No. 06-666

IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY, AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,
Petitioners,

v.

GEORGE W. DAVIS AND CATHERINE V. DAVIS,
Respondents.

On Writ of Certiorari to the Court of Appeals of Kentucky

BRIEF OF ALAN D. VIARD, ALEX BRILL, CHRISTOPHER DEMUTH, JASON FURMAN, KEVIN A. HASSETT, R. GLENN HUBBARD, AND KENT SMETTERS AS *AMICI CURIAE* SUPPORTING RESPONDENTS

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QUESTION PRESENTED

Whether a state violates the dormant Commerce Clause by providing an exemption from its income tax for interest income derived from bonds issued by the state and its political subdivisions, while treating interest income realized from bonds issued by other states and their political subdivisions as taxable to the same extent, and in the same manner, as interest earned on bonds issued by commercial entities, whether domestic or foreign.

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INTEREST OF *AMICI CURIAE* [1]

Amici are scholars of public policy ("the public policy *amici*") who wish to ensure that the Court is fully informed of the key economic issues relating to the Kentucky tax exemption challenged in this case,

[1] The parties have filed blanket consents to the filing of *amicus* briefs in this case. Pursuant to Rule 37.6, *amici* state that this brief was not authored in whole or in part by counsel for any party, and that no person or entity other than *amici* or their counsel made a monetary contribution to the preparation or submission of this brief.

a selective exemption for interest income on municipal bonds issued by Kentucky and its political subdivisions that Kentucky does not grant to interest income on municipal bonds issued by other states. These *amici* believe that their extensive experience analyzing the economic effects of taxes and other public policies may assist the Court and that they bring a different perspective to the issue than the other parties. The public policy *amici* are filing this brief solely as individuals and not on behalf of any institution.

Alan D. Viard is a Resident Scholar at the American Enterprise Institute for Public Policy Research ("AEI"). He previously served as visiting scholar at the U.S. Treasury Department Office of Tax Policy, a senior economist at the President's Council of Economic Advisers, a senior economist at the Federal Reserve Bank of Dallas, an assistant professor of economics at Ohio State University, and an economist for the Joint Committee on Taxation of the U.S. Congress.

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Christopher DeMuth is President of AEI. Previous to joining AEI in 1986, he was managing director of the economics consulting firm Lexecon Inc., editor and publisher of *Regulation* magazine, administrator for regulatory affairs at the Office of Management and Budget and executive director of the Presidential Task Force on Regulatory Relief in the Reagan administration, lecturer at Harvard University's Kennedy School of Government and director of the Harvard Faculty Project on Regulation, an attorney with the Consolidated Rail Corporation and with the law firm of Sidley & Austin LLP and staff assistant to President Richard Nixon.

Jason Furman is a Senior Fellow at the Brookings Institution and Director of the Hamilton Project. Furman is also an affiliate of the Tax Policy Center, a joint venture of the Urban Institute and the Brookings Institution. He has written widely on tax policy and other economic policy issues. He has held a number of public service and teaching positions, including serving as a Staff Economist on the President's Council of Economic Advisers (1996–1997), Special Assistant to the President for Economic Policy, National Economic Council (1999–2000), Lecturer at Yale University (2001–2002), and Visiting Scholar at New York University's Wagner Graduate School of Public Service (2004–2007).

Kevin A. Hassett is Director of Economic Policy Studies and Senior Fellow at AEI and a weekly columnist for Bloomberg. He previously served as a senior economist at the Board of Governors of the Federal Reserve System and an associate professor at the Graduate School of Business of Columbia University. He also served as a policy consultant to the U.S. Department of the Treasury. Dr. Hassett is a member of the Joint Committee on Taxation's Blue Ribbon Dynamic Scoring Advisory Panel and its Estimating Review Panel. He is the author, coauthor or editor of six books on economics and economic policy and has published numerous scholarly papers in professional journals.

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Kent Smetters is an associate professor at the Wharton School at the University of Pennsylvania and a Visiting Scholar at AEI. Dr. Smetters previously served as Deputy Assistant Secretary for Economic Policy of the U.S. Treasury, an economist at the Congressional Budget Office, the Kaiser Visiting Professor of Economics at the Stanford University Economics Department, and a member of the Joint Committee on Taxation's Blue Ribbon Dynamic Scoring Advisory Panel.

