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Practical Consequences, Institutional Competence, and the Kentucky Bond Case

Bradley W. Joondeph
Santa Clara University School of Law, bjoondeph@scu.edu

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Bradley W. Joondeph is associate professor and associate dean for faculty development, Santa Clara University School of Law. The author worked as a consultant for the State and Local Legal Center in preparing its amicus curiae brief in Davis v. Kentucky *for the Government Finance Officers Association, National Governors Association, National League of Cities, National Conference of State Legislatures, National Association of Counties, Council of State Governments, U.S. Conference of Mayors, International Municipal Lawyers Association, and the International City/County Management Association. The brief supports the Kentucky Department of Revenue.* *Thanks are due to Brian Galle, Richard Ruda, and Ethan Yale for helpful comments in the development of this article.*

Introduction

On November 5 the U.S. Supreme Court will hear arguments in *Department of Revenue of the Commonwealth of Kentucky v. Davis*,[1] one of the most anticipated dormant commerce clause cases to come before the Court in several years. At issue is whether states can provide tax preferences for the interest earned on their own municipal bonds. Like more than 40 other states, Kentucky exempts the interest earned on Kentucky municipal bonds — bonds issued by the state and its various political subdivisions — from state personal income taxation, but it denies that exemption to municipal bonds issued by other states and their political subdivisions. The question presented in *Davis* is whether this preference for in-state municipal bonds impermissibly discriminates against interstate commerce.

As a doctrinal matter, the case largely turns on how the Court construes its decision from its last term in *United Haulers Assn., Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*[2] In *United Haulers*, the Court upheld two New York county "flow control" ordinances that required all solid waste in the counties to be processed at designated, municipally owned facilities, even though the ordinances plainly disadvantaged interstate commerce. Critically, the Court held that state laws that "favor the government," that "treat every private business, whether in-state or out-of-state, exactly the same," and that concern "a traditional government activity . . . do not discriminate against interstate commerce for purposes of the Commerce Clause."[3] State income tax preferences for in-state municipal bond interest seem to meet all three of those criteria. Thus, *United Haulers* provides a straightforward doctrinal basis for the Court to uphold tax exemptions like Kentucky's.

In many respects, though, the most interesting aspects of *Davis* lie outside its formal legal logics. Indeed, the case raises some fundamental questions about the role of practical consequences in judicial decision-making and the comparative institutional competencies of Congress and the Supreme Court.

If the Court invalidated Kentucky's tax exemption in *Davis*, it would mark a sea change in the state taxation of municipal bonds. States have provided tax preferences for their own municipal bonds since the advent of state personal income taxes in the early 1900s. And the Kentucky Court of Appeals decision in this case — the judgment now under review — was the first in U.S. history to hold such a preference unconstitutional. Given that history, as well as Congress's long-standing acquiescence in the practice, state governments have made substantial financial commitments on the understanding that those exemptions were constitutional. A decision by the Court to prohibit them would catch the states

[1]Docket No. 06-666, *cert. granted*, 127 S. Ct. 2451 (2007). (For coverage of the Kentucky Court of Appeal's decision, see *State Tax Notes*, Jan. 16, 2006, p. 108, *Doc 2006-627,* or *2006 STT 8-22*.)

[2]127 S. Ct. 1786 (2007).

[3]*Id.* at 1790.

over a barrel, forcing state governments to shoulder billions of dollars in losses transitioning to a system in which all municipal bonds must be taxed equally.

Importantly, the reason states would face those transition costs is that the Court's decision would apply retroactively. Regardless of how states decided to tax municipal bonds issued in the future, the Court's decision would force the states to incur large refund liabilities for taxes recently paid on out-of-state municipal bonds and to forgo taxing the interest on most out-of-state municipal bonds that have already been issued. As a result, state governments would be required to disgorge or forgo many billions of dollars in tax revenue. And they would incur those losses precisely because of their reliance on a status quo that, until January 2006, no one had much reason to question.

Davis v. Kentucky raises some fundamental questions about the role of practical consequences in judicial decision-making and the comparative institutional competencies of Congress and the Supreme Court.

Unlike the Court, Congress could completely avoid those transition costs. That is, if taxing in-state and out-of-state municipal bonds equally is indeed the best policy for interstate commerce, Congress could draft a purely prospective remedy that applied solely to municipal bonds that have not yet been issued. Thus, no matter what one thinks of *United Haulers* and existing dormant commerce clause doctrine, there are strong pragmatic reasons for the Court to ratify the status quo and uphold state tax preferences for in-state municipal bonds. As it has done in several other important state tax cases — such as *Moorman Mnfg. v. Bair*,[4] *Commonwealth Edison v. Montana*,[5] and *Quill v. North Dakota*[6] — the Court would be well advised to recognize the superior institutional competence of Congress in sorting out the details of a complicated economic question with huge fiscal ramifications.

I. Background

Like almost every state that imposes a personal income tax, Kentucky begins its calculation of personal income with a definition borrowed from the Internal Revenue Code.[7] Kentucky law then mandates several adjustments, one of which concerns the interest earned on out-of-state municipal bonds: All taxpayers must "include interest income derived from obligations of sister states and political subdivisions thereof."[8] There is no similar provision for the inclusion of interest earned on municipal bonds issued by Kentucky or its political subdivisions. Thus, Kentucky law operates to tax the income earned on out-of-state municipal bonds while exempting the interest earned on in-state bonds.

George and Catherine Davis are Kentucky citizens who own shares in mutual funds that include municipal bonds issued by states other than Kentucky. The Davises thus earned interest on out-of-state municipal bonds, for which they were required to pay Kentucky personal income tax. In April 2003 they filed a class-action complaint in Jefferson County Circuit Court representing all persons paying Kentucky income taxes on interest from municipal bonds issued by other states or municipalities. The Davises argued that Kentucky's unequal treatment of the income derived from in-state and out-of-state municipal bonds discriminated against interstate commerce and thus violated the dormant commerce clause.[9] They sought a declaratory judgment, an injunction, and tax refunds.

The Kentucky trial court granted the Kentucky DOR's motion for summary judgment. The court held that Kentucky's tax exemption for in-state municipal bond interest did not violate the dormant commerce clause because the state was effectively acting as a "market participant." It is well established in Supreme Court precedent that when a state or local government acts as a participant in the relevant market — as a buyer or seller, rather than as a regulator — its actions are exempt from dormant commerce clause scrutiny.[10] The dormant commerce clause restricts only states' capacity to regulate, and the trial court found that Kentucky's actions here did not amount to regulation: "Considering the entire transaction, the tax exemption granted to resident purchasers of municipal bonds qualifies under those doctrines which permit burdens on interstate commerce in certain limited contexts and is, therefore, not the type of burden with which the commerce clause is concerned."[11]

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[4]437 U.S. 267 (1978).

