individuals who perceived Medicaid applications as long and complicated were 1.8 times less likely to participate (Stuber, et al, 2000). Extending the periods between eligibility certification periods made it easier for households to continue receiving food stamps (Currie and Grogger, 2002). Bitler et al (2003) find that program rules that increase transaction costs of using the program – such as requiring more frequent visits to WIC office, more proof of income, and higher standards for nutritional risk – reduce participation.

Simplification also facilitates implementation of automatic enrollment programs, which some observers believe to be the most effective tool for increasing participation (Currie, 2004; Glied and Remler, 2003). Even though the elderly must pay premiums to participate, they must

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<sup>23</sup> Currie (2000) finds Medicaid enrollment among immigrant children increases with family size. Blank and Ruggles (1996) show that participation in AFDC and Food Stamps increases with the size of benefits (specifically, those likely to have relatively short spells of eligibility for benefits are less likely to participate). Scholz (1994) finds EITC participation is low among those with smaller benefits.

fill out a form in order to opt out of Medicare Part B and coverage is nearly universal. Medicaid and food stamps enrollment fell among eligible families after the enactment of welfare reform in 1996, after many AFDC recipients, who used to receive these benefits automatically, did not apply or became ineligible for TANF (Zedlewski, 1999; Ku and Garrett, 2000; Ellwood and Irwin, 2000). Participation in 401(k) plans increased when employees were automatically enrolled in a default program by their employer (Madrian and Shea, 2000). Each of these programs is characterized by extending eligibility to groups of easily-identifiable beneficiaries (Medicare recipients, welfare beneficiaries, workers in a firm offering retirement benefits).

Understanding the reasons for the success of automatic enrollment strategies may help policymakers design alternative approaches when eligibility rules are more restrictive. Automatic enrollment can reduce transactions costs by streamlining the application process. For subsidies operated through the tax system, using similar definitions to those already in tax system (e.g., the same definition of income or child) could reduce instructions and reporting requirements. Behavioral economics provide insight into other reasons for the success of automatic enrollment programs. First, individuals may procrastinate when faced with complicated choices (Madrian and Shea). Second, individuals may heavily discount the value of subsidies, when the up-front costs of applying are high and the benefits – such as those associated with health insurance – deferred until an uncertain future event (Currie, 2004). By making choices about future benefits relatively simple, automatic enrollment may increase participation. Even if automatic enrollment is not feasible, eligibility rules that recognize these concerns may facilitate participation.

### III. Verification

The tax and transfer systems offer different models for eligibility verification. At one extreme, there is the self-assessment model of the tax system, backed up by information reporting, occasional audits, and high penalties. At the other, there is the case-worker approach of the traditional welfare program, associated with in-office visits, up-front documentation requests, and phone calls to third parties to validate statements made by the applicant.<sup>24</sup>

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<sup>24</sup> For example, nearly all food stamp applicants must be interviewed in office by a caseworker. State rules vary, but applicants generally are required to bring extensive documentation in support of their claim. For example, Massachusetts required documentation of identity, residence, utility bills, bank accounts, pay stubs, dependent care expenses, unearned income, self-employment income, rental income, medical expenses, and other items.

The tax and transfer models yield very different administrative outcomes. The largest refundable tax credit administered by the IRS is the EITC. While between 75 and 86 percent of eligible taxpayers claim the credit, roughly 23 to 28 percent of EITC claims are paid in error (U.S. Treasury Department, 2008). In contrast, only about 59 percent of eligible households claim food stamps, but less than six percent of benefits are overpaid in error (Rosenbaum, 2007).

The dissimilar verification processes contribute to both the differences in participation and compliance rates. When EITC claimants whose eligibility could not be verified through third party data were asked to obtain and submit documentation showing that they met the credit's child residency requirements, compliance improved but there was also a drop-off in claims by eligible taxpayers (IRS,2005; IRS, 2007).

Another challenge, then, is how to improve compliance without causing participation to fall. Enforcing a mandate through the income tax may cause some individuals or businesses to drop out of the tax system and not file required returns. Subsidies may be costlier than intended if they are received by ineligible individuals, while their effectiveness may be hindered if those who are eligible fail to claim them. Balancing compliance and participation concerns, while keeping compliance burdens and administrative costs in check, may require the establishment of new information reporting requirements, data-sharing arrangements, and lower-cost alternatives to the traditional audit used by the tax system or the in-office interview used by welfare agencies.

Unique Identifiers. Without unique and consistent identifiers, it will be difficult to track compliance with mandates or receipt of overlapping government benefits. Unique identifiers, such as social security numbers (SSN) and employer identification numbers (EINs), provide a means by which tax returns can be linked to other data, including W-2s and other information returns.

