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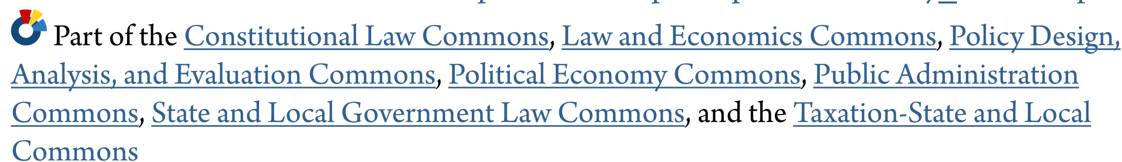
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ESSAY

IS THE PHILADELPHIA WAGE TAX UNCONSTITUTIONAL? AND IF IT IS, WHAT CAN AND SHOULD THE CITY DO?

MICHAEL S. KNOLL† & RUTH MASON‡

Philadelphia, the fifth largest city in the United States with a population over 1.5 million,[1] has a complex and antiquated tax system. The Philadelphia tax system in general, and the City's business taxes in particular, have long been criticized for driving employers and jobs away from Philadelphia by making it expensive to conduct business in the City. According to Professor Robert Inman of the University of Pennsylvania's Wharton School, taxes alone make operating a business in Philadelphia 19% more expensive than in the suburbs.[2] And those tax-induced higher costs have had a dramatic effect. According to Inman, about half of the 300,000 jobs Philadelphia lost between

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1 *See* Dylan Purcell & Maria Panaritis, *Philadelphia Gains Population Despite Challenges*, PHILLY.COM (Mar. 27, 2015), http://articles.philly.com/2015-03-27/news/60520945_1_new-census-data-david-elesh-montgomery-counties [https://perma.cc/G6E6-UWU7] (reporting the population of Philadelphia at the end of 2014 as 1,560,297); *The Largest U.S. Cities: Cities Ranked 1 to 100*, CITY MAYORS STAT., www.citymayors.com/gratis/uscities_100.html [https://perma.cc/E2Z2-K6CC] (last visited Mar. 26, 2016) (placing Philadelphia fifth as of 2012).

2 CENT. PHILA. DEV. CORP., CENTER CITY REPORTS: PATHWAYS TO JOB GROWTH 15 (2014), http://www.centercityphila.org/docs/CCR14_employment.pdf [https://perma.cc/9RMM-9SRR] [hereinafter PATHWAYS TO JOB GROWTH] (citing ROBERT P. INMAN, LOCAL TAXES AND THE ECONOMIC FUTURE OF PHILADELPHIA: 2008 REPORT (2009), http://www.phila.gov/taxpolicy/PDFs/localTaxesAndEconomicFuture.pdf [https://perma.cc/XN5D-STX4]).

the 1960s and 1990s are attributable to the City's tax system, which Inman described as "a primary contributor to the city's decline" over that period.[3]

Although Philadelphia is not the only city facing fiscal challenges, the specific problems Philadelphia faces are not widely shared by other cities. Philadelphia places an unusually large tax burden on highly mobile factors of production, such as capital and labor, and less on fixed factors, most notably land. According to a 2014 report, 66% of Philadelphia's tax revenue comes from taxing mobile wages and profits.[4] In contrast, for New York and Washington, D.C., the comparable figures are 34% and 35%.[5] And only 17% of Philadelphia's tax revenue comes from real estate, whereas the corresponding figures for New York and Washington, D.C., are 41% and 36%.[6] Moreover, not only does Philadelphia place an excessively high reliance on taxing mobile factors of production, but the centerpiece of the Philadelphia tax system, the Philadelphia wage tax—which raised more than $1.6 billion in 2014[7]—now faces a constitutional challenge. Several petitions recently filed with the Philadelphia Tax Review Board seek a declaration that the wage tax, one of Philadelphia's largest sources of revenue and one of its most controversial business taxes, is unconstitutional.[8] Although the cases have not yet been heard, let alone decided, in our view the Philadelphia wage tax—is clearly unconstitutional as currently constructed (as described below). Accordingly, the City will soon face the question whether to save the wage tax by reforming it or eliminating it altogether and replacing it with other sources of revenue.

This Essay explains the constitutional challenge to the City wage tax, describes steps that could be taken to save that tax, and raises the question of whether Philadelphia should save or eliminate its wage tax.

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3 Christopher Wink, *Philly's City Wage Tax Just Turned 75. Here's Its Dubious Legacy*, TECHNICAL.LY PHILLY (Dec. 12, 2014), http://technical.ly/philly/2014/12/12/Philadelphia-city-wage-tax [https://perma.cc/2G34-HS4W].