STATEMENT OF THE CASE

The Commonwealth of Kentucky assesses income tax on the bond interest income earned by its residents, including interest earned on bonds issued by municipal governments. Like many other states, however, Kentucky exempts the income earned as interest on bonds issued by municipalities within Kentucky. *See* KEN. REV. STAT. ANN. §§ 141.010, 141.020 (2005). Kentucky offers no similar exemption for interest earned on bonds issued by municipalities outside of Kentucky. Similarly, it offers no tax exemption (nor could it) on the interest earned on the bonds of Kentucky municipalities held by residents of other states.

Respondents filed suit in Jefferson Circuit Court in Jefferson County, Kentucky, alleging that the selective municipal bond tax exemption employed by Kentucky violated what is commonly referred to as the "dormant Commerce Clause" of the U.S. Constitution, because the selective tax exemption discriminates against interstate commerce. The Circuit Court granted Kentucky's motion for summary judgment and dismissed the case. In an opinion dated January 6, 2006, the Kentucky Court of Appeals reversed, holding that the exemption did violate the dormant Commerce Clause. *See Davis v. Kentucky*, 197 S.W.3d 557 (Ky. Ct. App. 2006). The Kentucky Supreme Court declined discretionary review on August 17, 2006, and this Court granted certiorari on May 21, 2007.

SUMMARY OF ARGUMENT

1. (a) This Court has held that state taxes may not discriminate against interstate commerce, relative to within-state commerce. Kentucky's selective municipal bond tax exemption discriminates against interstate commerce in municipal bonds, in both design and effect, because Kentucky taxes its residents on income earned on municipal bonds purchased from out-of-state issuers but not the income earned on Kentucky municipal bonds. Kentucky's exemption amounts to a subsidy of within-state bond holdings. Because the subsidy is limited to within-state bond holdings and excludes residents' interstate bond holdings, it is the equivalent of a tariff on imports of municipal bonds. It therefore discriminates against interstate commerce.

The selective exemption bears no economic resemblance to non-discriminatory policies by which Kentucky could promote its bonds to both residents and non-residents, such as coupons, rebates to all bondholders, or direct subsidies to municipalities.

(b) (i) The selective municipal bond tax exemptions adopted by Kentucky and 42 other states distort the interstate market for municipal bonds. More than one-third of the municipal bonds held through mutual funds and money-market funds have been invested in funds that specialize in holding a single state's bonds and marketing each state-specific fund primarily to residents of that state. This balkanization of the market along state lines has reduced consumer well-being, because the single-state bond funds suffer from limited diversification, poor liquidity, and high expenses.

(ii) The harm from Kentucky's selective exemption is reinforced, not offset, by the fact that most other states have adopted similar exemptions. Each state's exemption further balkanizes the market, causing greater cumulative harm to investors.

(iii) The purported benefit to Kentucky of lower financing costs is counterbalanced by the resulting lower tax revenues. Frequently, a state incurs net budgetary costs by granting a selective municipal bond tax exemption.

(iv) Moreover, even though the selective municipal bond tax exemption ultimately fails to lower the State's financing costs, Kentucky's selective exemption shifts costs to non-residents, who have no voice in the State's political processes. Non-residents who hold Kentucky bonds earn lower returns because the exemption drives down interest rates on Kentucky bonds, but, unlike Kentucky residents, non-residents do not receive an offsetting tax exemption. In addition, non-residents are deterred from purchasing Kentucky bonds by the lower interest rates and the lack of an offsetting tax exemption, which deprives non-residents of the opportunity to diversify.

(c) The rule adopted by the court below would not require Kentucky to subsidize other states. Kentucky could determine to extend its exemption to out-of-state bonds, as well as home-state bonds, or to withdraw the exemption from both. If it were to extend the tax exemption to all bonds, it would subsidize only its residents' holdings of such bonds, not all bond holdings nationwide. More importantly, because other states would have the same choice to extend their exemption, cross-subsidies could develop nationwide. There would be no systematic transfer of resources from Kentucky to other states.

2. The Court should not extend the market-participant exception to the dormant Commerce Clause to protect the selective municipal bond tax exemption. The market-participant exception permits states to act in the market in the same way that private market participants might. In this case, Kentucky is using its tax power to discriminate in a manner that no private party ever could. Accordingly, the market-participant exception to the dormant Commerce Clause should not be enlarged to include the selective municipal bond tax exemption.

