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LOCATION, LOCATION, LOCATION: USING COST OF LIVING TO ACHIEVE TAX EQUITY

James M. Puckett*

ABSTRACT

All other things being equal, the federal income tax ignores whether the taxpayer lives in a relatively affordable or expensive location. This approach can lead to unfairness; moreover, special deductions for the taxpayer's actual living expenses, such as home mortgage interest and state and local taxes, do not solve the problem. Tax law scholars have generally been quick to dismiss the equity issues based on assumptions about taxpayer mobility. The existing literature would tax comparable workers equally, regardless of salary and living costs. This approach would unfairly equate differently situated workers. This Article questions the assumption of taxpayer mobility, considers the equity issues associated with failure to index the tax system properly, and assesses potential solutions.

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INTRODUCTION

All other things being equal, the federal income tax ignores whether the taxpayer lives in a relatively affordable or expensive location. This approach can lead to unfairness; moreover, special deductions for the taxpayer's actual living expenses, such as home mortgage interest and state and local taxes, do not solve the problem.¹ Tax law scholars have generally been quick to dismiss the equity issues based on assumptions about taxpayer mobility. The existing literature would tax comparable workers equally, regardless of salary and living costs. This approach would unfairly equate differently situated workers. This Article questions the assumption of taxpayer mobility, considers the equity issues associated with failure to index the tax system properly, and assesses potential solutions.

The equity issue is whether it is fair to ignore what the taxpayer can afford to purchase with the taxpayer's income in determining the taxpayer's ability to pay tax.² Two workers who earn the same salary may have different purchasing power depending on where they reside. This is because the prices of housing, food, transportation, and other living expenses vary from place to place. The federal income tax generally disregards these variations. For example, a \$50,000 salary generally bears

1. These deductions are not intended to function as local cost of living adjustments; they do, however, have that effect.

2. See J. Clifton Fleming, Jr. & Robert J. Peroni, *Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?: A Critique of the "New Paradigm" and Its Denouement*, 30 VA. TAX REV. 135, 156 (2010) (describing "ability-to-pay" as the "most important" among an "array of widely accepted tax policy criteria").

the same federal income tax burden in affordable Mississippi as in unaffordable Manhattan. Residents of high-cost areas have claimed that their incomes are subjected to higher tax rates too quickly given their cost of living.³

The idea that ability to pay should take the taxpayer's purchasing power into account has somewhat carelessly percolated into the federal income tax system. Inflation adjustments increase the standard deduction,⁴ personal exemption,⁵ and the tax brackets⁶ to reflect purchasing power. Such adjustments prevent year-to-year increases in income from pushing a taxpayer into a higher tax bracket, if the taxpayer's purchasing power has not changed. Inflation adjustments are not, however, systematically applied throughout the tax system.⁷ Moreover, despite the recognized importance of purchasing power to ability to pay, the tax system generally has not extended the linkage to take into account differences in purchasing power that depend on where—as opposed to when—the taxpayer earns income.

Professors Kaplow, Knoll, and Griffith examine the inefficiency of the tax system's treatment of local cost of living differences, but their analysis essentially assumes that the inefficiency of the system eliminates any potential inequity.⁸ This literature assumes a highly mobile workforce such that the utility of comparable workers will be equal regardless of where workers are located; moreover, the literature assumes local cost of living adjustments to the tax system would simply lead to migration and wage and price changes.⁹ That is why the existing literature would tax comparable workers equally; under the literature's assumptions, to attempt to do otherwise would be ineffective and inefficient in the long run.

3. See Paul Sullivan, *Tax Burdens Tilt Coastal, and System's Fairness Is Debated*, N.Y. TIMES, Nov. 12, 2011, at B5 (“The system is not totally fair, but I guess the question is, who is it most unfair to?” said Mark Luscombe, principal federal tax analyst for CCH ‘It’s most unfair to the New Yorker, and no one has much sympathy for the New Yorker.’”); Charles E. Schumer, *Bay Ridge Is Not Biloxi*, NEWSDAY (New York), Oct. 11, 1993, at 40; David A. Levy, *Index Federal Income Taxes*, NEWSDAY (New York), Apr. 2, 1993, at 66; see also H.R. 1943, 111th Cong. (2009) (bill to index brackets for regional differences in cost of living).

4. I.R.C. § 63(c)(4).

5. I.R.C. § 151(d)(4).

6. I.R.C. § 1(f).

7. A complete examination of the intersection of inflation with the tax system is beyond the scope of this Article. Moreover, unless otherwise noted, references herein to variations in purchasing power or living costs mean differences from place to place, not differences over time. It is worth noting, however, that the tax system does not consistently account for inflation. For example, the basis of property is not indexed for inflation, nor is the principal of debt. For additional discussion, see INFLATION AND THE INCOME TAX (Henry J. Aaron ed., 1976); John T. Plecnik, *Abolish the Inflation Tax on the Poor & Middle Class*, 29 QUINNIPIAC L. REV. 925 (2011); Reed Shuldiner, *Indexing the Tax Code*, 48 TAX L. REV. 537 (1993).

8. See Louis Kaplow, *Regional Cost-of-Living Adjustments in Tax/Transfer Schemes*, 51 TAX L. REV. 175, 178 (1996); Michael S. Knoll & Thomas D. Griffith, *Taxing Sunny Days: Adjusting Taxes for Regional Living Costs and Amenities*, 116 HARV. L. REV. 987, 1018 (2003).

9. See *infra* Part II.A.

This Article rethinks the literature's assumptions about mobility. There is good reason to believe that significant frictions impede mobility.¹⁰ These frictions include location-specific ties, limitations on information, cognitive limitations, cognitive biases, and moving costs. Thus, many workers are effectively stranded, at least to some degree, in a particular location, even if better opportunities exist elsewhere. Accordingly, this Article argues that it is unfair to ignore local cost of living differences, particularly at relatively low incomes.

This Article proceeds in three parts. First, Part I argues that local cost of living should be a factor in the determination of a taxpayer's ability to pay tax. In Part II, this Article reviews the prior literature that examines how the federal income tax should account for local cost of living differences. Finally, in Part III, this Article assesses potential methods for implementation of local cost of living adjustments. This Article concludes that tax relief targeted to low-income taxpayers in high-cost areas, such as adjustments to the standard deduction and Earned Income Tax Credit, would be most defensible and appropriate.

I. ABILITY TO PAY TAX, PROGRESSIVITY, AND LOCAL COST OF LIVING

This Part argues that the cost of living structure where the taxpayer resides should be a factor in the implementation of a progressive income tax based on ability to pay. After laying out the case for local cost of living adjustments, this Part acknowledges objections and in response suggests a targeted approach.

A. *Progressivity Should Take into Account the Local Cost Structure*

The normative income tax base includes consumption plus changes in wealth during the taxable year.¹¹ As implemented, taxable income is subject to tax brackets with rates currently ranging from 0% at low incomes (counting the standard deduction and personal exemption together as a zero-rate bracket) to 35% at the highest incomes. The application of higher tax rates at higher incomes is known as progressivity.

The progressive rate structure is grounded in the fundamental tax fairness norm that the tax burden should be "allocated among resident taxpayers in relation to their taxpaying capacities, often referred to as the principle of ability-to-pay."¹² The norm of ability to pay is fairly well

10. See *infra* Part II.B.

11. Fleming & Peroni, *supra* note 2, at 144 n.36.

12. *Id.* at 156 (describing ability to pay as the "most important" among an "array of widely accepted tax policy criteria").

accepted; what is more problematic is identifying the precise rationales for ability to pay and progressivity.¹³ Blum and Kalven's classic article on the topic describes the case for progressivity as "stubborn but uneasy."¹⁴

Several potential justifications for progressivity exist. Utilitarians justify higher marginal rates at higher incomes on the assumption that utility diminishes faster than income rises.¹⁵ Losing a dollar, so the argument goes, feels less bad to the wealthy than to the poor. Others have rejected interpersonal comparisons of utility as the basis for progressivity.¹⁶ Yet another potential justification is that benefits received from the government increase faster than income.¹⁷ This could be true if, for example, expensive public goods such as national defense, highways, education, and the like are particularly beneficial to the wealthy.¹⁸ Another rationale is that income is distributed unfairly and the tax system should attempt to redistribute it to those with less resources.¹⁹ Rather than a direct and reliable product of merit and hard work, income may be a result of luck, social conditions, talent, and other factors.²⁰

Of these potential theories, redistribution aimed to reduce inequality seems more coherently to justify progressivity.²¹ As Professor Lawsky has argued, utilitarian theories of progressivity may implicitly assign value to equality or measure utility normatively, and may not aggregate taxpayers' subjective utility.²² Contrary to traditional assumptions of declining marginal utility, there is empirical evidence that the marginal utility of

13. See MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 30 (4th ed. 2002); LAURIE L. MALMAN, LINDA F. SUGIN, LEWIS D. SOLOMON & JEROME M. HESCH, *THE INDIVIDUAL INCOME TAX BASE: CASES, PROBLEMS AND POLICIES IN FEDERAL TAXATION* 12–13 (2002); Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417, 519–20 (1952); James M. Puckett, *Rethinking Tax Priorities: Marriage Neutrality, Children, and Contemporary Families*, 78 U. CIN. L. REV. 1409, 1417 (2010).

14. Blum & Kalven, *supra* note 13, at 519–20.

15. GRAETZ & SCHENK, *supra* note 13, at 30.

16. *Id.* ("This argument is criticized on the ground that the importance of particular preferences to individual taxpayers cannot be measured objectively. Indeed, there is little reason to assume that the progressive rate schedule is systematically related to the declining marginal utility of income.").

17. *Id.*

18. *Id.*

19. *Id.* at 32.

