To Form a More Perfect Union: Taxation, Economic Efficiency, and the Dormant Commerce Clause in *Department of Revenue v. Davis*[*]

The recent financial crisis has highlighted the means by which both the federal and state governments raise and spend money.[1] States and municipalities have long used debt issuance[2] as a method to raise funds to provide services.[3] Public debt issues of this type most commonly take the form of municipal bonds,[4] where an investor loans money to the government in exchange for a bond note later redeemable for the principal amount of the loan plus interest.[5] The amount of money raised by states and municipalities by debt issuance is immense—for example, in the six-year period from 1996 to 2002, "[s]tate and local government units issued nearly $2.1 *trillion* of tax-exempt bonds."[6] Roughly 33% of the money generated from these bond sales went to education, 13% to transportation, and 11% to utilities.[7] These municipal bonds account for a substantial majority of the capital expenditures by states and municipalities, financing approximately two-thirds of local government outlays.[8] Given the

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1. *See, e.g.*, Ed Henry, *Obama Planning Ambitious Road Ahead*, CNN, Feb. 13, 2009, http://www.cnn.com/2009/POLITICS/02/13/obama.whats.next/index.html (covering the debate over President Obama's federal stimulus package); ELIZABETH MCNICHOL & NICHOLAS JOHNSON, CTR. ON BUDGET & POLICY PRIORITIES, RECESSION CONTINUES TO BATTER STATE BUDGETS; STATE RESPONSES COULD SLOW RECOVERY 2 (2009), http://www.cbpp.org/9-8-08sfp.pdf (covering the budget shortfalls of numerous states).

2. Debt issuance refers to the process by which an entity, often the government, will sell securities to third parties in order to create immediate financing for the entity, enabling the entity to provide services and construct buildings that it formerly lacked the capital to do. *See* ROBERT S. AMDURSKY & CLAYTON P. GILLETTE, MUNICIPAL DEBT FINANCE LAW 9–12 (1992).

3. Dep't of Revenue v. Davis, 128 S. Ct. 1801, 1804 (2008) (highlighting that public debt issues have been used to finance state and municipal services "[f]or the better part of two centuries").

4. " 'Municipal bond' is commonly defined as a 'debt obligation of a state or local government entity.' " *Id.* at 1805 n.2 (quoting JOHN DOWNES & JORDAN ELLIOT GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 439 (7th ed. 2006)).

5. CYNTHIA BELMONTE, INTERNAL REVENUE SERVICE, TAX-EXEMPT BONDS, 1996–2002 at 151, http://www.irs.gov/pub/irs-soi/02govbnd.pdf (last visited Nov. 8, 2009).

6. *Id.* (emphasis added). These "[s]tate and local bonds" are exempt from federal income taxation. I.R.C. § 103 (2006).

7. BELMONTE, *supra* note 5, at 169–70.

8. *Davis*, 128 S. Ct. at 1806 (citing LLOYD B. THOMAS, MONEY, BANKING, AND FINANCIAL MARKETS 55 (2006)).

enormous sums involved, this system of public finance is vital to the economic health of individual states and the United States as a whole.

The United States Supreme Court recently addressed how the interest paid by state and local governments to bondholders should be taxed. In *Department of Revenue of Kentucky v. Davis*,[9] the Court considered the Kentucky state income tax statute that exempts interest earned on in-state municipal bonds from taxation while at the same time taxing interest earned on out-of-state municipal bonds.[10] The taxpayers argued that this differential tax scheme ran afoul of the Commerce Clause of the U.S. Constitution[11] because it impermissibly discriminated against interstate commerce.[12] After Kentucky state courts split on the question of constitutionality, the United States Supreme Court granted certiorari due to the exceedingly far-reaching consequences of this type of tax regime.[13] These consequences stem from the fact that Kentucky is not alone in exempting from taxation interest paid on in-state municipal bonds while simultaneously taxing interest paid on out-of-state municipal bonds.[14] At present, forty-one states have similar tax schemes for municipal bonds.[15] In fact, of the states that have a state income tax scheme, only *one*, Indiana, exempts all municipal bonds equally.[16]

In *Davis*, the Court relied on the opinion in *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Management Authority*,[17] issued in the immediately preceding term, which recognized that government functions are not subject to a standard dormant Commerce Clause analysis.[18] Instead of subjecting the Kentucky law to the strict scrutiny

9. 128 S. Ct. 1801 (2008).

