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POINT & COUNTERPOINT

Equity, Cost of Living, and the Internal Revenue Code

Cost of living varies by geographic areas. In this Point/Counterpoint, Professors James Angelini and Tracy Noga argue that geographic cost of living adjustments have been ignored by the Internal Revenue Code and it is time to implement changes in the Code to reflect these differences. Professor Calvin Johnson argues that adjusting the tax base to take away the variations in cost of living would be inequitable while Professor Joseph Dodge argues that the geographic adjustments are not necessary. Professors Angelini and Noga respond that, because inequity exists, a remedy is necessary.

NewsQuarterly encourages readers to submit responses or comments which may be published in a subsequent issue. — *Christopher M. Pietruszkiewicz, Vice Chancellor for Business and Financial Affairs and J.Y. Sanders Professor of Law, LSU Law Center, Baton Rouge, LA*

POINT

Improving the Equity of the Federal Income Tax

By James P. Angelini and Tracy Noga*

One of the qualities of a good tax system, identified by Adam Smith and others, is the concept of equity or fairness. A tax system is considered horizontally equitable if it treats all taxpayers in the same economic situation in the same fashion. This is the basis of the federal income tax system in the United States and is often taken for granted. In our study we find, however, that due to considerable cost of living differences across the United States, horizontal equity (HE) is significantly distorted, not only between the states but even within states. James P. Angelini and Tracy J. Noga, *Distortions in Equity Caused by Cost-of-Living Differences*, 121 Tax Notes 1165 (2008).

The purchasing power of a dollar is affected by time and space. Time differences are reflected in inflation adjustments to many (although not all) areas of federal income taxation. Periodic adjustments have been included in the Internal Revenue Code for many years. However, the Code virtually ignores geographic cost of living differences, except for a few minor adjustments. Although the cost of living varies considerably between geographic regions in the United States, the tax policies of a nation do not normally include major adjustments for the size, complexity and diversity of the economies of the cities and towns within its borders. As a result, HE is distorted. Furthermore, because changes in cost of living over time have not been made, the effects have compounded. A country as large and dynamic as the United States cannot expect to construct an income tax system that is horizontally equitable for all its citizens without taking into account the continually changing, and sometimes exponential, geographical differences in

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TAXATION
A Section of the American Bar Association

Legislative Challenges

President Obama, in his recent explanation of his revenue proposals for fiscal year 2010 (the so-called "Green Book") has laid out an ambitious agenda for changes to the Internal Revenue Code. Other changes in addition to those in the Green Book are brewing in Congress. Changes to estate and gift taxation, to foreign taxation, to executive compensation, and to health care are just a few of the many topics likely to be visited this year or next.

We will continue to be vigilant in our efforts to provide input to the Congress and the Administration on improvements and problems with our tax system. Simplification of the Internal Revenue Code remains one of our highest priorities. Unfortunately, we may be the only organization that makes a continual and concerted effort to improve tax simplification, which puts an even greater burden on us to continue to carry that torch.

Armando Gomez has provided outstanding service in representing the Section as Vice Chair, Government Relations, before Congress and the Administration. His valuable contributions to the efforts of the Section have made it certain that we were heard—even if we were not always listened to. I am sure that Armando's successor, Helen Hubbard, will deliver the Section's messages equally as well.

The Challenges of Keeping Up the Good Work

The activities of the Section are diverse and essential to maintaining the vitality of the tax community. By being involved in almost every aspect of tax law, from providing pro bono assistance to shaping the nation's tax system, the Section maintains its critical role as the leading organization on tax matters.

Maintaining this operation is not easy. We have roughly 50 committees, the largest of which has as many as 50 subcommittees, that undertake numerous activities, not the least of which is providing valuable and insightful comments to government regulators. Individuals at the IRS repeatedly tell me how important the comments of the Section are to them as they develop regulatory guidance. We all owe a debt of gratitude to Peter Connors, our Vice Chair, Committee Operations (VCCO), who keeps this machine operating efficiently. VCCO is not always the most well-recognized or popular position, but it is essential to the effective operations of the Section.