[5]453 U.S. 609 (1981).

[6]504 U.S. 298 (1992).

[7]Ky. Rev. Stat. Ann. section 141.010(9).

[8]Ky. Rev. Stat. Ann. section 141.010(10)(c).

[9]They also contended that Kentucky's tax preference for in-state bonds violated the equal protection clause of the 14th Amendment and similar provisions contained in sections 3 and 59 of the Kentucky Constitution. These claims are not before the Supreme Court.

[10]*See, e.g.*, *White v. Massachusetts Council of Constr. Employers, Inc.*, 460 U.S. 204 (1983); *Reeves, Inc. v. Stake*, 447 U.S. 429 (1980); *Hughes v. Alexandria Scrap. Corp.*, 429 U.S. 794 (1976).

[11]The trial court also ruled against the Davises on a procedural matter, holding that they lacked standing to

(Footnote continued on next page.)

The Davises appealed, and in an opinion written by Judge John D. Minton Jr. — who has since been elevated to the Kentucky Supreme Court — the Kentucky Court of Appeals reversed.[12] First, the court reasoned that "Kentucky's bond taxation system is facially unconstitutional as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds."[13] The exemption was therefore permissible only if it fell within one of the recognized exceptions to the dormant commerce clause. The only exception that might have applied was the market participant doctrine, and unlike the trial court, the court of appeals concluded Kentucky's actions amounted to more than market participation. Although the state "acts as a market participant when it issues bonds," the tax preference was enforced under its taxing power. And "'when a state chooses to tax its citizens, it is acting as a market regulator[,]' not as a market participant."[14]

The Kentucky DOR then filed a motion for discretionary review at the Kentucky Supreme Court. Puzzlingly, that court denied the motion. There were several reasons for the Kentucky Supreme Court to grant review. First, the court of appeals decision was the first in U.S. history to hold that a state's tax preference for its own municipal bonds — a practice that was at least 80 years old and perhaps much older — violated the dormant commerce clause. Second, the decision had huge fiscal ramifications for Kentucky, because of both the state's potentially large refund liability and its likely need to exempt future out-of-state municipal bond interest from income. Finally, and perhaps most importantly, the decision left Kentucky at a significant competitive disadvantage in the municipal bond market. While the other states with personal income taxes could continue to offer tax exemptions to their residents for in-state bonds, Kentucky was barred from doing the same. That meant Kentucky bonds were comparatively unattractive to the residents of the more than 40 other states with tax preferences for in-state bonds, but they were no more attractive than any other state's bonds to Kentucky residents. It was the worst of all worlds. Yet on August 17, 2006, the Kentucky Supreme Court denied review.

Kentucky then sought a writ of certiorari at the U.S. Supreme Court, at which point the timing of events became interesting.[15] Kentucky filed its petition on November 9, 2006. The Davises initially waived their right to file a brief in opposition to certiorari, but in mid-December the Court called for a response. (The Court will not grant certiorari until they have received a brief in opposition.) The Davises then filed their opposition brief on January 15, 2007,[16] and the justices scheduled *Davis* for their February 16 conference. Once a petition is scheduled for discussion at conference, the Court typically grants or denies review. On February 16, however, the Court took no action. The reason is that the justices had heard argument in *United Haulers* on January 8, and they recognized that the outcome in *United Haulers* might well affect the appropriate disposition of *Davis*. The Court therefore deferred consideration of the petition until it had handed down *United Haulers*.[17]

> ***The Court would be well advised to recognize the superior institutional competence of Congress in sorting out the details of a complicated economic question with huge fiscal ramifications.***

United Haulers came down on April 30, and the Court then scheduled *Davis* for discussion at its next conference, on May 10. After holding a certiorari petition pending another decision, the Court usually either "GVRs" the case — grants the petition, vacates the judgment below, and remands the matter for reconsideration in light of the recent decision — or it simply denies review. The Court GVRs when it believes the recent decision could cause the lower court to reach a different decision; otherwise, it denies certiorari. In *Davis,* though, the Court did

pursue their claims on behalf of any "non-individual" taxpayers — corporations, estates, trusts, and fiduciaries.

[12]*Davis v. Department of Rev. of Finance and Admin. Cabinet*, 197 S.W.3d 557 (Ky. Ct. App. 2006), *cert. granted*, 127 S. Ct. 2451 (2007).

[13]*Id.* at 562.

[14]*Id.* at 564 (quoting *Sharper v. Tracy*, 647 N.E.2d 550, 552 (Ohio Ct. App. 1994)). On the procedural issue, the court of appeals held that the trial court had confused the issue of standing with that of class certification, a matter that should not have been addressed until the Davises filed their motion for class certification. *See id.* at 565-66. That is not a part of the question presented at the Supreme Court, but it will be addressed by the trial court on remand if the Davises prevail.

[15]Details about the Supreme Court's handling of Kentucky's petition for certiorari are available on the Court's docket sheet. *See* http://www.supremecourtus.gov/docket/06-666.htm (last visited Sept. 26, 2007).

[16]By this point, the Davises had retained the counsel of David J. Guin of Donaldson & Guin in Birmingham, Ala. Donaldson & Guin is pursuing similar claims in several other states that permit class actions for tax refunds. It is also soliciting plaintiffs to "pursue individual refunds for trusts and high-wealth individuals in states that do not permit class actions." *See* http://www.dglawfirm.com/municipalbondtax.html (last visited Sept. 17, 2007).

[17]The Court refers to that procedure as "holding" the petition pending the outcome of the argued case.

neither. First, at its May 10 conference, the justices were unable to decide how to dispose of the petition, and they relisted *Davis* for their next conference. A week later, that indecision was gone. At least four justices concluded that the Court should hear the case on the merits, and the Court granted review. It has since scheduled the case for oral argument November 5.

II. United Haulers and Dormant Commerce Clause Doctrine

Timing can be quite important in life. And in the case of state tax exemptions for in-state municipal bond interest, the timing of *Davis* — coming to the Supreme Court only months after *United Haulers* — may prove crucial.