20. *Id.* at 33 ("The case for progressive taxation thus becomes far easier when one rejects the strong presumption that the market distribution of income and wealth is necessarily linked to fairness or freedom.").

21. See Blum & Kalven, *supra* note 13, at 519–20; Michael A. Livingston, *Blum and Kalven at 50: Progressive Taxation, "Globalization," and the New Millennium*, 4 FLA. TAX REV. 731, 745–46 (2000) ("The alternate arguments—diminishing marginal utility of money, the benefit theory and the breakup of large concentrations of wealth—were dubious even in Blum and Kalven's day, and intermediate developments have if anything weakened these further. . . . There is no escaping the redistributive or fairness issue.").

22. See Sarah B. Lawsky, *On the Edge: Declining Marginal Utility and Tax Policy*, 95 MINN. L. REV. 904, 914 (2011).

money actually increases at some ranges of income.²³ The explanation may be that there are differing socioeconomic levels within which increases in income are relatively insignificant, while climbing from one class to another—for example, from poor to middle class or from middle class to wealthy—is more meaningful.²⁴

As Professor Lawsky notes, “A welfarist who does not explicitly incorporate equality into his analysis (that is, a nonegalitarian welfarist) and assumes that all individuals have . . . utility curves [that] are convex for some range of income[] will recommend a tax system that is quite different than the current progressive, redistributive system.”²⁵ This is because such a welfarist “maximizes utility by summing individuals’ utility, giving equal weight to each individual.”²⁶ The non-egalitarian welfarist, therefore, “always wants to take a dollar from someone with lower marginal utility and give that dollar to someone with higher marginal utility.”²⁷ However, a welfarist can accommodate this notion by incorporating the importance of equality into her social welfare function or by acknowledging that utility is normative rather than subjective.²⁸ Once this move is made, utilitarian justifications for progressivity and egalitarian justifications tend to converge and lead to the same questions concerning fundamental fairness.²⁹

A comparison of incomes does not provide a complete picture of inequality when local cost of living structures differ. A taxpayer in a low-cost location may be wealthier at a lower income than a taxpayer in a high-cost location with a higher income. Framing wealth in this way implicitly values certain forms of wealth higher than others. Basic needs such as food, housing, and transportation are important. This should not be undercut because some taxpayers in high-cost locations have better access to a warm, sunny climate or other local amenities.

One might object that adjusting the taxpayer’s tax on account of high local cost of living is effectively a personal deduction. But that is how the progressive rate structure already works. Low-rate brackets can be reformulated as applying the highest rate to a base adjusted downward by

23. *Id.* at 929–39.

24. *Id.* at 935–36.

25. *Id.* at 940.

26. *Id.*

27. *Id.*

28. *Id.* at 950.

29. *Id.* at 951 (“But the conversations that she has will change. She can no longer refuse to discuss moral commitments, because she has acknowledged that her assumption of declining marginal utility of income is a moral commitment. Her results are not incontrovertible or unassailable; rather, they are open to challenges from those with different moral commitments. . . . And these are conversations worth having.”) (internal citations omitted).

deductions.³⁰ These unstated deductions are not in respect of any profit-seeking expense but rather are grounded in norms of distributive justice underlying progressivity. An egalitarian vision of progressivity treats certain personal expenditures—the most basic ones—better than others by imposing lower rates at lower incomes. The tax system should take into account purchasing power at a particular location in determining what level of income affords basic, and then more and more luxurious, standards of living.

B. Objections to Factoring Local Cost of Living into Progressivity

In a brief “Point–Counterpoint” forum, several tax scholars argue that local cost of living adjustments would be unfair.³¹ Professors Angelini and Noga conclude in a “Point” piece that eliminating personal deductions would improve the equity of the tax system because taxpayers with the same income should pay the same tax, even if local costs differ.³² Two pieces labeled “Counterpoints” seem to agree with the “Point” but frame it even more forcefully. Professor Johnson argues that “[y]ou get . . . what you pay for” on the market and “[i]f people are getting full value for their higher costs, it would be inequitable to filter that out of the tax system.”³³ Professor Dodge agrees that a “high cost must be worth it,” and likens high housing costs to excess consumption of “food, alcohol, drugs, or gambling.”³⁴

Alternatively, both Professors Johnson and Dodge appear to characterize living in a high-cost area as a choice that should not be subsidized, because taxpayers may move to a less expensive place. As Johnson explains, it is impossible to “avoid inflation by moving around in time, whereas you can avoid a high cost of living or adjust your costs to

30. To see how progressive rates function as a base modification, consider the following example. Rates below the highest rate in the rate schedule can be reformulated as a single high effective rate applied to a lower income. For example, a simple two-bracket tax system might provide that taxable income up to \$100 is taxed at a 20% rate, while the excess of income over \$100 is taxed at a 40% rate. An equivalent, but less obvious, way to express this concept is the tax equals 40% of an adjusted taxable income, where 50% of taxable income up to \$100 is excluded. For example, \$120 of income results in a tax of \$28 under either structure. The sum of \$100 taxed at 20% and \$20 taxed at 40% is a \$28 tax. Equivalently, 40% times an adjusted income of \$70 yields a \$28 tax. The \$70 adjusted income reflects a deduction of \$50 (50% of \$100) being taken from \$120.

31. *Point & Counterpoint, Equity, Cost of Living, and the Internal Revenue Code*, 24 A.B.A. SEC. TAX'N NEWSQUARTERLY 1 (Summer 2009).

32. James P. Angelini & Tracy Noga, *Improving the Equity of the Federal Income Tax*, 24 A.B.A. SEC. TAX'N NEWSQUARTERLY 1 (Summer 2009).

33. Calvin H. Johnson, *The Inequities in Cost of Living Adjustments*, 24 A.B.A. SEC. TAX'N NEWSQUARTERLY 24 (Summer 2009).

34. Joseph Dodge, *The Inequities in Cost of Living Adjustments*, 24 A.B.A. SEC. TAX'N NEWSQUARTERLY 26 (Summer 2009).

your preferences by moving around geographically.”³⁵ Similarly, Dodge asserts that “[n]o person is compelled to live in the Bay area or prohibited from moving to a low-cost area (say, Cleveland).”³⁶

C. A Response to the Critics: Limit Adjustments to Low-Income Taxpayers

In sum, scholars have raised two equity objections to adjusting the federal income tax for local cost of living differences. First, the taxpayer is implicitly paying for local amenities when the taxpayer pays for living costs. Second, taxpayers may relocate if they do not sufficiently value the local amenities.

1. Amenities and Externalities

If it is agreed that purchasing power matters in constructing ability to pay tax, then equating taxpayers with different purchasing power, because they arguably have different access to consumer amenities, amounts to taxing utility or deducting disutility. This is a selective foray into taxing imputed income. The enjoyment of amenities such as sunshine and consumer variety does not allow a taxpayer to pay expenses, unlike compensation. The tax system has generally ignored pleasure in assigning tax liability. Taxpayers do not, for example, recognize income upon reading books or walking around the park. Nor does the tax system allow deductions for unhappiness or stress, even if it is directly related to the taxpayer’s employment. It is certainly true that the tax system has generally used nominal dollar amounts as a proxy for ability to pay. This is, to be sure, convenient and easily administrable. Inflation adjustments, however, imply that the purchasing power of the income is important, even though looking beyond nominal amounts may be more complicated. Inflation adjustments are not barred simply because different goods or different qualities of goods are being offered in later years.

Moreover, some living costs have little to do with personal enjoyment. Living costs theoretically comprise two components: production amenities, which are valued by businesses, and consumption amenities, which are valued by consumers. Compensation may, therefore, *partially* adjust for production amenities.³⁷ A skilled worker pursuing a high paying job, which is fundamentally a productive endeavor, cannot opt out of the weather or the local culture.

35. Johnson, *supra* note 33, at 25.

36. Dodge, *supra* note 34, at 26.

37. See Katie Fitzpatrick & Jeffrey P. Thompson, *The Interaction of Metropolitan Cost-of-Living and the Federal Earned Income Tax Credit: One Size Fits All?*, 63 NAT’L TAX J. 419, 422 (2010) (showing limited association between wages and cost of living).

Might these amenities overlap? As Professor Edward Glaeser explains, despite “pundits . . . predicting that new forms of communication would make urban life irrelevant,” technology has not rendered proximity irrelevant.³⁸ Indeed, a “wealth of research confirms the importance of face-to-face contact.”³⁹ This productive face-to-face contact has been fueled by cities being “reinvigorated as places of consumption, through restaurants, theaters, comedy clubs, bars, and the pleasures of proximity.”⁴⁰ If skilled workers are more productive in close proximity to one another, and people are drawn close to one another because cities are “urban theme parks,”⁴¹ are the consumption amenities not also productive?⁴²

It would be unfair and incomplete to give residents of low cost areas a free pass in this analysis. Even if residents of low-cost areas sacrifice pleasure for purchasing power, they should be taxed on their purchasing power.⁴³ There does not, however, appear to be such a sacrifice; residents of low-cost areas often appear to be happier than residents of high-cost areas.⁴⁴ In addition, it is quite possible that residents of low-cost areas are getting *more* than what they pay for, because many low-cost locations are low-density. Low-density locations may have substantial environmental externalities.⁴⁵

2. *Limitations on Mobility*

Particularly at low incomes, moving or staying in place may not be a completely voluntary decision. It is true that migration is possible, and many people move even under financial distress, but there are important challenges. Moving may involve significant fixed costs relative to the means of a person who subsists paycheck-to-paycheck. Assuming she has the money, how will a poor Bay Area resident predict her job opportunities in Cleveland? What if she manages to move but does not actually secure the job of her dreams, or she misjudges the local cost structure? It seems unlikely that the government will assist much if a move fails but will

38. See EDWARD GLAESER, TRIUMPH OF THE CITY 36 (2011).

39. *Id.* at 34.