10. *Id.* at 1807. For the Kentucky state income tax statute, see KY. REV. STAT. ANN. § 141.010(10)(c) (LexisNexis 2006 & Supp. 2008).

11. U.S. CONST. art. I, § 8.

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

13. *Id.* at 1807–08. The dollar figures of these municipal bonds are staggering. For instance, "[b]etween 1996 and 2002, Kentucky [alone] . . . issued $7.7 billion in long-term bonds to pay for spending on transportation, public safety, education, utilities, and environmental protection." *Id.* at 1806 (citing BELMONTE, *supra* note 5, at 169–70).

14. *Id.* at 1806–07.

15. *Id.* at 1807 n.7. These states include: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Georgia, Hawaii, Idaho, Kansas, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont, Virginia, and West Virginia. *Id.* Several other states tax out-of-state bonds and exempt some, but not all, in-state bonds. *Id.*

16. *Id.*

17. 550 U.S. 330 (2007).

18. *Davis*, 128 S. Ct. at 1809 (citing *United Haulers*, 550 U.S. at 343). The dormant

analysis which would otherwise have been mandated,[19] the Court was exceedingly deferential to the statute.[20] The Court noted that, when analyzing a government function statute, the long-established principle outlined in *Pike v. Bruce Church, Inc.*[21] generally requires that a balancing test be used to weigh the " 'putative local benefits' " of the challenged statute against the " 'burden imposed on interstate commerce.' "[22] However, the Court declined to apply the *Pike* balancing test in *Davis*, explaining that the Court lacked the necessary expertise to engage in such an exercise.[23] After declining to apply the *Pike* balancing test, Justice Souter concluded that differential tax schemes like Kentucky's do "not 'discriminate against interstate commerce' for purposes of the dormant Commerce Clause" and are constitutional.[24] However, had the Court engaged in a *Pike* analysis and weighed the benefits against the burden on interstate commerce, it would have been apparent that differential taxation distorts the interstate bond market and impairs national economic efficiency. By failing to apply the *Pike* test, the Court unnecessarily obfuscated dormant Commerce Clause jurisprudence and permitted state regulation that frustrates a basic purpose of the Constitution.

In Part I, this Recent Development will detail the development of dormant Commerce Clause jurisprudence culminating with the expansion of the government function exception in *United Haulers*. Part I will further explain (1) that dormant Commerce Clause jurisprudence mandates that the Court inquire as to whether the differential tax treatment of bonds impairs national economic unity and efficiency under the *Pike* standard and (2) that the *Davis* Court failed to conduct the mandated analysis. In Part II, this Recent Development will conduct the *Pike* analysis that the Court failed to perform, weighing the local benefits of the Kentucky tax scheme against the burden it imposes on interstate commerce. Using the *Pike* test, the local benefits of differential taxation may be overstated, and

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Commerce Clause refers to "the principle that state and local laws are unconstitutional if they place an undue burden on interstate commerce." ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 403 (2d ed. 2002). The dormant Commerce Clause is an implied power of the federal government that is rooted in the Commerce Clause, which grants Congress the ability to regulate interstate commerce. *See id.*

19. *United Haulers*, 550 U.S. at 343.
20. *Davis*, 128 S. Ct. at 1811.
21. 397 U.S. 137 (1970).
22. *Davis*, 128 S. Ct. at 1808 (quoting *Pike*, 397 U.S. at 142).
23. *Id.* at 1817.
24. *Id.* at 1811 (quoting *United Haulers*, 550 U.S. at 342).

in fact, differential taxation distorts the interstate municipal bond market, thus diminishing national economic efficiency. This Recent Development will conclude that the *Davis* decision is unclear, incomplete, and violates established precedent.

I. DORMANT COMMERCE CLAUSE JURISPRUDENCE

A. *The Purpose of the Commerce Clause: National Economic Efficiency*

Understanding the history and purpose of the Commerce Clause is vital to comprehending its modern application. As well, a better understanding of the Commerce Clause will allow for a better understanding of the dormant Commerce Clause. The Clause's roots lie in Congress's response to the failings of the Articles of Confederation. The Articles failed to give Congress any authority over interstate commerce, giving states carte blanche to regulate as they saw fit.[25] The weakness of the Articles in this regard resulted in "a drift toward anarchy and commercial warfare between states" that "came 'to threaten at once the peace and safety of the Union.' "[26] The Founders realized that this interstate economic warfare could cripple the young nation and began to take steps to rectify the problem.[27] In 1786, representatives from the General Assembly of Virginia proposed a convention with the other states, the *sole* purpose of which was to evaluate interstate commerce and devise a uniform system of regulation to advance the states' common interests.[28] The