Before *United Haulers*, Kentucky had two basic arguments to defend its unequal taxation of in-state and out-of-state municipal bonds. First, it could argue that the Supreme Court had effectively upheld such tax preferences in its 1881 decision of *Bonaparte v. Tax Court*.[18] At issue in *Bonaparte* was Maryland's attempt to impose a property tax on out-of-state municipal bonds owned by a Maryland resident. The taxpayer argued that Maryland had violated the full faith and credit clause because the states issuing the bonds had exempted them from their own state property taxes. In a terse, five-paragraph opinion, the Court rejected the taxpayer's claim: "We know of no provision of the Constitution of the United States which prohibits such taxation."[19]

Kentucky might contend — indeed, it *has* contended in its briefs to this point — that *Bonaparte* stands for the proposition that states have the constitutional authority to tax other states' municipal bonds however they choose, regardless of how they tax their own municipal bonds. But that argument seems to misunderstand *Bonaparte*. At bottom, the issue in *Bonaparte* was jurisdictional. The question presented was whether states could effectively immunize their municipal bonds from taxation by other states. The Court rejected that idea, explaining that upholding such a power would allow the states to legislate extraterritorially. As the Court said in the opinion's critical passage, "No State can legislate except with reference to its own jurisdiction. One State cannot exempt property from taxation in another."[20] *Bonaparte* therefore stands for the uncontroversial proposition that State A has the jurisdiction to tax its own residents on the property or income that they derive from State B, regardless of how that property or income is taxed by State B.

[18]104 U.S. 592 (1881).
[19]*Id.* at 594.
[20]*Id.*

It says nothing about the quite different question whether a state can unequally tax its own residents on the interest they earn from in-state and out-of-state municipal bonds.

Second, Kentucky could argue — and, again, it has in its briefs — that by selling municipal bonds and choosing not to tax the interest paid thereon, the state is acting as a market participant. The difficulty with that argument, though, is identified by the Kentucky Court of Appeals: The unequal treatment challenged by the taxpayers seems to concern the way Kentucky *taxes* municipal bonds, not the way it sells them. And because there is no private market in taxation, imposing a tax (or providing a tax exemption) cannot qualify as market participation. Conceivably, one could view Kentucky's sale and taxation of its own bonds as a single sales transaction, with the pledge to forgo taxing the interest on the bonds as a term that runs with the bond's purchase. But that's not the only way to see the transaction, and it may not be the most intuitive.

In any event, before the Court's decision in *United Haulers*, Kentucky's legal position was something short of airtight. But *United Haulers* fundamentally altered the legal landscape — so much so that Kentucky now holds the upper hand.

Again, at issue in *United Haulers* was whether two flow- control ordinances adopted by Oneida and Herkimer counties in upstate New York violated the dormant commerce clause. The ordinances required that all trash in the counties be delivered to designated, municipally owned waste facilities for processing. A coalition of waste haulers contended that the ordinances discriminated against interstate commerce because they prohibited the haulers from delivering trash to out-of-state processing facilities at substantially lower cost.[21] And the waste haulers had a fairly strong argument: The Court had invalidated a nearly identical ordinance only 13 years earlier in *C & A Carbone, Inc. v. Clarkstown*.[22] As Chief Justice John Roberts acknowledged in his opinion for the Court in *United Haulers*, the "only salient difference" between the two cases was that the favored facility in *Carbone* was privately owned (at least in name), whereas the favored facilities in *United Haulers* were owned and operated by local government.[23]

But that sole difference was "constitutionally significant" — indeed, dispositive.[24] The Court explained that there are several "compelling reasons" to treat laws that benefit the government differently from those that benefit in-state private businesses

[21]*United Haulers*, 127 S. Ct. at 1792.
[22]511 U.S. 383 (1994).
[23]*United Haulers*, 127 S. Ct. at 1790.
[24]*Id.*

under the dormant commerce clause.[25] First, unlike private businesses, "government is vested with the responsibility of protecting the health, safety, and welfare of its citizens."[26] Laws favoring state and local governments therefore "may be directed toward any number of legitimate goals unrelated to protectionism."[27] Second, treating public and private entities alike for purposes of the dormant commerce clause "would lead to unprecedented and unbounded interference by the courts with state and local government."[28] Though the commerce clause plays an important role in preventing state and local governments from engaging in economic protectionism, it "is not a roving license for federal courts to decide what activities are appropriate for state and local government to undertake."[29] Finally, courts should be "particularly hesitant to interfere with [government] efforts under the guise of the commerce clause" when the activities in question are "both typically and traditionally a local government function."[30]

The basic rule of *United Haulers* is succinct: "Laws that favor the government" in areas of "traditional government activity," but which "treat every private business, whether in-state or out-of-state, exactly the same," "do not discriminate against interstate commerce for purposes of the commerce clause."[31] That rule seems to dictate that a state's tax preference for the interest earned on its own municipal bonds does not discriminate against interstate commerce, and is therefore constitutional.

> ***United Haulers fundamentally altered the legal landscape — so much so that Kentucky now holds the upper hand.***

First, tax preferences like Kentucky's favor state governments and their political subdivisions, not private business interests. Because of those exemptions, taxpayers are willing to accept a lower pretax rate of return on in-state municipal bonds. That means a state and its political subdivisions can issue their bonds at a considerably lower interest rate than the market would otherwise require. Thus, the beneficiaries of those exemptions are generally not the bondholders (though they certainly capture a portion of the benefit, at least in some states[32]); the market largely accounts for their favorable tax treatment by reducing their yield on the tax-preferred bonds.[33] The principal beneficiaries are the states and their political subdivisions, which are able to borrow at a considerably lower interest rate, reducing their costs in raising capital. Of course, it is quite possible that those exemptions actually cost the states more in forgone income tax revenue than they deliver in reduced borrowing costs.[34] But it was likewise possible in *United Haulers* that the additional costs inherent in creating a government-run monopoly for waste disposal in Oneida and Herkimer counties more than offset the benefits to the counties' citizens. The relevant point for purposes of *United Haulers* is that, to the extent the law at issue creates a preference, the preference favors a government entity.

Second, tax preferences like Kentucky's treat all private business interests identically. There was no advantage for any in-state businesses — whether they are bond issuers, bond dealers, bond brokers, or bondholders — over their out-of-state competitors. To be sure, those preferences plainly create a financial incentive for a state's citizens, when they are purchasing municipal bonds, to purchase their home state's bonds rather than those issued by another state. As a result, the proportion of investors holding a given state's municipal bonds who are citizens of that state is substantially greater than it would be absent the preferences.[35] That explains the existence of the roughly 640 state-specific mutual funds that various investment companies now market to investors.[36] But whatever one thinks of that impact on interstate commerce, the benefit is enjoyed by state governments and their municipalities, not by private businesses.

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[25]*Id.* at 1795.

[26]*Id.* (citing *Metropolitan Life Ins. Co. v. Massachusetts*, 471 U.S. 724, 756 (1985)).

[27]*Id.* at 1796.

[28]*Id.*

[29]*Id.*

[30]*Id.* (internal quotation marks and citation omitted).

[31]*Id.* at 1790.