However, privacy laws limit the use of social security numbers. The Health Insurance Portability and Accountability Act (HIPPA) requires the establishment of a national individual identifier as an alternative to the social security number for tracking health records, although no action has yet been taken by HHS. State privacy laws also restrict the use of the social security number as an identifier. California, for example, prohibits an individual's social security number from being printed on any materials that are mailed to the individual, unless state or federal law requires the social security number to be on the document to be mailed (California Department

of Consumer Affairs, 2007).<sup>25</sup> Health insurer providers are not prohibited from obtaining social security numbers, and they still use social security numbers for internal uses (e.g., verifying eligibility for government health benefits programs, transmission of electronic health care transactions, etc.). However, insurers have generally replaced social security numbers with alternative identifiers for external use (GAO, 2004).

While federal health reform would likely be able override state restrictions, state efforts may be hindered. As a result of privacy laws in California and elsewhere, the Massachusetts Department of Revenue is not requiring insurers to provide the social security numbers of policy holders and their subscribers. Instead, insurers are asked to provide subscriber numbers. This information will allow Massachusetts tax authorities to match tax returns filed by taxpayers and the information returns filed by insurers to verify a filer's claim of coverage. However, it will be difficult for Massachusetts to detect non-filers who evade the mandate because the tax authorities cannot match the information returns filed by insurers with other administrative data.

Information Returns. Information reporting from third parties is associated with lower noncompliance. The net misreporting rate is slightly above 1 percent for wage income, which is subject to both withholding and information reporting requirements. For other types of income subject to information reporting but not to withholding (such as interest and dividends), the net misreporting rate is 4.5 percent. Noncompliance rates are highest for income that is not subject to any third-party reporting requirements to the IRS. Nearly 54 percent of net income from proprietors (including farms), rents, and royalties is misreported (IRS, 2007).

The current income information reporting requirements do not appear to impose significant costs on either taxpayers or third parties. Compliance costs associated with preparing returns is highest among individuals reporting business income, who must assemble and retain their own records documenting net income. (See Table 1.) If third-party data allows the IRS to select cases for examination more efficiently, then it can also reduce post-filing compliance costs that would have been incurred by compliant taxpayers who, otherwise, would have undergone an audit. GAO examined nine firms, ranging in size from 5 to 1,000 employees, and found that the costs of existing information reporting requirements were small (GAO, November 2007).

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<sup>25</sup> Social security numbers may be included in applications and forms sent by mail, including documents sent as part of an application or enrollment process, or to establish, amend, or terminate an account, contract or policy, or to confirm the accuracy of the social security number.

New information reporting requirements would facilitate implementation of health reform. In Massachusetts, health insurance providers must send information reports (1099-HCs) to both insured individuals and the Massachusetts Department of Revenue by the end of January. The 1099-HC contains the name and identification number of the insurance company as well as the names, subscriber numbers, date of birth, and the starting and ending date of coverage for every person covered under the insurance policy. Taxpayers are required to copy the subscriber numbers to the new Schedule HC, which they attach to their tax return. When the filing season ends, the tax returns can be matched to the 1099-HCs to validate the taxpayer's claim that he or she was covered by health insurance. Massachusetts officials report cooperation from the insurance companies in developing the new reporting requirements.<sup>26</sup>

Enforcement of broader health reform proposals (including the fully-implemented Massachusetts plan) would require more information from insurance providers. Determining if the plan meets minimum standards for subsidy or mandate – or maximum standards if the exclusion is capped – would add another layer of complexity for both tax administrators and insurance providers. For both, the simplest measure would be a fixed dollar amount, which might vary with the type of coverage (single or family) but not with other individual characteristics. However, a fixed dollar cap would not recognize differences in individual circumstances (such as age, health status, or employment in a small business) that result in wide variations in the price for the same package of health benefits.

Alternatively, the subsidy or mandate could apply to health insurance providing a minimum set of benefits. If insurance was provided through the current system of employer-provided health insurance, each firm might be required to provide the IRS information on the actuarial measures of the cost of a hypothetical package of health insurance benefits for its employees. Some of this complexity could be shifted to purchasing pools under a managed competition system. With adoption of a managed competition system, it might fall to the purchasing pools to provide both taxpayers and the IRS with some sort of identifier to indicate whether a plan provides the minimum required benefits.