25. Robert N. Clinton, *A Brief History of the Adoption of the United States Constitution*, 75 IOWA L. REV. 891, 893 (1990). Article IX did grant Congress "the sole and exclusive right and power of . . . regulating the trade and managing all affairs with the Indians . . . provided that the legislative right of any State within its own limits be not infringed or violated." *Id.*

26. H.P. Hood & Sons v. Du Mond, 336 U.S. 525, 533 (1949) (quoting JOSEPH STORY, COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES 240 (1st ed. 1833)). In urging the states to ratify the Constitution, Alexander Hamilton argued:

> The interfering and unneighborly regulations of some States, contrary to the true spirit of the Union, have, in different instances, given just cause of umbrage and complaint to others, and it is to be feared that . . . if not restrained . . . would be multiplied and extended till they became . . . impediments to the intercourse between the different parts of the Confederacy.

THE FEDERALIST NO. 22, at 140 (Alexander Hamilton) (Clinton Rossiter ed., 1961).

27. *See* THE FEDERALIST NO. 22 (Alexander Hamilton), *supra* note 26, at 140.

28. *Hood*, 336 U.S. at 533 (citing Resolution of the General Assembly of Virginia (Jan. 21, 1786), *in* DOCUMENTS ILLUSTRATIVE OF THE FORMATION OF THE UNION OF THE AMERICAN STATES, H.R. DOC. NO. 69-398, at 38 (Charles C. Tansill ed., 1927)) (emphasis added). The so-called "Virginia Resolution" provided "that the National

Founders recognized that the most vitally needed federal power was the power to regulate a uniform system of national commerce.[29] They formally adopted this power in the Commerce Clause of the Constitution in 1787.[30] Article I, Section 8 of the U.S. Constitution prescribes that "[t]he Congress shall have power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."[31] The power of this statement is inversely proportional to its length: the Commerce Clause of the U.S. Constitution is one of Congress's most powerful regulatory tools.[32] In reality, the Commerce Clause serves two separate functions: the first is the *authorization* of congressional action concerning interstate commerce; the second *limits* state and local action concerning interstate commerce.[33] When operating in its second function, the section is known as the dormant Commerce Clause.[34]

The dormant commerce power is not expressly included in the Constitution[35] but is rather a judicial invention derived from the

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Legislature ought . . . to legislate in all cases for the general interests of the union, and also in those cases to which the States are separately incompetent, or in which the harmony of the United States may be interrupted by the exercise of individual Legislation." DOUGLAS KMIEC ET AL., THE AMERICAN CONSTITUTIONAL ORDER: HISTORY, CASES, AND PHILOSOPHY 234 (Combined Supp. 2008).

29. *Hood*, 336 U.S. at 533.

30. U.S. CONST. art. I, § 8. Daniel Webster stated in his brief to the Supreme Court in *Gibbons v. Ogden* that the basic purpose of the Commerce Clause was "to rescue . . . the general Union from 'the embarrassing and destructive consequences, resulting from the legislation of so many different States.' " KMIEC ET AL., *supra* note 28, at 233.

31. U.S. CONST. art. I, § 8.

32. CHEMERINSKY, *supra* note 18, at 238. When Congress uses the power granted by Article I, Section 8, it is exercising the authority of the Commerce Clause actively. The intrinsic power of the active Commerce Clause has been amplified rather than weakened by the Supreme Court: indeed, from 1937 (the beginning of the New Deal era) until 1995, the Court upheld every single law passed by Congress challenged under the active Commerce Clause. *Id.* at 239.

33. *Id.* at 401.

34. *Id.* The dormant Commerce Clause, which generally prohibits state interference in interstate commerce, is not clearly stated in the Constitutional text. Rather, the Supreme Court has inferred the Commerce Clause's *negative* power. *Id.* This inference, as explained by Felix Frankfurter, is essentially that the clause, "by its own force and without national legislation, puts it into the power of the Court to place limits on state authority." *Id.* (quoting FELIX FRANKFURTER, THE COMMERCE CLAUSE UNDER MARSHALL, TANEY & WAITE 18 (1937)). In simpler terms, "some state legislation runs afoul of the Commerce Clause, or limiting principles implied from it, even though Congress has not affirmatively exercised its commerce power to preempt that legislation. The law falls simply because the Commerce Clause is there, albeit in its dormant—that is, unexercised—state." DAN T. COENEN, CONSTITUTIONAL LAW: THE COMMERCE CLAUSE 209 (2004).