4 PATHWAYS TO JOB GROWTH, *supra* note 2, at 15.

5 *Id.*

6 *Id.*

7 Jim Saksa, *U.S. Supreme Court Decision Imperils a Portion of Wage Tax in Philadelphia and Wilmington; Officials Unwilling or Unable to Estimate Likely Budget Impact*, PLANPHILLY (Dec. 14, 2015), http://planphilly.com/articles/2015/12/14/u-s-supreme-court-decision-imperils-a-portion-of-income-tax-in-philadelphia-and-wilmington-officials-unwilling-or-unable-to-estimate-likely-budget-impact [https://perma.cc/ZF2S-S295].

8 *Id.*

I. THE PHILADELPHIA WAGE TAX

In 1939, Philadelphia became the first municipality in the United States to impose an income-type tax when it enacted a 1.5% wage tax.[9] Over time, the wage tax increased, reaching a high of 4.96% in 1983, where it stayed until the mid-1990s.[10] Since the mid-1990s the wage tax rate has been steadily but slowly decreasing.[11]

The City imposes a tax on "[s]alaries, wages, commissions and other compensation paid by an employer" to employees.[12] Residents of Philadelphia are subject to the wage tax regardless of the state in which they work.[13] Nonresidents pay the wage tax on their compensation from employment in Philadelphia.[14] Individuals who are self-employed do not pay the wage tax. Instead, they are subject to the City's net profit tax, which is levied on net profits from the operation of a trade, business, or profession conducted by individuals, partnerships or associations.[15] The City's net profit tax is at the same rate as its wage tax, with the difference that the wage tax is on gross wages whereas the net profit tax is on net profits. Neither the wage tax nor the net profit tax allows residents a credit for taxes paid to other jurisdictions. (In general, when we talk about the wage tax, what we say will also apply to the net profit tax.)

Table 1 illustrates the City wage tax. The left column represents Philadelphia residents and the right column represents residents of states other than Pennsylvania. Residents and nonresidents can earn income outside Pennsylvania (top row) or in Philadelphia (bottom row).[16] The Philadelphia tax regime has three components:

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9 Wink, *supra* note 3.

10 CITY OF PHILA., INCOME TAX REGULATIONS, at vi (2002), http://www.phila.gov/trb/pdfs/income_tax_regs.pdf [https://perma.cc/S8FU-V44H] [hereinafter CITY INCOME TAX REGULATIONS].

11 *Id.* at vii-viii.

12 *Id.* at § 102(a).

13 *See id.* at § 205 ("The entire compensation received by an employee . . . is subject to this tax . . . . [T]he place or places in or at which the services were rendered [is not] material in determining liability for the tax.").

14 *Id.* § 207.

15 *Id.* §§ 102(b), 103(b), 202, 220.

16 Table 1, which shows residents of Philadelphia and residents of states other than Pennsylvania, does not show residents of Pennsylvania who live outside Philadelphia or income earned in Pennsylvania, but outside of Philadelphia. We excluded those details from Table 1 because the Court's test for tax discrimination, described below, can be illustrated most simply and intuitively by focusing on Philadelphia and non-Pennsylvania residents and income.

1. A flat tax of 3.91% on income earned in Philadelphia by Philadelphia residents (domestic tax, T_d, bottom left quadrant)[17]
2. A flat tax of 3.91% on income earned outside Pennsylvania by Philadelphia residents (outbound tax, T_o, top left quadrant)[18]
3. A flat tax of 3.4828% on income earned in Philadelphia by nonresidents of Pennsylvania (inbound tax, T_i, bottom right quadrant)[19]

Philadelphia, however, does not tax and cannot tax because of a lack of nexus the non-Pennsylvania income of nonresidents (the top right quadrant).

Table 1: Philadelphia Wage Tax

	Philadelphia Resident	**Resident of Another State**
Activity in Another State	Outbound Tax (T_o) 3.91%	N/A
Activity in Philadelphia	Domestic Tax (T_d) 3.91%	Inbound Tax (T_i) 3.4828%

II. THE DORMANT COMMERCE CLAUSE

Although state governments, and derivatively municipal governments, have wide powers to tax residents on their worldwide income and nonresidents on the income they earn within the jurisdiction, the Constitution limits these taxing powers.[20] One of the most important limitations is the Dormant Commerce Clause of the U.S. Constitution. The Commerce Clause grants Congress the power "[t]o regulate [c]ommerce . . . among the several [s]tates."[21] The Commerce Clause's broad grant of authority was a response to the economic situation prior to the Constitution's adoption.

17 CITY OF PHILA., SUMMARY SCHEDULE OF TAX RATES SINCE 1952, at 3 (July 2015), http://www.phila.gov/Revenue/Documents/Tax%20Summary%20Schedule%20rev%207.1.pdf [https://perma.cc/3BC3-UGFC].

18 *Id.*

19 *Id.*

20 *See* I JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION pts. II–III (2d ed. 1993) (describing constitutional restrictions and limitations on state taxation). State (and local) governments cannot constitutionally tax nonresidents on their out-of-state income. Thus, for example, Pennsylvania can tax Pennsylvania residents on their Pennsylvania and out-of-state (say Virginia) income, but Pennsylvania cannot tax out-of-state residents (say Virginia residents) on their income earned in other states (say Virginia or California). Pennsylvania is said to lack the nexus to tax nonresidents on their income from outside the state. Nexus is a constitutional requirement for taxation.