Data-Sharing. Data-sharing among agencies could also facilitate enforcement, at relatively low cost to taxpayers. For example, Massachusetts is able to determine if a taxpayer is

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<sup>26</sup> Conversation with Melissa Cummings-Niedzwiecki, Director of Strategy, Massachusetts Department of Revenue, December 2007.

covered through a public plan, because state agencies report this information directly to the Department of Revenue. Private insurers may receive information on participation in public programs when acting as a contractor for the Medicare Advantage or Medicaid programs.

States, however, are currently not required to provide information on enrollments in state-administered programs, such as Medicaid or S-CHIP, to the federal government. The IRS often negotiates data-sharing arrangements with individual states, but such negotiations take time and do not always yield consistent data across states. Alternatively, a federal registry could be established, building on a voluntary data system currently in place. The Public Assistance Reporting Information System (PARIS), a computer data matching and information exchange system administered by HHS, matches enrollment data from the Temporary Assistance to Needy Families (TANF), the food stamp program, and Medicaid from participating states.<sup>27</sup> While PARIS provides a springboard for a federal registry, there are still significant obstacles to overcome before it could be used for broader enforcement. First, seven states (including California) currently choose not to participate.<sup>28</sup> Second, current rules allow states to report information only once a year. Finally, some of the state-reported data can be inaccurate, including dates for Medicaid coverage (Health Systems Research, 2007).

Accelerating Matching and Other Enforcement. The compliance data cited earlier suggests that the IRS's current systems of matching information returns with tax returns is successful, despite the fact that matching often does not occur for several months after the end of the tax year. Nonetheless, there can be advantages to accelerating data matching. Accelerating the matching of income tax returns and third-party data allows early detection of errors, making it easier to locate taxpayers and prevent erroneous payments of subsidies, which otherwise might be difficult to recapture. Over the past decade, the IRS has implemented EITC pre-refund enforcement initiatives that rely on matching returns to Social Security Administration and child support records during processing.<sup>29</sup>

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<sup>27</sup> The PARIS data files include beneficiaries' (1) social security numbers; (2) names; (3) dates of births; (4) addresses; (5) case numbers; (6) public assistance benefits being received; (7) dates that benefits were received. PARIS also includes data on participation in certain federal programs, including Veterans benefits.

<sup>28</sup> Nonparticipating states include Alabama, California, Iowa, New Hampshire, North Dakota, Texas, and Vermont.

<sup>29</sup> The IRS verifies the existence and age of child dependents and EITC qualifying child by matching returns to social security records during returns processing and can take action to deny claims before payment. (Since social security records on age are considered reliable, the IRS also has the authority to deny claims with missing or invalid

There are limitations to how fast matching can be accelerated, using the conventional information returns reporting system. Massachusetts requires insurers to report insurance coverage for subscribers by the end of January (one to two months sooner than income is reported). However, the IRS would be unlikely to be able to use information more rapidly if it were reported just one month earlier at the beginning of the year, because computing capacity would still be constrained by the demands of the filing season.

An alternative strategy would be to require insurers to report changes in enrollment as they occur. Relative to an end-of-year reporting requirement, this approach would increase reporting requirements for insurers, particularly for those individuals whose coverage fluctuates during the year. However, it would also allow the development of a data system (either by IRS or perhaps another agency that could transmit the files to the IRS) that could be matched to tax returns during the filing season.<sup>30</sup>

Limit Scope of Contact. The conventional IRS audit is expensive. Although sophisticated computer programs using discriminant functions (“DIF scores”) identify a pool of questionable returns for further investigations, the remaining tasks are fairly labor-intensive. Trained examiners review the questionable returns for audit issues and select a subset for audits. The audit takes place in an IRS office, requiring a face-to-face interview between an IRS examiner, the taxpayer, and possibly his or her representative (a CPA or lawyer, for example). Every item on the tax return can be open for review in such an examination.

Correspondence audits are a lower-cost alternative to the conventional audit. In a correspondence audit, the IRS sends a letter to a taxpayer requesting additional documentation regarding questionable items on their returns. Generally, correspondence examinations are limited to a few items on the return. Prior to 1995, the IRS conducted only a few hundred

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social security numbers using expedited enforcement processes known as mathematical error procedures.) Through the social security number, the IRS is also able to link returns to other government data sets containing some information identifying the child’s parent and custody arrangements. Because these data are also available to the IRS at the beginning of the filing season, the IRS can use the information from the match to select returns for pre-refunds audits.