40. *Id.* at 11.

41. *Id.*

42. The standard analysis is that an amenity is “productive” if a business compensates a worker for the cost of the amenity. However, compensation may not prove much about the nature of the amenities, because compensation depends on bargaining power and other factors. See Martha T. McCluskey, *Efficiency and Social Citizenship: Challenging the Neoliberal Attack on the Welfare State*, 78 IND. L.J. 783, 809 (2003) (“[T]he incentive effects neoliberalism calls ‘moral hazard’ boil down to questions of relative bargaining power. As one party to a transaction gets more bargaining power in relation to another, that party is better able to shift the costs of the transaction to the other party.”).

43. This is precisely what happens if a taxpayer earns money but would prefer leisure to work.

44. See *infra* text accompanying notes 112–115.

45. See GLAESER, *supra* note 38, at 217–22.

charge her with the ability to move successfully if she does not. Family and social connections at home may make child care more affordable and may help with sharing other costs, such as housing or transportation.

Even at higher incomes, relocation presents a risk. Perhaps the costs of conducting a move are less significant as income increases (or more likely to be borne by a new employer), but the issue of predicting happiness at a potential new home remains. How does the taxpayer confidently predict how a new social environment will work for her; how she will react to a different climate; how she will feel about being away from family and old friends; intangible aspects of a new job; and myriad other factors? If a whole family has to move, informational issues (predicting employment, happiness, or both, at the new location) multiply.⁴⁶

Divorce and child custody significantly impact labor mobility and the reasonableness of assessing fault against the taxpayer for not moving. For example, a joint custody agreement might require the parents to reside within a set geographic distance from the former spouse, on pain of losing joint custody rights. Visitation rights might also be contingent on geographic proximity. Given that many marriages end in divorce, the mobility problems associated with maintaining parental rights are far from merely theoretical. A parent might well choose to abjure better job prospects and opportunities for professional advancement in order to play an active parenting role. Moreover, the value of parenting is incommensurable; it is not realistic to affix a mathematical value on parenting and presume that, if a job in a distant market meets or exceeds the value of a divorced parent maintaining a relationship with a child, he or she will or should trade his or her parenting relationship for enhanced professional opportunities.⁴⁷

It is easy to assume, for purposes of analytical clarity, that people will move with the winds of economic opportunity, but in the real world, people find themselves, if not literally tied to the land, at least tied to each other in ways that significantly complicate worker mobility. Notwithstanding these concerns, one might balk at the idea of a potential subsidy for consumer

46. Fortunately and unfortunately, there is no omniscient Navigator to guide workers in this decision making process. See Shari Perkins, *The Navigator*, THEATER ONLINE <http://www.theateronline.com/reviewshow.xzc?PK=37284> (last visited Feb. 21, 2012) (“In a time of widespread unemployment, gut-wrenching debt, rampant home foreclosures, and families fracturing under the pressure of a financial crunch the like of which Americans have not experienced since the 1930s, it is easy to feel powerless and paralyzed. What if we could know what the right choice is at the each and every intersection in our lives? . . . This is the fantasy that Eddie Antar’s new play *The Navigator* explores . . .”).

47. See generally Martha Albertson Fineman, *Contract and Care*, 76 CHI.-KENT L. REV. 1403 (2001) (arguing that certain forms of dependency, such as childhood, disability, and old age are universal, and that society should support caregiving). A child might assume significant caregiving duties with respect to an elderly parent, for example, which might also significantly impact potential mobility.

amenities in high-cost areas. Past some income threshold, it may be more reasonable to assume that the taxpayer is simply paying for consumer amenities. This approach has the virtue of simplicity and would prevent abuse or the appearance of abuse. There is a risk to taxpayer morale of an unfair subsidy, or even the appearance of an unfair subsidy.⁴⁸ This risk presumably increases as taxpayers at higher income levels receive benefits. Taxpayers in or near poverty by local standards should receive a local cost of living adjustment, but whether the adjustment should extend beyond that income level is far more debatable.

In addition, local cost of living adjustments are less defensible as income rises because of departures in the statutory tax base from the normative tax base. Typically, for higher-income taxpayers, the tax base becomes decoupled from ability to pay, due to numerous statutory and non-statutory exclusions from income.⁴⁹ The realization rule⁵⁰ generally means that changes in wealth are not taken into account until a sale, exchange, disposition, or some other clear accession to wealth, as opposed to immediately upon appreciation.⁵¹ Gifts and inheritances are excluded from income.⁵² Long-term capital gains are generally taxed at a much lower rate than ordinary income.⁵³ These and other preferences result in a much less predictable effective rate of tax for wealthy taxpayers. As taxable income becomes a more imperfect proxy for ability to pay, it is less coherent to adjust for local cost of living.

II. REVIEW OF PRIOR LITERATURE

This Part first reviews the existing literature that examines how the federal income tax system should account for local cost of living differences; it then discusses why a different approach should be used.

48. See Sullivan, *supra* note 3 (“Or as Joseph J. Thorndike, the director of the tax history project at Tax Analysts, said, any regional adjustment ‘might as well be called the Bicoastal Elite Tax Relief Act.’ He added, ‘It would shower all these benefits on Palo Alto and New York City, and the rest of the country would be outraged.’”)

49. See Beverly Moran, *Wealth Redistribution and the Income Tax*, 53 HOW. L.J. 319, 322–26 (2010).

50. See I.R.C. § 1001(a); GRAETZ & SCHENK, *supra* note 13, at 154–55 (explaining the realization rule).

51. The realization rule has been rationalized as an administrative necessity, but the administrative difficulties of mark-to-market taxation may be overstated. See David Elkins, *The Myth of Realization: Mark-to-Market Taxation of Publicly-Traded Securities*, 10 FLA. TAX REV. 375 (2010); David M. Schizer, *Realization as Subsidy*, 73 N.Y.U. L. REV. 1549 (1998); David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986).

52. See I.R.C. § 102(a).

53. See I.R.C. § 1(h).

A. Summary of Prior Literature

To my knowledge, there are only two law review articles examining whether the federal income tax should be adjusted for local cost of living variations.⁵⁴ As discussed in this Part, both articles assume that there is no inequity in failing to adjust for local cost of living, because migration equalizes living standards across the country. Nevertheless, both articles argue that the tax system should tax comparable workers equally, to remove the tax disincentive on living and working in relatively productive locations. From an equity standpoint, however, their approach would unfairly equate differently situated workers.

1. Kaplow

In the seminal law review article examining local cost of living adjustments in the tax system, Professor Kaplow generally assumes that standards of living will be equalized from location to location through migration.⁵⁵ This is premised on workers' decisions maximizing their well-being.⁵⁶ Accordingly, if one location has relatively high pay in relation to cost of living, workers will move to that area, wages will move down in response to the increased supply of labor, and prices will move up in response to the increased demand.⁵⁷ In contrast, if one location has relatively low pay in relation to cost of living, workers will leave that area, wages will move up in response to the reduced supply of labor, and prices will fall in response to the reduced demand.⁵⁸ Thus, in equilibrium, workers will be indifferent among locations.⁵⁹

Building on the assumption that in equilibrium workers will be indifferent as to their location, Kaplow considers how the tax system should be adjusted to preserve the allocation of workers among locations that would be obtained in a no-tax world.⁶⁰ As he conceives of it, this is not an equity-based approach because migration would nullify any tax inequity among locations; rather, the goal is to avoid tax-induced migration.⁶¹ In other words, the assumption is that if taxes are too high in a location, workers will migrate to a low-tax location, which will cause wages to rise

54. See Kaplow, *supra* note 8; Knoll & Griffith, *supra* note 8.

55. Kaplow, *supra* note 8, at 178.

56. *Id.*

57. *Id.* at 179.

58. *Id.*

59. *Id.*

60. *Id.* at 180.

61. *Id.* ("This may appear to be a horizontal equity norm, but I do not posit any such normative significance to this benchmark.")

and living costs to fall in the high-tax location.⁶² Similarly, migration would cause wages to fall and living costs to rise in the low-tax location to which workers migrate.⁶³ Essentially, such market adjustments would move opposite any apparent tax inequity and nullify it. In this view, there is no tax inequity among locations, but tax-induced migration has been inefficient because it has resulted in an allocation of labor different from the one that would have been achieved in a world without taxes.⁶⁴

Kaplow envisions—but because of administrability concerns does not quite propose—local cost of living adjustments that would cause the tax system to impose the same reduction in purchasing power on individuals with the same pre-tax utility so that they would have equal post-tax utility.⁶⁵ The goal of maintaining equal utility between two given workers in different locations both pre- and post-tax is to eliminate any incentive for migration to achieve better results.⁶⁶ If the two workers who are as well-off as each other before tax remain equally well-off as one another after the tax is imposed, they would have no tax incentives to migrate, but if the tax imposes different reductions in purchasing power on the two workers, they will no longer be as well-off as each other and will have incentives to migrate.⁶⁷

Kaplow's system would not adjust for the cost of consumption amenities, because a taxpayer's well-being or utility includes both wages and the taxpayer's enjoyment of local amenities.⁶⁸ In "assessing economic well-being, there is no systematic difference between" a high-cost location with better climate and a low-cost location with worse climate.⁶⁹ Kaplow assumes that in a world without taxes, equilibrium would be reached taking into account amenities, resulting in greater demand for locations with amenities and higher prices in such locations.⁷⁰ Therefore, if a local cost of living adjustment purports to lower the tax burden in amenity-rich locations by adjusting taxes downward for the high cost of living, tax-induced migration will simply bid prices up even further, nullifying the apparent tax benefit.⁷¹ Ultimately, a tax adjustment for local cost of living due to amenities would not alter workers' well-being, but would result in an inefficient allocation across regions.⁷²

62. *Id.* at 179.