We also need to continue to maintain our public face. For this we owe our thanks to Ellen Aprill, our Vice Chair, Communications, and to Lou Mezzullo, our Vice Chair, Publications, for making the public aware of our activities and providing valuable technical publications. I look forward to working with Doug Mancino, who will be taking over our publications from Lou.

CLE is one of the most important activities of the Section and one that is highly valued by our members. Sam Braunstein, our Vice Chair, Professional Services, has done a magnificent job of not only maintaining, but elevating the quality and quantity of our CLE activities. I look forward to working with Emily Parker who will be taking over for Sam in leading our CLE efforts.

All of these efforts come together to make the Section the incredible organization that it is today. This success can only be continued with the renewed dedication of our members in these difficult times.

I look forward to working with each of you over the next year and would be pleased at any time to receive suggestions you may have regarding the issues outlined here or any other matters that the Section should address. I look forward to seeing everyone at our next meeting in September, which is a joint meeting with RPTE in Chicago. ■

COST OF LIVING ADJUSTMENTS | **POINT & COUNTERPOINT** *continued from page 1*

cost of living. We recommend several policy changes to help eliminate the inequities created by cost of living differences.

It is well known that geographic cost of living differences vary considerably by state, and within states by city and town. A person living in a high cost state, such as New York, will pay a significantly different federal income tax than someone living in a low cost state, such as Alabama, even though both taxpayers have the same income. This is due to several factors. Taxpayers in high cost states pay higher expenses that may be deductible, such as state and local income and property taxes, housing costs (mortgage interest), automobile expenses, travel and entertainment expenses, and other items. Therefore, taxpayers in high cost states may pay less in tax than their counterparts in low cost states.

In some cases, however, taxpayers in high cost states with larger deductions may pay higher federal income taxes than taxpayers in a low cost state because of the Alternative Minimum Tax, which disallows deductions for state and local income and property taxes and miscellaneous itemized deductions. Other examples of geographic inequity include the automobile mileage allowance and the parking fringe benefit exclusion, which is the same regardless of where you live. These amounts do not take into account wide geographical variances in auto insurance, gasoline, parking fees, average commuting distances, etc. Furthermore, in comparing high income states to low income states, adjusted gross income (AGI) will vary considerably among the states and itemized deductions and credits are affected because of phase-out rules and

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of the Joint Committee is to make sure that there are sufficient staff to perform the functions that they needed.

Q Did you work on hedge accounting?

A Normally most of the things you get to work on in the Joint Committee is legislation suggested by the administration. There was one project that I worked on where what happened was exactly the other way—a solution to a problem was considered by Congress but was adopted administratively by Treasury. This was the *Arkansas Best* issue. If you recall, *Arkansas Best* was a case that arguably overturned the *Corn Products* doctrine as to what assets would be treated as ordinary even though they did not literally come within the exclusions of what is a capital asset under section 1221. Well the uncertainty caused by that case became a huge issue because it effectively left a lot of people in a no man's land of uncertainty. Efforts to solve that uncertainty legislatively had stalled since, depending upon how you scored the effects of the *Arkansas Best* decision, legislation was going to either raise or cost a lot of money, with the result that it was impossible to move on the thing. I had been attending a study group sponsored by Virginia Tech where the subject of hedge accounting was discussed. In the case of hedge accounting, the two elements of hedge are paired together and not taken into account until the hedge was terminated. The idea of applying that concept to solve the *Arkansas Best* problem sounded like a good idea if a set of rules could be adopted that provided certainty, but could not be abused. Accordingly, I put together a group of people on our staff and Treasury and IRS to work on such a proposal. We worked over a year making sure that it worked and did not create either character or time mismatches. Unfortunately, our work did not solve the revenue problem.

In the meanwhile, the *Fannie Mae* case was decided and allowed ordinary treatment of some assets that did not literally come within the exclusions of section 1221, which meant that the Treasury was able to issue regulations under sections 1221 and 446 that basically adopted the Hill-originated proposal administratively since Congress was unable to adopt it legislatively. ■

POINT & COUNTERPOINT | COST OF LIVING ADJUSTMENTS *continued from page 6*

percentage limitations, which cause a taxpayer to lose deductions or credits as income rises.