<sup>30</sup> Some states may determine eligibility for Medicaid on a retrospective basis. Thus, information regarding participation in some state Medicaid programs might not be complete for several months following the end of a calendar year.

thousand correspondence audits annually. In FY 2007, 78 percent of examinations of individual income tax returns will occur through correspondence.<sup>31</sup>

Correspondence audits work best where the questions raised by a tax return are relatively simple (e.g., claims of dependents, choice of filing status). They would also seem suitable for enforcing health insurance mandate and verifying claims for subsidies. However, correspondence audits can raise other concerns. Because the taxpayer is not interacting with an examiner face-to-face, misunderstandings can occur, with taxpayers failing to respond or providing the wrong information, unless the correspondence is clear (GAO, 1999).

Audits vs. Penalties. Verification of self-assessed tax liabilities through wide-spread audits or other similar interventions can be expensive for the government and those under examination. As noted earlier, the IRS, with its \$11 billion budget, currently audits roughly 1 percent of returns. An alternative approach is to combine fewer audits with larger penalties, hoping to obtain compliance indirectly through a “fear factor.” Those subject to penalties will weigh the expected probability of being caught, and if sufficiently low, will engage in tax evasion.

Allingham and Sandmo (1972) first considered tax compliance in this framework, where taxpayers are risk averse and the policymaker has three basic policy tools: the marginal tax rate, the probability of audit, and the penalty for misreporting of income. Many of the early compliance models assumed that audits were expensive, but that penalties could be imposed without cost once an error had been detected. Not surprisingly, these models typically found that, subject to a fixed budget constraint, combining high penalties with low audit rates was socially optimal (McCubbin, 2004).

However, there may be constraints on how high penalties can be set. Society may prefer that penalties bear some relationship to the severity of the crime, thus constraining how high penalties can be set (Slemrod and Yitzhaki, 1987). As penalties increase, tax evaders may take more aggressive action to avoid detection, while judges and juries may set higher thresholds for reasonable doubts in their deliberations (Andreoni, 1995). McCubbin (2004) notes that high penalties may be expensive to administer: the IRS may act more diligently to ensure that penalties are appropriately imposed, while taxpayers may be more willing to fight imposition of

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<sup>31</sup> [http://www.irs.gov/pub/irs-news/irs\\_enforcement\\_and\\_service\\_tables\\_fy\\_2007.pdf](http://www.irs.gov/pub/irs-news/irs_enforcement_and_service_tables_fy_2007.pdf)

high penalties. It also may be difficult to collect monetary penalties from liquidity-constrained taxpayers, particularly those with low and moderate incomes.

An alternative to monetary penalties is to penalize noncompliance with the loss of current or future tax benefits. A taxpayer who intentionally files an erroneous claim for a health insurance subsidy could lose claim to future subsidies for one or more future years. The loss of future subsidies may be viewed as commensurate with the crime and easier to “collect” than monetary penalties. Further, there is a precedent under current tax law. Since 1998, EITC claimants are required to provide more information when they apply for the credit (“recertify”) after having undergone an audit in a previous year. If the IRS denies a credit and determined that the taxpayer acted recklessly or intentionally disregarded the rules, the taxpayer can be denied the EITC for two years. If the IRS determines the taxpayer acted fraudulently, the credit can be denied for ten years.

Others have suggested that mandates also be enforced through loss of tax benefits, such as personal exemptions or child tax credits (Steuerle, 1994). In 2007, Massachusetts taxpayers could lose their personal exemption if they did not comply with the mandate. However, linking noncompliance with the mandate to the loss of an unrelated tax benefit, such as the personal exemption, may yield a penalty structure that will strike many as unfair. The federal personal exemption is nonrefundable and phases out as income increases. As a result, both low- and high-income taxpayers receive little or no benefit from the personal exemption, meaning that the loss of this tax benefit would largely penalize only middle-income tax taxpayers. Beginning in 2008, failure to comply with the individual mandate in Massachusetts will be subject to a penalty equal to half of the lowest cost Commonwealth Choice premium.

#### IV. Timeliness

The income tax uses an annual accounting system to measure income and tax liabilities. While individuals and businesses may pay income and payroll taxes throughout the year, their accounts are not settled until the beginning of the following year when they file annual returns. Particularly for individual workers who pay taxes through withholding, the IRS has no record of their payments throughout the year until their employers file Forms W-2s at the end of the year.

The implications of an annual accounting system are broader than bookkeeping conventions. While each year the IRS processes millions of tax returns, billions of information

returns, and billions of dollars in refunds, the institution is structured to accomplish each of those tasks once a year (Williams, 2007). IRS resources from staff to computers to buildings are currently allocated based on assumptions regarding the timing of processing of tax returns and other documents during the year.

