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## Fixed Income Insecurities: Municipal Bonds and the Erosion of Dormant Commerce Clause Scrutiny in *Department of Revenue v. Davis*

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Fixed Income Insecurities: Municipal Bonds and the  
Erosion of Dormant Commerce Clause Scrutiny in  
*Department of Revenue v. Davis*

Evan S. Weiss\*

INTRODUCTION

The Supreme Court's 2008 decision in *Department of Revenue v. Davis*<sup>1</sup> all but exempted from dormant Commerce Clause scrutiny a potentially broad swath of state regulations, those that can be labeled as favoring "a traditional government function."<sup>2</sup> In *Davis*, the Court evaluated whether a scheme that taxed Kentucky citizens on interest earned from out-of-state municipal bonds, but not on in-state municipal bonds, was valid under the Commerce Clause.<sup>3</sup> The Court upheld the tax scheme, primarily on the grounds that regulations favoring traditional government functions are not susceptible to the same level of scrutiny as those favoring private interests when determining whether a regulation discriminates against interstate commerce.<sup>4</sup>

The *Davis* opinion could have serious implications for the future of the national market and interstate commerce by giving state regulations sanctuary from Commerce Clause analysis even when

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1. *Dep't of Revenue v. Davis*, 128 S. Ct. 1801 (2008).

2. *Id.* at 1811. It is debatable whether this traditional government functions test differs from that of *National League of Cities v. Usery*, 426 U.S. 833, 852 (1976), which was later deemed unworkable. *See infra* note 70 and accompanying text.

3. *Davis*, 128 S. Ct. at 1804.

4. *See id.* at 1810 & nn.8-9.

those regulations are protectionist of intrastate economic interests. This Note will evaluate the tax scheme at issue in *Davis* under traditional dormant Commerce Clause scrutiny. In doing so, it will demonstrate that the tax scheme did not discriminate against interstate commerce, because the costs of the regulation were born by the citizens of the state itself. Therefore, application of a traditional government functions exemption becomes unnecessary. This Note asserts that the *Davis* exemption for traditional government functions needlessly erodes the dormant Commerce Clause doctrine.

#### I. UNDERSTANDING THE DORMANT COMMERCE CLAUSE

Before one can fully understand the implications of the *Davis* opinion for the dormant Commerce Clause doctrine—along with its predecessor, *United Haulers Ass’n, Inc. v. Oneida-Herkimer Solid Waste Management Authority*<sup>5</sup>—it is important to first recognize the purpose that the doctrine serves and the reasons for the tests used to enforce it.

The Constitution’s Commerce Clause grants Congress the affirmative power to “regulate Commerce . . . among the several States . . . .”<sup>6</sup> Under the dormant Commerce Clause doctrine, the Supreme Court has interpreted the same provision as also limiting the authority of states to “erect barriers against interstate trade.”<sup>7</sup> This limitation does not completely prevent states from using their powers in any and every manner that affects interstate commerce.<sup>8</sup> States retain the right to use their general police powers to regulate matters of local concern.<sup>9</sup>

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5. *United Haulers Ass’n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 550 U.S. 330 (2007).

6. U.S. CONST. art. I, § 8, cl. 3.

7. *Lewis v. BT Inv. Managers, Inc.*, 447 U.S. 27, 35 (1980).

8. *Great Atl. & Pac. Tea Co., Inc. v. Cottrell*, 424 U.S. 366, 371 (1976); *H. P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525, 531–32 (1949).

9. See *Raymond Motor Transp., Inc. v. Rice*, 434 U.S. 429, 440 & n.15 (1978); *Great Atl. & Pac. Tea Co.*, 424 U.S. at 370–71.

*A. Theoretical Underpinnings of the Dormant Commerce Clause*

The Supreme Court and legal scholars' justifications for the dormant Commerce Clause express the limitations it imposes. The first justification is that granting Congress affirmative power to regulate commerce implicitly negates the same power in the states.<sup>10</sup> Another justification for the dormant Commerce Clause is that when Congress has not regulated a particular aspect of interstate commerce, its inaction implies a conscious determination to leave the subject unregulated.<sup>11</sup> A third justification, and the one generally adopted by the Court, is to ensure that state regulations do not undermine the objectives that the Commerce Clause was designed to serve.<sup>12</sup>

Applying the rationale that regulations should not undermine the objectives of the Commerce Clause, the most significant of those

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10. Martin H. Redish & Shane V. Nugent, *The Dormant Commerce Clause and the Constitutional Balance of Federalism*, 1987 DUKE L.J. 569, 582 (1987). This view underlies the remarks of Chief Justice Marshall in *Gibbons v. Ogden*, where he stated:

It has been contended . . . that, as the word "to regulate" implies in its nature, full power over the thing to be regulated, it excludes, necessarily, the action of all others that would perform the same operation on the same thing. . . . There is great force in this argument, and the Court is not satisfied that it has been refuted.

*Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 209 (1824). Although *Gibbons* was decided on federal preemption grounds, Justice Marshall's opinion is recognized as the foundation upon which all dormant Commerce Clause analysis stands. See Norman R. Williams, *The Dormant Commerce Clause: Why Gibbons v. Ogden Should be Restored to the Canon*, 49 ST. LOUIS U. L.J. 817, 817–21 (2005).

11. See Redish & Nugent, *supra* note 10, at 582. This theory argues that if the power to regulate interstate commerce is vested entirely in Congress, it is the prerogative of Congress to leave that matter unregulated. See *id.* There is also a degree of pragmatism associated with this argument. If states were free to enact any regulation affecting commerce in the absence of action by Congress, the federal legislature would be forced to react to all state regulations inconsistent with its policies for regulating interstate commerce. See *id.* at 588–90.

12. See *BT Inv. Managers, Inc.*, 447 U.S. at 35. It is worth noting that there have also been arguments attacking the validity of the dormant Commerce Clause doctrine in its entirety—attacks that have come from Supreme Court Justices and scholars alike. See, e.g., *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 550 U.S. 330, 349 (2007) (Thomas, J., concurring) ("The negative Commerce Clause has no basis in the Constitution and has proved unworkable in practice. . . . [A]pplication of the negative Commerce Clause turns solely on policy considerations, not on the Constitution. Because this Court has no policy role in regulating interstate commerce, I would discard the Court's negative Commerce Clause jurisprudence."); *Thurlow v. Massachusetts*, 46 U.S. (5 How.) 504, 579 (1847) (holding that state regulations of interstate commerce are valid unless in conflict with federal legislation); Redish & Nugent, *supra* note 10, at 617.

objectives fall under the broad category of promoting national unity through economic integration.<sup>13</sup> At the time of the Constitutional Convention, the lack of such integration was viewed as a significant failure of the Articles of Confederation that a new constitution should remedy.<sup>14</sup> Under this rubric of promoting national unity, the Court has struck down state laws affecting interstate commerce by utilizing four different justifications: ensuring uniform regulation;<sup>15</sup> promoting

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13. See Williams, *supra* note 10, at 817; Jennifer L. Larsen, Student Article, *Discrimination in the Dormant Commerce Clause*, 49 S.D. L. REV. 844, 846–47 (2004).