One of the fundamental characteristics of a fair tax, ability to pay (as measured by income), however, is not adjusted automatically for cost of living differences between geographic areas. Cost of living research indicates that there is no immediate theoretical correlation between the cost of living in a particular area and the wages paid in that area, except in the long term due to assumed migration, as the demand and supply functions are separate for these items. The cost of living is determined by the demand and supply of housing, food, etc., and wages are determined by the demand and supply of labor for a particular job.

For example, New York City has a high cost of living but that does not mean that if you are an engineer and you move there you should expect higher pay. Your pay is determined by the supply of engineers and the number of job openings for engineers. One may argue that theoretically, in the long term, these inequities should equalize due to migration of workers or businesses. However, we certainly cannot assume that there is no need to adjust tax laws to improve horizontal equity for cost of living differences because the other side of the equation, income, will automatically compensate, even in the long term. Workers and businesses migrate for various reasons, not all of which are economic or related to labor costs. Clearly, federal law taxes geographical differences on the income side of this equation. It should also make adjustments for differences on the expense side in order to improve equity.

As stated earlier, horizontal equity is defined as treating taxpayers in the same economic situation in the same fashion. Simply stated, with respect to the income tax, individuals in the same economic scenario should pay the same amount of federal tax. It is important to note that equity measures do not specifically measure the level (amount) of the tax liability. The equity measure simply determines if taxpayers in the same economic situation pay the same amount of tax; it does not determine if that amount is too high or too low relative to that of other groups.

In our study, we calculate HE for married filing joint individual tax return data for 2001. Our results show, on the federal level, an increase in income results in decreased HE. This seems counterintuitive because, as income rises, tax deductions and credits phase out and taxpayers are on more equal footing. However, looking at the detail for each state, HE does not systematically decrease with an increase in income. The interaction effect of owning vs. renting and dependent children vs. no dependent children further complicates the analysis, and is exacerbated (or perhaps explained) by the difference in HE between states and within states due to great variances in housing costs, property taxes, state and local income taxes, and tax credits and exemptions for dependent children. The analysis shows that there is a considerable difference between the tax burdens of individuals across the United States who are deemed to be in the same economic situation or who are deemed to have the same ability to pay.

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they are overrides. Various Code sections can expressly provide an allowance, ceiling, or floor on a particular item on joint returns that differs from double that on returns of single taxpayers, but they are all express, not inferred. Section 163(h)(4)(A), coupled with the parentheticals in section 163(h)(3)(B)(ii) and 163(h)(3)(C)(ii) can as easily, maybe more easily, be read as an express penalty on married taxpayers who file separate returns.

It is possible that the origin of the difficultly in interpreting the statutory language very well might lie in the drafters of the 1987 amendment to section 163(h) erroneously believing that married individuals filing a joint return as a matter of doctrinal law were converted into one unitary taxpayer. That is incorrect, but the same error led to some strange language in section 121(d)(1) that is discussed in an article I published shortly after section 121 was enacted. *See* Martin J. McMahon, Jr., *Taxation of Sales of Principal Residences After the Taxpayer Relief Act of 1997*, 75 TAXES 610 (Nov. 1997). It is also possible that the drafters of section 163(h)(3) might have failed to contemplate the fact pattern in the CCA. In 1987, these issues had been little discussed by tax professionals, with the exception of some in academia, and if the discussion was only in a mainstream law review, no one writing the statutory language was aware of it.

Thus we are forced to try to figure out the meaning of statutory language that very well might have been drafted on an erroneous premise regarding the default meaning of the word "taxpayer" in a Code provision, and which possibly never contemplated two single taxpayers co-owning a home with a purchase money mortgage. In the end, I think the words of the statute are better construed to mean that the $1,000,000 ceiling is both per physical residence unit and per taxpayer, than to mean that the statute creates a marriage penalty when two singles who co-own a principal residence with a $2,000,000 purchase money mortgage get married and file a joint return, thereby losing one-half of their interest deduction because the joint return is limited to interest on a $1,000,000 mortgage. Construing the statute to allow a husband and wife on a joint return to claim deductions for interest on a $2,000,000 mortgage but allowing them a deduction on only a $1,000,000 mortgage if they file separately is the least likely plausible construction.