21 U.S. CONST. art. I, § 8, cl. 3.

Under the Articles of Confederation, the central government had very little power over economic affairs and so the states would regularly enact protectionist legislation. Such legislation tended to divide the national marketplace into separate state markets dominated by local interests. A strong national government that could protect commerce was seen as necessary to the creation of a national economic market.[22]

In its "dormant" or "negative" Commerce Clause doctrine, the Supreme Court has interpreted the Commerce Clause's affirmative grant of power to Congress to regulate interstate commerce to preclude the states from interfering with interstate commerce. Accordingly, the Supreme Court has long interpreted the Commerce Clause to prohibit states from discriminating against out-of-state parties.[23] Although discriminatory taxes are unconstitutional, ascertaining whether a state (or local) tax is discriminatory has proven difficult and contentious, and the tests for doing so have varied over time.[24] However, the Supreme Court's most recent tax discrimination case, *Comptroller of the Treasury of Maryland v. Wynne*, reinvigorated an easy-to-implement test for discrimination.

III. *WYNNE*: REINVIGORATING INTERNAL CONSISTENCY

Brian and Karen Wynne, a married couple with five children who resided in Howard County, Maryland, brought suit against Maryland alleging that a portion of the Maryland individual income tax violated the Dormant Commerce Clause.[25] Maryland formally divided its individual income tax into a "state" portion with a maximum rate of 4.75%, and a "county" portion with rates ranging from 1.25% to 3.2%.[26] The Wynnes resided in Howard County, where the "county" tax rate was 3.2%. Thus, the Wynnes paid "county" tax of 3.2% on both their Maryland income and on their non-Maryland income. In contrast, nonresidents paid "county" tax of 1.25%

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22 *See* Hughes v. Oklahoma, 441 U.S. 322, 325 (1979) ("[I]n order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation.").

23 *See* Gonzales v. Raich, 545 U.S. 1, 16 (2005) ("The Commerce Clause emerged as the Framers' response to the central problem giving rise to the Constitution itself: the absence of any federal commerce power under the Articles of Confederation. For the first century of our history, the primary use of the Clause was to preclude the kind of discriminatory state legislation that had once been permissible.").

24 *See, e.g.*, Comptroller of Treasury of Md. v. Wynne, 135 S. Ct. 1787, 1809 (2015) (Scalia, J., dissenting) (criticizing the Court's "bestiary of ad hoc tests and ad hoc exceptions that we apply nowadays, including the substantial nexus test, the fair apportionment test, and the fair relation test"); *id.* at 1809 ("The internal consistency rule invoked by the Court nicely showcases our ad hocery.").

25 *Id.* at 1793 (Alito, J., majority).

26 MD. CODE ANN., TAX-GEN. §§ 10-105(a) (West 2007), 10-106(a)(1) (West 2001).

on their Maryland income.[27] Maryland allowed taxes paid to other states to fully offset the "state" portion of the tax, but it disallowed any credit against the "county" tax.[28]

The Wynnes challenged only the "county" tax,[29] which we illustrate in Table 2 below for Howard County, Maryland, where the Wynnes resided.

Table 2: Maryland "County" Tax as Applied to Howard County

	Howard County, Maryland Resident	**Resident of Another State**
Activity in Another State	Outbound Tax (T_o) 3.2%	N/A
Activity in Howard County, Maryland	Domestic Tax (T_d) 3.2%	Inbound Tax (T_i) 1.25%

By analogy to Table 1, the left column in Table 2 represents residents of Howard County, Maryland and the right column represents residents of other states. Howard County residents and residents of states other than Maryland earn income in Howard County (bottom row) and outside Maryland (top row). Howard County taxes residents at 3.2% on both their Howard County income (bottom left quadrant) and their out-of-state income (top left quadrant). Howard County also taxes non-Maryland residents at 1.25% on their Howard County income (bottom right quadrant). Maryland, however, does not tax and cannot tax because of a lack of nexus the non-Maryland income of nonresidents (the top right quadrant).[30]

27 *See* MD. CODE ANN., TAX-GEN. § 10-106.1 (West 2004) (setting the nonresident "county" tax equal to the "lowest county income tax rate set by any Maryland County"); REVENUE ADMIN. DIV., COMPTROLLER OF MD., STATE & LOCAL TAX FORMS & INSTRUCTIONS 10 (2006), http://forms.marylandtaxes.com/06_forms/residentbook.pdf [https://perma.cc/CAW6-UCAK] (indicating that in 2006, Worchester County had the lowest county income tax rate of 1.25%).