35. Because of the lack of textual basis, some jurists, Justices Clarence Thomas and Antonin Scalia chief among them, have disavowed the doctrine as an "exercise of judicial power . . . for which there is no textual basis." Camps Newfound/Owatonna, Inc. v. Town

silence of Congress regarding state-imposed barriers to interstate commerce.[36] Throughout its history, the Supreme Court "has advanced the solidarity and *prosperity* of this Nation by the meaning it has given to these great silences of the Constitution."[37] National prosperity has consistently been used as the basic rationale behind invalidating state action that restrains interstate commerce. For example, in striking down a New York law restricting the sale of milk from Vermont, Justice Cardozo, speaking for a unanimous Court in *Baldwin v. G.A.F. Seelig, Inc.*,[38] wrote 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* [is] . . . in union and not division."[39] From Justice Cardozo's comment it is evident that a major reason the Court has restrained the power of the states to impose barriers on interstate commerce is to promote the *economic efficiency* of the Union.[40]

B. The Modern Framework: United Haulers *and* Davis

The Court recently reaffirmed the established dormant Commerce Clause framework in both *Davis*[41] and *United Haulers*.[42] Under that framework, judicial scrutiny of a state law alleged to have violated the Clause begins with a threshold issue: whether the state law, on its face, discriminates against interstate commerce.[43]

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of Harrison, 520 U.S. 564, 612 (1997) (Thomas, J., dissenting); *see* Am. Trucking Ass'ns v. Smith, 496 U.S. 167, 202 (1990) (Scalia, J., concurring). Many commentators have also criticized the doctrine as a judicial usurpation of that which should be left solely to the legislature. *See, e.g.*, Julian N. Eule, *Laying the Dormant Commerce Clause to Rest*, 91 YALE L.J. 425, 428 (1982); Richard D. Friedman, *Putting the Dormancy Doctrine Out of its Misery*, 12 CARDOZO L. REV. 1745, 1745 (1991); Patrick C. McGinley, *Trashing the Constitution: Judicial Activism, the Dormant Commerce Clause, and the Federalism Mantra*, 71 OR. L. REV. 409, 412 (1992).

36. The genesis of the dormant Commerce Clause can be seen in several nineteenth-century Supreme Court cases. *See, e.g.*, Wabash, St. Louis & Pac. Ry. Co. v. Illinois, 118 U.S. 557, 558 (1886); Welton v. Missouri, 91 U.S. 275, 275 (1876); Cooley v. Bd. of Wardens, 53 U.S. (12 How.) 299, 320 (1851); Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 177 (1824).

37. H.P. Hood & Sons v. Du Mond, 336 U.S. 525, 535 (1949) (emphasis added).

38. 294 U.S. 511 (1935).

39. *Id.* at 523 (1935) (emphasis added).

40. Justice Stewart noted this, stating that, historically, "the Court has viewed with particular suspicion state statutes requiring business operations to be performed in the home State that could more *efficiently* be performed elsewhere." Pike v. Bruce Church, Inc., 397 U.S. 137, 145 (1970) (emphasis added).

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

42. United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth., 550 U.S. 330 (2007).

43. *See Davis*, 128 S.Ct. at 1808 (citing Or. Waste Sys., Inc. v. Dep't of Envtl. Quality

Ordinarily, when a law "expressly draws a distinction between in-staters and out-of-staters," it is discriminatory.[44] If the law is facially discriminatory, it is "virtually *per se* invalid."[45] The only way that a discriminatory law can pass constitutional muster is "if it 'advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.' "[46] This, in practical effect, requires a court to use at least intermediate scrutiny to determine whether the state law is valid.[47] The rationale for this heightened review is that discriminatory laws are presumed to be "motivated by 'simple economic protectionism.' "[48] However, if the state law at issue is not discriminatory and "regulates even-handedly" such that "its effects on interstate commerce are only incidental," the court takes a markedly different approach.[49] When a law does not discriminate against interstate commerce, the court uses a balancing test[50] that often, but not always, upholds the challenged state activity.[51]

The law at issue in *Davis* draws a distinction between municipal bond interest payments based solely on whether the payments originate in Kentucky or another state.[52] The law's effect is "[to give] 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."[53] Furthermore, the statute is related to

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of Or., 511 U.S. 93, 99 (1994)); *United Haulers*, 550 U.S. at 338; Am. Trucking Ass'ns v. Mich. Pub. Serv. Comm'n, 545 U.S. 429, 433 (2005); Fort Gratiot Sanitary Landfill, Inc. v. Mich. Dep't of Natural Res., 504 U.S. 353, 359 (1992).