There is one conclusion of which I am certain. It is inconceivable that Congress intended to allow two unmarried taxpayers who share a principle residence each to deduct interest on acquisition indebtedness of up to $1,000,000, for a total of $2,000,000 of acquisition indebtedness, while limiting married couples filing jointly to a deduction for interest on acquisition indebtedness of up to only $1,000,000. Unless the statutory language unambiguously compels that result, any interpretation of the statute that reaches that result is likely to be rejected by the courts. Thus, the most reasonable conclusion is that if challenged, the Service's conclusion in CCA 200911007 likely will be sustained. ■

POINT & COUNTERPOINT | COST OF LIVING ADJUSTMENTS *continued from page 11*

Our analysis shows horizontal equity cannot be classified by region, i.e., we cannot say the Northeast is more/less equitable than the Southwest. However, considering taxpayers who own homes, we observe the states that are the most inequitable tend to be in the coastal areas. Likely, this is a reflection of the cost of living disparities between areas within the state. The states where renters have the most inequity are more scattered. Interestingly, there are only eight states whose Coefficient of Variation Ratio (the measure we used for HE) for this group of taxpayers is above the federal average (i.e., has worse horizontal equity) for both owners and renters: California, Colorado, Florida, Hawaii, Montana, New York, North Dakota, and Vermont.

In a perfect HE world, the United States would be economically homogeneous within income bands. Of course, this is not the case. The size and diversity of the United States is arbitrary and changes over time, yet the Code applies the same law to everyone regardless of location. Changes in tax prices, like all prices, are caused in part by changes in space (geography) and time (inflation). Congress has been much more aggressive addressing the inequities caused by inflation. They have, for the most part, neglected the very real inequities caused by geographical differences within the United States.

Policy recommendations must be weighed against increases in complexity and compliance burdens. One fairly easy way to eliminate some of this inequity is to create different federal income tax brackets for each state or city that would take into account the federal tax subsidy due to, for example, housing cost differences. We anticipate that different tax rate schedules would be needed for different taxpayers (e.g., itemizers vs. non-itemizers or renters vs. homeowners) for a particular location, which would add some complexity (and possible political problems) and may create new tax avoidance schemes. For those states that have a tax system that is derived from federal tax law, this change could prove problematic.

Another possibility would be to eliminate the mortgage interest, property tax, and state income tax deductions for all taxpayers, if these variables are causing variances in horizontal equity, while

at the same time lowering tax rates. A further way to reduce HE variability is to place deduction caps on the variables that are responsible for the differences, once they are known. Specific policy recommendations can be made when we know more about the variables creating the geographical differences in HE. This will require further research.

COUNTERPOINT

The Inequities in Cost of Living Adjustments

By Calvin H. Johnson*

Professors Angelini and Noga propose to reduce tax in high cost of living locations and shift the tax burden to low cost of living locations. Cost of living varies across locations for many reasons. For most of the reasons, adjusting the tax base to take away the variations in cost of living would be terribly inequitable.

Cost of living, first, is the purchase price for amenities. People bid up the price of New York City living space to get access to the opera, dance, theater, symphony, extraordinary French restaurants, and professional sports. In the desert, there is no such access. Similarly, the cost of real estate is higher in southern California than in northern Minnesota because the weather is better on the California coast. People buy sunshine and temperate weather by bidding up the price of limited California coast land. By contrast, you can get space cheaply in rat-infested, falling down houses in crime-ridden, polluted neighborhoods with bad schools, bad weather, and bad access to transportation. If you are willing to put up with a three-hour commute to center city, then the cost of living will go down.