63. *Id.*

64. *Id.* at 183–84.

65. *Id.* at 183, 194–95.

66. *Id.*

67. *Id.*

68. *Id.* at 190.

69. *Id.*

70. *Id.* at 191.

71. *Id.* at 191 n.43.

72. *Id.*

As Kaplow demonstrates, in a flat tax with no exemptions, the tax system essentially adjusts automatically without local cost of living adjustments. As an example, assume a worker in high-cost location H is as well-off with a \$25,000 income as a worker in low-cost location L with a \$20,000 income.⁷³ In other words, the cost of living in H is 1.25 times the cost of living in L. This example assumes there are no differences in amenities; implicitly, then, the cost of living in H must be due to production amenities. Subjecting both workers' incomes to a 10% tax results in a tax liability of \$2,500 for the worker in H and a tax liability of \$2,000 for the worker in L.⁷⁴ These amounts, although nominally different, have the same purchasing power in their respective locations. Thus, both workers are still equally well-off after taxes.

Kaplow does not state how a flat tax should be adjusted if there are differences in consumption amenities. Kaplow's logic—equal tax for taxpayers with equal utility—seems to require income to be increased for local consumption amenities and decreased for local consumption disamenities. Otherwise, there would be a tax incentive to move to regions that compensate for low salaries with high amenities. Presumably, this would be accomplished indirectly, by adjusting salary by a relative salary multiplier.⁷⁵

Kaplow explains why a tax system with multiple tax rate brackets is inefficient without adjustment for local cost of living differences. The adjustment can be accomplished by adjusting incomes or tax brackets.⁷⁶ Assume, as before, that the cost of living in H is 1.25 times the cost of living in L.⁷⁷ If, for example, income up to \$10,000 is untaxed in L, H's 0% bracket should extend to \$12,500. Also assume, as before, that a worker in L earns \$20,000 and a worker in H earns \$25,000. On these assumptions, the taxpayer in L would pay \$1,000 in tax, while the taxpayer in H would pay \$1,250 in tax. These are locally equivalent reductions in purchasing power so the taxpayers remain equally well-off after tax. Kaplow shows that an equivalent method is to adjust income in H (\$25,000) down to its equivalent in L (\$20,000), apply the tax rates to the adjusted income (yielding \$1,000 in tax), then convert the tentative tax into an amount that carries equivalent purchasing power in H (\$1,250).⁷⁸

In contrast to his overarching goal of preserving the allocation in a world without taxes, Kaplow concludes that migration of the poor from high-cost to low-cost areas would be efficient. As Kaplow explains,

73. *Id.* at 182.

74. *Id.*

75. *Id.* at 194–95.

76. *Id.* at 187.

77. *See id.* at 183 n.18.

78. *Id.*

“Taking the extreme case, it is more efficient for those who do not work and just receive welfare payments to live in low-cost rather than high-cost areas, for then they can be maintained at the same standard of living at a lower cost to the government.”⁷⁹ Because dollars go further in low-cost areas, lower nominal amounts in low-cost areas can be more generous than higher nominal amounts in high-cost areas. Kaplow assumes that if benefits are somewhat more generous in low-cost areas, the poor would move.⁸⁰

2. *Knoll and Griffith*

Professors Knoll and Griffith make a similar argument for local cost of living adjustments in the tax system. Like Kaplow, Knoll and Griffith assume migration will equalize living standards among locations and eliminate tax inequity. As they put it, “fairness arguments—either for or against adjusting the tax burden to account for differences in regional living costs—are uneasy at best because competition from interregional migration tends to eliminate differences in living standards for individuals with similar skills and drive.”⁸¹ However, Knoll and Griffith reject the allocation of workers in a world without taxes as the benchmark by which tax adjustments should be judged. Knoll and Griffith argue that such allocation fails to maximize social benefits.

In their view, “[i]nterregional efficiency requires that total social benefits are equal when private benefits are equal.”⁸² The premise behind this conclusion is that “the purchasing power of a dollar of after-tax income is in proportion to the cost of living in the region where it was earned, while the purchasing power of a dollar of tax revenue is independent of the cost of living in the region where it was raised.”⁸³ Location-independent uses of revenue include “generating national public goods, such as foreign aid, national defense, public parks, or the Washington bureaucracy.”⁸⁴ Accordingly, Knoll and Griffith propose indexing even under a flat tax.⁸⁵

Knoll and Griffith would impose higher tax rates in low cost areas and lower tax rates in high-cost areas in order to increase tax revenue.⁸⁶ It is assumed that consumption amenities are equal so the difference in local cost of living must come from differences in local production amenities. Assuming workers are indifferent before these new taxes are imposed, this

79. *Id.* at 187.

80. *Id.*

81. Knoll & Griffith, *supra* note 8, at 988.

82. *Id.* at 1000.

83. *Id.*

84. *Id.* at 995.

85. *Id.* at 1000.

86. *Id.* at 1002–04.

is expected to induce migration to high-cost, high-productivity areas—where pay and tax revenue will be higher—and away from low-cost, low-productivity areas—where pay and tax revenue will be lower.⁸⁷ Pay in the low-cost areas would be expected to rise, while pay in the high-cost areas would be expected to fall.⁸⁸ As indicated previously, Knoll and Griffith assume that migration and its effect on pay will make comparable workers equally well-off no matter where they reside.

Under Knoll and Griffith's proposal, tax rates are not adjusted for the cost of consumption amenities, but tax rates are adjusted to the extent salaries are changed by consumption amenities.⁸⁹ Relatively low levels of consumption amenities push salaries higher, push living costs lower, or some combination of the two; in contrast, relatively high levels of consumption amenities may push salaries lower, push living costs higher, or both.⁹⁰ Their approach prefers an allocation with more labor in high-salary, low-consumption amenity locations and less labor in low-salary, high-consumption amenity locations because this results in more revenue being collected from higher-salary workers and spent in a location-independent manner.

Because of the inability of cost adjustment to account for consumption amenity differentials reflected in salaries, Knoll and Griffith adopt a relative salary method.⁹¹ The relative salary method involves identifying comparable workers across locations and constructing a relative pay index by location. High relative salaries are taxed at a relatively low rate, while low relative salaries are taxed at a relatively high rate. High relative salaries are assumed to compensate for local cost of living differences due to productive amenities, low consumption amenity levels, or both. Low relative salaries are assumed to reflect lower production amenities and/or higher consumption amenities. Professor David Albouy also calls for the tax system to adjust for local cost of living by use of relative salaries.⁹² Albouy seems cautious about the feasibility of measuring equivalent labor,⁹³ but warns that the alternative of adjusting by local cost of living will overly subsidize living in cities with consumer amenities and result in overcrowding.⁹⁴

87. *Id.* at 1010.

88. *Id.*

89. *Id.* at 1016–17.

90. *Id.* at 1008.

91. *Id.* at 1013.

92. See David Albouy, *The Unequal Geographic Burden of Federal Taxation*, 117 J. POL. ECON. 635, 648 (2009).

93. *Id.*

94. *Id.* at 649.

B. Neoclassical Model Used by Prior Literature Is Deficient

The prior literature's conclusions generally follow from its assumptions, but this Article argues that different assumptions would be more reasonable. As discussed below, there is good reason to believe that migration will not correct tax inequity. If this is true, adjustment by relative salaries could lead to unfairness rather than misallocation of resources; moreover, the benefits and penalties could simply be windfalls. For example, it is unfair to equate pleasure with purchasing power, as the relative salary adjustment would do. Adjusting income by a relative salary method unfairly overtaxes workers with low purchasing power in high-cost/high-amenity locations and unfairly undertaxes workers with high purchasing power in high-salary/low-amenity locations. To the extent that workers will not move in response to the tax adjustment, or would have moved anyway, the adjustments would create unfair windfalls and losses.

It is unclear theoretically that migration will lead to equal well-being among locations. Classical economic models tend to assume perfect information, utility-maximizing choices, and no transaction costs.⁹⁵ Under these assumptions, it is clear that workers would migrate from one area to another if they could improve their after-tax well-being. In reality, these assumptions are unrealistic. Information can be imperfect, information sometimes requires time and money to acquire, moving costs may be significant, and individuals may not be perfectly capable of making utility-maximizing calculations.⁹⁶

Although Kaplow tends to minimize the potential for the market to be out of equilibrium,⁹⁷ Kaplow concedes that this is an incomplete picture:

Individuals consider more than wage levels, price indexes, and general levels of amenities in deciding where to live. First, individuals' preferences among nonpecuniary job attributes, goods and services, and amenities will differ. Second, as a result of personal history, individuals will have particular locational preferences. Any move may involve significant direct costs. In addition, one develops networks of friends, relationships with institutions, and knowledge of the opportunities an area has to

95. See Diane Lourdes Dick, *Tax and Economic Policy Responses to the Medicaid Long-Term Care Financing Crisis: A Behavioral Economics Approach*, 5 CARDOZO PUB. L. POL'Y & ETHICS J. 379, 387-99 (2007).