3. This Court's recent decision in *United Haulers Association, Inc. v. Oneida-Herkimer Solid Waste Management Authority*, 127 S. Ct. 1786 (2007), also should not be expanded to protect the selective municipal bond tax exemption. *United Haulers* is inapposite because the statute upheld in that case

mandated use of a governmentally-operated business —a restriction that burdened within-state and interstate commerce alike. By contrast, Kentucky's tax scheme discriminates against interstate commerce and favors within-state commerce. Even if this Court were to conclude that *United Haulers* is relevant, this case should be remanded, not overturned. The Court issued its decision in *United Haulers* after the Kentucky Court of Appeals had decided this case, and the court below never had an opportunity to consider the import of that decision. Remand is particularly appropriate because the balancing test announced in *Pike v. Bruce Church*, *Inc*. 397 U.S. 137 (1970), applies if the selective exemption is analyzed under *United Haulers*, and the public policy *amici* submit that the selective municipal bond tax exemption fails that balancing test. The harms caused by the selective exemption far outweigh the doubtful benefits. Finally, it is uncontested that a substantial number of the municipal bonds at issue are actually "private activity" bonds, issued on behalf of private firms or non-profits. Bonds issued to assist in private financing do not come within the scope of *United Haulers*.

ARGUMENT

I. KENTUCKY'S SELECTIVE MUNICIPAL BOND TAX EXEMPTION DISCRIMINATES AGAINST INTERSTATE COMMERCE AND HAS, PREDICTABLY, LED TO HARMFUL MARKET BALKANIZATION.

A. Kentucky's Selective Tax Exemption Discriminates Against Interstate Commerce Because It Promotes Within-State Municipal Bond Holdings Over Interstate Holdings.

The Court scrutinizes a tax challenged under the Commerce Clause to ascertain whether it discriminates against interstate commerce. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). The Court has held that a state "tax may not discriminate between transactions on the basis of some interstate element," *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 332 n.12 (1977), and "may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State," *Armco Inc. v. Hardesty*, 467 U.S. 638, 642 (1984).

From the standpoint of basic economics, there can be no dispute that Kentucky's selective municipal bond tax exemption discriminates against interstate commerce. That state's exemption grants a tax reduction to Kentucky residents who purchase Kentucky municipal bonds. (The fact that the tax exemption applies to the interest income on bond holdings rather than directly to the purchase of the bond is economically irrelevant.) The State, however, provides no such tax break to Kentucky residents who buy municipal bonds issued by other states or, obviously, to non-residents who buy Kentucky municipal bonds. As such, the tax break discriminates against interstate commerce because it is in effect a "within-state" subsidy, *i.e.*, a subsidy that is restricted to transactions that occur entirely within the state, with an in-state issuer and in-state purchaser. The Court has held that sort of tax subsidy to be a violation of the dormant Commerce Clause. *See Camps Newfound/ Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997).

From an economic viewpoint, a tax exemption functions like a subsidy. A broad-based subsidy to all purchasers or holders, just like a broad-based state sales tax on all purchases or holdings, typically poses no interstate commerce clause problem. This is because a subsidy on all purchases or holdings of a particular good by in-state parties does not discriminate on the basis of the location of the other parties to the transactions or the source of the good, either within and without the state. Such a subsidy is generally neutral with respect to interstate commerce. It applies equally to within-state transactions and holdings, on the one hand, as it does to transactions and holdings involving out-of-state parties on the other hand.

It is plain here that Kentucky's municipal bond tax exemption is properly characterized as a within-state subsidy that *does* discriminate against interstate commerce. When a state subsidizes within-state transactions but does not subsidize either imports or exports, then it encourages in-state purchasers to buy from in-state sellers and discourages them from buying from out-of-state sellers. Such a subsidy also decreases the ability of out-of-state purchasers to buy from in-state sellers, by increasing the price they pay and reducing the supply available to out-of-state purchasers. The same holds true with respect to a subsidy of within-state holdings.

The case at hand therefore closely resembles *Camps Newfound/Owatonna, Inc.*, where this Court struck down a property tax exemption granted to camps that primarily served state residents. By subsidizing such camps, the tax exemption there in issue promoted within-state sales over interstate sales and thereby discriminated against interstate commerce. As the Court recognized, 520 U.S. at 580–81, this subsidy transformed what would have been a neutral property tax into a protectionist export tariff that discriminated against camps serving non-residents.