A commonly cited articulation that national economic solidarity is a chief concern of the Commerce Clause, as well as a principle justification for the dormant Commerce Clause doctrine, is Justice Jackson's opinion for the Court in *Hood & Sons v. Du Mond*:

While the Constitution vests in Congress the power to regulate commerce among the states, it does not say what the states may or may not do in the absence of congressional action, nor how to draw the line between what is and what is not commerce among the states. Perhaps even more than by interpretation of its written word, this Court has advanced the solidarity and prosperity of this Nation by the meaning it has given to these great silences of the Constitution . . . . This Court consistently has rebuffed attempts of states to advance their own commercial interests by curtailing the movement of articles of commerce, either into or out of the state, while generally supporting their right to impose even burdensome regulations in the interest of local health and safety.

336 U.S. at 534–35; see also *Baldwin v. G. A. F. Seelig, Inc.*, 294 U.S. 511, 523 (1935) (stating that the Constitution “was framed upon the theory that the peoples of the several states must sink or swim together, and that in the long run prosperity and salvation are in union and not division”).

14. Alexander Hamilton and James Madison advocated for federal regulation of interstate commerce in *The Federalist*, citing lack of such power as a significant weakness of the Confederation. Hamilton stated, “there is no object, either as it respects the interests of trade or finance, that more strongly demands a federal superintendence [than the power to regulate commerce]. The want of it . . . has given occasions of dissatisfaction between the states.” THE FEDERALIST NO. 22 (Alexander Hamilton). Similarly, Madison contended:

The defect of power in the existing confederacy, to regulate the commerce between its several members, is in the number of these which have been clearly pointed out by experience . . . . A very material object of this power was the relief of the states which import and export through other states, from the improper contributions levied on them by the latter. Were these at liberty to regulate the trade between state and state, as must be foreseen, that ways would be found out to load the articles of import and export, during the passage through their jurisdiction, with duties which would fall on the makers of the latter, and the consumers of the former. We may be assured, by past experience, that such a practice . . . would nourish unceasing animosities, and not improbably terminate in serious interruptions of the public tranquillity [*sic*].

THE FEDERALIST NO. 42 (James Madison).

15. The Court addressed the need for uniformity of regulation in cases dealing with rail and truck transportation rules as well as price control regulations. These cases, particularly the

a national free market;<sup>16</sup> minimizing political friction between and among states;<sup>17</sup> and, above all, avoiding economic protectionism.<sup>18</sup> An additional rationale for the dormant Commerce Clause doctrine has been to prevent states from regulating those beyond their borders to whom they are not politically accountable.<sup>19</sup>

*B. Testing the Validity of a State Regulation under the Dormant Commerce Clause*

Over nearly 200 years, the Court has applied varying tests to evaluate the validity of a state regulation under the dormant Commerce Clause, some of them more effective than others for

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transportation cases, demonstrated a concern that inconsistent regulation could hinder the free flow of interstate commerce. *See, e.g.*, *Healy v. Beer Inst.*, 491 U.S. 324 (1989); *Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth.*, 476 U.S. 573 (1986); *Kassel v. Consol. Freightways Corp.*, 450 U.S. 662 (1981); *Bibb v. Navajo Freight Lines, Inc.*, 359 U.S. 520 (1959); *S. Pac. Co. v. Ariz. ex rel. Sullivan*, 325 U.S. 761 (1945).

16. The promotion of a national free market and a concern about economic balkanization emerges in such cases as *Hughes v. Oklahoma*, 441 U.S. 322, 339 (1979) (“States may promote [a] legitimate purpose only in ways consistent with the basic principle that ‘our economic unit is the Nation’ . . . .” (citing *H.P. Hood & Sons, Inc.*, 336 U.S. at 537)) and *H.P. Hood & Sons, Inc.*, 336 U.S. 525. As explained by Justice Jackson in *Hood & Sons v. Du Mond*,

[o]ur system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged . . . by the certainty that he will have free access to every market in the Nation . . . . Likewise, every consumer may look to the free competition from every producing area in the Nation . . . . Such was the vision of the Founders; such has been the doctrine of this Court which has given it reality.

*Id.* at 539.

17. Justice Cardozo expressed concern about friction among states in *Baldwin v. G. A. F. Seelig*, where he remarked, “If New York . . . may guard [its farmers] against competition with the cheaper prices of Vermont, the door has been opened to rivalries and reprisals that were meant to be averted by subjecting commerce between the states to the power of the nation.” 294 U.S. at 522. Similarly, Justice Jackson stated in *Hood & Sons v. Du Mond*, “We need only consider the consequences if each of the few states that produce copper, lead, high-grade iron ore, timber, cotton, oil or gas should decree that industries located in that state should have priority. What fantastic rivalries and dislocations and reprisals would ensue if such practices were begun!” 336 U.S. at 538–39; *see also* Michael E. Smith, *State Discrimination against Interstate Commerce*, 74 CAL. L. REV. 1203, 1208 (1986).

18. *See* *New Energy Co. v. Limbach*, 486 U.S. 269, 273–74 (1988); *Bacchus Imps., Ltd. v. Dias*, 468 U.S. 263, 270–73 (1984); *Guy v. Baltimore*, 100 U.S. (10 Otto) 434, 443 (1879).

19. *See* Smith, *supra* note 17, at 1209; Larsen, *supra* note 13, at 849. Yet another rationale, economic liberty, is implicit in some dormant Commerce Clause opinions, but is not dealt with explicitly by the Court. *See* Bruce F. Broll, Student Article, *The Economic Liberty Rationale in the Dormant Commerce Clause*, 49 S.D. L. REV. 824 (2004).

delineating between valid applications of police power and invalid regulations of interstate commerce. Those tests have included inquiries into (1) whether the state had actually attempted to regulate interstate commerce;<sup>20</sup> (2) whether the subject being regulated is one that calls for national uniformity of regulation and therefore cannot be regulated by the states;<sup>21</sup> (3) whether the effect of the state regulation on interstate commerce is direct or indirect;<sup>22</sup> (4) whether the purpose of the regulation was a legitimate concern of the police power or rather a protectionist measure against out-of-state competition;<sup>23</sup> (5) whether the state regulation discriminated against or merely burdened interstate commerce;<sup>24</sup> and (6) whether the state interest in the particular regulation outweighed the national interests in uniform regulation and the free flow of commerce.<sup>25</sup>

Ultimately, the Court settled on a two-part test consisting of a hybrid of the discriminatory-burdensome test and the state-versus-national-interests test. Under this two-part test, the Court first evaluates whether the state regulation in question discriminates against or merely burdens interstate commerce.<sup>26</sup> Second, the Court weighs the interests of the state against the interests of the nation.<sup>27</sup> If the regulation discriminates against interstate commerce, the Court applies the *Hunt* test, whereby the regulation will be deemed invalid unless the state can demonstrate a compelling interest for upholding it

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20. See *Willson v. Black Bird Creek Marsh Co.*, 27 U.S. (2 Pet.) 245 (1829). This inquiry comports with the rationale for the dormant Commerce Clause espoused by Chief Justice Marshall in *Gibbons v. Ogden* that the Constitution grants Congress alone, and not the states, the authority to regulate interstate commerce. *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 209 (1824); see *supra* note 10.