96. *Id.*

97. Kaplow, *supra* note 8, at 179 n.9 ("One might think that most workers are immobile so that migration will be limited. But mobility is likely to be sufficient for the system usually to be in (or near) equilibrium. If even a small fraction of individuals relocate each year—particularly among those graduating from college, getting married, or changing occupations—the cumulative effect over time will be substantial.").

offer. Moving to a different region thus may involve considerable sacrifice. Finally, individuals' locational decisions are interrelated: Spouses need to make joint decisions and choices may depend on the location of other relatives.⁹⁸

In addition, it seems realistic to assume that tastes are heterogeneous.⁹⁹ Accordingly, only the marginal worker will be indifferent among locations, even if equilibrium has been reached.¹⁰⁰ Some will value amenities more than the market; some will value them less.¹⁰¹ Kaplow suggests that “[t]he existence of preference variations also implies that the equilibrium adjustment process may be slower than it otherwise would be.”¹⁰² Moreover, some theories suggest that regional shocks may be long lasting or that regional productivity advantages can be self-perpetuating.¹⁰³

The tax literature follows a hedonic model of urban development and migration, which conceives of amenities as a driving force in the growth of cities and the flow of population.¹⁰⁴ Studies indicate that local consumption amenities and high prices usually accompany one another, but they do not prove that local consumption amenities cause high prices.¹⁰⁵ Professors Storper and Scott review the new amenity literature and find it “devoid of any consistent analytical description of the factors underlying the origins of urban centers.”¹⁰⁶ In their view, the better explanation of city growth is “an organized production system that is increasingly locked into the initial location by its own expanding stock of agglomeration economies in a temporal dynamic of circular and cumulative causation.”¹⁰⁷ Amenities

98. *Id.* at 193.

99. One study concluded that more educated medical professionals have to be paid a premium to locate in rural areas and will accept a decrease in wages for a desirable urban location, while lower-income medical professionals require a wage premium in high cost areas because they do not value the amenities. See Sanghoon Lee, *Ability Sorting and Consumer City*, 68 J. URB. ECON. 20 (2010).

100. Kaplow, *supra* note 8, at 193.

101. *Id.*

102. *Id.*

103. See MARK D. PARTRIDGE & DAN S. RICKMAN, *THE GEOGRAPHY OF AMERICAN POVERTY: IS THERE A NEED FOR PLACE-BASED POLICIES?* 54 (2006).

104. See *id.* at 177; Knoll & Griffith, *supra* note 8, at 991; cf. Michael Storper & Allen J. Scott, *Rethinking Human Capital, Creativity, and Urban Growth*, 9 J. ECON. GEOGRAPHY 147, 147–48 (2009) (noting that the amenity-based “alternative body of research has risen to a position of prominence” but concluding that the model has profound deficiencies).

105. See Storper & Scott, *supra* note 104, at 154 (“impregnable circularity”).

106. *Id.* at 153 (“Accordingly, important forces endogenous to urban growth will be systematically underestimated. The types of models examined above implicitly and necessarily assume the pre-existence of urban centers because this is the condition for subsequent amenity-induced adjustments to occur. But what accounts for the existence of these cities to begin with? If we consider only natural amenities such as sunshine, then it is necessary to explain why, at certain moments, they move up or down in preference rankings.”).

107. *Id.* at 158.

would be marginally relevant, if at all.¹⁰⁸ Storper and Scott conclude that there is no easy solution to optimize growth, but generally the focus should be on “collective action to internalize externalities, to build effective norms of economic interdependence, and to avoid adverse path selection.”¹⁰⁹

Moreover, recent empirical findings concerning the effect of taxation on migration and salaries do not comport with the hedonic model. A study examining data from 1977 to 2002 finds that state “tax changes do not impact interstate population flows, nor do they affect the relative wages of movers.”¹¹⁰ A “natural experiment” examining the response of millionaires to new high-income surtaxes in New Jersey finds “minimal effect” on migration, even among the richest households.¹¹¹

The amenity-based models do not appear to account for reported happiness among the states. In a recent study of happiness among the states, the authors analyze a random sample of 1.3 million U.S. residents who reported their life satisfaction on a scale of 1 to 4, where 4 means “very satisfied.”¹¹² Differences in reported satisfaction “across states are not minor . . . they correspond to up to 0.12 life-satisfaction points across U.S. states, which is similar in size to the individual cross-sectional effect on life satisfaction of marital separation or unemployment.”¹¹³ The authors regress reported life satisfaction against quality of life predicted by the “most recent and thorough research in this vein” by economists.¹¹⁴ Although the study finds a statistically significant correlation, it finds that the economic models explain only 36% of the variance in reported happiness.¹¹⁵

A behavioral economics perspective would suggest that tax-induced migration is unlikely to occur. Behavioral economics emphasizes limits on rational decision making.¹¹⁶ First, a potential decision maker may not even engage with a problem in the first place. This seems quite likely in the case of a worker with a well established life in a location. Second, there are limits on rational decision making if the problem is actually considered. Decision makers may not be able to comprehend all the data involved in a

108. *Id.*

109. *Id.* at 164.

110. See Andrew Leigh, *Do Redistributive State Taxes Reduce Inequality?*, 61 NAT'L TAX J. 81, 95 (2008).

111. See Cristobal Young & Charles Varner, *Millionaire Migration and State Taxation of Top Incomes: Evidence from a Natural Experiment*, 64 NAT'L TAX J. 255, 278 (2011).

112. Andrew J. Oswald & Stephen Wu, *Objective Confirmation of Subjective Measures of Human Well-Being: Evidence from the U.S.A.*, 327 SCI. 576, 577 (2010).

113. *Id.* at 578.

114. *Id.* at 577 (citing Stuart A. Gabriel et al., *Compensating Differentials and Evolution in the Quality-of-Life Among U.S. States*, 33 REG. SCI. URB. ECON. 619 (2003)).

115. *Id.* at 579.

116. See Dick, *supra* note 95, at 387–99.

national relocation. Risk aversion tends to prevent the decision maker from making optimal moves if there is a risk of loss as well as a potential for gain.¹¹⁷ Even if a potential mover rationally would expect to be better off on a move, she is likely to stay at home unless the move looks especially attractive. This is true even when the decision maker knows exactly what the probabilities are. However, in a potential relocation, the decision maker likely does not know the probabilities of success (improving her well-being) or failure (reducing her well-being). Third, default rules have been found to have a strong effect on decision making (defaults are “sticky”), even when they would appear extremely easy to overcome, such as checking a box to make a 401(k) contribution.¹¹⁸ Staying put rather than relocating would seem to be a rather strong default given the financial cost to relocate as well as the need to spend time researching the facts.

As an example of these phenomena outside the relocation context, it is apparent that even when one’s health is at stake, decision making behavior does not follow the pathways that classical economic models would predict. Traditional models would expect that “the tremendous cost of long-term care, combined with a regulatory scheme that encourages reliance on private funding sources, should lead the rational consumer with sufficient resources to develop and maintain an economically sound financial plan for long-term care.”¹¹⁹ Contrary to these predictions, “most consumers do not have a financial plan in place.”¹²⁰ A behavioral economics model accounts for this outcome in a number of ways.¹²¹ First, many people may find the experience of even contemplating old age and health care unpleasant and so would increase their utility by avoiding decision making entirely.¹²² Many consumers may be deeply biased to prefer care by family members to institutional care.¹²³ Consumers also tend to overvalue current costs and benefits to future costs and benefits.¹²⁴

Medical decision making is, to be sure, an imperfect analog to relocation decision making; however, the discrepancy between the expected results under a classical model of rational decision making and the actual outcomes are surprising, even with a subject as vital as long term health care. Similar obstacles to rational decision making might possibly inhibit relocation decisions. It may be unpleasant to even begin to consider

117. See RICHARD THAYER & CASS SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* 33–35 (2008).

118. *Id.* at 103–11.

119. Dick, *supra* note 95, at 388.

120. *Id.* at 389.

121. *Id.*

122. *Id.* at 391.

123. *Id.* at 393–94.

124. *Id.* at 396.

relocation—it may in other words enhance a worker’s utility to assume that home is optimal rather than question whether she could be better off elsewhere. Relocation also involves comparing current costs to future benefits and may not involve a perfect discounting heuristic.

The costs of relocation have taken on a qualitatively different character after the housing bubble and collapse. Now, many homeowners owe more on their mortgages than their homes are worth and cannot move even if they would clearly be better off working in different locations, and they are aware of this. Even those who are not “underwater” and are able to sell may not want to sell because of psychological barriers to recognizing a loss.¹²⁵

Another increasing factor in immobility is the aging of the population and the prevalence of two-worker households. As demographer Peter Francese aptly puts it:

The largest and most rapidly growing age groups in the U.S. are people aged 45 to 54 (largest) and 55 to 64 (fastest growing). People in those groups are in their prime working years, they have kids in local schools, and have for the most part put down roots in their communities.

They are far less likely to move away than someone in their 20s or early 30s who have yet to form community bonds. Also, in roughly half of all marriages, both spouses are employed full time. This makes moving just to get a better job for one of them next to impossible.¹²⁶

Even younger adults are staying put in unusual numbers. It is unclear whether this is simply because they cannot find jobs, or because young adults have become less confident than they were before about moving to obtain a new job.¹²⁷

III. IMPLEMENTATION OF LOCAL COST OF LIVING ADJUSTMENTS

This Part assesses options for implementation of the thesis developed in Part I—that local cost of living should be a factor in determining the

125. See David Kestenbaum, *What a Coin Toss Has to Do with the Housing Market*, NPR (Feb. 25, 2011, 1:04 PM), <http://www.npr.org/blogs/money/2011/02/25/134033237/what-a-coin-toss-has-to-do-with-the-housing-market>.

126. Peter Francese, Contribution to *A Nation of Hunkered-Down Homebodies*, N.Y. TIMES (Jan. 10, 2010, 7:00 PM), <http://roomfordebate.blogs.nytimes.com/2010/01/10/a-nation-of-hunkered-down-homebodies>.

127. See Sam Roberts, *Slump Creates Lack of Mobility for Americans*, N.Y. TIMES, Apr. 22, 2009, at A1, available at <http://www.nytimes.com/2009/04/23/us/23census.html>.

taxpayer's ability to pay tax. First, for purposes of comparison, this Part lays out a full indexation method; this or something similar will probably be proposed by residents of high-cost areas. Second, consistent with Part I, this Part rejects full indexation and suggests a fairer, more defensible system targeting low-income taxpayers. Finally, this Part explores other issues for implementation, including special issues relating to deductions, construction of the cost of living index, and non-tax issues.