[32]*See* Brian D. Galle and Ethan Yale, "Can Discriminatory State Taxation of Municipal Bonds Be Justified? Thoughts on the *Davis* Topside Briefs," p. 229 of this issue.

[33]*See* C. Steven Cole, Pu Liu, and Stanley D. Smith, "The Capitalization of the State Tax Exemption Benefit in Municipal Bond Yields," 7 *J. Fin. & Strategic Decisions* 67, 68 (1994), *available at* http://www.studyfinance.com/jfsd/pdffiles/v7n2/cole.pdf (last visited Sept. 26, 2007) (finding 100 percent capitalization of the state tax exemption benefit in the yield of municipal bonds).

[34]*See id.* at 68, 72.

[35]The strength of that incentive turns on the taxpayer's marginal state income tax rate. The effect is apt to be strongest for bonds issued by states like California, where the top marginal income tax rate is 9.3 percent, while it less significant for bonds issued by states like Connecticut, where the top marginal rate is 5 percent.

[36]According to a recent study, as of May 31, 2007, there were 642 different single-state municipal bond mutual funds, with assets totaling $192.2 billion. *See* Brief of Churchill Tax-Free Fund of Kentucky et al., *Amici Curiae* in Support of Petitioners at 11, *DOR v. Davis* (No. 06-666).

Finally, the act of borrowing money to finance the construction of infrastructure and other public improvements certainly seems like a "traditional government activity." Of course, the concept of traditional governmental functions has a checkered past at the Supreme Court. In two separate lines of cases, the Court has previously attempted to apply a similar standard only to abandon it as unmanageable.[37] The more recent episode began in 1976 with the Court's decision in *National League of Cities v. Usery*,[38] which held that Congress may not use its commerce power to "displace the States' freedom to structure integral operations in areas of traditional governmental functions."[39] The Court thus invalidated the minimum wage and maximum-hour provisions of the Fair Labor Standards Act to the extent they displaced state control over employer-employee relationships in areas such as fire prevention, police protection, sanitation, and public health. But in a series of subsequent decisions attempting to apply *National League of Cities*, the Court struggled to define those functions as immune from federal regulation.[40] Hence, only nine years later, in *Garcia v. San Antonio Metropolitan Transit Auth.*,[41] the Court gave up the effort, concluding that the "traditional governmental function" standard was "unsound in principle and unworkable in practice."[42] Thus, there is reason to wonder how important the "traditional governmental activity" criterion was to the Court's decision in *United Haulers* and how long it will remain a part of the Court's doctrine. For now, though, it is plainly an element of the governing rule, and therefore an issue that Kentucky must address.

Fortunately for the states, that should not be a problem. First, the practice of issuing municipal debt has deep historical roots, predating the issuance of corporate debt by several centuries.[43] American cities incurred debt as early as the 17th century.[44] New York City issued the first officially recorded municipal bond in 1812 to finance the construction of the Erie Canal.[45] By 1843, U.S. cities had accumulated approximately $25 million in outstanding debt, and the number of municipal bond issues has grown exponentially ever since.[46] State and local governments issued $26 billion in municipal bonds in 1975, and they issued more than 10 times that amount ($263.8 billion) in 1999.[47] The value of outstanding U.S. municipal bonds is now roughly $2.4 trillion.[48]

More fundamentally, borrowing money is critical to state and local governments' capacity to provide essential but costly governmental services.[49] There are approximately 87,000 state and local governments in the United States,[50] and only the very largest are capable of financing any significant capital improvements exclusively from current revenue. Even for state governments, issuing bonds is often

[37]*See United Haulers*, 127 S. Ct. at 1810-11 (Alito, J., dissenting).

[38]426 U.S. 833 (1976).

[39]*Id.* at 852.

[40]*See, e.g., FERC v. Mississippi*, 456 U.S. 742 (1982); *Transportation Union v. Long Island R. Co.*, 455 U.S. 678 (1982); *Hodel v. Virginia Surface Mining & Recl. Assn.*, 452 U.S. 264 (1981).

[41]469 U.S. 528 (1985).

[42]*Id.* at 546.

[43]*See* Judy Wesalo Temel, *The Fundamentals of Municipal Bonds* 49 (5th ed. 2001) (noting that Italian city-states borrowed from major merchant banking families during the Renaissance).

[44]*See id.*

[45]*See* Frank Shafroth, "Which State Taxes Are 'Preferred' for Infrastructure?" *State Tax Notes*, Apr. 17, 2006, p. 237, *Doc 2006-6560*, or *2006 STT 73-4*.

[46]*See* Temel, *supra* note 43, at 49-50.

[47]*See id.* at 3.

[48]*See* Tom Herman, "Justices to Hear Muni-Bond Case — Kentucky Tax Fight Over Exemptions Affects Many States, " *The Wall Street Journal*, May 22, 2007, at D3.

[49]Conceivably, that is less true of some kinds of private activity bonds. Municipal bonds fall into two basic categories: governmental bonds and private activity bonds. *See* Cynthia Belmonte, "Tax-Exempt Bonds, 1996-2002," at 151-52 (*Statistics of Income Bulletin*, Summer 2005), *available at* http://www.irs.gov/pub/irs-soi/02govbnd.pdf (last visited July 17, 2007). Governmental bonds have no statutory definition. *See Public Finance Network, Tax-Exempt Financing: A Primer* 3. They are generally issued to finance facilities that are owned, controlled, and operated by state or local governments, such as schools, streets, and utilities. *See id.* at 2; Belmonte, at 155. Private activity bonds are defined by section 141 of the Internal Revenue Code. *See* 26 U.S.C. section 141. In brief, a municipal obligation will be considered a private activity bond, "irrespective of the purpose for which it is issued or the source of payment, if (1) more than 10 percent of the proceeds of the issue will finance property that will be used by a nongovernmental person in a trade or business, and (2) the payment of debt service on more than 10 percent of the proceeds of the issue will be (A) secured by property used in a private trade or business or payments in respect of such property, or (B) derived from payments in respect of property used in a private trade or business." Temel, *supra* note 43, at 251. Roughly three-fourths of the municipal bond market consists of governmental bonds, and one-fourth of private activity bonds. *See* Belmonte, at 151 (between 1996 and 2002 more than $1.5 trillion in governmental bonds and $548 billion in private activity bonds were issued).

[50]U.S. Census Bureau, "Statistical Abstract of the United States: 2007," at p. 264 (Table 415).

the only practical means to finance the construction of essential infrastructure, such as roads, highways, airports, and utilities. Bond issues make those public investments possible by allowing state and local governments to spread the relevant tax burden over several years.