21. See *Cooley v. Bd. of Wardens*, 53 U.S. 299 (1851).

22. See *Seaboard Air Line Ry. v. Blackwell*, 244 U.S. 310 (1917); *S. Ry. Co. v. King*, 217 U.S. 524 (1910); *Smith v. Alabama*, 124 U.S. 465 (1888).

23. See *Bradley v. Pub. Utils. Comm'n*, 289 U.S. 92 (1933). This inquiry, although not used explicitly, was also influential on the Court's opinion in *Buck v. Kykendall*, 267 U.S. 307 (1925).

24. See *S.C. State Highway Dep't v. Barnwell Bros., Inc.*, 303 U.S. 177 (1938).

25. See *Kassel v. Consol. Freightways Corp.*, 450 U.S. 662 (1981); *Bibb v. Navajo Freight Lines, Inc.*, 359 U.S. 520 (1959); *S. Pac. Co. v. Ariz. ex rel. Sullivan*, 325 U.S. 761 (1945).

26. See *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 550 U.S. 330, 338 (2007).

27. *C & A Carbone, Inc. v. Clarkstown*, 511 U.S. 383, 390 (1994).

irrespective of national economic interests.<sup>28</sup> If the regulation merely burdens interstate commerce, the Court evokes the *Pike* test, whereby the regulation will be upheld unless the national interests outweigh those of the state.<sup>29</sup>

The initial determination of whether the regulation is discriminatory is highly significant, because the Court applies strict scrutiny to discriminatory regulations.<sup>30</sup> Therefore, an appropriate measure of what constitutes discrimination against interstate commerce is crucial to dormant Commerce Clause analysis. The common concern underlying each inquiry is whether the state is favoring in-state interests at the expense of out-of-state interests.<sup>31</sup> The Court has recognized state discrimination against interstate commerce where the regulation in question is discriminatory on its face, in its effects, or in its purpose.<sup>32</sup>

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28. “When discrimination against commerce . . . is demonstrated, the burden falls on the State to justify it both in terms of the local benefits flowing from the statute and the unavailability of nondiscriminatory alternatives adequate to preserve the local interests at stake.” *Hunt v. Wash. Apple Adver. Comm’n*, 432 U.S. 333, 353 (1977).

29. “Where the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.” *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970).

30. “Discriminatory laws motivated by ‘simple economic protectionism’ are subject to a ‘virtually *per se* rule of invalidity.’” *United Haulers*, 550 U.S. at 338 (citing *Philadelphia v. New Jersey*, 437 U.S. 617, 624 (1978)).

31. “[D]iscrimination’ simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter.” *United Haulers*, 550 U.S. at 338 (citing *Or. Waste Sys., Inc. v. Dep’t of Env’tl. Quality*, 511 U.S. 93, 99 (1994); *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 273 (1988)).

32. See Smith, *supra* note 17, at 1239–44. An example of facial discrimination is *Hughes v. Oklahoma*, 441 U.S. 322, 323, 336 (1979) (involving regulation that prohibited the transportation or shipment of minnows “seined or procured within the waters” of Oklahoma for the purpose of selling them outside the state (citing OKLA. STAT. tit. 29 § 4–115(B) (Supp. 1978))). For examples of cases involving discriminatory purpose, compare *Buck v. Kuykendall* 267 U.S. 307, 315–16 (1925) (invalidating a regulation the purpose of which is prohibiting competition), with *Bradley v. Public Utilities Commission*, 289 U.S. 92, 96 (1993) (upholding as valid those regulations deemed necessary to promote public safety). See also *Kassel v. Consol. Freightways Corp.*, 450 U.S. 662, 677 (1981) (finding evidence of discriminatory purpose to limit interstate traffic through Iowa based on comments of governor). For examples of cases measuring discriminatory effects, see *Dean Milk Co. v. City of Madison*, 340 U.S. 349, 350, 354, 356 (1951) (invalidating ordinance prohibiting the sale of milk unless bottled within five miles of the central square of Madison), and *Hunt*, 432 U.S. at 333 (concerning a North Carolina statute requiring that all apples sold or shipped into North Carolina in closed



The discriminatory effects test has emerged as the most useful of the three tests for discriminatory legislation. Facial discrimination alone cannot suffice as a measure of discrimination, because a state intent on discriminating against interstate commerce can simply adopt measures that appear to treat in-state and out-of-state interests equally, even though all of the burdens actually fall out of state.<sup>33</sup> Conversely, there may be instances in which a regulation appears discriminatory on its face but upon further analysis proves not to be.<sup>34</sup> Evaluating whether the regulation is discriminatory in purpose may be the most intuitive measure of discrimination, given that the overarching concern is whether the state is using its police powers to regulate legitimate local concerns or rather to enact protectionist measures that will undermine national unity.<sup>35</sup> However, only in rare instances will clear evidence of the motives behind enactment of a regulation be readily ascertainable.<sup>36</sup> The most effective test of discrimination is the discriminatory effects test.<sup>37</sup> This test makes particular sense, considering that the dormant Commerce Clause doctrine is primarily concerned with ensuring that states not obstruct the results that the Commerce Clause was designed to secure.<sup>38</sup>

To evaluate whether the effects of a state regulation are discriminatory, the appropriate analysis is to determine whether the most palpable burden of the regulation is born by those in the state or those beyond the state's borders.<sup>39</sup> A comment from Justice Stone—predating the test, but from which the test is derived—explains that “when the regulation is of such a character that its burden falls principally upon those without the state, legislative action is not likely to be subjected to those political restraints which are normally

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containers be identified by no grade on the container other than the applicable federal grade or a designation that the apples are not graded).

33. See Smith *supra* note 17, at 1240.

34. *Id.* As this Note will demonstrate, *Davis* is arguably such a case. See *infra* notes 74–82 and accompanying text.

35. See *supra* note 13 and accompanying text.

36. See Smith, *supra* note 17, at 1242; Larsen, *supra* note 13, at 859.

37. Smith, *supra* note 17, at 1249.

38. See Redish & Nugent, *supra* note 10, at 582.

39. Even the *United Haulers* Court paid lip service to this test while failing to apply it. *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 550 U.S. 330, 345 (2007). See *infra* note 48 and accompanying text.

exerted on legislation where it adversely affects some interests within the state.”<sup>40</sup> In light of Justice Stone’s remarks, the most palpable burden test addresses several concerns of the Commerce Clause. It discourages economic protectionism by requiring in-state interests to carry the burdens of state regulations.<sup>41</sup> It minimizes political friction between and among states by compelling state regulators to consider potentially adverse consequences of their regulatory measures.<sup>42</sup> Furthermore, it prevents states from regulating those beyond their borders to whom they are not politically accountable, essentially by giving voice to out-of-state concerns through in-state disaffected constituents.<sup>43</sup>

### *C. The Davis Exemption for Regulations Supporting Government Entities*

In 2007, the Court issued its opinion in *United Haulers*, upon which the *Davis* opinion was based.<sup>44</sup> In *United Haulers*, the Court upheld as nondiscriminatory a county flow control ordinance that required all solid waste generated within Oneida and Herkimer Counties to be delivered to a government owned and operated waste-processing site.<sup>45</sup> In so doing, the Court deemed it significant that the regulation favored a government entity rather than private business.<sup>46</sup> It held that ordinances favoring a government entity yet treating “in-state private business interests exactly the same as out-of-state ones, do not ‘discriminate against interstate commerce’ for purposes of the dormant Commerce Clause.”<sup>47</sup>

In *United Haulers*, however, the Court did not abandon entirely the most palpable burden test. The Court noted that “it bears

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40. S.C. State Highway Dep’t v. Barnwell Bros., 303 U.S. 177, 185 n.2 (1938).