A. Full Indexation

Recall that the federal income tax generally ignores local differences in living costs, applying progressive rates to taxpayers in high-cost locations beginning at too low an income. As a numerical example of how this leads to unfairness, consider a world in which there are three otherwise identical cities: Cheap, Average, and Pricey.¹²⁸ Their cost of living indexes reflect how much it costs, relative to the benchmark average cost, to purchase a defined bundle of goods and services.¹²⁹ Assume the cost of living index is 0.8 in Cheap, 1.0 in Average, and 1.2 in Pricey.¹³⁰ This means \$1,000 in Cheap, \$1,250 in Average, and \$1,500 in Pricey are all approximately equivalent to each other in terms of purchasing power. To state this another way, one dollar buys a different amount of goods and services depending on the location: 25% more goods and services in Cheap than in Average, and 50% more in Cheap than in Pricey. In sum, the same incomes can carry different purchasing power,¹³¹ and different purchasing power can be expressed as the same income;¹³² this is the fundamental idea that has led residents of high-income states to propose local cost of living adjustments.¹³³

In the case of a flat tax with no exemptions, these cost of living differences would not lead to any tax unfairness. This is because the tax imposes the same reduction in purchasing power on taxpayers with the same pre-tax purchasing power. As an example, a 10% tax on all income

128. This illustration is adapted from Knoll & Griffith, *supra* note 8, at 993–97 (examples using “Cheap,” “Middling,” and “Pricey” with cost of living indexes of 0.8, 1.0, and 1.2, respectively).

129. As one potential source for these figures, each quarter, the American Chamber of Commerce Research Association (ACCRA), a nonprofit organization, publishes a listing of cost of living indexes by city.

130. To be sure, larger variations do exist. In the ACCRA cost of living index, values range from approximately 0.85 in Conway, Arkansas, to 2.2 in Manhattan. ACCRA COST OF LIVING INDEX, 2010 ANNUAL AVERAGE DATA (2011).

131. Income of \$10,000 represents different purchasing power among the three cities: 25% (1/8) more in Cheap than in Average, and 17% less (1/1.2) in Pricey than in Average.

132. Incomes of \$10,000 in Cheap, \$12,500 in Average, and \$15,000 in Pricey would represent equivalent purchasing power.

133. See Sullivan, *supra* note 3.

would result in a \$1,000 tax on a taxpayer in Cheap with an income of \$10,000; a \$1,250 tax on a taxpayer in Average with an income of \$12,500; and a \$1,500 tax on a taxpayer in Pricey with an income of \$15,000. The pre-tax incomes of all three taxpayers are equivalent in purchasing power, as are the reductions in their purchasing power.

The federal income tax system, however, has multiple rates. Multiple rates include both a zero-rate bracket of income (as established by the standard deduction¹³⁴ and personal exemptions¹³⁵) and increasing rates at higher incomes.¹³⁶ The fixed bracket amounts, standard deduction, and personal exemptions will represent relatively high (25% higher) purchasing power in Cheap, and relatively low (17% lower) purchasing power in Pricey. If the tax system is not indexed, the tax will reduce the purchasing power of a taxpayer in Cheap less than it reduces the purchasing power of a taxpayer in Average, and even less than it reduces the purchasing power of a taxpayer in Pricey, assuming they all start with the same pre-tax purchasing power. The following table illustrates the effect for three unmarried taxpayers with gross income equivalent to \$100,000 in Average terms. This illustration assumes 2011 tax rates¹³⁷ and deductions of \$9,500, which is equal to the standard deduction plus one personal exemption.

	Cheap	Average	Pricey
Gross Income	\$80,000	\$100,000	\$120,000
Taxable Income	\$70,500	\$90,500	\$110,500
Tax	\$13,750	\$18,957	\$24,557
Purchasing Power of Tax in Average	\$17,188	\$18,957	\$20,464

To impose the same purchasing power reduction on all three taxpayers, the tax brackets, the standard deduction, and the personal exemption could be set lower in Cheap and higher in Pricey.¹³⁸ This can be accomplished by multiplying the brackets in Average terms by the cost of living index in Cheap or Pricey. It is equivalent to (i) converting income into purchasing power in Average terms by dividing the income in Cheap or Pricey by the cost of living index in the relevant city; (ii) computing the amount of tax; and then (iii) converting the amount of tax (which will be in Average terms) into its equivalent in Cheap or Pricey by multiplying the amount of

134. I.R.C. § 63.

135. I.R.C. § 151.

136. I.R.C. § 1.

137. Rev. Proc. 2011-12, 2011-2 I.R.B. 297.

138. Cf. Kaplow, *supra* note 8, at 183.

tax by the cost of living index in the relevant city.¹³⁹ For simplicity of display, local cost of living adjustments will be illustrated using the income conversion method rather than showing two new sets of brackets.

The following table shows the difference in tax liability if the tax system is fully adjusted for local cost of living differences.¹⁴⁰ As above, the illustration assumes the taxpayer is an unmarried individual with gross income equal to \$100,000 of purchasing power in Average who will take no deductions other than the standard deduction and one personal exemption.

	Cheap	Average	Pricey
Gross Income	\$80,000	\$100,000	\$120,000
Indexed Gross Income ¹⁴¹	\$100,000	\$100,000	\$100,000
Indexed Tax	\$18,957	\$18,957	\$18,957
Actual Tax Under Proposal ¹⁴²	\$15,166	\$18,957	\$22,748
Tax Under Current System	\$13,750	\$18,957	\$24,557

In sum, local cost of living adjustments result in additional tax in Cheap and less tax in Pricey than under the actual tax system. Moreover, taxpayers in Cheap, Average, and Pricey all pay different amounts of tax, but these different amounts represent the same reduction in purchasing power for taxpayers with the same pre-tax purchasing power.

Certain tax credits also could be adjusted for differences in purchasing power due to local cost of living. There are, to be sure, different goals underlying different credits. However, for a credit that is intended to be redistributive, the theory underlying progressivity¹⁴³ would seem to apply equally. Even if a credit and a deduction have a similar economic effect, the law arguably has a different expressive function in a credit compared to a deduction. This issue merits further consideration, but assuming the goal of a transfer is to redistribute to the needy, it would seem appropriate to

139. *Cf. id.* at 183 n.18.

140. This illustration, to be sure, is oversimplified, because the local cost of living adjustments would have a revenue effect that would lead to a new set of tax brackets, etc., for an average cost location.

141. Indexed Gross Income = Gross Income/Cost-of-Living Index.

142. Actual Tax = Indexed Tax * Cost-of-Living Index.

143. *See* Part I.

provide equally meaningful assistance to persons with the same purchasing power.¹⁴⁴

The Earned Income Tax Credit is a significant redistributive transfer for many low-income taxpayers.¹⁴⁵ The EITC provides a transfer equal to a percentage of the taxpayer's earned income (40% for a single taxpayer with two children), up to a maximum credit amount (\$5,112) which is reached when the taxpayer's income reaches the earned income amount (\$12,780).¹⁴⁶ The EITC stays flat over a further range of income (\$12,780–\$16,690), and then begins to phase out beginning at a fixed income threshold (\$16,690).¹⁴⁷

As an illustration of the effect of a local cost-unindexed EITC, the following table compares the schedule for the EITC among Cheap, Average, and Pricey for a single parent with two qualifying children. Dollar amounts for Cheap and Pricey are converted into their purchasing power in Average.

	Cheap	Average	Pricey
Earned Income Amount	\$15,975-Average	\$12,780	\$10,650-Average
Max. Credit	\$6,390-Average	\$5,112	\$4,260-Average
Threshold Phase-out	\$20,863-Average	\$16,690	\$13,908-Average
Completed Phase-out	\$51,205-Average	\$40,964	\$34,136-Average

The maximum credit will represent relatively high purchasing power in Cheap and relatively low purchasing power in Pricey. The fixed phase-out threshold will correspond to relatively high purchasing power in Cheap and relatively low purchasing power in Pricey. This means that benefits begin phasing out too late in Cheap, where workers are less needy and too early in Pricey, where workers are needier.¹⁴⁸ This can be corrected by the same adjustment as the income tax brackets. The earned income amount and

144. *But see supra* text accompanying notes 79–80 (discussing potential countervailing efficiency considerations).

145. *See Moran, supra* note 49, at 326–29; Jennifer Bird-Pollan, *Who's Afraid of Redistribution? An Analysis of the Earned Income Tax Credit*, 74 MO. L. REV. 251, 258–60 (2009) (noting lack of explicit legislative intent but clear redistributive effect).

146. *See* I.R.C. § 32(a); Rev. Proc. 2011-12, 2011-2 I.R.B. 297.

147. *Id.*

148. This appears to significantly hinder the EITC's effectiveness as a work incentive rather than redistributive program. *See Fitzpatrick & Thompson, supra* note 37, at 437 (“[T]he high-cost areas where the EITC produces no discernible labor supply . . . represent as much as 40 percent of the total population.”).

phase-out threshold can be multiplied by the location's cost of living to create a new set of EITC brackets. Or, the taxpayer's income can be converted into purchasing power in Average; the credit would be calculated using the Average schedule, and then converted into its equivalent in Cheap or Pricey by multiplying by the local cost of living index.

B. Partial Indexation

As discussed in Part I.C, adjusting for local cost of living is most defensible at low incomes. Admittedly, the lines between the poor and the middle class and the wealthy are rather imprecise and subjective. There is a broad range of options, the two endpoints of which are sketched below.