44. *See* CHEMERINSKY, *supra* note 18, at 412, 414.

45. *Davis*, 128 S. Ct. at 1808 (quoting Or. Waste Sys., Inc. v. Dep't of Envtl. Quality of Or., 511 U.S. 93, 99 (1994)); *see also* City of Philadelphia v. New Jersey, 437 U.S. 617, 624 (1978).

46. *Davis*, 128 S. Ct. at 1808 (quoting Or. Waste Sys., Inc. v. Dep't of Envtl. Quality of Or., 511 U.S. 93, 101 (1994)); *see* Maine v. Taylor, 477 U.S. 131, 138 (1986).

47. *See* CHEMERINSKY, *supra* note 18, at 424. In *Hughes v. Oklahoma*, the Supreme Court held that laws discriminating against interstate commerce required the use of "the strictest scrutiny." *Id.* (quoting Hughes v. Oklahoma, 441 U.S. 322, 337 (1979)). However, as Professor Chemerinsky notes, "[r]equiring only a 'legitimate' purpose is characteristic of highly deferential rational basis review and not the 'strictest scrutiny.' " *Id.* The Court has certainly imposed a standard of review more stringent than the rational basis test, but it does not undertake a traditional strict scrutiny analysis in most cases. The Court in *United Haulers* chose to categorize its approach as "rigorous scrutiny." United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth., 550 U.S. 330, 338 (2007).

48. *United Haulers*, 550 U.S. at 338.

49. Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

50. *See* CHEMERINSKY, *supra* note 18, at 418.

51. *Davis*, 128 S. Ct. at 1808–09.

52. KY. REV. STAT. ANN. § 141.010(10)(c) (LexisNexis 2006 & Supp. 2008).

53. *Davis*, 128 S. Ct. at 1825 (Kennedy, J., dissenting). Justice Kennedy thus

interstate commerce because the in-state bonds and out-of-state bonds are in competition with one another for the same investment funds—indeed, that competition is what necessitates the differential tax treatment.[54] Accordingly, the law is discriminatory and would ordinarily be subject to the "rigorous scrutiny" applied to discriminatory laws.

To that end, the Court has historically struck down as unconstitutional differential tax schemes that benefit in-state interests and harm out-of-state interests. For example, in *Boston Stock Exchange v. State Tax Commission*,[55] the Court struck down a New York statute that placed a $350 maximum tax on New York securities sales but taxed out-of-state sales without limitation.[56] Justice White reasoned that differential taxation distorted the securities market by "foreclos[ing] tax-neutral decisions" of consumers in the market.[57] Consequently, "the flow of securities sales is diverted from the most economically efficient channels and directed to New York," a result which is "wholly inconsistent with the free trade purpose of the Commerce Clause."[58] The Court also adhered to these principles in *Bacchus Imports, Ltd. v. Dias*,[59] striking down a Hawaii tax scheme that exempted local brandy from a 20% excise tax on liquor intended to stimulate the development of Hawaii's liquor industry.[60] Speaking for a unanimous Court twelve years later, Justice Souter struck down a North Carolina tax provision that reduced the state tax liability of citizens who owned stock in corporations doing business in the state.[61] The practical effect of the provision, that "a North Carolina investor [would] probably favor investment in corporations doing business within the State," was deemed impermissible.[62] This rationale closely traces *Boston Stock Exchange*—if investors choose to avoid interstate commerce because of another state's tax treatment of out-of-staters, the restraint on trade is unconstitutional.[63]

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concluded that the Kentucky statute was "an *explicit* discrimination." *Id.* (emphasis added).

54. *Id.* at 1826.
55. 429 U.S. 318 (1977).
56. *Id.* at 328.
57. *Id.* at 331.
58. *Id.* at 336.
59. 468 U.S. 263 (1984).
60. *Id.* at 273.
61. Fulton Corp. v. Faulkner, 516 U.S. 325, 346 (1996).
62. *Id.* at 343.
63. *See* Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 331 (1977).