Health reform could challenge the current accounting conventions as well as the IRS operating structure. To be effective, subsidies for health insurance may need to be paid out throughout the year, while compliance with mandates may be determined on an ongoing basis. It may be difficult for the IRS to meet some of these challenges in the immediate future, without sacrificing target-efficiency or sharing administrative responsibilities with other agencies or the private sector.

Monitoring Mandates in Real Time. In its first two years of existence, the Massachusetts health reform plan has demonstrated two different ways to administer an individual mandate through the tax system. During 2007, the first year of the mandate, individuals were required to have coverage by the end of the calendar year. With an end-of-year snapshot, no monitoring was necessary during the year. Beginning in 2008, coverage will be mandated on a monthly basis, and insurers will report on an annual basis on the Form 1099-HC the months that an individual was covered under a plan.

Monitoring a monthly mandate, in the manner as done in Massachusetts, creates new tasks for tax authorities. Additional information returns must be processed, edited, and matched to tax returns, more cases must be worked when discrepancies arise, and potentially more penalties may be imposed, giving rise to more collections activities. But even if additional resources were dedicated to these tasks, the tax authorities would not detect noncompliance with the mandate until months after the failure to obtain health coverage. Requiring timelier reporting of health insurance coverage during the year may not lead to much earlier detection of noncompliance, unless the IRS has the capacity to monitor changes throughout the year.

An alternative strategy is to enlist employers in monitoring compliance with an individual mandate, building on the existing withholding systems but passing additional administrative costs to third-parties. Employers could withhold penalties for months in which an individual refused coverage. The penalties would be aggregated and submitted as part of withholding payments, with individual reconciliation (on the Form W-2) occurring at the end of the year. Those who did not purchase health insurance through their employers could be required to file

quarterly estimated tax payments, showing compliance with the mandate on an ongoing basis. In both cases, interest charges and additional penalties could apply for failure to pay the initial penalty in a timely manner. The costs of enforcing an individual mandate, then, would be shifted to employers and taxpayers.

Paying Subsidies in Real Time. The effectiveness of a subsidy meant to encourage the purchase of health insurance may diminish if there are long lags between enrollment in a health insurance plan and its receipt. Taxpayers can reallocate spending during the year to accommodate the receipt of a future tax benefit, and there is some evidence that even low-income taxpayers adjust spending in response to an anticipated tax refund as a result of the EITC (Smeeding et al, 2001; Barrow and McGranahan, 2001; Romich and Weisner, 2001). However, a less fungible tax credit may provoke a different reaction from liquidity-constrained taxpayers, who may forgo or limit their expenditures on a specific tax-preferred item if they must wait a long time to receive the subsidy. As noted earlier, behavioral economists have found that individuals tend to procrastinate, particularly when choices are complicated and there are lags between up-front costs and future benefits. Even shorter lags may be disruptive. Under HIPPA, health insurance plans do not have to cover pre-existing conditions if there is a break in coverage of more than 63 days.

The individual income tax system has two mechanisms to accelerate tax benefits. First, taxpayers with sufficient income tax liabilities can potentially adjust withholding to receive benefits. Adjusting withholding, however, may not suffice. The withholding rules trade off precision for simplicity, and thus taxpayers with more than one job or a working spouse can find it difficult to fine-tune withholding to match annual tax liabilities. Lower-income taxpayers may have little or no income tax withholdings to adjust. A second mechanism, then, is to pay a tax credit in advance, as has been done with the EITC, HCTC, and stimulus rebates in 2001, 2003, and 2008. The United Kingdom and several other countries have also allowed recipients to claim credits in advance.

Designing an advance payment mechanism for a tax credit providing health insurance presents several challenges: first, adjusting for differences in ability-to-pay during the year; second, ensuring that advance payments are used to purchase insurance; and third, and perhaps most difficult of all, developing an administrative apparatus to both process applications for advance payments and pay out the credits during the year.

*Targeting:* Using an annual accounting system, the tax system adjusts for differences in ability to pay based on taxpayers' characteristics during the year. Providing a tax benefit in advance may require the taxpayer to estimate their annual income and family status at the end of the year. A flat credit amount, with universal eligibility, would be simpler to pay in advance, but may be too costly to implement.

Eligibility for the advance EITC is based, in large part, on future events, including the taxpayer's total annual earnings and adjusted gross income, his or her marital status on the last day of the year, and the number of months the taxpayer lived with a child. The individual applies for the advance payment by giving a form to his or her employer, but there is no validation of eligibility for the EITC until a tax return is filed at the end of the year. If a taxpayer earns more than he or she anticipated, loses custody of a child before the year is half over, or divorces at any time during the year, all or some portion of the advance payment will have to be repaid when the taxpayer files an annual tax return. Taxpayers who find themselves in that situation may choose not to file a tax return or understate the amount received in advance payments; others, fearful of large tax bills at the end of the year, may choose to forgo advance payments.