Thus, issuing bonds functions as a temporal extension of the states' authority to tax, a power that lies at the core of their sovereignty. Municipal bonds permit governments to extend the time frame of taxation over the useful life of the capital improvement rather than forcing them to impose the entire tax burden at the time of the improvement's construction. Moreover, bonds promote fairness in public finance by enabling state and local governments to better ensure that the citizens who benefit from long-term capital improvements (those who live in the community over the life of the assets) are those who pay for them (in taxes that go toward servicing the debts). Absent that spreading of the tax burden, taxpayers required to fund the entire cost of public works at the time of their construction would have a strong incentive to undersupply those public goods.

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In short, a state's income tax preference for its own municipal bonds appears to fall squarely within the rule announced in *United Haulers*: It favors the government, provides no advantage to private businesses, and involves a traditional governmental activity.

That is not to say that distinguishing *United Haulers* from *Davis* would be impossible, particularly if the justices were eager to cabin *United Haulers*'s implications. First, one could lean on the Court's statement in *United Haulers* that "the most palpable harm imposed by the ordinances — more expensive trash removal — [was] likely to fall upon" the residents of Oneida and Herkimer counties.[51] According to the Court, that meant that there was a reliable political check in place: Those bearing the costs of the ordinances were represented in the political process that enacted them and that could repeal them. In contrast, the costs of state tax preferences for their own municipal bonds are borne mostly outside the state — specifically, by other state governments and their political subdivisions. Kentucky's tax scheme reduces the state's borrowing costs, but it increases those expenses for any government outside Kentucky attempting to sell its bonds to Kentucky citizens. That exportation of costs, one might argue, means that the political process cannot be trusted to prevent excessive taxation.[52]

On closer inspection, though, that distinction seems incapable of carrying much weight. First, it founders on its own factual premise. The parties most palpably disadvantaged in *United Haulers* were probably not the residents of Oneida and Herkimer counties but instead the out-of-state waste processors that the ordinances deprived of customers.[53] Indeed, the very reason the plaintiffs brought suit is that, absent the ordinances, the haulers would have delivered the waste to lower-cost, out-of-state processors. Second, and more fundamentally, drawing such a distinction between *Davis* and *United Haulers* would spawn a doctrine that would likely be judicially unmanageable. *Every* regulation favoring a government entity in an activity involving interstate commerce will impose costs on out-of-state interests. Thus, differentiating state or local laws based on their cost exportation would always be a matter of degree. As a result, the Court would be forced to devise some standard for what level of cost exportation was "too much" and, in the application of that standard, to answer a host of complicated empirical questions concerning the relevant externalities.[54] Worse still, the Court might be required to determine when out-of-state interests forced to bear those costs nonetheless had "sufficient" representation in the political process that the results of that process could be trusted. Whatever the merits of that approach in theory, it seems unworkable in practice.

Alternatively, one might argue that *United Haulers* differs from *Davis* in terms of the nature of the competitors disadvantaged by the challenged laws. Specifically, while the flow control ordinances favored local government at the expense of private businesses, tax preferences for in-state municipal bonds favor one government at the expense of other governments. In other words, the preference in *Davis* is for a public entity engaged in public versus public competition rather than public versus private competition. One could therefore argue that, while

[51] *United Haulers*, 127 S. Ct. at 1797.

[52] For an excellent articulation of this argument, see Yale and Galle, "Muni Bonds and the Commerce Clause After *United Haulers*," *State Tax Notes*, June 18, 2007, p. 877, *Doc 2007-14387*, or *2007 STT 118-4*.

[53] *See id.* at 1044 ("The Court's assertion in *United Haulers* that the added costs of trash removal are the 'most palpable' harm of the Oneida-Herkimer ordinance is dubious").

[54] Those were precisely the reasons the Court rejected the taxpayers' challenge to Montana's coal severance tax in *Commonwealth Edison v. Montana*, 453 U.S. 609 (1981), discussed in greater detail *infra*.

the relevant competitors were not "similarly situated" in *United Haulers*, they are in *Davis*, such that their unequal treatment by Kentucky more clearly resembles economic protectionism.[55]

No doubt, the costs of tax exemptions like Kentucky's are principally (though not exclusively) felt by out-of-state governments.[56] But it is unclear why that should matter under *United Haulers*. Nothing in *United Haulers* suggests that, had some of the waste processors that lost business because of the flow control ordinances been publicly owned, the result would have been different. Indeed, the rationale behind the Court's statement in *United Haulers* that government and private business are not similarly situated was that, "unlike private enterprise, government is vested with the responsibility of protecting the health, safety, and welfare of its citizens."[57] That sentence makes sense in reference to the governments of Oneida and Herkimer counties, the entities responsible for protecting the health, safety, and welfare of the communities that had enacted the ordinances. It makes much less sense in reference to "government" more generally. Out-of-state governments are no more responsible for the health, safety, and welfare of the citizens of Oneida and Herkimer counties than is private enterprise. In that respect, out-of-state governments are no different than private businesses under the logic of *United Haulers*. Neither is similarly situated to the government that has enacted a law favoring itself in the performance of a traditional government activity on behalf of its citizens.

Of course, one might take issue with *United Haulers*. That is, one could argue that allowing state and local governments to enact legislation that protects their own economic interests in the performance of various activities — such as the disposal of waste or the sale of municipal bonds — will cause more harm to the national economy than is justified by the benefits of enhanced state autonomy. But unless the Court wants to reconsider a decision it handed down only six months ago, that is water under the bridge. If we take *United Haulers* seriously, the outcome in *Davis* should be clear: Tax exemptions like Kentucky's do not discriminate against interstate commerce for purposes of the dormant commerce clause.

And establishing that those tax preferences are nondiscriminatory should be all that is necessary to establish their constitutionality. Since 1977 the Supreme Court has typically applied the four-part test from *Complete Auto Transit, Inc. v. Brady*[58] to determine whether a state tax provision is consistent with the dormant commerce clause.[59] Under *Complete Auto*, a state tax is permissible so long as it "is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided."[60] In *Davis,* there is no plausible claim that Kentucky lacks a sufficient nexus with the values it seeks to tax, that its tax is unfairly apportioned, or that it is not fairly related to the services it provided. The only possible dormant commerce clause argument — and, indeed, the only one posited by the Davises[61] — is that exemptions like Kentucky's discriminate against interstate commerce. Thus, if Kentucky's tax preference is indeed nondiscriminatory, it should satisfy *Complete Auto* and thus be constitutional.[62]

III. Practical Consequences and Institutional Competence

United Haulers provides a solid legal basis for the Court to hold that state income tax preferences for their own municipal bonds do not violate the dormant commerce clause. But cases that reach the Supreme Court are rarely about doctrinal niceties alone. *Davis* is no exception. Indeed, the most interesting aspects of *Davis* involve its practical consequences and the comparative institutional competencies of Congress and the Court. And ultimately it is those considerations that provide the most compelling justification for siding with Kentucky.