Prior to 2008, differential taxation usually violated the dormant Commerce Clause.[64] The *Davis* decision, however, excluded the discriminatory Kentucky tax law from the "rigorous scrutiny" normally demanded.[65] Ordinarily, discriminatory laws are subject to heightened scrutiny because they are presumed to be motivated by protectionism.[66] However, the Court explained in *Davis* that this protectionism is *not* presumed when the discriminatory law "favors, not local private entrepreneurs, but [State] and local governments."[67] Relying on *United Haulers*, decided the previous Term, Justice Souter wrote that "a government function is not susceptible to standard dormant Commerce Clause scrutiny owing to its likely motivation by legitimate objectives distinct from the simple economic protectionism the Clause abhors."[68] Instead, when a government receives the benefits from a discriminatory law, but all private companies are treated identically, the new presumption is that the state's motive is

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64. In an early example from 1939, the Supreme Court considered a Florida statute that required out-of-state cement be inspected upon entering the state and mandated the payment of an inspection fee of fifteen cents per hundredweight. Hale v. Bimco Trading, Inc., 306 U.S. 375, 379 (1939). The statute therefore imposed a tax on imported cement to which in-state cement was not subjected. *Id.* The Court struck down the statute, saying that "no reasonable conjecture can here overcome the calculated discrimination against foreign commerce." *Id.* at 380. Continuing the trend, the Supreme Court invalidated an Ohio law that awarded a tax credit to gas stations for selling ethanol produced in Ohio but did not award the credit for selling out-of-state ethanol. New Energy Co. of Ind. v. Limbach, 486 U.S. 269, 271 (1988). Six years later, even Justice Thomas, a noted dormant Commerce Clause opponent, joined in the long line of justices invalidating differential state taxation by striking down Missouri's 1.5% use tax on using or consuming any article of personal property purchased out-of-state. Associated Indus. of Mo. v. Lohman, 511 U.S. 641, 648–49 (1994).

65. The Supreme Court's established dormant Commerce Clause analysis has two defined exceptions. *See* CHEMERINSKY, *supra* note 18, at 429. The Court uses a different and less scrutinizing constitutional analysis when (1) Congress authorizes the state action, and (2) the state is acting as a "market participant." *See* Lewis v. BT Inv. Managers, Inc., 447 U.S. 27, 44 (1980) (describing the "congressional authorization" exception); Hughes v. Alexandria Scrap Corp., 426 U.S. 794, 808–10 (1976) (articulating the "market participant" exception). In *Davis*, the Court relied somewhat on the market participant exception in excluding the Kentucky tax from the heightened scrutiny reserved for discriminatory laws, stating that "there is no ignoring the fact that imposing the differential tax scheme makes sense only because Kentucky is also a bond issuer [in addition to being a regulator]." Dep't of Revenue v. Davis, 128 S. Ct. 1801, 1812 (2008). The Court used the fact that Kentucky was acting (at least somewhat) as a market participant as a justification for analyzing the statute under a balancing test. *Id.* This Recent Development does not attempt to explain the merits of that conclusion.

66. United Haulers v. Oneida-Herkimer Solid Waste Mgmt. Auth., 550 U.S. 330, 338–39 (2007).

67. *Davis*, 128 S. Ct. at 1814.

68. *Id.* at 1810 (citing *United Haulers*, 550 U.S. at 343).

not protectionism, and, thus, the law is constitutional.[69] Accordingly, the *Davis* Court analyzed the discriminatory Kentucky statute as a non-discriminatory law.[70]

The balancing test generally used in analyzing non-discriminatory laws is governed by the standard articulated in *Pike v. Bruce Church*, *Inc.*,[71] which states that the challenged state law " 'will be upheld unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits.' "[72] To satisfy the *Pike* test, a court must conduct a "cost-benefit analysis"[73] to measure two things: (1) the local benefits and (2) the burden on interstate commerce.

In *Davis*, the Court began a *Pike* analysis but then failed to complete it. The Court identified the nature of the local benefits,[74] but then began questioning whether *Pike* would apply to the facts of the case.[75] The Court ultimately determined that *Pike* could not be applied because the *Pike* analysis was not raised below in Kentucky state court.[76] Even if *Pike* did apply, the Court stated that "the Judicial Branch is not institutionally suited to draw the reliable conclusions of the kind that would be necessary" to find the statute unconstitutional[77] because courts are " 'unsuited to gather the facts upon which economic predictions can be made, and professionally untrained to make them.' "[78]

However, after placing the Kentucky tax scheme under the balancing test umbrella reserved for non-discriminatory statutes, the Court only conducted one side of a balancing test—the side of the

69. *See United Haulers*, 550 U.S. at 342.