One way to reduce this uncertainty is to limit the amount of the credit that can be claimed in advance. Since 1994, taxpayers can not claim more than 60 percent of the EITC available to families with one child in advance. However, GAO (2007) recently found that only 3 percent of eligible taxpayers claim the EITC in advance. Among those who do, 40 percent of advance payments claimants did not file a tax return. About two-thirds of those who both file a tax return and had an advance payment reported on their Form W-2s also underreported or fail to report the advance payments that they received on their tax returns.

A second way to reduce the uncertainty is to allow taxpayers to estimate their eligibility for advance credits based on information known to both them and the tax authorities at the time of payment and to hold taxpayers harmless for changes in circumstances. Recently, Dorn (2007) has suggested using earnings records from state unemployment offices to verify income for advance credits.<sup>32</sup> A more common approach has been to use prior year income and family characteristics as a proxy for current circumstances.

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<sup>32</sup> Writing about the HCTC, Dorn (2007) proposes that eligibility for advance credits could be based on quarterly unemployment data, contained in the National Database of New Hires (NDNH). At this point in time, the IRS has

- The 2001 and 2003 stimulus rebates were tax credits applied to tax liabilities in 2002 and 2004, respectively, but advance payments were made automatically based on characteristics reported on prior year returns. If taxpayers were, in fact, eligible for a larger credit, they could file a return at the end of the year to receive the additional amount. However, they were held harmless for changes in status that would have caused a reduction in the credit amount.
- Eligibility for the Health Coverage Tax Credit (HCTC) depends on past economic dislocations, such as a plant closing due to foreign imports or becoming eligible for Pension Benefit Guaranty Corporation pension payments.
- Similarly, the Bush Administration proposed a refundable tax credit for health insurance in its FY 2006 budget that would have used prior year income to determine eligibility.
- In the United Kingdom, taxpayers are eligible for advance refundable Child and Work Tax Credits based on current tax year characteristics with a built-in cushion for changes in income. Currently, taxpayers can ignore changes in income under 25,000 pounds.<sup>33</sup>

Basing eligibility for advance payments on prior year characteristics eliminates much of the uncertainty and risk of claiming the credit in advance but may make other policy goals difficult to achieve. Advance payments based on prior year characteristics, combined with a hold-harmless provision, would not reflect a taxpayer's current ability-to-pay and would add to budgetary costs. Changes in income, more so than changes in marital status or number of children, appear to cause low-income taxpayers to become or lose eligibility for the EITC from year-to-year (Dowd, 2005). There is substantial variability in earnings and income from year-to-year, particularly among younger workers (Orszag, 2007).

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limited access to the NDNH for EITC enforcement only. Information from the NDNH would be timelier and, with respect to wages, more reliable than using taxpayer's self-reported amounts on their tax returns. However, the NDNH does not include information on self-employment earnings or non-labor income. There are also lags in the reporting of wage data. State agencies are required to report within four months of end of calendar year quarter, although some states are reporting quarterly wage data monthly or weekly.  
[http://www.acf.hhs.gov/programs/cse/newhire/library/ndnh/background\\_guide.pdf](http://www.acf.hhs.gov/programs/cse/newhire/library/ndnh/background_guide.pdf)

<sup>33</sup> Originally, taxpayers were required to repay overpayments if their income exceeded the prior year amount by 2,500 pounds. However, many taxpayers had to repay substantial amounts, often because of programming errors by HM Revenue and Customs. A 2005 report by the Parliamentary and Health Service Ombudsman raised concerns about the hardships resulting from the technical difficulties, and Parliament increased the threshold to 25,000 pounds in 2007.

Nor does retrospective eligibility determination resolve all timing and accuracy concerns. First, eligibility for advance payments based on prior year tax information can not be determined until tax returns are filed and processed. Some taxpayers may accelerate filing of returns in order to obtain payments, but this could create bottlenecks in processing of returns. In addition, the IRS would still not be able to verify income until information returns are processed and matched to tax returns after the end of the filing season.

While basing ability-to-pay on prior year income is rare in the United States tax system and usually associated with temporary stimulus provisions, it is not unprecedented for assistance programs outside the tax system. For example, food stamp eligibility is based on a snapshot at a point-in-time, and workers are held harmless for changes in earnings until their next certification, sometimes as long as six months later.