The nub of the case is this: A decision to invalidate Kentucky's tax scheme would impose billions of dollars in transition costs on state treasuries.[63] And the reason the states would incur those losses is that

[55]Again, Yale and Galle make this argument nicely. *See* Yale and Galle, *supra* note 52.

[56]Not exclusively because there is certainly *some* competition for capital between state and local governments and the private issuers of debt (and, indeed, other types of securities). *See id.* at 1043.

[57]*United Haulers*, 127 S. Ct. at 1795.

[58]430 U.S. 274 (1977).

[59]*See, e.g.*, *Oklahoma Tax Comm'n v. Jefferson Lines, Inc*., 514 U.S. 175, 183 (1995); *Itel Containers Int'l Corp. v. Huddleston*, 507 U.S. 60, 73 (1993); *Trinova Corp. v. Michigan Dept. of Treasury*, 498 U.S. 358, 372 (1991); *Goldberg v. Sweet*, 488 U.S. 252, 257-60 (1989).

[60]*Complete Auto*, 430 U.S., at 279.

[61]And that, in fact, is the only dormant commerce clause claim the Davises have made.

[62]More specifically, if Kentucky's tax preference does not discriminate against interstate commerce, it should not also have to pass the so-called *Pike* balancing test, which asks whether the state law at issue imposes costs that are "clearly excessive in relation to the putative local benefits." *Pike v. Bruce Church*, 397 U.S. 137, 142 (1970). The Court appears to have treated the other three prongs of the *Complete Auto* test as the *Pike* standard translated into the context of state and local taxation, as the Court has never actually applied the *Pike* test to a state or local tax scheme. *See* Galle and Yale, *supra* note 32.

[63]*See* Joel Michael, "*Kentucky v. Davis:* Implications for State Tax Policy and Dormant Commerce Clause Doctrine,"

(Footnote continued on next page.)

the Supreme Court's judgment would apply retroactively. Because the states had every reason to believe that those exemptions were constitutional, they structured their fiscal affairs accordingly, making large financial commitments to their taxpayers and bondholders. A decision in *Davis* declaring those exemptions impermissible would therefore catch the states over a barrel, forcing them to pay hundreds of millions of dollars in tax refunds and to forgo many billions of dollars in tax revenue on municipal bonds that have already been issued. Setting aside what the Court's ruling might mean for the states going forward — that is, for the tax treatment of municipal bonds that have not yet been issued — it clearly would require state governments to absorb huge financial losses solely because of commitments they had made when they reasonably believed those preferences were constitutional.

Congress, however, could avoid those transition costs. It could develop a prospective remedy that applied exclusively to municipal bonds that have not yet been issued. Thus, even if the justices are convinced that interstate commerce would benefit from the states' equal taxation of in-state and out-of-state municipal bonds, the Court would be well advised to stay its hand and ratify the status quo. Congress is in a far better position to craft an equitable transition to such a regime.

A. The Stakes for the States

American state and local governments have imposed various forms of personal income taxes since the Colonial period.[64] Wisconsin enacted the first modern personal income tax in 1911, and several other states quickly followed suit.[65] From their inception, those state income tax codes have exempted the interest earned on municipal bonds issued by the taxing state or one of its political subdivisions and they have denied that benefit to the interest earned on bonds issued by their sister states. For instance, Massachusetts adopted that preference in 1918, New York in 1919, North Carolina in 1921, and Virginia in 1926.[66] Moreover, Congress has been aware of those tax preferences for several decades, and it has taken no action to limit or prohibit them.[67] Today, 42 states offer some form of tax preference for the interest earned on in-state municipal bonds.[68] And until the Kentucky Court of Appeals handed down its decision in *Davis*, no court in the United States, state or federal, had held that the differential tax treatment of in-state and out-of-state municipal bonds was unconstitutional.[69]

Given that history, state governments have structured their financial affairs around the assumption that providing a tax preference for the interest earned on in-state municipal bonds is constitutional. Those commitments mean that, were the Supreme Court to invalidate Kentucky's tax scheme in *Davis*, the states would be forced to endure some significant financial dislocations.

To appreciate what is at stake for state governments, it is useful to isolate the implications of *Davis* for two distinct (but overlapping) groups of taxpayers. The first group is taxpayers who have recently paid state income tax on interest earned on out-of-state municipal bonds. The second and far more significant group is taxpayers who now own out-of-state municipal bonds. Regarding the first group, a decision to invalidate state tax preferences for their own municipal bonds would require the states to disgorge hundreds of millions of dollars in tax refunds. Regarding the second group, it would effectively force the states to forgo many billions of dollars in income tax revenue well into the future.

1. Taxpayers who have recently paid taxes on interest earned on out-of-state municipal bonds

As a threshold matter, it is clear that a ruling in *Davis* that invalidated tax exemptions like Kentucky's would apply retroactively. Granted, the Court's precedent has "left unresolved the precise extent to which the presumptively retroactive effect of this Court's decisions may be altered in civil cases."[70] But the Court held in *Harper v. Virginia Dept. of Taxation*[71] that "when this Court applies a rule of federal law to the parties before it, that rule . . . must be given full retroactive effect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate our announcement of the rule."[72] Thus, unless the Court actually withheld relief from the Davises themselves, a decision invalidating Kentucky's tax

State Tax Notes, Sept. 17, 2007, p. 753, *Doc 2007- 18392*, or *2007 STT 181-2* (discussing the near-term fiscal ramifications for the states).

[64]*See* Jerome Hellerstein and Walter Hellerstein, *State Taxation*, para. 20.01 (2007).

[65]See *id.*

[66]1918 Mass. Acts 7; 1919 N.Y. Laws 1641-42; 1921 N.C. Sess. Laws 208; 1926 Va. Acts 961.

[67]*See* Brief of National Association of State Treasurers, *Amicus Curiae* in Support of Petitioners at 15-17, *DOR v. Davis* (No. 06-666).

[68]Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming impose no taxes on personal income, Hellerstein and Hellerstein, *supra* note 64, at para. 20.01 n. 5, while Indiana does not distinguish in-state from out-of-state municipal bonds, see Ind. Code Ann. section 6-3-1-3.5.

[69]See Hellerstein and Hellerstein, *supra* note 64, at para. 4.13.

[70]*Harper v. Virginia Dept. of Taxation*, 509 U.S. 86, 96 (1993).

[71]*Id.* 509 U.S. 86 (1993).