41. *See id.*

42. *See id.*

43. *See id.* Not all justices agree that the most palpable burden test is the appropriate test for discrimination. *See, e.g.,* West Lynn Creamery, Inc. v. Healy, 512 U.S. 186, 211–12 (1994) (Scalia, J., concurring); *id.* at 212 (Rehnquist, C.J., dissenting).

44. “It follows *a fortiori* from *United Haulers* that Kentucky must prevail.” Dep’t of Revenue v. Davis, 128 S. Ct. 1801, 1810 (2008).

45. *United Haulers*, 550 U.S. 330.

46. *Id.* at 343–44.

47. *Id.* at 345 (citation omitted).

mentioning that the most palpable harm imposed by the ordinances . . . is likely to fall upon the very people who voted for the laws . . . . Here, the citizens and businesses of the Counties bear the costs of the ordinances.”<sup>48</sup> In short, the *United Haulers* Court went to great lengths to differentiate regulations favoring government entities from those favoring private ones even though the regulations were already nondiscriminatory on the basis of the most palpable burden test.<sup>49</sup>

This extensive discussion of regulations favoring government versus private entities was necessary to distinguish the holding in *United Haulers* from a contrary outcome in a nearly identical case, *C & A Carbone, Inc. v. Clarkstown*.<sup>50</sup> In *Carbone*, the Court had struck down as discriminatory a flow control ordinance requiring all solid waste to be processed at a facility in Clarkstown.<sup>51</sup> The only basis upon which the Court was able to distinguish the ordinance at issue in *United Haulers* from that of *Carbone* was that the former required the waste to be processed at a publicly-owned facility while the latter required waste to be processed at a private facility.<sup>52</sup> However, the

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48. *Id.* Because the flow control ordinances required that all waste be delivered to one waste processing facility, the counties prevented trash haulers from seeking out competitor facilities, either in-state or out-of-state, with lower “tipping fees”—disposal charges levied by a processing facility against the waste collectors who drop off waste at the facility. *Id.* at 335–37. Due to the monopoly that the ordinances granted to the publicly operated processing facility, the waste haulers were forced to accept tipping fees that in some instances were more than twice the rates of competitor facilities. *Id.* at 337. Presumably, these costs were passed through to the tax-paying general public, who therefore bore the burden of the regulation in the form of increased costs of waste removal. See *Davis*, 128 S. Ct. at 1810–11.

49. *United Haulers*, 550 U.S. at 343–44.

50. *C & A Carbone, Inc. v. Clarkstown*, 511 U.S. 383 (1994). In *Carbone*, the Court examined a flow control ordinance just like that in *United Haulers*, except that the ordinance in *Carbone* required disposal at a private, not public, processing facility. *Id.* at 387. Because the ordinances at issue in *Carbone* and *United Haulers* were nearly identical, the Court could not uphold the ordinances in *United Haulers* on the basis of the most palpable burden test alone. Rather, the Court was compelled to distinguish *United Haulers* from *Carbone*, lest it be forced to overturn *Carbone* altogether. *United Haulers*, 550 U.S. at 339–41. The result was the elaborate discussion in *United Haulers* of the reasons for treating public and private entities differently for purposes of evaluating whether a state regulation is discriminatory. *Id.* at 342–45.

51. *Carbone*, 511 U.S. 383.

52. *United Haulers*, 550 U.S. at 334 (“The *only salient difference* [between the two ordinances] is that the laws at issue here require haulers to bring waste to facilities owned and operated by a state-created public benefit corporation.”) (emphasis added). Even that distinction, however, is superficial. The facility in *Carbone* was to be constructed and operated by a private developer for five years, after which the government would purchase the facility

Court's mention in *United Haulers* that the ordinance would not have been discriminatory under the most palpable burden test is tacit recognition that the holding in *Carbone* was wrong. In both instances, the local population would bear the costs of the ordinance.<sup>53</sup> But rather than overturn *Carbone*, the Court introduced the traditional governmental functions exemption to dormant Commerce Clause scrutiny.<sup>54</sup>

One year after *United Haulers*, the Court issued its opinion in *Davis*, addressing a Kentucky state tax scheme in which the state granted residents an exemption from taxation on interest from in-state municipal bonds yet taxed them interest earned on out-of-state municipal bonds.<sup>55</sup> States presumably implement tax schemes like that of Kentucky to make their municipal bonds more competitive with respect to taxable bonds of comparable risk that yield a higher interest rate.<sup>56</sup> As of 2008, forty-one states, including Kentucky, had

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for one dollar. *Carbone*, 511 U.S. at 387. The ordinance was designed to generate sufficient revenues to make the deal worthwhile for the developer, with the town agreeing to cover any deficit. *Id.* The ordinances thus supported a facility that was private in form only, not in substance.

53. See *supra* note 48.

54. *United Haulers*, 55 U.S. at 343–44.

55. Dep't of Revenue v. *Davis*, 128 S. Ct. 1801, 1804–05 (2008). The Kentucky statute imposes an annual tax on its residents' "net income" in accordance with KY. REV. STAT. ANN. Section 141.020(1) (LexisNexis 2006). Net income is calculated in reference to "gross income" as defined by the Internal Revenue Code. See KY. REV. STAT. ANN. § 141.010(9)-(11) (2006 LexisNexis Supp. 2009); see also 12 U.S.C. § 61 (2006). Gross income, under the Internal Revenue Code, excludes interest on any state or local bond (i.e., municipal bond). 26 U.S.C. § 103(a). However, in calculating net income, Kentucky statute reinserts into the equation "interest income derived from obligations of sister states and political subdivisions thereof . . ." KY. REV. STAT. ANN. § 141.010(10)(c) (2006 & LexisNexis Supp. 2009).

Prior to *Davis*, the Court had struck down numerous state taxes that it viewed as favoring in-state over out-of-state products, activities, or enterprises. See, e.g., *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996) (overturning a state tax on intangible property favoring investment in in-state over out-of-state corporations); *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388 (1984) (striking down an income tax credit limited to corporations engaging in export-related activity from within the state); *Bacchus Imps., Ltd. v. Dias*, 468 U.S. 263 (1984) (invalidating an excise tax on liquor from which locally produced beverages were exempt).