70. *Davis*, 128 S. Ct. at 1810. Justice Souter explained that the logic of *United Haulers* "applies with even greater force to laws favoring a State's municipal bonds, given that the issuance of debt securities to pay for public projects is a quintessentially public function," hence, "[t]he Kentucky tax scheme falls outside the forbidden paradigm." *Id.* at 1814.

71. 397 U.S. 137 (1970).

72. *Davis*, 128 S. Ct. at 1808 (alteration in original) (quoting *Pike*, 397 U.S. at 142).

73. *See id.* at 1818 (categorizing *Pike* as a cost–benefit test).

74. *Id.* at 1810 ("By issuing bonds, state and local governments [s]pread the costs of public projects over time.") (quoting AMDURSKY & GILLETTE, *supra* note 2, at 11) (alteration in original).

75. *Id.* at 1817 (indicating that a "market participant" exception would eliminate the need for a *Pike* analysis). The so-called "market participant" exception to the dormant Commerce Clause generally provides that where a state itself enters into interstate commercial activity, as either a buyer or seller, it may choose to purchase only from in-state producers or sell only to its own citizens. JOHN E. NOWAK & RONALD D. ROTUNDA, CONSTITUTIONAL LAW 333 (6th ed. 2000).

76. *Davis*, 128 S. Ct. at 1817.

77. *Id*.

78. *Id.* at 1818 (quoting Gen. Motors Corp. v. Tracy, 519 U.S. 278, 308 (1997)).

scale measuring "putative local benefits" was not weighed against any analysis of the burden on commerce. The cost–benefit test generally prescribed by *Pike* was limited in *Davis* to just a "benefit" test without consideration of any potential costs.[79] But, a basic analysis of the underlying economics of the challenged Kentucky statute would have revealed an economic burden. Additionally, a basic economic analysis would have revealed the fact that the "local benefits" purported to result from the differential taxation of municipal bonds can actually result in local *harm*. After evaluating the underlying economics of differential municipal bond taxation, the economic burdens might well exceed the local benefits. Thus, the statute would fail the *Pike* analysis and be unconstitutional.

II. ECONOMIC EFFICIENCY OF DIFFERENTIAL TAX SCHEMES

A. Neoclassical Framework

A simple and recognized framework is needed to effectively evaluate (1) the burdens of the tax scheme on interstate commerce and (2) the putative local benefits. One widespread and tested framework useful in analyzing market economics is the neoclassical theory. Neoclassicism[80] posits that resources are most efficiently allocated by the operation of free markets and that this efficient allocation leads to utility maximization.[81] Utility maximization is the satisfaction one gains by consuming.[82] The basis of neoclassical economics is thus that free markets most effectively lead to the satiation of society's needs and wants.

This is not a treatise on the merits of neoclassicism as an economic theory. However, a survey of the Supreme Court's Commerce Clause jurisprudence indicates the Court's willingness to adopt a neoclassical understanding of economics. The Court has reasoned that the national prosperity of the United States stems from the national common market mandated by the dormant Commerce

79. *Id*. at 1817.

80. Neoclassical theory has often been defined as a "metatheory," "a scientific research program that generates economic theories." E. Roy Weintraub, *Neoclassical Economics*, *in* THE FORTUNE ENCYCLOPEDIA OF ECONOMICS (David R. Henderson ed., 1993), *available at* http://www.econlib.org/library/Enc1/NeoclassicalEconomics.html. This "program" is governed by three basic, unchanging assumptions: "1. People have rational preferences among outcomes. 2. Individuals maximize utility and firms maximize profits. 3. People act independently on the basis of full and relevant information." *Id.*

81. *See* Geoffrey D. Korff, *Reviving the Forgotten American Dream*, 113 PENN ST. L. REV. 417, 430 (2008).