As with the *Camps* exemption, the economic objection to the selective exemption in this case is that Kentucky promotes only within-state holdings—*i.e.*, holdings of Kentucky bonds by Kentucky residents—and discourages out-of-state transactions, both exports of Kentucky bonds and imports of other states' bonds. Contrary to arguments by petitioners and supporting *amici*,[2] the exemption is therefore unlike

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[2] Eight *amicus* briefs in support of petitioners were filed with the Court. For the purpose of this brief, the public policy *amici* refer to each of the following briefs by the abbreviation in parentheses following the name: Brief for the Churchill Tax-Free Fund of Kentucky, *et al*. ("Churchill Br."); Brief for Dupree Mutual Funds ("Dupree Br."); Brief for the Government Finance Officers Association, *et al*. ("GFOA Br."); Brief for the Multistate Tax Commission ("MTC Br."); Brief for the National Association of State Treasurers ("NAST Br."); Brief for Nuveen Investments, Inc. ("Nuveen Br."); Brief for the Securities Industry and Financial Markets Association ("SIFMA Br."); Brief for State of North Carolina, *et al*. ("Br. 49 States").

In addition, one *amicus* brief was filed in support of neither party: Brief for the National Federation of Municipal Analysts ("NFMA Br.").

a discount, rebate or coupon, which would apply to all purchasers and so would be neutral between within-state and interstate transactions. (Pet. Br. 13; Dupree Br. 15.) Instead, the selective municipal bond tax exemption operates as a discriminatory tariff that gives state residents—and only state residents—an incentive to prefer in-state goods over out-of-state goods.

Likewise, the selective municipal bond tax exemption is not economically equivalent to a direct subsidy or cash payment by the Kentucky state government to municipal governments within the state. (GFOA Br. 20.) Though both arrangements provide a financial benefit to the municipality, the direct subsidy, unlike the tax exemption in issue, would create no incentive for Kentucky residents to prefer in-state bonds over out-of state bonds or disincentive for non-residents considering whether to purchase Kentucky bonds. A direct subsidy to municipalities, quite simply, would not discriminate against interstate commerce.

Accordingly, the objection to the selective municipal bond tax exemption from an economic viewpoint is *not* an objection to state favoritism of its own bonds. Rather, it is an objection to a form of favoritism that discriminates against interstate commerce. Kentucky may create rebates, discounts or coupons in conjunction with its bonds, offer attractive terms for its bonds, and advertise the merits of its bonds. Such practices do not discriminate against purchases and holdings by non-residents; they merely encourage everyone to purchase Kentucky bonds instead of other states' bonds. These forms of favoritism would be available to all purchasers and would encourage interstate commerce and in-state commerce equally.

Similarly, Kentucky may favor Kentucky residents over non-residents by subsidizing its residents' holdings of municipal bonds as long as that favoritism is in a form that does not discriminate against interstate commerce. If Kentucky does subsidize Kentucky bondholders, it must subsidize holdings of both out-of-state and home-state bonds. Instead, Kentucky has created an import tariff on out-of-state holdings by Kentucky residents. The selective tax exemption also has effects similar to an export tariff because it raises the price at which non-residents can purchase Kentucky bonds, as discussed in section I.B.4, *infra*. Such interference with interstate commerce (and the corresponding injury to consumer welfare outlined in Part I.B, *infra*) is exactly the kind of harm that the dormant Commerce Clause doctrine was developed to prevent.

B. Kentucky's Selective Tax Exemption, Together With Other States' Selective Tax Exemptions, Has Resulted In A Balkanized Municipal Bond Market That Harms All Bondholders And The States Themselves.

Kentucky's selective municipal bond tax exemption and the similar selective exemptions of other states have negative consequences for the national market for municipal bonds, consequences that are readily admitted by petitioners and the *amici* who filed briefs in support of petitioners. The states' discrimination against interstate transactions and holdings harms market participants, including the issuers of municipal bonds, and none of the justifications offered by petitioners or the *amici* supporting petitioners justifies or excuses balkanization of the market.

1. *The Selective Tax Exemption's Effects On The Interstate Municipal Bond Market Are Harmful To Consumers.*

The negative impact of the selective exemption on interstate commerce is far from theoretical. The petitioners themselves, as well as the *amici*, actually demonstrate that the selective exemption has balkanized the municipal bond market.