*Who receives the payments?* Individuals receive many of the tax benefits to which they are entitled directly. Taxpayers can deduct housing costs, medical expenses (above a limit), charitable contributions, and miscellaneous employment-related expenses from their income and receive the tax benefit directly. Employer contributions for health insurance are excluded from income, and employees' paychecks increase. Similarly, taxpayers who claim the advanced EITC see an immediate increase in their paycheck. However, with long lags between the receipt of the benefit and validation, many ineligible individuals receive the advance credit.

Another approach is to have third parties claim the tax benefit, although the taxpayer may be the ultimate beneficiary. In the United Kingdom, individuals reduce their payments to charities by the anticipated tax benefit associated with the contribution. Charities file forms with HM Revenues and Customs to collect the tax benefit resulting from the individual's contribution to their organization. Although the charity claims the tax benefit, the individual benefits by seeing his or her contribution effectively increased.<sup>34</sup>

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<sup>34</sup> Payment of a subsidy to a third-party may raise incidence concerns. In 1999, the British government considered moving to a U.S. approach for charitable contributions, whereby the taxpayer directly receives the tax benefit (e.g., the taxpayer makes the full contribution to the charity and then deducts the contribution on his or her tax return, assuming the taxpayer itemizes deductions). One theory was that the U.S. approach would encourage greater charitable giving, because taxpayers would receive the tax benefits directly. The U.S. approach was ultimately rejected, partly because charities were concerned that they would lose more in payments from HM Revenue and Customs than they would receive in increased donations. Further, HM Treasury concluded that the U.S. approach could not be adapted to a return-free system without requiring more taxpayers to file returns. HM Treasury suggested further research was needed on the impact of alternative approaches to delivering tax benefits for charitable contributions (HM Treasury, 1999).

The HCTC combines both approaches. Taxpayers can claim the HCTC on their tax return and receive its benefits directly. Or, they can claim the credit in advance, by paying a reduced premium, with the insurer collecting the remaining amount from the IRS. (In fact, the individual pays his or her share of the premium to the IRS, who adds the subsidy before transmitting the combined amount to the insurer.)

Under the current system, the IRS does not know if an individual qualifies for the HCTC until he or she has already enrolled in a health plan. Qualifying for the HCTC thus requires the taxpayer to have sufficient resources to pay the full premium amounts before becoming eligible for a subsidy.<sup>35</sup> Dorn (2008) and others have attributed low participation rate in the HCTC partly to this requirement.

Timing advance payments to coincide with the first premium payment may increase administrative costs for both insurers and the IRS. Taxpayers could apply for advance payments and receive the tax credit in the form of a voucher, which they could then submit to an insurer as payment for insurance. The insurer could then turn the voucher into the IRS for cash, reduce withholding payments by an offsetting amount, or (in the case of for-profit firms) use the voucher as a credit against the firm's taxes. This is sometimes known as a transferable tax credit. Alternatively, taxpayers could apply for insurance and provide information regarding potential eligibility for the tax credit to the insurer. The insurer would transmit this information to the IRS or another designated agency and receive (within some set period) an indicator as to whether the person was eligible for a premium subsidy.

*IRS Capability:* The EITC approach to making advance payments requires very little from the IRS during the year. Taxpayers essentially determine their own eligibility, and employers pay out the advance credit by reducing payments of withholding taxes without requiring advance approval by the IRS. However, participation and compliance are both low.

The HCTC approach, as well as the alternatives discuss above, envision a very different method of operations for the IRS. If adopted in health reform, eligibility determination and payments would be made on a recurring basis, when the IRS typically reviews returns and makes refund payments once a year. The increased workload could be quite substantial and could

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<sup>35</sup> Some states have "gap filler" programs that use DOL grants to pay 65 percent of health insurance premiums before the IRS certifies eligibility for the HCTC. In addition, the taxpayer would be able to claim the HCTC for insurance premiums paid prior to the start-up of the advance payments.

conflict with other IRS priorities, particularly during the capacity-constrained returns processing season.

After the HCTC was enacted, the IRS determined that it could not verify eligibility and make advance payments. The agency, instead, turned to an outside contractor to handle these responsibilities. The up-front costs for establishing the system were \$40 million, with current costs running at about \$16 million (or 16 percent of total program costs) for a program that covered about 45,000 individuals (28,000 taxpayers plus 17,000 family members) in 2005. Given economies of scale, the IRS estimates that tripling enrollment would increase administrative costs by 40 percent (Williams, 2007). However, it is difficult to extrapolate from the HCTC to other programs with different eligibility requirements.