56. See Brief of the National Ass'n of State Treasurers as Amicus Curiae Supporting Petitioners at 4, Dep't of Revenue v. *Davis*, 128 S. Ct. 1801 (2008) (No. 06-666). For example, consider a municipality that wants to issue bonds to pay for improvements to its high school. Assume that the prevailing market interest rate on a bond of comparable risk is ten percent. A bond purchaser living in the state where the municipality is located could purchase a \$1000 bond at the market rate and earn \$100 in the first year. If that bond purchaser pays an eight percent state income tax, he will be taxed \$8 on his \$100 income, reducing his after-tax

laws similar to the one at issue in *Davis*.<sup>57</sup> Moreover, states have been enacting such measures since the early twentieth century.<sup>58</sup>

As of the end of 2006, approximately \$2.4 trillion in federal tax-exempt municipal bonds were outstanding.<sup>59</sup> While the market for those bonds is diverse and complex, they are all issued by state and local government to “finance expenditures that address public needs.”<sup>60</sup> Those needs include essential government services, operating requirements, and public works projects and programs.<sup>61</sup> Between 1996 and 2002, Kentucky and its subdivisions issued \$7.7 billion in long-term municipal bonds.<sup>62</sup> Given the wide use of the tax scheme at issue in *Davis* and the vast size of the municipal bond market, the potential ramifications of deeming the tax scheme unconstitutional were severe.

The Davises, Kentucky taxpayers who paid state income tax on interest derived from out-of-state municipal bonds, sued the state tax collectors for a tax refund on the grounds that the differential tax scheme unconstitutionally discriminated against interstate

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earnings to \$92. But, if the state exempts interest earned on in-state municipal bonds, the municipality can pay 9.2 percent interest on the bond, rather than the market rate of ten percent, and the bond purchaser will earn the same after-tax return of \$92 on his \$1000 bond. If the municipality were to pay 9.5 percent interest, then its bond would become more competitive than market rate bonds, because the municipal bond would earn the purchaser \$95 in after-tax returns, while market rate bonds subject to state income tax would earn the purchaser only \$92. MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 212–15 (4th ed. 2001).

57. 128 S. Ct. at 1806–07. Of the forty other states with tax schemes like the one at issue in *Davis*, thirty-six were nearly identical to that of Kentucky. *Id.* at 1807 n.7. The other four states tax out-of-state municipal bonds and exempt some, but not all, in-state municipal bonds. *Id.* Of the nine states that do not have statutes similar to that of Kentucky, Utah exempts its own bonds and only exempts the out-of-state bonds of those states that do not tax Utah bonds; Indiana exempts all municipal bonds from taxation; and the other seven states have no personal income tax. *Id.*

58. New York enacted the first such tax exemption in 1919, the same year it began imposing an income tax. *Id.* at 1806 (citing 1919 N.Y. Laws 1641–1642; ALZADA COMSTOCK, *STATE TAXATION OF PERSONAL INCOMES* 104 (Columbia University 1921) (reprinted 2005)).

59. Brief for the National Federation of Municipal Analysts as Amicus Curiae, in Support of Neither Party at 10, *Davis*, 128 S. Ct. 1801 (No. 06-666) (citing SECURITIES INDUS. AND FIN. MARKETS ASS’N, *HOLDERS OF MUNICIPAL BOND SECURITIES*, [http://www.sifma.org/research/pdf/Holders\\_Municipal\\_Securities.pdf](http://www.sifma.org/research/pdf/Holders_Municipal_Securities.pdf)).

60. *Id.* at 4; see also Brief of the National Ass’n of State Treasurers, *supra* note 56, at 3.

61. Brief of the National Ass’n of State Treasurers, *supra* note 56, at 3.

62. *Davis*, 128 S. Ct. at 1806 (citing CYNTHIA BELMONTE, *TAX-EXEMPT BONDS 1996–2002*, 169–70, <http://www.irs.gov/pub/irs-soi/02govbnd.pdf>).

commerce.<sup>63</sup> In 2004, the trial court granted the state's motion for summary judgment, holding that the tax scheme was constitutional because it had a "reasonable, legitimate public purpose."<sup>64</sup> The Kentucky Court of Appeals vacated the trial court's order in 2006, finding that none of the exemptions for facially discriminatory regulations applied to the Kentucky tax scheme and concluded that "we have no choice but to find that Kentucky's system of taxing only extraterritorial bonds runs afoul of the Commerce Clause."<sup>65</sup> The Supreme Court of Kentucky denied the state's motion for discretionary review.<sup>66</sup>

In 2008, the Supreme Court reversed the Kentucky Court of Appeals. First, the Court deemed the tax scheme nondiscriminatory, stating that "Kentucky's tax exemption favors a traditional government function without any differential treatment favoring local [private] entities over substantially similar out-of-state interests."<sup>67</sup> According to the Court, the rationale for the distinction was that regulations favoring government functions are more likely motivated by legitimate goals rather than "simple economic protectionism."<sup>68</sup> Justice Souter, writing for the Court, further explained that the purpose of the traditional government functions inquiry is not to

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63. *Davis*, 128 S. Ct. at 1807.

64. *Davis v. Revenue Cabinet*, No. 03C103282, 2004 WL 5358776 (Ky. Cir. Ct. Aug. 30, 2004), *vacated sub nom.*, *Davis v. Dep't of Revenue of Fin. and Admin. Cabinet*, 197 S.W.3d 557 (Ky. Ct. App. 2006), *rev'd sub nom.* *Dep't of Revenue v. Davis*, 128 S. Ct. 1801 (2008). The trial court based its finding in part on the market participant exception to the dormant Commerce Clause. *Davis v. Revenue Cabinet*, 2004 WL 5358776. Justice Souter's opinion for the Court also addressed the market participant exception. *See infra* note 67.

65. *Davis v. Dep't of Revenue of Fin. and Admin. Cabinet*, 197 S.W.3d at 562–64, *rev'd sub nom.* *Dep't of Revenue v. Davis*, 128 S. Ct. 1801 (2008).

66. *Davis*, 128 S. Ct. at 1807–08.

67. *Id.* at 1811. Justice Souter's opinion for the Court also deemed the tax regulations nondiscriminatory on the basis of the market participant exception. *Id.* However, this reasoning was not joined by a plurality of the Court, and therefore is not addressed here. For a further discussion of the applicability of the market participation doctrine to the *Davis* case, compare Scott K. Attaway, Note, *The Case for Constitutional Discrimination in Taxation of Out-of-State Municipal Bonds*, 76 B.U. L. REV. 737, 758–61 (1996) (commenting that as a participant in the bond market, the state is permitted to favor resident bondholders by paying them higher rates of interest), with Ethan Yale & Brian Galle, *Muni Bonds and the Commerce Clause after United Haulers*, 115 TAX NOTES 1037, 1040–41 (June 11, 2007) (concluding market participant exception does not apply because other participants in the bond market do not have the power to determine the taxable status of competitors' bonds).

68. *Davis*, 128 S. Ct. at 1810.