[72]*Id.* at 97.

exemption would immediately apply retroactively to all similarly situated taxpayers nationwide.

Further, the due process clause would require that retroactive remedy to "provide meaningful backward-looking relief to rectify any unconstitutional deprivation."[73] In a case like *Davis*, in which the claim is that the state's tax scheme discriminates against interstate commerce, that relief could take three forms, any of which would remedy the constitutional problem:

- the states could refund all taxes paid on any interest earned on out-of-state municipal bonds;
- the states could retroactively impose a tax on any interest earned on in-state municipal bonds; or
- the states could enact some combination of the two that resulted in the equal tax treatment of all municipal bond interest during the relevant time period.[74]

Although each of those options might be open in theory, reality is a different matter. As Walter Hellerstein and Dan Coenen have recognized, "in the real world, . . . the practical and political difficulties of fashioning any retroactive remedy other than a refund (as well as legal difficulties presented by federal and state strictures regarding retroactive legislation) make solutions that require back-tax collections unlikely."[75] Thus, the states would effectively be required to award refunds to every taxpayer who had paid income tax on interest earned on out-of-state municipal bonds within the relevant limitations period. And that would be a substantial liability. For instance, in 2003, New York residents reported $636.4 million of interest income from out-of-state municipal bonds.[76] New York's estimated tax revenue from this interest was $45.8 million.[77] For Connecticut, the estimated income tax revenue in 2004 from out-of-state municipal bond interest and the dividends paid by municipal bond mutual funds was $70.9 million.[78] Thus, the immediate tax refund liability for the states as a whole would run well into the hundreds of millions — and probably several billions — of dollars.

[73]*McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 31 (1990).

[74]*See id.* at 40-1.

[75]Walter Hellerstein and Dan T. Coenen, "Commerce Clause Restraints on State Business Development Incentives," 81 *Cornell L. Rev.* 789, 873 (1996).

[76]Dwight Denison, Merl Hackbar, and Michael Moody, "*Davis v. DOR of Kentucky:* A Preliminary Impact Assessment," IFIR Working Paper 2007-03 (2007), at pp. 13-14, *available at* http://www.ifigr.org/publication/ifir_working_papers/IFIR-WP-2007- 03.pdf (last visited Sept. 26, 2007).

[77]*Id.* at 14.

[78]*Id.*

2. The tax treatment of outstanding municipal bonds

While substantial, the states' immediate liability for tax refunds would be small compared with the fiscal consequences related to the taxation of the interest yet to be earned on outstanding out-of-state municipal bonds. Again, a decision invalidating Kentucky's tax exemption would require the states to treat all municipal bonds equally. For the interest earned on municipal bonds that have already been issued, the states would have two choices in providing an adequate remedy: They could tax the interest earned on in-state municipal bonds or they could exempt the interest earned on out-of-state municipal bonds.

> ***To treat in-state and out-of-state municipal bonds equally, most states would be forced to abstain from taxing the interest earned by their taxpayers on any outstanding out-of-state municipal bonds.***

For most states, the option of taxing the interest earned on in-state municipal bonds that investors have already purchased would be impracticable, if not legally foreclosed. In-state investors have purchased those bonds in reliance on their favorable state tax treatment. For most in-state investors, the state tax exemption is a critical aspect of the transaction: They have accepted a lower yield in exchange for the state income tax benefit, such that they still receive a competitive after-tax rate of return on their investment. Thus, taxing the interest on in-state municipal bonds that taxpayers have already acquired would be highly inequitable. It would change the rules on the bondholders midstream, forcing them to accept an after-tax rate of return well below that of comparable investments. Moreover, several state constitutions prohibit the taxation of municipal bond interest, and in other states the tax exemption is contractually guaranteed.

That means that, to treat in-state and out-of-state municipal bonds equally, most states would be forced to abstain from taxing the interest earned by their taxpayers on any outstanding out-of-state municipal bonds. The fiscal repercussions of such a mandate would be substantial. As discussed above, the revenue loss for the states for a single year would run well into the hundreds of millions of dollars.[79] Given that many outstanding bonds will not mature for another 30 or 40 years, holding those

[79]*See id.* at 13-14.

tax preferences unconstitutional would cost state governments many billions of dollars in forgone tax revenue.

Perhaps those consequences would be less disquieting had the states persisted in imposing income taxes that they had reason to believe were unconstitutional.[80] But that is not the case here. Before January 2006, state governments had little reason to believe that those tax exemptions were constitutionally suspect, and they acted accordingly.[81] Forcing the states to shoulder those transition costs, despite their reasonable and substantial reliance on extant understandings of the dormant commerce clause, seems inappropriate under the circumstances.

B. The Institutional Competencies of Congress and the Court

Again, all of the aforementioned fiscal consequences would be *transition* costs — costs attributable to the states' obligation to honor commitments that they had made when they reasonably believed that their tax exemptions were constitutional. Thus, they are costs that would disappear if the mandate to tax all municipal bonds equally applied only prospectively to bonds that had not yet been issued. Again, the Supreme Court could not issue such a mandate. But Congress clearly could.

As the Court has recognized on several occasions, Congress "unquestionably" has the authority under the commerce clause to regulate the states' taxation of interstate commerce.[82] And Congress has invoked that authority on numerous occasions to protect interstate commerce from various burdens it has deemed inconsistent with the national interest.[83] Thus, if Congress concluded that state tax preferences for in-state municipal bonds unduly interfered with interstate commerce, it could enact legislation limiting or prohibiting them. And that legislation could ensure that the mandate of equal taxation applied only to municipal bonds to be issued in the future. States would not be required to pay refunds, and they could tax outstanding municipal bonds under the rules that existed at the time of their issuance. The transition costs would disappear.

At this point, one might argue that those practical consequences, as well as the comparative institutional competencies of Congress and the Court, are not matters that the Court should consider in adjudicating questions of constitutional law. The Court should simply interpret the traditional sources of constitutional law — the text, structure, history, and precedent — and let the chips fall where they may. For the Court to entertain various policy considerations would be to venture beyond the proper judicial role. It would amount to the sort of political, results-oriented decision-making that is reserved to the elected branches.

I have two responses. First, as an empirical matter, that conception of Supreme Court decision-making is highly unrealistic (to put it politely). Constitutional law, especially in cases that reach the Court, rarely yields clear answers. That indeterminacy means that the justices' views about public policy will inevitably affect their decisions. Even if the justices do not *consciously* pursue their policy preferences in their votes and opinions, we know that all human beings, no matter their intentions, are quite motivated reasoners. The human animal is incredibly adept at convincing himself that purely objective analysis leads to results that he otherwise finds pleasing. Thus, the justices' policy views necessarily influence their attraction to particular constitutional theories, frame their readings of language and history, and shade their interpretations of precedent. No matter how consciously committed the justices are to interpreting the law (and doing nothing more), policy considerations will always influence the Court's decisions.