28 MD. CODE ANN., TAX-GEN. § 10-703(a) (West 1995).

29 The formal division by Maryland of its taxes into "state" and "county" taxes has no effect on constitutional analysis, as both types of taxes are considered to be state taxes for constitutional purposes. *See, e.g.*, Nippert v. City of Richmond, 327 U.S. 416, 417, 434 (1946) (striking down a municipal license tax on business solicitors for violating the Dormant Commerce Clause); Frey v. Comptroller of Treasury, 29 A.3d 475, 492 (Md. 2011) (concluding that Maryland's "county" income taxes were state taxes for constitutional law purposes).

30 By analogy to Table 1, Table 2 does not show Maryland residents who live outside Howard County, nor does it show income earned in Maryland, but outside of Howard County. Such persons and income are excluded from Table 2 because their inclusions are not necessary to show that the challenged Maryland tax fails the internal consistency test.

In *Wynne*, a sharply divided Supreme Court struck down the Maryland "county" tax on the ground that the tax violated the Dormant Commerce Clause.[31] In striking down the Maryland tax, the Court relied upon the internal consistency test. Prior to *Wynne*, the Court had evoked the internal consistency test in seven cases and had used that test to strike down a state statute in three.[32] Nevertheless, the Court had been narrowing the test in recent years and had not struck down a state tax for failing the internal consistency test for roughly thirty years.[33] As described by the Supreme Court twenty years ago:

> Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear. This test asks nothing about the degree of economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate.[34]

Thus, the internal consistency test directs a court to assume that every state enacts the challenged state's tax regime, and then it asks whether, under such hypothetical harmonization, interstate commerce bears more tax than purely in-state commerce. Accordingly, in order to test the Maryland "county" tax for internal consistency, the Court assumed counterfactually that every other state enacted the challenged Maryland tax and then the Court looked to see how cross-border income would be taxed as compared to in-state income. We illustrate the Court's application of the internal consistency test in Table 3.

31 135 S. Ct. at 1803-06.

32 *See id.* at 1801-02 (citing Cent. Greyhound Lines, Inc. v. Mealey, 334 U.S. 653 (1948); Gwin, White & Prince, Inc. v. Henneford, 305 U.S. 434 (1939); and J. D. Adams Mfg. Co. v. Storen, 304 U.S. 307 (1938) as cases in which internally inconsistent tax schemes were held unconstitutional).

33 *See id.* at 1820-21 (Ginsburg, J., dissenting) (citing the sparse use of the internal consistency test in the past as supporting restrained use of the test now).

34 Okla. Tax Comm'n. v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995).

Table 3: Maryland "County" Tax Fails the Internal Consistency Test

	Howard County, Maryland Resident	Resident of Another State
Activity in Another State	$T_i + T_o$ 4.45%	T_d 3.2%
Activity in Howard County, Maryland	T_d 3.2%	$T_i + T_o$ 4.45%

Table 3 takes a single state (say Delaware) as a proxy for the other forty-nine states and assumes that state adopts the challenged Maryland tax. Table 3 then allows for simple comparisons of the tax burden imposed on in-state and cross-border commerce. Maryland residents (the left column) are subject to tax on their Maryland income only by Maryland (bottom left quadrant), but they are subject to both Delaware and Maryland taxation on their Delaware income (upper left quadrant). Similarly, Delaware residents are subject to tax only by Delaware on their Delaware income (top right quadrant), but they are subject to both Maryland and Delaware taxation on their Maryland income (bottom right quadrant). The shaded quadrants in Table 3 represent cross-border activity, and they show that, under the assumption that all states adopt the Maryland tax system, such income is taxed more heavily than domestic income. In the top left quadrant, the inbound tax (T_i) combines with the outbound tax (T_o) to increase the burden on Marylanders' out-of-state activities (4.45%). This combination also occurs in the lower right quadrant, which represents the burden on non-Marylanders' activities in Maryland. In contrast, for domestic income, the tax is only T_d (3.2%). Maryland's tax regime is internally inconsistent—thus violating the Dormant Commerce Clause—because under the Supreme Court's hypothetical harmonization, interstate income bears more tax (4.45%) than purely in-state income (3.2%).[35] Accordingly, the Supreme Court struck down the Maryland tax as unconstitutional.

35 On cross-border income, taxpayers would pay a tax of 1.25% to the state where the income arose and a tax of 3.2% to their state of residence. Because neither tax would have been deductible from the other, the total tax would be 4.45%.

