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A Tale of Three Cities: How Similar Taxpayers Pay Drastically Different Taxes

By David Brown

Consider two mechanics alike in almost every respect. They work equivalent jobs and the same hours. They are also identical as consumers—they live in identical three-bedroom homes, drive the same Ford F-150, buy the same groceries, and put away the same amount into savings. As a result, the two mechanics theoretically have the same ability to pay taxes. But under the U.S. tax code, one may owe thousands in federal income taxes, while the other gets a refund worth thousands.

How can that be? These mechanics have one critical difference—the city in which they live. A mechanic in a low-cost, low-wage city qualifies for certain valuable tax credits, but the mechanic in a high-cost, high-wage city does not. In this report, we demonstrate how middle-class families are subject to price and wage differences in three U.S. cities. We then show how differently these families are treated by the U.S. tax code.

The Tax Code's Top Six Cost-of-Living Disparities

- 1. Earned Income Tax Credit (EITC):** Subsidizes wages for working families earning up to \$43,000. Its phase-out makes it less beneficial to taxpayers in high-cost cities.
- 2. Childcare Credit:** Offsets childcare expenses for all families but at higher rates for those earning less than \$43,000. That threshold means more families in low-cost cities receive higher rates.
- 3. Saver's Credit:** Subsidizes retirement savings for low- to middle-income families. The phase out ends at \$59,000, making the credit less accessible in high-cost cities.
- 4. Child tax credit:** Provides a \$1,000 per-child credit for families at most income levels. The flat, nominal amount is of greater relative benefit to families in low-cost cities.
- 5. Free File:** Allows taxpayers with income up to \$58,000 to e-file their returns for free. The flat, nominal cap means fewer taxpayers benefit in high-cost cities.
- 6. Alternative Minimum Tax (AMT):** Raises tax rates for some upper-middle class families in high-cost cities, although its original purpose was to limit tax benefits for the wealthy.

In Hicksville, New York, workers pay more for everything from apartment rent to a box of Cheerios. Businesses account for these differences by paying higher wages in higher cost-of-living areas. But does the government account for price differences?

The federal tax code—not to mention numerous other federal programs—is full of means-tested provisions that fail to account for regional differences in cost of living. The result is that when two workers who have the same ability to pay—but who live in different places—sit down to do their taxes, the one living in South Texas may qualify for a variety of means-tested family credits, while his Long Island counterpart does not.

In this paper, we present a case study to illustrate and explain how middle-class families are affected by price and wage differences in three representative local economies: high-price, high-wage Nassau County, New York; medium-price, medium-wage Akron, Ohio; and low-price, low-wage McAllen, Texas. We then show the vastly different treatment the U.S. tax code gives families across regions, whether they're working class or upper-middle class.

In the early stages of tax reform, policymakers have engaged in plenty of discussion on how businesses are treated under the tax code. As they move forward, policymakers may also consider how the tax code treats individuals across regions and whether the code should be amended so that policies designed for the working and middle classes are truly helping their intended beneficiaries.

MANY COSTS OF LIVING

Wages and prices vary significantly across regions in the United States. To illustrate how much, we will explore the budgets of six hypothetical, but representative, families in three U.S. cities.

The first city, McAllen, Texas, is one of many low-wage, low-cost cities found in the Southern and Southwestern states. Located in the Rio Grande Valley near the U.S.-Mexico border, McAllen's rapidly growing metropolitan area is home to 800,000. Similarly sized Akron, the second city, is located in Ohio's industrial northeast. Akron has an area population of 700,000 and typifies the average-wage, average-price cities found across the Midwest. The third city is more accurately described as a large suburb. Nassau County lies directly east of New York City on Long Island and is home to 1.3 million. While less expensive than the city itself, Nassau County has the high prices and high wages common to urban areas on the East and West coasts.

In each city we assess two families: a working-class family and an upper-middle-class family. In McAllen, Akron, and Nassau County, the working-class family is headed by two parents: one working as a nurse's assistant and the other

as a security guard. They earn the median wage for their professions in their city and have two children.

The upper-middle-class families are also two-parent, two-child households. One parent is a sales manager and the other a mechanical engineer. Again, the workers earn the median wage for their professions in their city. These families are doing well in each of their respective economies. Whether or not these families are middle class is a question some would debate. The purpose in this example, however, is not to define the limit of the middle class. Rather, it is to assess how the tax code treats similarly situated, two-earner professional families living in different cities.