“draw fine distinctions among governmental functions,” distinguishing traditional from nontraditional functions.<sup>69</sup> Rather, said Souter, the purpose is to determine whether the preference benefits private interests or benefits “a government fulfilling governmental obligations.”<sup>70</sup>

After declaring the statute nondiscriminatory, the Court then declined to subject the Kentucky regulations to the *Pike* balancing test, deeming evaluation of the tax scheme a more appropriate role for Congress.<sup>71</sup> In refusing to apply the *Pike* test, Justice Souter remarked,

we are being asked to apply a federal rule to throw out the system of financing municipal improvements throughout most of the United States, and the rule in *Pike* was never intended to authorize a court to expose the States to the uncertainties of the economic experimentation the Davises request.<sup>72</sup>

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69. *Id.* at 1810 n.9.

70. *Id.* Drawing this distinction was necessary in light of Court precedent in cases addressing federal regulations under the Commerce Clause. In a prior case, the Court held that the Commerce Clause does not empower Congress to impose regulations upon the States “in areas of traditional governmental functions.” *Nat’l League of Cities v. Usery*, 426 U.S. 833, 852 (1976). When the impracticability of discerning traditional from nontraditional government functions later became clear, the Court overruled *National League of Cities* in *Garcia v. San Antonio Metropolitan Transit Auth.*, 469 U.S. 528 (1985). Justice Souter’s attempt to distinguish the test in *Davis* from that in *National League of Cities*, however, is not especially convincing. As argued by Daniel Ray:

Despite the Court’s assurances to the contrary, there is little reason to think that the traditional government functions rule in this context will not fall victim to the same problems it had time and again in the past. Depending on the Court’s inclinations, traditional government functions may eventually describe something approaching a null set, or it may be a set with nearly limitless boundaries. The traditional government functions rule also tempts the Court to engage in policymaking under the cover of constitutional principles. A Court that is inclined to recalibrate the federal-state balance of power, or to act as an umpire judging whether various state activities hit the dormant Commerce Clause strike zone, will find traditional government functions to be a handy tool in the kit.

Daniel R. Ray, *Cash, Trash, and Tradition: A New Dormant Commerce Clause Exception Emerges from United Haulers and Davis*, 61 *TAX LAW.* 1021, 1041 (2008).

71. *Davis*, 128 S. Ct. at 1819.

72. *Id.* Justice Souter also noted that leaving the question to Congress has two advantages: “Congress has some hope of acquiring more complete information than adversary trials may produce, and an elected legislature is the preferable institution for incurring the economic risks of any alteration in the way things have traditionally been done.” *Id.* This justification for

Unlike the Court in *United Haulers*, the *Davis* Court never considered how the tax scheme at issue would fare under the most palpable burden test. It made the traditional government functions exception dispositive, adopting wholesale the rule that regulations favoring state and local government are nondiscriminatory as long as those regulations treat in-state and out-of-state private business equally.<sup>73</sup>

## II. ANALYSIS

The *Davis* opinion significantly weakened the dormant Commerce Clause doctrine. The dissent, at least, would have deemed the tax scheme invalid as discriminatory in purpose.<sup>74</sup> But none of the Justices advocated application of the most palpable burden test, which has evolved as the most effective test to evaluate whether a state regulation has a discriminatory effect, thereby receiving a higher level of judicial scrutiny.<sup>75</sup> Such high level scrutiny is warranted for discriminatory regulations because they are more likely than nondiscriminatory ones to undermine the objectives served by the Commerce Clause.<sup>76</sup> What is unfortunate about the *Davis* opinion, as with the *United Haulers* opinion, is that the traditional government functions exception was entirely unnecessary. Application of the most palpable burden test reveals that the tax scheme was nondiscriminatory.

At first glance, the scheme appears discriminatory, both on its face<sup>77</sup> and because it influences investor behavior so as to cause

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leaving the tax scheme intact could have been used irrespective of the Court's ultimate determination of whether the tax was discriminatory.

73. *Id.* at 1811.

74. Justice Kennedy, joined by Justice Alito, states in his dissent that the tax scheme is invalid under the line of cases instructing "that laws with either the purpose or the effect of discriminating against interstate commerce to protect local trade are void." *Id.* at 1824 (Kennedy, J., dissenting). He later states that "Kentucky gives favored tax treatment to some securities but not others depending solely upon the State of issuance, and it does so to disadvantage bonds from other States." *Id.* at 1825.

75. *See supra* notes 39–43 and accompanying text.

76. *Hunt v. Wash. Apple Adver. Comm'n*, 432 U.S. 333, 350 (1977).

77. *See* Conor J. Bennett-Ward, Note, *Kentucky v. Davis: A Better Approach to Saving Differential Taxation of Municipal Bonds*, 62 *TAX LAW.* 503, 515–16 (2009) (labeling Kentucky's tax scheme "Discrimination Too Obvious to Ignore").



balkanization of the municipal bond market.<sup>78</sup> The effectiveness of the scheme is readily apparent through an analysis of the bond fund market.<sup>79</sup> Municipal bonds can be bought and sold on the secondary market through municipal bond funds. These funds are broken down into single state funds, designed to take advantage of both federal and in-state tax savings<sup>80</sup> and national funds, which receive only the benefits of federal tax savings but offer a diversity of holdings from across the country.<sup>81</sup> Purchasers of state-specific municipal bond funds are almost certain to be residents of the state where the fund is invested.<sup>82</sup>

Between 1984 and 2007, the total municipal bond fund market grew from \$20.79 billion to \$373.84 billion of assets.<sup>83</sup> Single state

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78. See Brief for Respondents, *Davis*, 128 S. Ct. 1801, 26-28 (No. 06-666). Finding the tax discriminatory on these grounds would also be consistent with the Court's opinion in *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318 (1977). In *Boston Stock Exchange*, the Court addressed a New York State transfer tax on securities transactions. *Id.* "[T]ransactions by nonresidents of New York are afforded a 50% reduction . . . in the rate of tax when the transaction involves an in-state sale. Taxable transactions by residents (regardless of where the sale is made) and by nonresidents selling outside the State do not benefit from the rate decrease." *Id.* at 324. Additionally, New York capped the total tax liability of any taxpayer for a transaction involving a New York sale but imposed the tax on out-of-state sales involving an in-state transfer without limitation. *Id.* at 324-25. The Court deemed the tax invalid because it imposed greater tax liability on sales that occurred outside the state than on those that occurred inside the state. *Id.* at 331. In so holding, the Court found that the tax prevented tax-neutral decision making in the marketplace, encouraging sales at New York stock exchanges at the expense of out-of-state exchanges. *Id.*

However, *Davis* is distinguishable from *Boston Stock Exchange* on grounds beyond a mere distinction between favoring government rather than private enterprise. In *Boston Stock Exchange*, the differential tax is used to increase the volume of private sector transactions occurring in the state. The cost of the scheme is born primarily by the private sector of other states that witness a decline in transactions. Constituents within the state are unlikely to challenge the measure. In *Davis*, however, Kentucky's foregone tax revenues amount to the state paying effectively higher interest rates to borrow money from investors. See *infra* note 91. The costs, therefore, are principally born by the state's taxpayers. See *infra* note 92 and accompanying text.

79. Bond funds are structured in such a way as to easily distinguish funds investing in a specific state versus on a national basis. As such, they provide the most reliable and readily available data about the manner in which state tax exemptions are influencing investor behavior. See Brief for the National Federation of Municipal Analysts, *supra* note 59, at 12.