Second, setting that point aside, the Court's own precedent has endorsed a tradition of judicial deference to Congress's superintendence of interstate commerce in cases raising similar issues of institutional competence, particularly when they involve

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[80]*Cf. McKesson*, 496 U.S. at 49-50 (discussing Florida's continued imposition of a liquor tax that was blatantly protectionist and only cosmetically different from one the Court had previously invalidated).

[81]The one possible exception is Minnesota, where some state officials in 1995 discussed the possibility that the state's tax preference for Minnesota municipal bonds would be declared unconstitutional. *See* Brief for Respondents at 47-8, *DOR v. Davis* (No. 06-666).

[82]*Camps Newfound/Owatonna, Inc. v. Harrison*, 520 U.S. 564, 572 (1997). *See also Quill*, 504 U.S. 298, 318 (1992); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 280 (1978); *Prudential Ins. Co. v. Benjamin,* 328 U.S. 408, 434 (1946). (For the decision in *Camps Newfound/Owatonna*, see *Doc 97-13082* or *97 STN 99-36*.)

[83]*See, e.g.*, Pub. L. No. 86-172, 73 Stat. 55, codified at 15 U.S.C. section 381 (prohibiting the states from imposing income taxes on businesses that keep their contacts within the taxing state beneath a specific threshold); Internet Tax Freedom Act, Pub. L. No. 108-435, 118 Stat. 2615 (2004) (prohibiting states from imposing taxes on Internet access or "discriminatory taxes on electronic commerce"); Pub. L. No. 104-95, 109 Stat. 979, codified at 4 U.S.C. section 114 (restricting the states' authority to tax the retirement income of nonresidents); Soldier and Sailors Civil Relief Act of 1940, Act of Oct. 17, 1940, ch. 888, section 514, codified at 50 App. U.S.C. section 571 (limiting the states' power to tax the property and personal income of military personnel); Railroad Revitalization and Regulatory Reform Act of 1976 (the 4-R Act), Pub. L. No. 94-210, 90 Stat. 54, codified at 49 U.S.C. section 11501 (prohibiting states from imposing higher taxes on railroad property than on other commercial or industrial property).

(Footnote continued in next column.)

matters of state and local taxation. Consider *Moorman Mfg. Co. v. Bair*, which addressed Iowa's single-sales-factor formula for apportioning the income of interstate businesses. The plaintiff demonstrated that Iowa's method of apportionment likely subjected many out-of-state taxpayers to multiple taxation, and thus disadvantaged interstate commerce relative to purely intrastate commerce.[84] But the Court reasoned that it was ill-suited to resolve the controversy, because doing so would have effectively required the Court to choose a particular method of apportioning income under the guise of interpreting the dormant commerce clause.[85] "It is clear that the legislative power granted to Congress by the commerce clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions."[86]

> ***Even if interstate commerce would benefit from the states' equal taxation of in-state and out-of-state municipal bonds, Congress is the only institution capable of devising an equitable transition to such a system.***

Or consider *Commonwealth Edison Co. v. Montana*, which involved a severance tax that Montana imposed on all coal mined in the state. Because the rate of the tax was extremely high, and because its economic incidence fell predominantly on out-of-state electricity consumers, the plaintiffs asserted that Montana had effectively exported its tax burden to other states, a core concern of the dormant commerce clause.[87] Indeed, Justice Byron White conceded in his concurrence that the case was "very troublesome."[88] But because a holding in favor of the taxpayers would have forced the Court to make a range of difficult empirical economic judgments, it upheld the state's tax scheme and left the policy questions to Congress: "Under our federal system, the determination is to be made by state legislatures in the first instance and, if necessary, by Congress, when particular state taxes are thought to be contrary to federal interests."[89]

Perhaps the most analogous case is *Quill Corp. v. North Dakota*, which addressed whether a state could require an out-of- state vendor to collect use taxes on sales to the taxing state's consumers, even when the vendor had no physical presence in the taxing state. The Court had invalidated an identical collection obligation 25 years earlier in *National Bellas Hess, Inc. v. DOR of Ill.*,[90] and an entire industry had grown up in reliance on *Bellas Hess*'s bright-line, "physical presence" requirement.[91] Despite some evident ambivalence — the Court conceded that the physical presence requirement "appears artificial at its edges," and that it had rejected a "similar bright-line, physical-presence requirement" in other state tax cases[92] — the Court reaffirmed the rule of *Bellas Hess*. Although there were problems with *Bellas Hess*, Congress was in the best position to alter the status quo.[93] "The underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions."[94]

Moorman, *Commonwealth Edison*, and *Quill* together represent an important, pragmatic strand of the Supreme Court's dormant commerce clause jurisprudence. They show that even when state tax schemes arguably burden interstate commerce, the Court's disruption of the status quo may not be the wisest course. For reasons of institutional competence, the Court is better off in some instances leaving the matter to Congress.

In my opinion, *Davis* is just such a case. Even if interstate commerce would benefit from the states' equal taxation of in-state and out-of-state municipal bonds, Congress is the only institution capable of devising an equitable transition to such a system. A judicial decree mandating that equality would impose costs that are too high — and too unfair to state governments — to justify such a holding.

Conclusion

In the concluding paragraph of his opinion for the Court in *Quill*, Justice John Paul Stevens offered the following insight:

> Even if we were convinced that *Bellas Hess* was inconsistent with our commerce clause jurisprudence, this very fact might give us pause and counsel withholding our hand, at least for now. Congress has the power to protect interstate commerce from intolerable or even undesirable burdens. In this situation, it may be

[84]*Moorman Mnfg.*, 437 U.S. at 276-77.
[85]*Id.* at 278-80.
[86]*Id.* at 280.
[87]*Commonwealth Edison*, 453 U.S. at 617-18.
[88]*Id.* at 637 (Justice White, concurring).
[89]*Id.* at 628.

[90]386 U.S. 753 (1967).
[91]*See Quill*, 504 U.S., at 316.
[92]*See id.* at 315, 317.
[93]*See id.* at 317-18.
[94]*Id.* at 318 (footnote omitted).

that the better part of both wisdom and valor is to respect the judgment of the other branches of the Government.[95]

The same is true in *Davis*. Given what is at stake for the states, the Court would be wise to stay its hand and ratify the status quo. For even if state tax preferences for their own municipal bonds are indeed a drag on the national economy, Congress is much better suited than the Court to solve the problem. ✰

[95]*Id.* at 318-19 (internal quotation marks, alterations, and citations omitted).