Wage Differences Across Cities: Median Salaries for Select Occupations and Representative Families¹

	Nassau County	Akron	McAllen
Working Class Family Income			
Nurse's Assistant	\$35,080	\$22,520	\$19,080
Security Guard	\$27,730	\$22,940	\$20,670
Total Income	\$62,810	\$45,460	\$39,750
Upper-Middle Class Family Income			
Sales Manager	\$142,680	\$99,000	\$89,270
Mechanical Engineer	\$97,230	\$69,830	\$54,670
Total Income	\$239,910	\$168,830	\$143,940

Whether families are working class, upper-middle class, or something else, they face substantially different wages in McAllen, Akron, and Nassau County. But those wage differences reflect similar differences in the prices of goods and services in each city. Consider the biggest cost almost any family faces: housing. In McAllen, a working class family can expect to pay \$1,041 a month in rent for a three bedroom house. In Akron, the cost would be \$1,104, and in Nassau County it would be \$2,493.²

Take the upper-middle-class families. Let's say each owns a four-bedroom home purchased ten years ago. The McAllen family likely paid \$122,500 for that home, whereas the Akron family paid \$217,500 and the Nassau County family \$615,000.³

With respect to other goods and services, prices don't always vary as much as they do with housing, but they do vary. A loaf of bread costs \$1.29 in McAllen, \$1.36 in Akron and \$1.79 in Nassau County. A gallon of gas costs \$3.36 in McAllen, \$3.54 in Akron, and \$3.85 in Nassau County.

Below we look at how typical expenses vary from region to region.

Representative Prices Across Cities: Average Prices of Selected Consumer Goods and Services⁴

	Nassau County	Akron	McAllen
	Food and Groceries		
One pound of ground beef	\$3.85	\$3.62	\$3.24
Half gallon of milk	\$2.40	\$2.16	\$2.59
One dozen eggs	\$2.45	\$1.65	\$1.77
One pound of bananas	\$0.70	\$0.60	\$0.48
Loaf of bread	\$1.79	\$1.36	\$1.29
Orange juice	\$3.77	\$3.52	\$3.13
Cereal	\$4.23	\$3.83	\$2.66
McDonalds Quarter-Pounder with Cheese ⁵	\$4.69	\$3.79	\$3.70
	Energy		
Home energy bill	\$212.94	\$171.98	\$175.85
Gallon of gas	\$3.85	\$3.54	\$3.36
	Health		
Doctor visits	\$98.11	\$93.30	\$73.33
Dentist	\$98.12	\$72.25	\$72.17
Ibuprofen	\$10.18	\$11.19	\$8.31
Lipitor	\$213.03	\$193.84	\$195.84
	Services		
Hair cut	\$12.93	\$14.10	\$9.30
Tires balanced	\$10.95	\$12.89	\$8.63
Dry cleaners	\$10.70	\$12.78	\$8.33
Babysitter (per hour) ⁶	\$13.25	\$10.00	\$9.75
Auto insurance (annual premium) ⁷	\$1,253	\$991	\$1,428
	Home		
Monthly Rent	\$2,493	\$1,104	\$1,041
Monthly mortgage payment (3 bedroom home) ⁸	\$1,581	\$456	\$353
Monthly property taxes ⁹	\$618	\$178	\$160
Monthly homeowners insurance ¹⁰	\$77	\$88	\$247

What do all these price differences add up to? Economists at the Council for Community and Economic Research have developed a cost-of-living index for U.S. cities. The index shows that a typical working-class family in Nassau County faces prices 34% higher than the U.S. average. A McAllen family faces prices 12% below the U.S. average. And an Akron family faces prices equal to the U.S.

average. Prices faced by an upper-middle-class family reveal similar differences. In Nassau County, prices are 34% higher than the U.S. average; in McAllen, they are 14% below average; and in Akron, they are 2% above average.*

So do people in McAllen, Akron and Long Island earn wages that reflect the cost of living in their cities? For the most part, they do. Start with Akron, the city with an average cost of living. There, the median-earning nurse's assistant makes \$22,520, and the median-earning security guard makes \$22,940. Together the couple makes \$45,460. The equivalent McAllen family makes \$39,750 (13% less) and the equivalent Nassau County family makes \$62,810 (38% more).

In this example, the wage premium that the Long Island workers receive compensates them for the higher cost of living, relative to their McAllen and Akron counterparts. Of course, this wouldn't be the case for all occupations and locations. Some cities may have a labor shortage in certain skills, causing workers who possess them to earn more and enjoy a higher quality of life than similarly skilled workers in other areas.