80. See Yale & Galle, *supra* note 67, at 1038.

81. *Id.*

82. Investment companies caution investors that state-specific municipal bond funds are only appropriate for residents of that state. *Id.*

83. See INVESTMENT COMPANY INSTITUTE, 2008 INVESTMENT COMPANY FACT BOOK 113 (2008), [http://www.ici.org/pdf/2008\\_factbook.pdf](http://www.ici.org/pdf/2008_factbook.pdf).

funds accounted for approximately twenty-three percent (\$4.78 billion) of the market share for municipal bond funds in 1984.<sup>84</sup> By 2007, that market share had grown to approximately forty-two percent (\$155.83 billion).<sup>85</sup> These data demonstrate that the perceived state tax benefits of municipal bonds make them popular among investors, who are drawn to the funds by the belief that the tax exemption improves their returns relative to the level of risk assumed.<sup>86</sup> Put simply, money that would otherwise be flowing across state lines is being kept within the state.<sup>87</sup>

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84. *Id.*

85. *Id.*

86. Bond purchasers only benefit from the in-state tax savings inasmuch as the expected tax benefits do not result in an increase in the price or decrease in the yield of the bond. In an efficient market, the tax savings on municipal bonds would be fully capitalized into the price or yield of the bonds. In other words, those selling the bonds can demand a higher initial investment to reflect the additional value that the purchaser expects to receive in the form of tax benefits. With respect to the federal tax exemption for interest earned on municipal bonds, the tax benefits have not been capitalized into the bond yields. Investors have been able to derive interest earnings on municipal bonds in substantial excess of their federal income tax savings, a phenomenon commonly termed the "muni puzzle." See, e.g., John M. R. Chalmers, *Default Risk Cannot Explain the Muni Puzzle: Evidence from Municipal Bonds that are Secured by U.S. Treasury Obligations*, 11 REV. OF FIN. STUD. 281, 282 (1998). The data with respect to the state tax exemption for municipal bonds, however, are conflicting. A 1980s study of the primary market for municipal bonds indicated that the state tax benefits are not reflected in the bond yield, thereby giving investors better-than-market returns. See David S. Kidwell, Timothy W. Koch & Duane R. Stock, *The Impact of State Income Taxes on Municipal Borrowing Costs*, 37 NAT'L TAX J. 551 (1984). A later multiple regression analysis of the secondary market for municipal bonds found that one hundred percent of the in-state tax benefits are capitalized into the bond yields for municipal bonds. See C. Steven Cole, Pu Liu & Stanley D. Smith, *The Capitalization of the State Tax Exemption Benefit in Municipal Bond Yields*, 7 J. FIN. AND STRATEGIC DECISIONS 67, 73 (1994). To the extent that these findings are accurate, the in-state tax exemption would offer no benefits to a purchaser of municipal bonds in the secondary market. If those results can be extended to the primary market, the benefit for purchasers in the primary market would likewise be illusory. Whether illusory or real, however, investors believe the tax benefits are real and invest accordingly.

87. It is essentially impossible to determine which states benefit from this system and which states suffer. The only way to make that assessment would be to compare current bond purchases to the counterfactual scenario of bond purchases in a system without the tax scheme. If that comparison were possible, it would likely reveal that some states are able to find more buyers for their bonds, while others are able to find fewer. For instance, if New York's municipal bonds are inherently more attractive than Kentucky's, then Kentucky may be able to sell its bonds to Kentucky citizens who would otherwise be investing that money in New York bonds. New York, on the other hand, would lose the out-of-state investors who chose to invest in their home state. Ability to demonstrate such gains and losses would raise another interesting question. Would the tax scheme only be discriminatory in states that benefit from the system?

But the fact that the tax regime influences investor behavior, causing partial balkanization of the municipal bond market, is insufficient in and of itself to make the regulations discriminatory. Investors will not limit their investments to in-state municipal bonds, despite the tax benefits, because anyone familiar with basic investment principles will always pursue a diversified portfolio. More importantly, however, even though the tax regime discourages some degree of investment in out-of-state bonds, the costs of employing that system are actually born by the state and its citizens. In that respect, the regulations in *Davis* resemble those of *United Haulers*.<sup>88</sup>

States contend that not taxing income from in-state municipal bonds helps them fund public projects by borrowing money from investors in the bond market at lower interest rates than would otherwise be available to them.<sup>89</sup> That rationale only makes sense to the extent that a state's savings from reduced interest expenditures exceeds its foregone tax income. In fact, however, states incur greater losses of tax revenue than they save on reduced interest rates,<sup>90</sup> and

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88. See *supra* note 48 and accompanying text.

89. See Brief of the National Ass'n of State Treasurers, *supra* note 56, at 4. By issuing bonds, the government is borrowing money from bond purchasers and compensating those investors by paying them interest, just as if it had borrowed money from a bank or other lending institution. Granting a tax exemption to investors for that interest income permits the government to lower the interest rate on the bond. See *supra* note 56.

90. Taking the example from note 56, *supra*, suppose that a municipality in a state with an eight percent income tax rate issues a \$1,000 bond to an investor when the prevailing market interest rate is ten percent. As already demonstrated, the state tax exemption for municipal bonds means the municipality can offer any interest rate above 9.2 percent and be more competitive than taxable bonds at the prevailing interest rate. If the municipality pays a 9.4 percent interest rate, it will be able to pay the investor \$94 in interest for one year, rather than the \$100 it would have to pay to remain competitive without the state tax exemption. The municipality, therefore, has saved \$6 in interest. But without the tax exemption, in which case the municipality would have to pay ten percent interest, the state could tax the bond purchaser on \$100 of interest earned on the bond. With an eight percent tax rate, the state would have received \$8 in tax revenues. Therefore, by granting the tax exemption, the state actually loses \$2 (saving \$6 in interest and losing \$8 in tax revenues). Essentially, the tax exemption amounts to a state subsidy to the municipality in the form of foregone tax revenues. See also Cole, Liu & Smith, *supra* note 86, at 73 (“[T]he cost to the states in the form of lost tax revenues is significantly greater than the estimated benefit of reduced interest costs to in-state issuers.”); cf. Alan D. Viard, *The Dormant Commerce Clause and the Balkanization of the Municipal Bond Market*, 2 (Am. Enter. Inst., Working Paper No. 139, 2007), available at <http://www.aei.org/paper/26952> (“The interest rate on the state's bonds falls, but by less than the amount of the resident subsidy. State residents gain, because they earn a higher (subsidy-inclusive) return on home-state bonds. The state treasury incurs a net financial loss, as the cost of the subsidy

the tax scheme actually results in wasteful government spending.<sup>91</sup> Therefore, the tax deduction imposes a high cost on the state itself. That cost is passed on to taxpayers in the form of either higher taxes or reduced services.<sup>92</sup> Because the costs of the tax scheme are born by

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outweighs the interest savings. The residents' gain is typically larger than the state treasury's cost, yielding a net within-state gain.”).