IV. APPLYING THE PRINCIPLE ARTICULATED IN *WYNNE* TO THE PHILADELPHIA WAGE TAX

The application of *Wynne* to the Philadelphia wage tax is straightforward, as illustrated in Table 4. As with the Maryland "county" tax challenged in *Wynne* and illustrated in Table 3, it is easiest and most intuitive to analyze the Philadelphia wage tax by considering one state, say New Jersey, as a proxy for the other forty-nine states. Assume Camden, New Jersey, adopts the Philadelphia wage tax. Residents of Philadelphia and Camden who work where they live will pay only the domestic tax on their wages (T_d), which totals 3.91%. In contrast, residents of either Philadelphia or Camden who reside in one city, but work in the other city, will pay both the inbound and the outbound taxes ($T_i + T_o$) for a combined tax rate of 7.3928%. Because under hypothetical harmonization cross-border commerce is taxed at a higher rate (7.3928%) than in-state commerce (3.91%), the Philadelphia wage tax is internally inconsistent and under the majority's analysis in *Wynne*, the tax unconstitutionally discriminates against cross-border commerce.

Table 4: Challenged Philadelphia Tax Under the Internal Consistency Test

	Philadelphia Resident	**Resident of Another State**
Activity in Another State	$T_i + T_o$ 7.3928%	T_d 3.91%
Activity in Philadelphia	T_d 3.91%	$T_i + T_o$ 7.3928%

It should come as no surprise that the Philadelphia wage tax is internally inconsistent because the Maryland tax and the Philadelphia tax are similar in structure. Both the Maryland tax and the Philadelphia tax subject residents to tax on their domestic and outbound income at the same rate. At the same time, both Maryland and Philadelphia assess an inbound tax on nonresidents' inbound income, and neither Maryland nor Philadelphia provides residents a credit for taxes paid to the source jurisdiction (the other state) on their out-of-state income.[36] The regimes differ in their rates, but here the

36 Although the structures of the Philadelphia wage tax and the Maryland "county" tax are similar, they are not identical. For example, Maryland has a uniform state-wide inbound tax rate, which equals the state's minimum domestic tax rate (1.25%). In contrast, the Philadelphia inbound tax rate (3.4828%) exceeds the inbound and domestic tax rates outside of Philadelphia (0). Although such differences cannot save the Philadelphia wage tax from the same fate as the Maryland "county"

Philadelphia wage tax rate is even higher than the Maryland "county" tax rate. Because the inbound Philadelphia wage tax is higher than the inbound Maryland "county" tax, the incremental tax on cross-border activity is greater with the Philadelphia wage tax (3.4828%) than it was with the Maryland "county" tax (1.25%).

V. The Relationship Between Internal Consistency and Discrimination

Maryland and its supporters did not argue that the Maryland "county" tax was internally consistent. Instead, they argued that the Maryland tax was not discriminatory because it did not discourage cross-border commerce and hence should have been upheld. To support the argument that Maryland did not discriminate against its own residents' out-of-state income, Maryland and its supporters pointed to the equality of the tax rates on residents' Maryland and out-of-state income. Since Maryland set both rates at 3.2%, Maryland reasoned that it did not discourage residents from earning income outside of Maryland.[37]

Maryland had similarly defended its inbound tax from constitutional challenge in an earlier case.[38] In that case, Maryland compared the inbound tax rate of 1.25% with the domestic tax of 3.2%, and Maryland reasoned that it did not discriminate against nonresidents because it taxed nonresidents at a lower rate than its own residents. Thus, Maryland and its supporters argued that the tax non-discrimination principle should be written as follows:

$$T_d \geq T_i \text{ and } T_d \geq T_o \qquad (1)$$

Equation 1 says that a tax system is not discriminatory if the domestic tax rate equals or exceeds each of the inbound and the outbound tax rate.

In *Wynne*, the Court addressed and explicitly rejected that argument. In striking down the Maryland "county" tax and reinvigorating the internal consistency test, the Court relied on an amicus brief we wrote and another amicus brief submitted by eight tax economists and principally written by Alan Viard.[39] Those two briefs explained the economic underpinnings for the

tax, those differences might make it more difficult to save the Philadelphia wage tax by crediting local taxes than to save the Maryland "county" tax by crediting local taxes.

37 Brief for the Petitioner at 35-36, Comptroller of Treasury of Md. v. Wynne, 135 S. Ct. 1787 (2015) (No. 13-485). *See also* Transcript of Oral Argument at 18, *Wynne*, 135. S. Ct. 1787 (No. 13-485) (the Assistant to the Solicitor General argued on Maryland's behalf that the Court should reject the discrimination claim because Maryland's domestic and outbound tax rates were equal).

38 *See* Frey v. Comptroller of Treasury, 29 A.3d 475, 505 (Md. 2011) (holding that the Maryland tax "satisfies the compensatory tax doctrine and, consequently, does not violate the dormant Commerce Clause").