The relative value of the costs across the country is kept in equilibrium by the high level of geographical mobility in this country. According to the Census, 38 million people moved in 2007 and almost six million of them moved to a different state. Each household that moves must make the judgment as to what is the best value to be had for the money allowed by its budget. The moving households bid up the more attractive locations and do not bid for the less attractive locations until the price comes down. People who are settled have a strong psychological tendency not to move. Those who do move are market makers who set the price between their choices. Settled taxpayers can rely on the movers to keep the relative price of a location more or less in equilibrium. Given that settled taxpayers do not move, moreover, they must get even more value from their current location than is reflected in the price of their house. You get by and large what you pay for in an open competitive market. The market price of a location comes to reflect the advantages and the disadvantages of the location in which one lives.

If people are getting full value for their higher costs, it would be inequitable to filter that out of the tax system. Indexing to take the costs of amenities out of the tax base would reduce tax on those who pay for a rich full life in sunshine or excitement and shift the tax burden, inequitably, over to those who live with rats, pollution, bad schools, crime, cold, parched land, or long commutes.

Cost of living is also correlated with wealth. Rich people move into desirable neighborhoods and drive up the price. Restaurants and recreation follow the rich so that the non-housing budget is higher in those locations as well. On the other side of the coin, the poor get priced out of desirable locations and move to old housing in crime-ridden or polluted neighborhoods, or to parched land with long commutes, because that is what they can afford.

Some of the differentiation between the locations of the rich and less rich is already tax driven. The tax subsidies for housing in the form of the home mortgage interest deduction, the deduction of property taxes, and the failure to tax the noncash rental-value return from investing in housing have a value that depends upon tax brackets. In neighborhoods where purchasers are in the 35% tax bracket, the price of the house will come to reflect at least some of the tax subsidy because existing homeowners selling their houses try to capture as much of the value of the tax subsidy as they can. When purchasers are in lower brackets or get no tax savings from itemized deductions, there is less tax savings for selling homeowners to capture. The deductions for interest and property taxes and exclusions for real return from investment in a home plausibly already reflect too much of the variable cost of housing. Equity might well be improved by taxing *more* of the difference in cost of living, not less.

Because of the migration of rich and less rich, and the differential tax benefits reflected in price, zip codes over time come to be richer than average, or disproportionately poorer. Indexing for cost of living per zip code, under those circumstances, will shift tax away from the wealthier, who can more comfortably bear another dollar of tax, and over to less wealthy taxpayers, from whom another expense, including tax, would be devastation. Shifting the tax burden from richer to less rich would increase the damage that tax does to the sum of human happiness.

Another part of the difference in cost of living is costs of transporting goods. Oranges are more expensive in the North, beef is more expensive on the coasts, and toys and electronic goods are more expensive the farther you live from China. In general, consumption costs, including the embedded transportation costs, are personal expenses that properly are not deductible. An even tax on all consumption reduces private consumption across the board. It is the suppression of private consumption that allows room for public spending. I don't see why the government should subsidize the transportation component of consumption by treating it better than other personal costs.

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Cost of living can sometimes be plausibly treated in part as an expense for the production of income, and then there is a more reasonable case for deduction. People move where the jobs are in order to make higher wages, sometimes even when the pleasures of the new location are a lot worse than the amenities of the old. Section 162(a)(2) allows a deduction for meals and lodging while away from home, on the grounds that such meals and lodging are atypically expensive. Cost of living adjustments can be rationalized as just a liberalization of section 162(a) to include expensive meals and lodging while not away from home. I have expressed doubt that section 162(a)(2) is good policy—consumption is a personal expense that needs to taxed whatever its context. Calvin H. Johnson, *An Employer-level Proxy Tax on Fringe Benefits*, 123 Tax Notes 483 (April 27, 2009). Still, Professors Angelini and Noga undercut the best case for the deduction, by arguing that there is no "*immediate* theoretical connection" between the costs of living in an area and the wages paid. An immediate nexus between costs and taxable wages would improve their case.