Another alternative is to spread responsibilities over several agencies. President George H.W. Bush proposed transferable health insurance credits, giving taxpayers the option to obtain vouchers during the year from either the Social Security Administration or state agencies that they could then give to insurers in lieu of premiums. Similarly, the Clinton Administration proposed a pilot that would have allowed four states to choose an alternative agency (including state tax offices, welfare agencies, and unemployment compensation offices) to provide advance payments of the EITC. These proposals would have reduced IRS costs but increased costs incurred by other federal and state agencies. Neither legislative proposal was enacted, however.

## V. Conclusions

It is not difficult to envision a broader role for the tax system in helping to reform the health care system, as many health reform proposals do. However, implementing health reform through the tax system will face many challenges. Perhaps, the most difficult of these challenges is distributing subsidies through the tax system in a timely fashion.

Still, even for the simpler challenges, it may take the IRS time to identify problem areas, absorb new data, determine how best to use available information, and obtain sufficient resources and authority to tackle the problem. Verification of eligibility for subsidies or compliance with mandates may fall short of desired goals, at least in the short-term, and policymakers may need to make trade-offs between various tax and health policy goals in the interim. In the longer-term, new information and computing systems could be built, that would facilitate the flow and processing of data, eligibility determination, and payments.

Many of these issues are not unique to the tax system. Other agencies would also face challenges in implementing health reform. Another agency may be more accustomed to providing subsidies in real-time or monitoring labor laws based on characteristics of a firm's employees, but they would face other challenges, such as the lack of access to detailed income information from taxpayers and their payers.

Using the tax system to achieve health reform also challenges other goals of tax policy. With a voluntary compliance rate of 83 percent and a post-enforcement compliance rate of 86 percent, the IRS compares favorably to compliance for other federal and state mandates. A recent survey by Glied et al (2007) finds compliance rates ranging from 30 to 90 percent, with mandates covering child support at the low end and auto insurance and childhood immunizations at the higher end of this spectrum. However, the overseers for the IRS have set higher goals for the agency. The IRS Oversight Board has adopted an 86 percent voluntary compliance goal by 2009, and Senate Finance Committee Chairman Max Baucus has asked for a 90 percent voluntary compliance goal by 2017. Similarly, tax simplification and fundamental tax reform remain goals for many policymakers. Some may be concerned that using the tax system to achieve health reform could hinder these efforts.

On the other hand, challenges can create opportunities. Some of the new information systems and technologies that could be used to implement health reforms might aid in other compliance efforts, and initiatives to simplify tax-related tax benefits could serve the goals of tax reform as well.

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Table 1

## Average Taxpayer Burden for Individuals by Activity

Major Form Filed or Type of Taxpayer	Percentage of Returns	Average Time Burden (Hours)						Average Cost (Dollars)
		Total Time	Record Keeping	Tax Planning	Form Completion	Form Submission	All Other	
All taxpayers	100	26.4	15.0	4.7	3.3	0.6	2.8	207
Major Forms Filed								
1040	69	33.5	19.8	5.9	3.7	0.6	3.4	267
1040 or 1040A	31	10.4	4.2	1.8	2.5	0.5	1.4	72
Type of Taxpayer								
Non-Business	71	14.1	5.6	3.3	3.0	0.5	1.6	114
Business	29	56.9	38.4	8.0	4.2	0.7	5.7	440

Source: Internal Revenue Service, Instructions 1040, 2007, pg. 84.

Note: Business filers include taxpayers who filed a Form 1040 and one of the following schedules: Form C, C-EZ, E, or F or Form 2106 or 2106-EZ.

Table 2

## Poverty, Filing, and Income Tax Thresholds in 2007

Filing Status	Number of Child Dependents	Poverty Threshold (\$)	Filing Threshold		Tax Threshold	
			Amount (\$)	Percent of Poverty	Amount (\$)	Percent of Poverty
Single	0	10,787	8,750	81	10,416	97
Head of Household	1	14,291	11,250	79	29,275	205
Married, Filing Jointly	2	21,027	17,500	83	42,850	204

Source: Congressional Budget Office

Table 3

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**Income Tax Units with No Reported Income Tax Liability, 2007**

Units in Millions

	Filers	Non-Filers	Total
Presence of wage income or payroll tax liability			
Greater than zero	29.2	0.6	30.0
None	8.1	28.2	36.3
Total	37.5	28.8	66.3

Note: An income tax unit consists of a primary taxpayer and a spouse if married.

A dependent who files his or her own return is not included in these counts.

Estimates exclude taxpayers who fail to file a required return.

Source: Joint Committee on Taxation.

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**Figure 1**  
**Tax and Poverty Thresholds**