39 Brief of Michael S. Knoll and Ruth Mason as Amici Curiae in Support of Respondents, *Wynne*, 135 S. Ct. 1787 (No. 13-485) [hereinafter Knoll & Mason Brief]; Brief of the Tax Economists

internal consistency test, and the Court described the economic analysis in those two briefs as "undisputed."[40] Those briefs in turn drew upon academic work by us and others.[41]

As we have described in our prior academic work, it is common and (to most non-economists) intuitive to assume that the impact of taxes on competition can be understood from absolute comparisons of tax rates in only the market of interest. Although Maryland did not put its argument in precisely those terms, that is what it argued. But that intuition is wrong. As basic economic textbooks describe, jobs and investments are held not according to absolute advantage, but according to comparative advantage.[42]

Thus, it follows that determining whether a tax system is neutral between intrastate and interstate commerce requires looking beyond the particular market in question. In order to determine the impact of a state's taxes on interstate competition, we need to consider how a state taxes residents and nonresidents on *both* in-state and out-of-state income. Our principal result can be expressed as requiring adherence to a simple rule: all taxes should be assessed on either a *uniform source* or a *uniform residence* basis.[43] A source tax is uniform if it applies at the same rate and on the same base[44] to both

as Amici Curiae in Support of Respondents, *Wynne*, 135 S. Ct. 1787 (No. 13-485) [hereinafter Tax Economists Brief]. In addition to these two briefs, friends of the court filed twelve other briefs in *Wynne*, including the Solicitor General, who filed an amicus brief for the United States in support of Maryland.

40 *Wynne*, 135 S. Ct. at 1804.

41 *See* Ruth Mason & Michael S. Knoll, *Waiting for Perseus: A Sur-Reply to Graetz and Warren*, 67 TAX L. REV. 375 (2014) (responding to Professors Graetz and Warren's criticisms of competitive neutrality); Ruth Mason & Michael Knoll, *A Brief Sur-Reply to Professors Graetz and Warren*, 123 YALE L.J.F. 1 (2013), http://www.yalelawjournal.org/forum/a-brief-sur-reply-to-professors-graetz-and-warren [https://perma.cc/MM2R-L5JJ] (same); Ruth Mason & Michael S. Knoll, *What Is Tax Discrimination?*, 121 YALE L.J. 1014 (2012) [hereinafter Mason & Knoll, *Tax Discrimination*] (arguing that a tax nondiscrimination principle requires competitive neutrality among states, but does not require identical taxation of residents and nonresidents). *See generally* Ryan Lirette & Alan D. Viard, *State Taxation of Interstate Commerce and Income Flows: The Economics of Neutrality* 1 (Am. Enter. Inst., Working Paper No. 2014-07, 2014).

42 Expressed more formally, taxes distort the allocation of jobs and investments only when they affect comparative advantage. Accordingly, the competitive position of an economic actor considering working or investing in a particular market is determined not simply by how *that actor is taxed in the particular market relative to how other actors are taxed in that market* (absolute advantage). Rather, it is determined by *the relationship between how that actor is taxed in the particular market and how that actor is taxed in alternative markets as compared to the relationship between how that actor's competitors are taxed in the particular market and alternative markets* (comparative advantage). *See* Michael S. Knoll & Ruth Mason, *The Economic Foundation of the Dormant Commerce Clause*, VA. L. REV. (forthcoming 2017), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2754321 (explaining the connections between the economic principle of comparative advantage, the doctrine of tax discrimination, and the internal consistency test).

43 *See* Mason & Knoll, *Tax Discrimination*, *supra* note 41, at 1060-74 (describing uniformity requirements of taxes to prevent them from distorting competition).

44 "Tax base" refers to the rules for calculating taxable income.

residents' and nonresidents' income from the state. A residence tax is uniform if it applies at the same rate and on the same base to residents' in-state and out-of-state income.[45]

In the special case where the challenge is only to a tax system's rates (not to the tax base), the above rule reduces to a simple mathematical formula. The requirement that both a state's source and residence taxes apply to its own residents (coupled with a recognition that the Dormant Commerce Clause prohibits states from discouraging cross-border commerce, but does not prohibit them from encouraging such commerce) implies that the tax rate assessed by a state on its residents' domestic income, T_d, must equal or exceed the combined tax imposed on residents' outbound income, T_o, and nonresidents' inbound income, T_i. When residents are taxed on worldwide income and are allowed neither a deduction nor a credit for taxes paid on outbound income,[46] this can be written arithmetically as follows:

$$T_d \geq T_i + T_o \qquad (2)$$

Equation 2 says the tax rate paid by residents on domestic income must equal or exceed the sum of the tax rates paid by residents on outbound income and by nonresidents on inbound income.

Equation 2 resembles the internal consistency test as can be readily seen from Table 4, where the Philadelphia wage tax was shown to be internally inconsistent because the tax rate on domestic income (T_d) was less than the combined tax rate on inbound and outbound income ($T_i + T_o$).[47] Thus, not only does the internal consistency have the doctrinal backing of the Supreme Court, it is an economically sensible test for discrimination. It is a sensible economic test for discrimination because, as we have argued in our academic work,[48] and as *Wynne* confirms,[49] discrimination means discouraging cross-border commerce at the expense of in-state commerce.