Once you take amenities, wealth, and transportation costs out of the mix, there may not be any adjustments left in cost of living differentials. If it exists, we may not be able to identify residual cost of living differential. Professors Angelini and Noga analogize between indexing the tax brackets for time variations in cost of living—what we call "inflation"—and indexing the tax brackets for geographical variation in the residual cost of living. Of course, one can not avoid inflation by moving around in time, whereas you can avoid a high cost of living or adjust your costs to your preferences by moving around geographically.

Even considering the residual differences in cost of living not explained by amenities, wealth, or transportation, a good case can be made for *increasing* tax in the high cost of living areas. The government needs a dollar to close the deficit, pay for the Marines, or whatever. To the government, the dollars are the same no matter where they come from. If a dollar buys less value in high cost of living locations, we should collect more tax from those locations. The science of tax is the science of taking dollars away that do the least harm to private utility, and taking dollars away from places where the dollar buys less will do less harm.

Professors Angelini and Noga set up a "Coefficient of Variation Ratio" that purports to identify horizontal inequity. The ratio is valid only on the assumption that every variation is an inequity. The variations in tax for varying costs of living, however, are mostly mandated by equity. Wealthier taxpayers who buy greater amenities, for example, should pay greater tax. Moving over to a ratio before establishing the underlying equities being measured just obscures the debate. It is far too early to move over to the ratios.

For further reading, *see, e.g.,* Michael S. Knoll & Thomas D. Griffith, *Taxing Sunny Days: Adjusting Taxes for Regional Living Costs and Amenities*, 116 Harv. L. Rev. 987 (2003), and Louis Kaplow, *Regional Cost of Living Adjustments in Tax-Transfer Schemes*, 51 Tax L. Rev. 175 (1996).

COUNTERPOINT

The Inequities in Cost of Living Adjustments

By Joseph Dodge*

I do not understand Professors Angelini and Noga (especially in their *Tax Notes* piece of December 8, 2008) to be proposing a geography-based high-housing-cost-of-living adjustment. Their core finding is of a "wide geographical variation in horizontal equity among the states likely attributable to varying amounts of federal income tax [itemized] deductions for mortgage interest, property taxes, and state income taxes." Horizontal equity (HE) is measured by net economic income (AGI) as adjusted upward to remove various exclusions and deductions related to savings. That is, the baseline for measuring HE assumes the absence of the itemized deductions in question, two of which (mortgage interest and property taxes) are attributable to the cost (and/or value) of housing, which varies by geography, and the third of which can be described in neutral terms as a geographical cost-of-living variable. In simple English, the charge is that these itemized deductions derived from geographical cost-of-living variables produce *lower* tax for people in high-housing-cost localities than those with the same economic income in normal-cost-of-living localities. If anything, the thrust of their article calls for repeal of these deductions, because they don't really reduce what they consider to be the normative tax base, namely, ability to pay.

In any event, the fact that taxes fall unevenly according to geography is not a problem in itself. Residents of Connecticut pay higher per capita income taxes than people in Mississippi because, under a personal income tax, differences in income are supposed to matter, and residents of Connecticut have the higher per capita income. *The relevant question is whether the itemized deductions are appropriate in the first place.* If they are, then there's no problem of geographical uniformity. Suppose residents of West Virginia incur higher uninsured medical expenses than residents of Florida (and assume that income distributions are otherwise the same). If the medical expense deduction is an appropriate adjustment to the tax base, and if West Virginia residents benefit disproportionately, then there's no unfairness problem just because the tax benefits play out disproportionately according to geography. Similarly, if

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the itemized deductions identified by Professors Angelini and Noga are sound, then there's no fairness problem, because the tax base is correctly measuring what it is supposed to measure. It happens that the scholarly literature is opposed to the home mortgage interest deduction, and there are commentators on both sides as to the deductibility of state and local taxes. Opponents of these deductions might be grateful to Professors Angelini and Noga for possibly providing them with further ammunition, but I doubt if anybody on the fence would be persuaded to get off of it by this study.