For example, the petition for certiorari concedes that the exemption encourages the concentration of in-state bond holdings: "The tax exemption influences a Kentucky resident to choose to acquire a bond issued by Kentucky or a Kentucky municipality over a bond issued by another state or other state's municipality that pays a higher rate of interest or has a stronger credit rating." (Cert. Pet. 12.) *Amici* supporting petitioners also acknowledge that the selective exemption promotes within-state holdings. (GFOA Br. 24–25; MTC Br. 13; SIFMA Br. 14; NAST Br. 27; Dupree Br. 7, Nuveen Br. 7, 16; Churchill Br. 6–7, 10.)

Over 600 single-state municipal bond funds (including both open-end mutual funds and closed-end funds) have been established to serve investors who live in a single state to encourage them to concentrate their holdings in that state's bonds. (Churchhill Br. 11.) In its *amicus* brief supporting neither party, the NFMA states that $155 billion of long-term municipal bonds are held in single-state mutual funds, about 42 percent of all long-term municipal bonds held in mutual funds. (NFMA Br. 11–12.) Also, $125 billion of short-term municipal bonds are held in single-state money-market funds, about 33 percent of the total short-term municipal bonds held in money-market funds. (*Id.*) The NFMA suggests that a similar degree of within-state concentration prevails for bonds held outside of mutual funds and money-market funds. (*Id.* 12.) The NFMA's brief further predicts that most of the single-state funds would cease to be viable if selective municipal bond exemptions did not exist. (*Id.* 18.)

This Court has recognized that consumer welfare would be significantly reduced if each state had to obtain agricultural and manufactured products from its own farmers and firms. *H.P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525, 539 (1949). The same principle applies equally to the market for municipal bonds. When every state attempts to obtain the bulk of its municipal financing from its own residents and to discourage them from purchasing municipal bonds issued by other states, similarly harmful economic consequences follow. The diversification, liquidity and cost savings offered by an unimpeded national municipal bond market are lost.

The NFMA details the impact of these exemptions in its brief, commenting, "[b]ecause of their sharply reduced geographical diversification and somewhat higher expense ratios relative to national funds (because the expense ratio is spread over a smaller asset base), single state funds appeal primarily to investors seeking to maximize their tax-exempt return." (NFMA Br. 13.) Thus, the NFMA acknowledges that balkanization has deprived consumers of diversification and has added expense. The NFMA further states that "national mutual funds place a higher premium on the liquidity of their holdings than do single state funds, which are willing to purchase less liquid bonds of smaller and less familiar issuers because of the state tax advantage." (NFMA Br. 19.)

Here the NFMA acknowledges that balkanization diminishes liquidity. The NFMA further acknowledges that balkanization has created wasteful overhead that could be decreased if there were an unimpeded national market, noting that "elimination of single state funds would lead to a reduction in the number of municipal mutual fund analysts employed within mutual fund complexes that offer a substantial number of such funds." (NFMA Br. 19.)

The NFMA does not express a view either way as to the desirability or undesirability of the status quo in the municipal bond market. The public policy *amici* here respectfully submit that the phenomenon the NFMA describes—higher costs to provide a less liquid and less diversified product—can only be viewed as a harm to investors caused by the balkanized condition of the market.

Petitioners and supporting *amici* argue that the states, as sovereigns, cannot compete against each other to provide essential public services such as police and fire protection. (Pet. Br. 27; MTC Br. 9–10.) That observation, though obviously true, is irrelevant to this case. The states do compete against each other in the municipal bond market to *finance* those services. They can and should compete on an equal basis without discriminating against interstate commerce. By inhibiting such competition and discriminating against interstate commerce, the selective municipal bond tax exemption has greatly reduced investor well-being.

2. *The Harm Caused By Any One State's Selective Tax Exemption Is Reinforced, Not Offset, By Other States' Selective Tax Exemptions.*

Amici supporting petitioners contend that the near universality of the selective municipal bond tax exemption resolves any problems posed by the exemption. (Nuveen Br. 9; SIFMA Br. 6–7; NAST Br. 28). This argument is premised on a misunderstanding of the economic objection to the selective exemption.