Our example also does not consider the preferences some workers may have for living in some cities over others. If you love warm weather and Tex-Mex or want to live near family, you might be willing to make less—even after adjusting for cost of living—to be in a place like McAllen. Some localities may provide better public goods, such as more accessible public transportation or less pollution. Some of these discrepancies, but not all, are reflected in the levels of state and local taxes: to some extent, workers who get more services pay for them through higher taxes.

These caveats aside, the labor market—particularly in the private sector—does a pretty good job of reflecting, through wages, the price levels in various regions. Our examples illustrate this point: that people doing the same work in different cities tend to face prices commensurate with their wages. As a result, they have roughly the same ability to pay federal taxes. But, the tax code is far from uniform in how these families are treated.

ONE-SIZE TAX CODE

Most parameters in the federal tax code that affect working class families are set at fixed dollar amounts, regardless of regional differences in cost of living. For example, a married couple with two kids, filing jointly, can claim the Earned-Income Tax Credit (EITC) if the earners make less than \$43,000, no matter where they live. Similarly, the Saver's Credit is available for those earning less than \$59,000.

Our three families illustrate just how much these parameters matter. The working-class McAllen family is eligible for five popular tax preferences:

* These relative cost-of-living statistics, for working class families are from C2ER data and are based on a basket of goods typical for family in the second income quintile. For upper-middle class families, the basket of goods is typical for executive and professional households in the top income quintile.

- **EITC:** a refundable credit for low-to moderate-income worker; up to \$5,372 is available to a married couple with two dependent children earning less than \$43,038 a year.
- **Childcare credit:** a credit that can be claimed for up to \$3,000 spent on care for one dependent 12 or younger or \$6,000 for two or more. For families with income less than \$15,000, the credit is worth 35% of the expenses, and the rate phases down to 20% for families with income over \$43,000.
- **Saver's Credit:** a credit of up to \$2,000, for contributions made to an individual retirement account (IRA) available to a couple married filing jointly with income up to \$59,000.
- **Child tax credit:** For each child under the age of 17, families receive a credit of \$1,000. The credit is limited for jointly filing couples earning more than \$110,000 and singly filing parents earning more than \$75,000.
- **Free File:** an IRS service that allows taxpayers earning less than \$58,000 a year to prepare and e-file their federal tax returns for free.

Largely as a result of these rules, the South Texas family receives a net gain of \$3,289 on its federal income taxes. The working class Akron family is eligible for some, but not all, of the means-tested benefits available to the working class McAllen family. As a result, it nets \$1,458 from the federal government. The working class Nassau County family misses out on some of the targeted low-income tax credits, such as the EITC and the Saver's Credit. In the end, it owes a total of \$1,511 in federal income taxes.

Tax Disparities Facing Working-Class Families: A Representative Tax Bill for a Security Guard and Nurse's Assistant, Married Filing Jointly¹¹

	Nassau County	Akron	McAllen
Income	\$62,810	\$45,460	\$39,750
401K contributions	\$3,141	\$2,273	\$1,988
AGI	\$59,670	\$43,187	\$37,763
Standard deduction	\$12,200	\$12,200	\$12,200
Exemptions	\$15,600	\$15,600	\$15,600
Taxable Income	\$31,869	\$15,387	\$9,963
Regular tax	\$3,888	\$1,539	\$996
EITC	\$0	\$611	\$1,812
Childcare credit	\$377	\$273	\$274
Saver's Credit	\$0	\$114	\$199
Child tax credit	\$2,000	\$2,000	\$2,000
Federal income tax owed	\$1,511	-\$1,458	-\$3,289
Effective tax rate	2.4%	-3.2%	-8.3%
Free File	No	Yes	Yes

Disparities are also evident in the taxes faced by upper-middle-class families. In the case of the families of managers and engineers, unequal tax treatment results largely from the Child Tax Credit and the Alternative Minimum Tax (AMT). The upper-middle-class McAllen family has income low enough to qualify for a reduced Child Tax Credit of \$1,000, whereas the other families do not qualify for the credit at all.