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45 In a recent working paper, Alan Viard and Ryan Lirette analogize non-uniform taxes to tariffs because such taxes have an effect similar to a tariff: they discourage cross-border commerce in favor of in-state commerce. Lirette & Viard, *supra* note 41.

46 Equation 2 assumes the taxing jurisdiction (Philadelphia) does not allow residents either a credit or a deduction for taxes paid on outbound income to other jurisdictions. As we show in earlier work, for worldwide taxation not to distort cross-border commerce, residence states must either provide an unlimited foreign tax credit or taxes on outbound income must be deductible. In the latter case, Equation 2 is written as: $T_d \geq T_i + T_o - (T_i \times T_o)$. *See* Mason & Knoll, *Tax Discrimination*, *supra* note 41, at 1064-69 (describing what we call "ideal deduction").

47 Both the internal consistency test as illustrated in Table 4 and as described in Equation 2 require that the domestic tax rate equal at least 7.3928% given an outbound tax of 3.91%, an inbound tax of 3.4828%, and no provision for a deduction or a credit for taxes paid to the source state against outbound income.

48 *See supra* notes 41–42.

49 Comptroller of Treasury of Md. v. Wynne, 135 S. Ct. 1787, 1804 (2015) (calling our and the Tax Economists' economic analysis "undisputed").

VI. GOING FORWARD: HOW PHILADELPHIA CAN SAVE ITS WAGE TAX

If the courts conclude that the Philadelphia wage tax violates the Dormant Commerce Clause, which is highly likely given its similarity to the Maryland tax successfully challenged in *Wynne*, Philadelphia will have to either eliminate the tax or amend it so that the tax is internally consistent. If Philadelphia decides to keep the wage tax, then to comply with the Constitution, Philadelphia's wage tax rates must obey Equation 2. Notice that Equation 2 does not specify tax rates; rather it specifies a relationship among tax rates. A state may set its tax rates high or low. Moreover, a state has flexibility to set any two tax rates it chooses, but given any two tax rates, the third rate is constrained. Thus, although the Dormant Commerce Clause prevents a state from setting its tax on domestic income independently from its tax on interstate (inbound and outbound) income, it nevertheless provides a state with multiple ways to cure a violation.

For example, suppose Philadelphia determines that it wants to maintain both the current inbound tax rate, T_i, of 3.4828% and the current outbound tax rate, T_o, of 3.91% without allowing either a credit or deduction. Philadelphia can maintain both of those tax rates consistently with the Dormant Commerce Clause by raising the domestic tax rate, T_d, to no less than the combined inbound and outbound tax rates, or 7.3928%.[50] While such a tax would be internally consistent, the sharp rise in tax rates on residents working in Philadelphia would likely discourage people from living in Philadelphia.[51]

A second way for Philadelphia to save its wage tax would be for the City to eliminate the inbound tax (T_i), the tax paid by nonresidents on income earned in Philadelphia. This is how the New York City income tax operates, which is why New York City is not at risk of having the courts determine that its rate structure violates of the Dormant Commerce Clause.[52] Eliminating the inbound tax would at first redound to the benefit of commuters, who would keep more of their Philadelphia wages. In time, employers would be expected to lower their wages (relative to wages paid outside of Philadelphia where there is no such tax), thereby increasing employment in the City. In effect, the wage tax becomes a residence tax. Such a tax would discourage

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50 If the City were to allow residents to deduct taxes paid to other jurisdictions from outbound income, the minimum domestic tax rate would be 7.2566%, which is calculated as: $T_d \geq T_i + T_o - (T_i \times T_o)$, that is, 3.4828% + 3.91% – (3.4828% x 3.91%) = 7.2566%. *See supra* note 46.

51 The change could be made revenue neutral by lowering the inbound and outbound tax rates from their current level and raising the domestic rate so that Equation 2 is satisfied.

52 *See* James W. Wetzler, *Fixing Discrimination in New York's Local Income Taxes*, ST. TAX TODAY, June 25, 2015, at 139-7, (arguing that the rate structure of New York's residency tax does not violate the internal consistency test, but two aspects of the tax—its interaction with the unincorporated business tax and its statutory residence rule—are internally inconsistent).

living in Philadelphia, but it would not discourage working there. To be revenue neutral, however, both the domestic and outbound tax rates would have to rise, further encouraging emigration out of Philadelphia.

A third way for Philadelphia to save its wage tax would be for the City to eliminate the outbound tax. In this case, Philadelphia could raise the inbound tax to the domestic tax rate without failing the internal consistency test. Taxing income only where it is earned would resemble how most nations tax cross-border income. Most nations tax the income earned within their borders by both residents and nonresidents, while exempting income earned abroad. However, an important difference between cities and nations is that it is much easier for jobs and people to cross municipal boundaries than national boundaries. Elimination of the outbound tax, which would have to be accompanied by an increase in the domestic and inbound tax rates to be revenue neutral, would further discourage employment in Philadelphia.