The problem is that the selective municipal bond tax exemption prefers within-state bond holdings over interstate bond holdings. That problem is reinforced, not offset, when other states adopt selective exemptions, because each state's residents own more of their own state's municipal bonds than they otherwise would, and the amount of interstate commerce is correspondingly reduced. Due to Kentucky's selective exemption, for example, Kentucky residents disproportionately hold Kentucky bonds, thereby reducing interstate holdings. Due to Ohio's selective exemption, Ohio residents disproportionately hold Ohio bonds, thereby further reducing interstate holdings. The same pattern holds in each of the states with selective exemptions. The fact that 43 states have selective exemptions does not mean that the playing field is almost level. Instead, it means that 43 playing fields are tilted towards within-state holdings and against interstate holdings.

The poor diversification, illiquidity, and high expenses caused by one state's selective tax exemption are not offset by the poor diversification, illiquidity, and high expenses caused by other states' selective tax exemptions. To the contrary, the greater the number of states that carve out within-state markets, the more balkanized the municipal bond market becomes. Today's balkanized municipal bond market reflects the combined impact of 43 states' selective muncipal bond tax exemptions. The idea that the harm from one jurisdiction's trade restrictions can be offset by another jurisdiction's trade restrictions is not merely contradicted by mainstream economic theory, *see* Dennis R. Appleyard, *et al.*, INTERNATIONAL ECONOMICS 313 (5th ed. 2006), but has also been rejected by this Court. *See Great Atl. & Pac. Tea Co. v. Cottrell*, 424 U.S. 366, 378–81 (1976) (one state's trade barriers cannot be justified by the existence of other states' barriers).

3. *The Selective Tax Exemption Does Not Provide Any Offsetting Benefits Through Lower Financing Costs.*

Amici supporting petitioners argue that the selective exemption provides a potentially offsetting economic benefit to this market balkanization by lowering the State's financing costs. (MTC Br. 6; NAST Br. 29; Br. 49 States 10; GFOA Br. 24). Because the exemption increases demand for Kentucky bonds by making them more attractive to one set of potential holders (Kentucky residents), it lowers the interest rate that Kentucky must pay to sell its bonds. That does not obviously result in lower financing costs, however, since there is an offsetting loss of state tax revenue resulting from the exemption. The state effectively takes money out of one pocket and places it in another. At best, one would expect the within-state subsidy to be a wash economically.

Significantly, however, a state government may actually be worse off financially for choosing this route to reduce its financing costs. Economists have observed a phenomenon known as the "muni bond puzzle" whereby states routinely fail to recoup the cost of the tax subsidy in the form of lower financing rates. *See* John Chalmers, *Default Risk Cannot Explain the Muni Puzzle: Evidence from Municipal Bonds that are Secured by U.S. Treasury Obligations*, 22 REV. FIN. STUD. 281, 282–83 (1998) (reviewing economics literature on the muni bond puzzle).[3] The purported benefits of this discriminatory tax system therefore in no way offset the observed harms.

4. *Kentucky's Selective Tax Exemption Imposes Costs On Non-Residents, Who Have No Voice In Its Political Processes.*

Although the selective tax exemption does not actually lower Kentucky's financing costs, it does shift costs to non-residents, contrary to the contention of petitioners and supporting *amici* that the costs of each state's exemption falls primarily or exclusively upon the state itself. (Pet. Br. 24–25; MTC Br. 13; GFOA Br. 20; NAST Br. 28.) Kentucky and the other states and supporting *amici* confirm that the selective tax exemption lowers the interest rates on municipal bonds. (Pet. Br. 23: GFOA Br. 17-18; Br. 49 States 9-10; NAST Br. 20; Dupree Br. 6; MTC Br. 6, 14.) The interest-rate reduction neces-

[3] For an analysis that brings together the muni bond puzzle and the issues raised by this litigation, *see* Brian D. Galle & Ethan Yale, *Can Discriminatory State Taxation of Municipal Bonds be Justified? Thoughts on the* Davis *Topside Briefs,* 117 TAX NOTES (forthcoming Oct. 2007) (manuscript at 5–6 & n.8, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1014138).

sarily means that non-resident holders of Kentucky bonds are harmed by Kentucky's selective exemption because they receive a lower interest rate on Kentucky bonds with no offsetting subsidy. In addition, some non-residents who would otherwise have held Kentucky bonds choose not to do so in response to the lower interest rates and lack of tax exemption, thereby losing an opportunity to diversify their portfolios. Kentucky's selective exemption therefore imposes costs on non-resident holders and potential holders of its bonds, who have no voice in Kentucky's political processes.