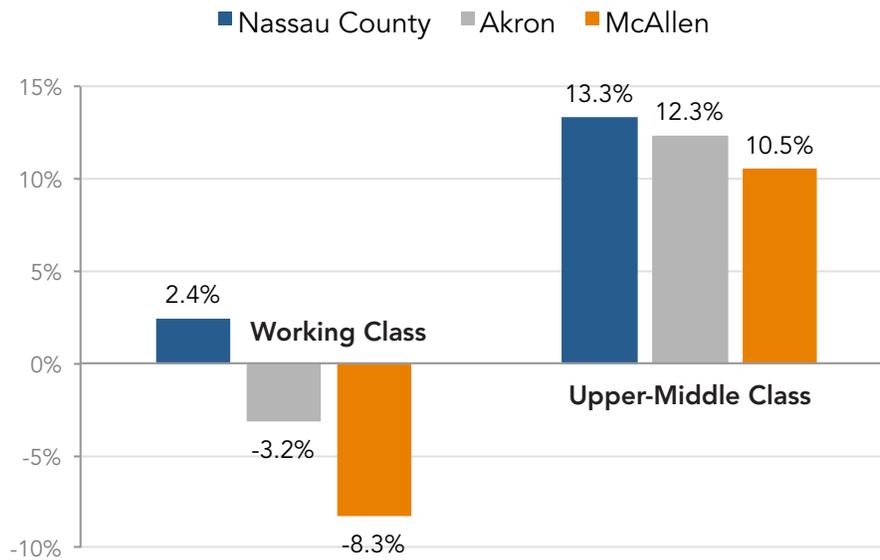
The upper-middle-class Nassau County family lands in a higher tax bracket than the upper-middle-class families in Akron and McAllen, but the higher marginal rates are partly offset by the ability to itemize deductions. The upper-middle-class Nassau family pays significantly higher property and state income taxes, and it pays more in mortgage interest. In the end, however, only the upper-middle-class Nassau family is hit by the AMT. That adds \$2,094 to its tax bill, causing it to face an effective tax rate of 13.3%, while the upper-middle-class Akron family pays 12.3% and the upper-middle-class McAllen family 10.5%.

Tax Disparities Facing Upper-Middle-Class Families: A Representative Tax Bill for a Sales Manager and Mechanical Engineer, Married Filing Jointly¹²

	Nassau County	Akron	McAllen
Income	239,910	168,830	143,940
401K contributions	23,991	16,883	14,394
AGI	215,919	151,947	129,546
Property tax	12,350	3,563	3,190
State income tax	13,009	7,016	1,836
Mortgage interest	18,472	5,328	4,121
Exemptions	15,600	15,600	15,600
Taxable income	156,488	120,441	101,746*
Regular tax	31,282	21,968	17,294
AMT	1,877	0	0
Tax before credits	33,159	21,968	17,294
Childcare Credit	1,200	1,200	1,200
Child Tax Credit	0	0	1,000
Federal income tax owed	31,959	20,768	15,094
Effective tax rate	13.3%	12.3%	10.5%

* The McAllen family takes the standard deduction of \$12,200.

Effective Federal Income Tax Rates: Representative Families Across Three Cities



CONCLUSION

Prices and wages vary considerably across U.S. cities. While the labor market mostly compensates workers for the prices they face, the U.S. tax code largely does not. As a result, a working-class family in an expensive area like Nassau County can end up owing thousands on its federal tax return, while an almost identical family in a low-cost city like McAllen gets thousands in return. Similarly situated working-class families, which work the same jobs and buy the same goods and services, can end up owing \$1,511 in federal income taxes in Long Island, but get a refund of \$3,289 in South Texas. Higher up the income scale, a Long Island family can be hit with AMT, paying a 13.3% average federal income tax rate, while its South Texas counterpart pays no AMT, claims the Child Tax Credit, and gets an average rate of 10.5%.

The tax code is not the only area in which federal means-tested programs fail to account for cost-of-living disparities. That is largely because many means-tested programs are based on the Federal Poverty Line, which does not account for cost-of-living disparities. Such programs include:

- Supplemental Security Income: SSI provides monthly cash assistance to people who are blind, disabled, or elderly and have little income and few assets. Unlike many federal means-tested programs, SSI has a uniform federal eligibility formula, which does not account for cost-of-living disparities.¹³
- Supplemental Nutrition Assistance Program: SNAP, formerly known as the Food Stamp Program, provides vouchers for food purchases to low-

income Americans. SNAP eligibility rules are largely uniform across the states. To be eligible, a three-person household must have annual income below about \$24,800 a year.¹⁴

- National School Lunch Program: NSLP provides free and reduced meals to children of eligible families attending public or nonprofit private schools. To receive free meals, for example, a family of four—in almost any location—must have annual income less than \$30,615.¹⁵

All of these programs should be evaluated, and a good place to examine cost-of-living disparities would be the tax reform effort already underway in both the House and Senate. Just as policymakers work to assess the effectiveness of business tax provisions, they should also ask if critical middle class tax provisions need to be amended to help middle-class families—whether they live in Texas, Ohio, or New York.