One approach that has some precedent in the current tax system is the threshold for the phase-out of personal exemptions and the threshold for the overall limitation on itemized deductions—both were \$166,800 in 2009.¹⁴⁹ These phase-outs presumably reflect a decision to impose additional tax on high-income taxpayers in a less obvious manner than by modifying the tax rate schedule. Eliminating tax benefits for high-income taxpayers would require a decision concerning both the threshold for and the speed of the phase-out. A paradigm exists in Section 11,¹⁵⁰ where a high-income corporation's tax is increased over a certain range of income to eliminate the benefit of the low-rate tax brackets.¹⁵¹ A consequence of this manner of

149. These phase-outs have been temporarily abolished since 2010 but are scheduled to resume in 2013. Another idea is the \$200,000 figure that President Obama has offered up to identify a wealthy individual. See Ron Lieber, *A Tax Plan That Might Not Be So Painful*, N.Y. TIMES, Sept. 24, 2011, at B1, available at <http://www.nytimes.com/2011/09/24/your-money/taxes/obama-tax-plan-could-be-a-wash-for-some-high-earners.html>.

150. I.R.C. § 11(b)(1) provides:

The amount of the tax imposed by subsection (a) shall be the sum of—

- (A) 15 percent of so much of the taxable income as does not exceed \$50,000,
- (B) 25 percent of so much of the taxable income as exceeds \$50,000 but does not exceed \$75,000,
- (C) 34 percent of so much of the taxable income as exceeds \$75,000 but does not exceed \$10,000,000, and
- (D) 35 percent of so much of the taxable income as exceeds \$10,000,000.

In the case of a corporation which has taxable income in excess of \$100,000 for any taxable year, the amount of tax determined under the preceding sentence for such taxable year shall be increased by the lesser of (i) 5 percent of such excess, or (ii) \$11,750. In the case of a corporation which has taxable income in excess of \$15,000,000, the amount of the tax determined under the foregoing provisions of this paragraph shall be increased by an additional amount equal to the lesser of (i) 3 percent of such excess, or (ii) \$100,000.

151. See 6 FED. TAX COORDINATOR (SECOND SERIES) (RIA) ¶ D-1005 (2007) (“The graduated rates for corporations are phased out at certain income levels. Thus, the tax saving of \$11,750 on the first \$75,000 of taxable income (i.e., the tax on the first \$75,000 of income is \$11,750 less than if the tax on all its income were 34%) is phased out for corporations with taxable income in excess of \$100,000 and the tax saving of \$100,000 on the first \$10,000,000 of taxable income (i.e., the tax on the first \$10,000,000 of income is \$100,000 less than if the tax on all its income were 35%) is phased out for corporations with taxable income in excess of \$15,000,000.”).

phase-out is that over the phase-out range there would be higher marginal rates than the nominal statutory rate.

Arguably, however, the “high-income” threshold discussed above is too high for the purpose of local cost of living adjustments. Another approach, which would be better targeted to lower-income taxpayers and have the benefit of simplicity, is adjusting only the standard deduction, personal exemption, and EITC for local cost of living. The standard deduction tends to effectively phase out at moderate-to-high incomes, because of the increasing importance of itemized deductions. There would be some unintended consequences from modifying the standard deduction; absent a separation of the standard deduction’s zero-rate and floor function,¹⁵² it would effectively nullify the effect of a greater amount of itemized deductions in high-cost areas, where the standard deduction would increase.

C. Special Issues Relating to Deductions

As discussed in Part I, the normative income tax base includes the sum of consumption plus changes in wealth. Expenses incurred in profit-seeking activity reduce wealth but do not represent consumption, so they should reduce the income tax base. Consumption may also be framed as a manifestation of ability to pay, whereas non-consumption expenses reduce the taxpayer’s ability to pay. As discussed below, the Code generally follows this theoretical framework, but there are exceptions.

The most basic deduction in an income tax is for expenses incurred in profit-seeking activities. Section 162(a) allows a deduction for “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business,” while Section 212(a) provides a similar deduction for expenses incurred in producing income (even though not rising to the level of a “business”).¹⁵³ Because the amount of the allowable deduction generally equals the full amount of expenses paid,¹⁵⁴ such deductions are implicitly indexed to local costs.

In contrast, the Code generally disallows deductions in respect of “personal, living, or family expenses.”¹⁵⁵ The Code does, however, include

152. See John R. Brooks II, *Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COLUM. J. TAX L. 203 (2011) (arguing that the standard deduction should be a zero-rate bracket and floors on itemized deductions should be individualized deduction-by-deduction).

153. I.R.C. §§ 162(a), 212(a).

154. The allowable deduction for certain profit-seeking expenses that are incurred in an activity not considerable or regular enough to qualify as a business may be reduced by the floor on miscellaneous itemized deductions and the overall limitation on itemized deductions. See I.R.C. §§ 67, 68.

155. I.R.C. § 262(a).

a number of special provisions allowing deductions for personal expenses. As discussed below, some of these rules may have the effect of a local cost of living adjustment, but they do not correctly implement the principle that ability to pay depends on purchasing power. This Article has argued that it is unfair to ignore the taxpayer's purchasing power, but it is another thing to allow a deduction based on the taxpayer's actual personal expenses.

1. Homeownership

The federal income tax grants numerous subsidies for homeownership.¹⁵⁶ Personal interest expense is generally nondeductible, but an exception to this limitation is the allowance of an itemized deduction for home mortgage interest.¹⁵⁷ Taxpayers generally may deduct interest paid with respect to up to \$1 million of acquisition indebtedness and \$100,000 of home equity indebtedness with respect to a qualified residence.¹⁵⁸ Even though the taxpayer may deduct the expense of owning a home, the taxpayer does not include the imputed rental value of the home in income. Finally, the taxpayer may exclude from income a gain of up to \$250,000 on the sale of a residence meeting certain requirements.¹⁵⁹

Neither the \$1,100,000 total maximum indebtedness for purposes of the mortgage interest deduction nor the \$250,000 maximum exclusion from gains on the sale of a qualified residence is indexed for local cost of living differences. These caps are more generous in low-cost locations than in high-cost locations. However, most taxpayers are not limited by the cap on qualified indebtedness because the cap is such a large amount. This leaves ample room for variation below the cap so that homeowners where the cost of living is low typically borrow less—and therefore deduct a lesser amount of interest—than taxpayers who reside in high-cost areas. Though the exclusion of imputed income is unlimited, the imputed rental value—and thus the understatement of income—is greater as the value of the home increases. Thus, in a rough way, the mortgage interest deduction and the exclusion of imputed rental value appear to result in a greater reduction of the tax base in high-cost areas than in low-cost areas.¹⁶⁰

156. See Dorothy A. Brown, *Shades of the American Dream*, 87 WASH. U. L. REV. 329, 336–39 (2009).

157. The mortgage interest deduction is one of the largest items in the tax expenditure budget. See J. COMM. ON TAX'N, BACKGROUND INFORMATION ON TAX EXPENDITURE ANALYSIS AND HISTORICAL SURVEY OF TAX EXPENDITURE ESTIMATES 18 (Mar. 1, 2011), available at <http://www.jct.gov/publications.html?func=startdown&id=3740>.

158. I.R.C. §§ 163(h)(1), (2)(D), (3).

159. I.R.C. § 121.

160. See Angelini & Noga, *supra* note 32, at 6.

The reduction of the tax base from homeownership preferences, though disproportionately allocable to high-cost areas, does not achieve tax equity. Ability to pay should be linked to purchasing power, not the taxpayer's actual purchasing decisions. In addition, densely populated areas with building restrictions are most likely to see the tax benefits of homeownership capitalized into the price of housing, so the apparent tax benefit in high-cost areas may well be illusory.¹⁶¹ Areas where land is plentiful or development is less regulated will tend to have lower housing prices and tend not to see the tax benefits of homeownership capitalized into home prices.¹⁶² Thus, what appears to be an indirect form of local cost of living adjustment seems to favor low-cost areas in its actual operation.

Most scholarly commentators advocate the abolition of the mortgage interest deduction, noting that it is inefficient, fails to encourage homeownership (as opposed to more expensive homes), and channels tax benefits disproportionately to wealthy households.¹⁶³ Elimination of the mortgage interest deduction would, in a rough way, offset the inequity of the exclusion of imputed rental value. Because it is practically inconceivable that imputed rent would be taxed, the abolition of the mortgage interest deduction is the next best solution.¹⁶⁴ The solution is second best not only because the offset (mortgage interest versus imputed income) is rough, but also because there is no offset at all to the extent of home equity (i.e., there is imputed income but no offsetting interest expense to disallow as a deduction).

The mortgage interest deduction, despite its poor reception among tax scholars, may not be repealed any time soon. If a limited form of partial indexing were to be adopted (i.e., only the standard deduction, personal exemption, and EITC), as this Article suggests, the homeownership subsidies would have a limited conflict, because only itemizers deduct home mortgage interest. It is true that some low-income households would still benefit from the imputed income exclusion, and thus may have more

161. See William G. Gale, Jonathan Gruber & Seth Stephens-Davidowitz, *Encouraging Homeownership Through the Tax Code*, 115 TAX NOTES 1171, 1179 (2007).

162. *Id.*

163. See Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 LAW & CONTEMP. PROBS. 233, 259–62 (2010) (noting “consensus of postwar tax experts” against the mortgage interest deduction); Brown, *supra* note 156, at 333 n.13 (“Adding insult to injury, economists agree that virtually no one buys a house because of those tax subsidies, but the subsidies do increase the cost of housing.”).