C. Affirming The Court Below Would Not Require Kentucky To Subsidize Other States.

One other point of economic confusion should be addressed. *Amici* supporting petitioners contend that ruling in favor of respondents would unreasonably require Kentucky to subsidize other states. (MTC Br. 12, 14; Br. 49 States 11; Nuveen Br. 17.) That assertion is incorrect.

To begin, Kentucky would have a choice whether to continue exempting its residents' holdings of home-state municipal bonds and extend the same tax exemption to its residents' holdings of out-of-state bonds or to stop granting a tax exemption with respect to any bonds, whether out-of-state or with-in state. Kentucky is not required to subsidize other states, and the practical effect of a choice by Kentucky to exempt all municipal bond income from tax, including both home-state bonds and other states' bonds, would depend on how the other states react to the Court's ruling in this case. Other states would have the same choice as Kentucky. If other states determined to subsidize all municipal bonds held by their residents, for example, cross subsidies among the states could occur and could work to Kentucky's advantage. In reality, if Kentucky extended its exemption to all municipal bonds, then all municipal bonds would become more attractive to Kentucky residents; and if other states did the same, then all municipal bonds would similarly become more attractive to their residents. Kentucky and the other states would likely be affected in similar ways: Each state's treasury would save financing costs from the interest-rate reduction, and each state's residents would earn lower interest rates on their bond holdings.

In any event, even if Kentucky were the only state to exempt all municipal bond income, the subsidy to other states would be limited to the holdings of Kentucky residents. Whenever a state subsidizes its residents' purchases of any good, out-of-state producers generally capture some of the gains. Such an effect cannot justify discrimination against interstate transactions.

II. THE MARKET-PARTICIPANT DOCTRINE SHOULD NOT BE EXTENDED TO UPHOLD THE SELECTIVE MUNICIPAL BOND TAX EXEMPTION.

The Kentucky Court of Appeals below declined to apply this Court's market participant doctrine on the ground that the State, by creating preferential tax treatment for its municipal bonds, had acted as a regulator rather than as a market participant. Petitioners and certain *amici* attack this distinction as formalistic. For example, Nuveen argues that Kentucky, as a market participant, would be "free to pay whatever rate of interest it wishes, to whomever it wishes" under this Court's market participant precedents. (Nuveen Br. 3.) Nuveen concludes from this premise that "the Court of Appeals erred by refusing to acknowledge the economic reality of the Kentucky exemption, that is, the fact that the exemption is the functional equivalent of an additional interest payment" on state municipal bonds to state residents. (*Id.*)

Nuveen's argument and similar assertions by petitioners (Pet. Br. 41) are mistaken. There is a substantive distinction between a state's decision to discriminate against interstate commerce by means of its governmental taxing authority and a state's decision to discriminate as a market participant by paying different rates of interest to different holders. Through its use of the selective municipal bond tax exemption, Kentucky does not discriminate between in-state and out-of-state parties as a direct part of its market transaction. Rather, it uses the income tax system to discriminate after the market transaction has occurred and separate from it. Such a means of discrimination between in-state and out-of-state investors is simply not available to private parties. Indeed, given that participants in the public securities markets typically deal with each other in an impersonal manner without regard for the identities of counterparties, it is doubtful that private actors in this market could discriminate against the residents of other states even if they wanted to do so.

Petitioners' proposal that the Court allow the state to act as a "market participant" is therefore really a request that states be allowed to act in a way that no other market participant ever could. Such a request goes well beyond this Court's precedents. The market participant exception has been traditionally justified by analogizing states to private market participants, with the implication that states should be as free to act in the market in the same manner as private parties. *Reeves, Inc. v. Stake*, 447 U.S. 429, 439 & n.12 (1980) (quoting *United States v. Colgate & Co.*, 250 U.S. 300, 307 (1919)). Accordingly, it is appropriate for the Court to decline to extend the exception to this context, where the State is attempting to discriminate against interstate interests in a manner that no private participant could. Certainly, the balkanization in the $2 trillion municipal bond market counsels against the extension of the market participant exception to these circumstances.