91. The higher interest paid by the state as a result of the tax exemption is confounded by progressive state tax rates. As Patrick Fleenor, Chief Economist for the Tax Foundation, explains, in order to sell a sufficient number of bonds, the state must adjust interest rates to make them attractive to income levels below the highest tax bracket. See PATRICK FLEENOR, TAX FOUND., TAXING MORE TAKING LESS: HOW BROADENING THE FEDERAL TAX BASE CAN REDUCE INCOME TAX RATES 7 (2005). “[T]here is no practical way of selectively selling bonds with different interest rates to investors in different tax brackets . . . .” *Id.* As a result, higher tax brackets receive even better returns. See *id.* Fleenor’s report addressed the federal income tax exemption for municipal bonds, but the argument applies equally to states that apply a progressive tax rate, most of which do. See THE TAX FOUNDATION, STATE INDIVIDUAL INCOME TAX RATES, 2009, <http://www.taxfoundation.org/publications/show/228.html>.

Extending the example from note 90, *supra*, consider a state with progressive taxation where the two highest tax brackets are six percent and eight percent. Assume that with no tax incentive, a \$1,000 municipal bond would have to pay just above a ten percent return annually, or more than \$100, to be more competitive than the prevailing market rate. However, with the deduction, individuals in the highest tax bracket (eight percent) would be willing to lend state or local governments funds for anything more than 9.2 percent (which would generate \$92 interest income and tax savings of \$8). But to attract those in the next highest bracket (six percent), the state would have to pay an interest rate of more than 9.4 percent (which would generate \$94 interest income and tax savings of \$6). Therefore, if the state offers a 9.5 percent interest rate, it will save \$5 in annual interest for every bond issued. For those bond purchasers at the six percent tax rate, the state will forego \$6 in tax revenue, resulting in a net loss of \$1. But for those at the eight percent tax rate the state will forego \$8 in tax revenues, for a net loss of \$3.

92. It could be argued that the costly implications of the tax scheme do not raise sufficient awareness to generate the necessary political restraints that would render the tax scheme nondiscriminatory. Some have used this argument to explain why the Court has permitted direct subsidies in favor of the local market while prohibiting tax breaks that operate to the same effect. As Dan T. Coenen remarks, “subsidies have a heightened ‘political visibility’ that puts a check on their perpetuation not applicable to tax exemptions. At a minimum, the annual revisitation of legislated subsidies should assure that the state interest supporting the program remains a keen one.” Dan T. Coenen, *Untangling the Market-Participant Exemption to the Dormant Commerce Clause*, 88 MICH. L. REV. 395, 481 (1989). However, the same rationale does not apply to the case of municipal bond tax exemptions. Whereas a tax break favoring the private sector may be viewed as a less visible subsidy, the tax exemption for municipal bonds actually generates a significant amount of wasteful government spending. See *supra* note 91. Such waste ought to produce heightened political awareness. Whether that heightened awareness is sufficient to generate the type of political check envisioned by the most palpable burdens test is perhaps a question of fact for the courts to address. Nonetheless, the tax regime at issue in *Davis* is certainly distinguishable from tax regimes favoring the private sector on those grounds. The existence of organizations like the Tax Foundation and others devoted to eliminating government waste should make the tax here nondiscriminatory.

all of the state's constituents, there is a sufficient in-state burden to make the regulations nondiscriminatory.<sup>93</sup>

### CONCLUSION

The Kentucky tax scheme, shared by forty other states, is discriminatory on its face but not in effect. It does not actually place all the burdens outside the state while reserving all the benefits for inside the state. Granted, the tax regime is attractive to investors and causes some balkanization of the municipal bond market. The states, however, pay a significant cost to sustain the tax regime, because the tax revenues they forego exceed their savings from lower interest rates and result in government waste. That cost is born by every constituent within each state utilizing the scheme, in the form of either higher tax rates or reductions in services.

Even if the tax scheme was discriminatory, the Court's concern that the scheme is designed to support important government functions could properly have been addressed by the *Hunt* balancing

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For further discussion of the comparability of tax benefits and direct subsidies, see Edward A. Zelinsky, *Are Tax "Benefits" Constitutionally Equivalent to Direct Expenditures?*, 112 HARV. L. REV. 379 (1998).

93. To the extent that paying higher interest rates to borrow money drives up the costs for other states to borrow money, that concern is represented by Kentucky residents whose tax dollars are likewise being used to pay above market interest rates.

Another argument to suggest that the tax scheme is nondiscriminatory is that investors, too, will put a political check on state legislators. That argument is not an especially strong one, but it would be articulated as follows: While the state imposes a tax on out-of-state bonds, it is in-state investors who incur the tax. The significance of that fact is evidenced by the motives of the plaintiffs in *Davis*. George and Catherine Davis may have sued the Department of Revenue of Kentucky on Commerce Clause grounds, but their concern was not for the federal balance of power. Their objective was to obtain a refund of taxes collected on interest they earned from out-of-state bonds. *Dep't of Revenue v. Davis*, 128 S. Ct. 1801, 1807 (2008). The Davises were perfectly content to have Kentucky continue its tax exemption for in-state bonds. They simply wanted that exemption to extend to out-of-state bonds as well.

A troublesome question for the most palpable burden test, though, is what role perception plays in this analysis. To what extent is the tax scheme viewed by constituents as a tax exemption for in-state municipal bonds, and to what extent is the scheme perceived as an affirmative tax on out-of-state municipal bonds? If given the choice between having a tax on all municipal bonds and having a tax on only out-of-state bonds, constituents would certainly prefer the latter. But if the choice is between taxation of out-of-state municipal bonds or no taxation of municipal bonds whatsoever, they would again choose the latter. As with most tax exemptions, taxpayers likely view the scheme primarily as an exemption from what otherwise would be a general tax on all interest income from municipal bonds.

test for discriminatory state regulations. If the Court felt the state's fundraising interests outweighed the national interest in a unified national market for municipal bonds, it could have stated as much. Moreover, the Court could have argued that the statutory scheme is so pervasive that if Congress had wanted to put an end to the practice it would have legislated it out of existence.<sup>94</sup>

Rather than take either of these approaches, the Court unnecessarily created a lower standard of review for all state legislation that can be construed as supporting government functions. Such a sweeping exception could have dramatic consequences for interstate commerce and the national market.<sup>95</sup> At the very least, the exception will likely embolden states to enact legislation that they previously would not have due to concerns that their regulations might not withstand judicial scrutiny. The Court thus eliminated an important check on state legislatures for preserving the federal balance of power. Then again, perhaps shifting the federal balance of power was the very purpose of the *Davis* opinion.

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94. One justification for the dormant Commerce Clause is that because the power to regulate interstate commerce is vested in Congress, its inaction on a particular matter means that Congress is exercising its desire to leave that matter unregulated. *See supra* note 11 and accompanying text. This approach prevents Congress from having to respond to every state legislative act that regulates interstate commerce in an undesirable manner. However, one could also argue the converse. When a regulation affecting interstate commerce is widespread among the states, Congress's silence can be interpreted as acquiescence and complacency.

95. *See also Davis*, 128 S. Ct. at 1825 (Kennedy, J., dissenting) ("The tax imposed here . . . cannot be sustained unless the Court disavows the discrimination principle, one of the most important protections we have elaborated for the Nation's interstate markets.").