Another way of stating the matter is that how you construct the model pretty well determines what comes out. Professors Angelini and Noga construct a concept of the normative tax base by which to determine HE by assuming that the deductions in question should not be considered. It is predictable that regional differences in quantity of expenses that generate these non-normative deductions will show up as geographical discrimination.

However, there is a danger that talk about regional discrimination could have the opposite effect than what is intended. For example, Professors Thomas Griffith and Michael Knoll argue that regional housing-cost differences matter on economic efficiency grounds. These authors assume that a given wage in Atlanta yields a higher standard of living than the same wage in Manhattan, but at the same time this disparity might be compensated for by "amenities" unique to Manhattan. The bottom line for Professors Griffith and Knoll is that failure to make an appropriate *downward* tax adjustment discourages moves to areas where higher wages are offered either to compensate for higher living costs or to compensate for lower amenities. Thomas Griffith & Michael Knoll, *Taxing Sunny Days: Adjusting Taxes for Regional Living Costs and Amenities*, 116 HARV L. REV. 987 (2003). Perhaps the Angelini and Noga research rebuts the high-salary/high-cost scenario in that the higher deductible costs will already provide the appropriate tax base adjustment. But then their findings will be used to support a contrary thesis to theirs, namely, that the deductions in question are at least partially justified.

In the "Point" to which I am responding, Professors Angelini and Noga appear to have moved to a position that is more open to geographical adjustments of all sorts than was proposed in their December 8 piece. Openness to downward tax adjustments for high-housing-cost localities could only be justified if living costs should be taken into account in determining HE. Otherwise, why care about cost of living? The only thing that would matter would be income (net of costs of income production). Housing costs are a prime component of personal consumption, which (in principle) is not deductible at all under an income tax. People can choose how to spend their money. The value of things to people is, according to market theory, reflected in their costs. Housing costs must be high in San Francisco because housing has a higher market value pursuant to the dynamics of supply and demand, whether by reason of location, climate, access to good schools, level of government services, access to culture, or proximity to Whole Foods. The high cost must be worth it.

The case for deducting "high" housing costs is no more persuasive than the case for allowing a deduction to one who consumes an excess of any other consumption item, such as food, alcohol, drugs, or gambling. No commentator has proposed a tax allowance for excess consumption even where it is "involuntary" (the result of addiction or psychological compulsion). No person is compelled to live in the Bay area or prohibited from moving to a low-cost area (say, Cleveland). Unlike inflation costs, excess housing costs can be avoided by moving to a cheaper location and cashing in, mostly tax-free, on the gains of any existing homes they happen to own. The economic efficiency case advanced by Griffith and Knoll is not persuasive. Wouldn't a rational employer move rather than pay higher wages to compensate either for higher costs or lack of amenities? The failure to move must be explainable either by higher profits (net of the higher wages) or a subjective locational preference.

If it is appropriate to offer a downward tax adjustment for high housing costs, then it would also be appropriate to mandate an upward tax adjustment to reflect low housing costs. Politicians, however, are loathe to inflict harm on significant groups of taxpayers. Accordingly, proposals of this sort tend to be implemented asymmetrically, that is, by only offering tax breaks without inflicting correlative tax burdens.

A tax allowance related to hypothesized higher costs essentially operates as a subsidy. Such is the case with section 911, which allows a deduction for incremental housing costs of U.S. taxpayers having foreign-source earned income. Section 911 is intended to lower the assumed psychological barrier of moving to a foreign country, and has been roundly criticized by commentators. There is no barrier (other than of the psychological sort) to moving to lower-cost U.S. locations, and there is no reason to subsidize those who choose to move to Aspen from Akron. I'm not even sure that the persons least able to move are the poor. But now we are talking about a relocation subsidy rather than a housing subsidy.