It is no response to argue, as Nuveen does, that if the State may permissibly discriminate by offering different interest rates to different bond holders, then the State should be able to reach the same result through an administratively more convenient method. (Nuveen Br. 8.) There is no reason for the Court to encourage such discrimination by permitting states to favor in-state interests through *any* means at their disposal, including a quintessentially regulatory means such as tax policy. As the Court said in *Camps*, 520 U.S. at 593, "A tax exemption is not the sort of direct state involvement in the market that falls within the market-participation doctrine."

The Court should therefore decline petitioners' request to extend the market participation doctrine in this context.

III. *UNITED HAULERS* DOES NOT VALIDATE THE SELECTIVE MUNICIPAL BOND TAX EXEMPTION.

In a recent decision, this Court upheld an ordinance requiring firms hauling waste in a county to bring the waste to a publicly-owned facility. *See United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Man. Auth.*, 127 S. Ct. 1786 (2007). *United Haulers* announced a new exception to the dormant Commerce Clause, holding that a state may mandate that residents transact business with a state-run business if all private competitors, both in-state and out-of-state, are treated even-handedly. The public policy *amici* here respectfully submit that *United Haulers* does not apply to this case because the nature of the discrimination is quite different. In *United Haulers*, the ordinance at issue discriminated against *all* private trash haulers, whether local or out-of-state. By contrast, the selective municipal bond tax exemption discriminates directly against interstate commerce alone, creating a tax exemption that applies only to within-state municipal bond holdings. *United Haulers* is inapposite.

If the Court should nevertheless decide that *United Haulers* applies, the better course of action would be to remand the case to the Kentucky courts to consider the issue in the first instance. The Court decided *United Haulers* after the Kentucky Court of Appeals issued its decision, and the lower courts have not had a chance to consider the relevance, if any, of *United Haulers*. Prudence suggests that this Court wait to rule on an issue until it has been properly developed by the lowers courts. *See, e.g., Lockheed Corp. v. Spink*, 517 U.S. 882, 898 (1996) (Breyer, J., concurring in part and dissenting in part) (the Court should not reach a "highly technical" issue when it was not addressed by the lower courts); *Lebron v. National R.R. Passenger Corp.*, 513 U.S. 374, 407 (1995) (O'Connor, J., dissenting) ("we often defer consideration of novel questions of law to permit further development").

That course is particularly appropriate if the Court concludes that *United Haulers* might apply, given the plurality's decision that a court should use the balancing test derived from *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970), when applying *United Haulers*. That balancing test compares local benefits to the burden on interstate commerce. As explained above, the burden on interstate commerce is severe and has resulted in an inefficient balkanization of the municipal bond market, while the main alleged benefit of the selective exemption, lower financing costs, has not been demonstrated and is actually contradicted by the available evidence. Here, because *United Haulers* was not yet decided, the record has not been developed sufficiently to enable the application of the *Pike* test. *Cf. United Haulers*, 127 S. Ct. at 1797 (relying on lower-court findings based on "years of discovery" to support claimed local benefits).

Finally, the public policy *amici* note that roughly one-quarter of the municipal bonds in the market are "private activity" bonds, issued not on behalf of municipal governments, but on behalf of private businesses or non-profits. Private-activity bonds, are issued by state and local governments acting merely as conduits for non-governmental organizations. (NFMA Br. 6–7.) *See also* Joel Michael, Department of Revenue of Kentucky v. Davis: *Implications for State Tax Policy and Dormant Commerce Clause Doctrine*, 45 STATE TAX NOTES (forthcoming 2007) (manuscript at 13, *available at* papers.ssrn.com/sol3/papers.cfm? abstract_id=1005433). In *United Haulers*, this Court stressed that the exception discussed in that decision applies to state and local governments, not to private firms. 127 S. Ct. at 1795 ("Unlike private enterprise, government is vested with the responsibility of protecting the health, safety, and welfare of its citizens. . . . Given these differences, it does not make sense to regard laws favoring local government and laws favoring private industry with equal skepticism."). With private-activity bonds, however, private parties are the actual borrowers, not state or local governments. The *United Haulers* exception should not apply in any event to this segment of the municipal bond market.

The Court should therefore decline to extend the *United Haulers* exception to Kentucky's selective municipal bond tax exemption.

CONCLUSION

For the reasons set forth above, the public policy *amici*, Messrs. Viard, Brill, DeMuth, Furman, Hassett, Hubbard, and Smetters, respectfully submit that the decision of the Court of Appeals of Kentucky should be affirmed.

Respectfully Submitted,

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