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Endnotes

1 All wage statistics reflect the median. See United States, Department of Labor, Bureau of Labor Statistics, "Occupational Employment Statistics: Metropolitan and nonmetropolitan area," Dataset, May 2012. Accessed August 20, 2013. Available at: <http://bls.gov/oes/>.

2 Based on Zillow Rent Index for 1,500 square-foot homes in Nassau County, Summit County (Akron, Ohio) and Hidalgo County (McAllen, Texas). See "Zillow Rent Index (ZRI): ZRI per square foot by county," Data, Zillow Real Estate Research. Accessed August 19, 2013. Available at: <http://www.zillowblog.com/research/data/>.

3 Author's calculations, based on a 2,500 square-foot home. See "Zillow Home Value Index (ZHVI): Median ZHVI per square foot by County," Data, Zillow Real Estate Research. Accessed August 19, 2013. Available at: <http://www.zillowblog.com/research/data/>.

4 Unless otherwise noted, price data provided by: "ACCRA Cost of Living Index: 2012 Q1 – 2013 Q3 Average Prices," Dataset, The Council for Community and Economic Research (C2ER), May 2013. Available for purchase at: <http://www.coli.org/>.

5 Local McDonald's store employees, Interview by David Brown, Phone interview, Third Way, August 19, 2013.

6 "Babysitting Rates," Web calculator, Sitter City. Accessed August 19, 2013. Available at: <http://www.sittercity.com/babysitters/babysitters-rate-calculator.html>.

7 Rates reflect the annual premium on a Ford Focus S, for the cities' respective states, as estimated by "Compare Car Insurance," MSN Money, 2013. Accessed August 19, 2013. Available at: <http://money.msn.com/auto-insurance/auto-insurance-quotes>.

8 Estimates based on June 2013 average prices for three-bedroom homes in the cities' respective counties. See "Zillow Home Value Index (ZHVI): 3 Bedroom Homes by County," Data, Zillow Real Estate Research. Accessed August 19, 2013. Available at: <http://www.zillowblog.com/research/data/>.

9 Estimates based on ZHVI data and average property tax rates of 1.9% for Nassau County, 1.9% for Akron, and 2.2% for McAllen. For property tax estimates, see City-Data.com. Accessed August 19, 2013.

10 Replacement cost value estimates gathered from "Is your home adequately insured," Online calculator, Yahoo Homes. Accessed August 19, 2013. Available at: http://homes.yahoo.com/calculators/home_insurance.html; for Insurance quotes provided, see also "Get a Homeowners Rate Quote," Online quote generator, State Farm Insurance Company. Accessed August 19, 2013. Available at: http://homes.yahoo.com/calculators/home_insurance.html.

11 Calculated using: "MyTaxBurden: Tax Policy Calculator," The Tax Foundation, Updated April 2013. Accessed August 19, 2013. Available at: <http://interactive.taxfoundation.org/taxcalc/#calculator>. Tax year is 2013. Each family is assumed to: contribute 5% of its wages to an Individual Retirement Account (IRA), take the standard deduction, claim four exemptions, and spend 3% of its income on childcare expenses.

12 Calculated using "MyTaxBurden." Tax year is 2013. Each family is assumed to: contribute 10% of its wages to an Individual Retirement Account (IRA); hold a mortgage on a 2,500 square-foot home purchased in 2003 at the median ZHVI price per square foot, with a 20% down payment, and a current interest rate of 4.5%; to pay property taxes according to the previous assumptions and local property tax rates; to pay state income taxes according to respective state income tax codes—or to deduct consumption taxes if no state income tax exists (Texas); and to claim the maximum amount of expenses for the Childcare Credit.

13 "Introduction to the Supplemental Security Income (SSI) Program," Report, Center on Budget and Policy Priorities. Accessed August 20, 2013. Available at: <http://www.cbpp.org/cms/index.cfm?fa=view&id=3367>.

14 "Policy Basics: Introduction to the Supplemental Nutrition Assistance Program (SNAP)," Report, Center on Budget and Policy Priorities. Accessed August 20, 2013. Available at: <http://www.cbpp.org/cms/index.cfm?fa=view&id=2226>.

15 Alaska and Hawaii have different eligibility thresholds, but the remaining 48 states are subject to the same nominal eligibility levels. See United States, Federal Register, "Department of Agriculture: Food and Nutrition Service: Child Nutrition Programs; Income Eligibility Guidelines," Vol. 78, No. 61, March 29, 2013. Accessed August 20, 2013. Available at: <http://www.fns.usda.gov/school-meals/federal-register-notice>.