A fourth option for Philadelphia is to grant a credit for taxes paid by Philadelphia residents to other jurisdictions.[53] Such a solution resembles the United States' approach to taxing cross-border income. The United States taxes U.S. persons on their worldwide income and allows a credit for taxes paid to other jurisdictions on income sourced outside of the United States. That approach would also follow Maryland, which responded to its loss in *Wynne* by providing residents with a credit for taxes paid to other states' county and municipal governments on outbound income.[54] Whether such an approach would protect the Maryland "county" tax (and, similarly, the Philadelphia wage tax) from constitutional challenge has yet to be determined and is not clear.[55] If, however, such a fix would be sufficient, the revenue cost

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53 We discussed the options for Maryland to cure the internal consistency in its tax regime in our amicus brief, and those options are also open to Philadelphia. Knoll & Mason Brief, *supra* note 39, at 28-32. For a discussion of the requirements for state taxes to not distort interstate commerce when the taxing state offers a credit for taxes paid to other states (which differ from the requirements when the state is not offering a credit), see Mason & Knoll, *Tax Discrimination*, *supra* note 41, at 1063-64, 1072-74.

54 *Maryland Comptroller Updates FAQs on* Wynne *to Address Additional Credit, Interest Claims*, ST. TAX TODAY Dec. 7, 2015, at 238-19.

55 There are at least two potential hurdles. First, because local taxes are state taxes for constitutional purposes, it is not clear whether crediting local taxes, but not state taxes, would save Maryland's "county" tax and Philadelphia's wage tax. Second, assuming municipalities do not generally have to credit state taxes against local taxes, the Philadelphia wage tax would still arguably fail the internal consistency test if it credited only local taxes paid in other states. For example, assume New Jersey adopts a wage tax like Philadelphia's, which applies only in Camden. Camden (Philadelphia) residents earning income in Philadelphia (Camden) will pay the same tax on income earned in Camden and Philadelphia (3.91%). Camden (Philadelphia) residents will also pay the same tax on income earned in their home state of New Jersey (Pennsylvania), but not in Camden (Philadelphia) (3.91%). Also, New Jersey (Pennsylvania) residents living outside Camden (Philadelphia) will pay the same tax on income earned in New Jersey outside of Camden and on income earned in Pennsylvania outside of Philadelphia (3.4828%). However, New Jersey

of limiting the credit to taxes imposed by other cities and counties (and excluding states) would likely be low.[56] If, however, a municipality seeking to cure an internally inconsistent tax with a credit must credit not only other states' county or municipal taxes, but also other states' state taxes, the cost to the City would likely be much higher, especially in light of Philadelphia's proximity to Delaware, New Jersey, and New York, all of which have income tax rates above Pennsylvania's flat tax rate of 3.07%. In that case, to be revenue-neutral, Philadelphia would have to raise tax rates, thereby discouraging both working and living in Philadelphia.

In the last few paragraphs we have described how Philadelphia could revise its wage tax to save it from violating the Dormant Commerce Clause. The more fundamental question is whether Philadelphia should save the City wage tax or replace it with other taxes. As a 2014 report on the prospects for job growth in Philadelphia observes:

> Two successive tax commissions, one in 2003 and one in 2009, noted that many of Philadelphia's ailments are self-inflicted. Industrial jobs are gone, but the downward cycle endures. As the 2009 *Task Force on Jobs and Economic Competitiveness* suggested, "The fundamental problem is that Philadelphia has a tax structure that was appropriate to an industrial economy when people and firms were tied to the fixed assets of railroads, factories, and ports. By continuing to derive the lion's share of locally generated revenues by taxing people and jobs that are now highly mobile, we continue to undermine our future."[57]

As the quotation above makes clear, the Philadelphia wage tax has long been criticized for undermining the City's economy by discouraging people from living and working in Philadelphia.

Although the Philadelphia wage tax has been around for more than seventy-five years, its days—at least in its current form—appear numbered. In the next few years, the courts will likely declare the City wage tax unconstitutional. That threat is an opportunity for the City to modernize its

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(Pennsylvania) residents living outside Camden (Philadelphia) will pay more tax on income earned in Philadelphia (Camden) (3.91%) than on income earned in their home state of New Jersey (Pennsylvania) outside of Camden (Philadelphia) (3.4828%). This is one place where the structural differences between the Maryland "county" tax and the Philadelphia wage tax can have constitutional consequences. Assuming Delaware adopts Maryland's "county" tax, regardless of where Delaware and Maryland residents reside and earn income, one always pays the same tax on interstate and intrastate income.

56 With the exception of Wilmington, Delaware, there are few counties or municipalities close to Philadelphia that impose income taxes on nonresidents. *Cf.* Saksa, *supra* note 7 (describing Wilmington's tax).

57 PATHWAYS TO JOB GROWTH, *supra* note 2, at 15.

tax system. Whether Philadelphia takes advantage of that opportunity remains to be seen.

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