164. See Gale et. al., *supra* note 161, at 1182 (“Gross imputed rent on owner-occupied housing is not currently taxed, however, and there is virtually no chance that it will be taxed in the U.S. in the foreseeable future. As a result, a search for alternative, or second-best, tax policies toward housing is necessary.”). Other countries have experimented with taxing imputed rental values but have generally abandoned the effort due to administrative difficulties. See Richard K. Green, *Homeowning, Social Outcomes, Tenure Choice, and U.S. Housing Policy*, 5 CITYSCAPE: J. POL’Y DEV. & RES. 21, 27 (2001), available at <http://www.huduser.org/periodicals/cityscape/vol5num2/green.pdf>.

ability to pay than appears on the surface. Policymakers might consider limiting local cost of living adjustments to renters, but this would distort the decision whether to own a home, and might unfairly exclude too many taxpayers for whom the amount of imputed income is not significant.

2. State and Local Taxes

The deduction for state and local taxes¹⁶⁵ is another important itemized deduction that varies significantly depending on the taxpayer's residence. State and local taxes are excluded from cost of living indexes, such as ACCRA, because they depend too much on a taxpayer's personal circumstances.¹⁶⁶ Thus, a deduction for state and local taxes would not be "double dipping" in a system with local cost of living adjustments. Indeed, if the partial indexation method were adopted, policy makers might consider adding an amount to the cost of living index for state and local taxes to simulate the deduction for non-itemizers. There is, however, an issue as to whether state and local taxes should be conceived of as an amount paid that varies with the value of local benefits.¹⁶⁷ In other words, do state and local taxes reduce purchasing power or simply represent an additional purchase? State and local taxes are not voluntary and may depend as much on greatly differing state fiscal capacities as actual benefits received.¹⁶⁸ Moreover, the limitations on taxpayer mobility would seem to apply equally in the context of state and local taxes. Thus, it is defensible to conceive of the taxpayer's state and local taxes as reducing ability to pay and therefore not in tension with local cost of living adjustments.¹⁶⁹

3. Deduction Phase-Outs

Many personal itemized deductions are disallowed or phased out after a certain high-income threshold. Under the partial indexation proposal, deduction phase-outs generally would not need to be adjusted for local cost

165. See I.R.C. § 164.

166. See *ACCRA Cost of Living Index Methodology*, COUNCIL FOR CMTY. & ECON. RESEARCH, <http://c2c.coli.org/compare.asp?action=methodology> (last visited Feb. 21, 2012).

167. See Brian Galle, *Federal Fairness to State Taxpayers: Irrationality, Unfunded Mandates, and the "SALT" Deduction*, 106 MICH. L. REV. 805, 817–18 (2008) (questioning the rational taxpayer model and arguing that "citizens will sometimes fail to recognize that an alternative package of taxes and benefits would better satisfy their preferences").

168. See Kirk J. Stark, *Rich States, Poor States: Assessing the Design and Effect of a U.S. Fiscal Equalization Regime*, 63 TAX L. REV. 957, 957–58 (2010) (describing differences in state fiscal capacity that have not been equalized by the federal government, noting that most other developed countries provide equalization payments to poor states).

169. This Article is considering the deduction through the lens of ability to pay and equity; there may, of course, be other reasons that the state and local tax deduction may or may not be desirable. See Galle, *supra* note 167, at 831–42 (discussing vertical exporting, externalities, and federalism concerns).

of living. However, under a more complete indexation approach, some of the phase-outs would need to be adjusted for local cost of living. In general, phase-outs that reference a constant amount will need to be adjusted for local cost of living. Otherwise, the phase-out will begin disallowing deductions at too low an income in high-cost locations and at too high an income in low-cost locations. Phase-outs in this category include the overall limitation on itemized deductions¹⁷⁰ and the personal exemption phase-out.¹⁷¹ In addition, floors expressed as a percentage of adjusted gross income (AGI)¹⁷² would, under a full indexation approach, need to be reconfigured. For example, the 2% of AGI floor on miscellaneous itemized deductions¹⁷³ would pertain to this category.

D. *Constructing a Local Cost of Living Index*

As indicated previously, local cost of living adjustments are rare in the federal income tax system, but there is at least one existing model that can be built upon in constructing an index. A taxpayer may submit an offer in compromise to the IRS to settle a tax debt, if the taxpayer has insufficient income and assets to pay the debt in full.¹⁷⁴ The IRS must apply locality-based guidelines to ensure that the taxpayer retains “adequate means to provide for basic living expenses.”¹⁷⁵ Although the IRS has issued national standards for food, clothing, and other items, its guidelines for housing and utilities drill down to the county level.¹⁷⁶ This is not to suggest that no work remains to be done; this Article assumes that it would be feasible to construct a fair and reliable local cost of living index. Moreover, the fact that the IRS has been obligated to determine ability to pay by local standards for many years suggests that developing other local cost of living indices would not be an insurmountable administrative burden.

170. See I.R.C. § 68(a) (generally reducing the amount of certain itemized deductions by “3 percent of the excess of adjusted gross income over the [inflation adjusted] applicable amount”).

171. See I.R.C. § 151(d)(3) (for an unmarried taxpayer, the personal exemption is phased out by “2 percentage points for each \$2,500 (or fraction thereof) by which the taxpayer’s adjusted gross income for the taxable year exceeds the [inflation adjusted] threshold amount”).

172. See I.R.C. § 62. Adjusted gross income means the taxpayer’s gross income less certain deductions, commonly called “above the line” deductions. The principal above the line deductions are business deductions, reimbursed employee business expenses, losses from sales of property, and expenses attributable to the production of rents or royalties. *Id.*

173. See I.R.C. § 67(a) (disallowing “miscellaneous itemized deductions” except “to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income”). The classic examples of miscellaneous itemized deduction are unreimbursed employee business expenses and investment expenses.

174. See I.R.C. § 7122; IRS Form 656, available at <http://www.irs.gov/pub/irs-pdf/f656.pdf>.

175. I.R.C. § 7122(d)(2)(A).

176. See *Collection Financial Standards*, IRS, <http://www.irs.gov/individuals/article/0,,id=96543,00.html> (last visited Feb. 21, 2012).

E. Non-Tax Issues

It is beyond the scope of this Article to address all federal programs, but the theoretical bases of progressive taxation would appear to have potential relevancy to many other federal government programs. In general, the federal government's incorporation of local cost of living into spending programs appears to be haphazard and unpredictable. Scholars should work toward a careful and consistent approach to which federal programs should be indexed and explanations for departures from that principle.

Federal social welfare programs (e.g., social security, food stamps, and cash and other Temporary Assistance for Needy Families) generally are not adjusted for local cost of living.¹⁷⁷ There are, however, important exceptions. Federal housing assistance programs generally base eligibility on a percentage of local area median income.¹⁷⁸ For example, in the Section 8 Housing Choice Voucher program, local Public Housing Authorities receive applications for vouchers and administer waiting lists.¹⁷⁹ Public Housing Authorities have some flexibility in prioritizing the waiting list, but the program is targeted at extremely low-income households, which have an income below 30% of the local area median income.¹⁸⁰ Families who receive vouchers must make a rent contribution of 30–40% of their adjusted income.¹⁸¹ The federal government makes up the difference between the family's payment and a maximum payment, which is set by the Public Housing Authority at between 90–100% of local fair market rent.¹⁸² Fair market rents are based on a survey of rents for standard units in each metropolitan area or non-metropolitan county in the country.¹⁸³

As a proportion of federal spending, Section 8 housing assistance is a relatively modest program.¹⁸⁴ Medicare, however, is one of the largest components of federal spending. Medicare tailors payments to prevailing local costs even though contributions are not based on local costs.¹⁸⁵ As an example, under Medicare Part B physician reimbursements are based on a fee schedule determined by the Centers for Medicare and Medicaid

177. See Kaplow, *supra* note 8, at 175–76.

178. See KAREN SPAR, CONG. RESEARCH SERV., RL 33340, CASH AND NONCASH BENEFITS FOR PERSONS WITH LIMITED INCOME: ELIGIBILITY RULES, RECIPIENT AND EXPENDITURE DATA, FY 2002 – FY 2004, at 18–19 (2006) [hereinafter CRS REPORT].

179. HOUSE WAYS AND MEANS COMMITTEE, 2008 GREENBOOK 15-2 (2008).

180. CRS REPORT, *supra* note 178, at 89.

181. *Id.* at 90.

182. *Id.*

183. *Id.*

184. *Id.* at 89.

185. See Melissa H. Weresh, *Effect of Geographic Practice Cost Indices on Physician Reimbursement and Patient Access*, 5 RUTGERS J.L. & PUB. POL'Y 362, 366, 369 (2008).

Services (CMS).¹⁸⁶ Rates are adjusted based on geographic practice cost indices set for eighty-nine payment locations.¹⁸⁷

CONCLUSION

Imposing tax based on ability to pay, which depends in part on what the taxpayer can afford to purchase where the taxpayer lives, is consistent with a progressive federal income tax system that taxes earnings, not endowment. This Article has proposed a local cost of living adjustment targeted at low-income taxpayers. From a neoclassical perspective, indexing for living costs does too much, yet targeting low-income taxpayers does too little. This Article's approach may have a social cost, but the moral opportunity in reducing inequality should not be ignored.¹⁸⁸ As Henry Simons wrote, "Both progress and justice are costly luxuries—costly, above all, in terms of each other."¹⁸⁹

186. *Id.* at 363.

187. *Id.* at 363–65.

188. *See* McCluskey, *supra* note 42, at 820–21 (The "alternative visions refuse to define existing market structures as necessarily and naturally efficient-in the overall societal interest-they escape the problem that alternative distributions of rights and responsibilities are inherently harmful to aggregate well-being. . . . Each reconstructs the increased bargaining power resulting from government protection for impoverished families as socially beneficial moral opportunity, not moral hazard.")

189. HENRY C. SIMONS, *PERSONAL INCOME TAXATION* 24 (1938).