The income tax, following the ability-to-pay concept, provides allowances off the bottom for subsistence. But the case for increasing the standard deduction for residents of selected high-housing-cost localities has not been made. It is not clear that subsistence in Vallejo, California is really higher than in Newark, New Jersey. The study by Professors Angelini and Noga does not cover persons with ability-to-pay income below $40,000. Since poor and working class people are able to find housing in the vicinity of high-housing cost areas, an initial hypothesis might be that housing costs at the bottom do not vary

greatly by geography, or else that those at the bottom are sufficiently compensated either by amenities or higher wages. In addition, housing costs are not tied to current economic conditions as are (say) food costs, because housing costs (and in California, property tax costs) are set at the time of purchase (or, in the case of rent, possibly by rent control laws) as opposed to the time of consumption, and the purchase (or lease) might have been decades or generations in the past. Thus, tax return information wouldn't be adequate to identify persons who really need a subsidy. Tax allowances off the bottom would not help the really poor. Other federal and state programs exist that are designed to subsidize housing for the poor. There is no reason to assume that the poor would obtain the entire benefit of any subsidy directed at them. Any tax allowance will give such persons more money to spend on housing, and the increased demand would be expected to drive prices (rents) up, just as existing tax benefits for home ownership are considered to have driven up home prices.

The notion of location-based adjustments to the tax base is an idea whose time (fortunately) has not come.

A Response to Professors Johnson and Dodge

By James P. Angelini and Tracy Noga

We wish to thank Professors Johnson and Dodge for their thoughtful comments on our paper regarding geographic differences in horizontal tax equity. However, both professors' comments reflect common misconceptions about horizontal equity (HE).

HE is not about tax burdens or total taxes paid by taxpayers in different parts of the country. Both professors focus on the tax liability rather than the *variance* in the tax liability. HE is about each income group paying the same amount of tax, not how much tax they pay. HE does not speak to whether the tax liability is too high or too low relative to other income groups but only within an income group. We did not say we were equalizing tax burdens or "taking away variations in cost of living" or reducing taxes in high cost of living areas. We do not advocate shifting tax burdens to low cost areas, as both authors seem to imply (and spend much time discussing). In fact, our data suggest the opposite.

People in low cost areas actually pay more tax relative to taxpayers in higher cost areas that make the *same* income. We agree that taxpayers in high income areas shouldn't be subsidized. Looking at the detail for each state, our measure of HE does not systematically decrease (*i.e.*, get more equitable) with an increase in income. Both authors assume that our results suggest HE varies perfectly with cost of living variances. In fact, it does not. HE can be high (inequitable) in high cost states and low cost states. Both authors imply that HE correlates with income, which we did not demonstrate or claim. An examination of our results indicates that HE does not systematically decrease with an increase in income, as many might expect.

Both authors focus virtually solely on the housing cost variable. Our prior research, the basis for this commentary, simply establishes the magnitude of the inequity inherent in the current federal income tax system. Although we suggest housing costs as one of the many causes, our ongoing research focuses on the many variables that contribute to inequity. Admittedly, one of the largest contributors to inequity may be housing; however, there are many other variables that are potentially causal, such as AMT (loss of state and local tax deductions, miscellaneous itemized deductions and some mortgage interest deductions), marital status, number of dependents, itemizers vs. non-itemizers, state and local income taxes, and others.

For example, our research indicates that HE for a particular income group varies considerably between states for renters with no children and that HE decreases for taxpayers with children more than for those without children. The data also shows less HE for taxpayers that own houses versus those that rent. None of these results exhibit the "rich vs. poor" scenarios postulated by Professors Johnson and Dodge. Our research merely points out that there is a significant difference in HE within income groups both between and within states. We suggest possible causes but cannot demonstrate empirically any causation at this time, other than that HE does vary, which it should not in a perfectly equitable tax system.

Critiquing our HE measure (Coefficient of Variation) is a fair criticism. Trying to measure HE is difficult and researchers have struggled for years to come up with a measure, yet it remains imperfect. Nonetheless, it does not mean that we should not study nor be concerned with HE.

Both authors miss the point of our research, which for the first time demonstrates that horizontal equity, not just tax burden, varies geographically. This variation is a fundamental violation of equity principles and needs to be studied and possibly corrected, regardless of the cause of the inequity. We recommend further study into the root causes of this geographical difference as well as other causes of inequity. Depending upon the results of the future research, recommendations for tax policy changes can be made. ■