82. *Id.*

Clause,[83] and this requirement establishes that the United States should be "an area of trade free from interference by the States."[84] The Court's basic premise in evaluating the dormant Commerce Clause has always reflected this free trade purpose.[85] If states were permitted to restrict trade to benefit in-state businesses and burden out-of-state businesses, the Court has stated that it " 'would invite a multiplication of preferential trade areas destructive' of the free trade which the Clause protects."[86] The Court has even gone so far as to say that "the fundamental purpose of the Clause is to assure that there be free trade among the several States. This free trade . . . is a freedom to trade with any State, to engage in commerce across all state boundaries" to assure that business operations are conducted in the most efficient place possible.[87] Capitalist free trade principles, therefore, have historically driven the Court's dormant Commerce Clause jurisprudence.[88] This sentiment was espoused by Justice Jackson, who stated:

> Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation, that no home embargoes will withhold his exports, and no foreign state will by customs duties or regulations exclude them. Likewise, every consumer may look to the *free competition* from every producing area in the Nation to protect him from exploitation by any. Such was the vision of the Founders; such has been the doctrine of this Court which has given it reality.[89]

Focusing on the efficiency of the free market, the Court's historic view comports with the basic tenets of neoclassical economic theory,

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83. Hunt v. Wash. State Apple Adver. Comm'n, 432 U.S. 333, 350 (1977) (quoting Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970)).

84. Freeman v. Hewit, 329 U.S. 249, 252 (1946).

85. *See, e.g.*, McLeod v. J.E. Dilworth Co., 322 U.S. 327, 330 (1944).

86. Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 329 (1977) (quoting Dean Milk Co. v. Madison, 340 U.S. 349, 356 (1951)).

87. *Id.* at 335–36.

88. *See* Richard A. Posner, *The Constitution as an Economic Document*, 56 GEO. WASH. L. REV. 4, 17 (1987) (noting that the dormant Commerce Clause, as historically interpreted, "becomes a charter of free trade," and hence "an element of an efficient federalism"). In recent years, however, the Court has begun to retreat from interpreting the dormant Commerce Clause to categorically endorse free markets. *See* Maine v. Taylor, 477 U.S. 131, 151 (1986) ("The Commerce Clause significantly limits the ability of States and localities to regulate or otherwise burden the flow of interstate commerce, but it does not elevate free trade above all other values.").

89. H.P. Hood & Sons, Inc. v. Du Mond, 336 U.S. 525, 539 (1949) (emphasis added).

with its emphasis on efficient markets[90] and competition.[91] However, the Court retreated from this long-held position in *Davis*, upholding an anticompetitive tax regime that fosters, at least to some degree, inefficient interstate capital flow.

B. Davis *and the "Burden on Interstate Commerce"*

To perform the *Pike* balancing test that was not performed by the Supreme Court, one must weigh the potential burden a state law imposes on interstate commerce against any potential benefits conferred by operation of the law.[92] As will be demonstrated, a *Pike* analysis of differential taxation of bonds yields, at best, inconclusive results and demonstrates that the burdens of differential taxation may actually outweigh the benefits. Because the *Pike* issue is at least a close call (meaning, at a minimum, that the *Pike* test does not *clearly* demonstrate that the tax regime is inconsequential to economic efficiency), the Supreme Court was obligated to address it rather than cursorily assert that the Court cannot conduct the analysis.

The first step in a *Pike* analysis is to assess any potential burden a challenged law places on interstate commerce. The Kentucky statute clearly has an effect on interstate commerce by imposing a tax regime whereby "states seeking to attract both in-state and out-of-state capital for public projects must sell their securities in two distinct markets—a market enjoying only a federal tax exemption," the out-of-state market, "and a market enjoying both federal and state tax exemptions," the in-state market.[93] The result of this market segmentation is that the price of out-of-state bonds is artificially raised by the application of the state income tax. This extra cost can

90. *See* Gen. Motors Corp. v. Tracy, 519 U.S. 278, 300 (1997) ("The dormant Commerce Clause protects markets and participants in markets.").

91. *See* Jim Rossi, *Political Bargaining and Judicial Intervention in Constitutional and Antitrust Federalism*, 83 WASH. U. L.Q. 521, 533 (2005). "[T]he Supreme Court's dormant commerce clause jurisprudence might be said to embrace a pro-competition stance, consistent with the ideology and goals of the neoclassical economics framework, in which law sees its primary role as intervening to correct for market failure." *Id.* This is not to say that the *sole* purpose of the dormant Commerce Clause is to promote economic efficiency through the endorsement of free market principles. *See id*. The Clause has also been interpreted to promote *political* efficiency as well. *Id*. at 536. "Rather than inherently protecting competition and free markets, the purposes of [the Clause] can be understood within the frameworks of Madisonian democracy as well as efficiency—specifically, as limiting welfare-reducing interest-group rent-seeking in the state regulatory process." *Id.*

92. *See* Dep't of Revenue v. Davis, 128 S. Ct. 1801, 1817 (2008).

93. James F. Blumstein, *Some Intersections of the Negative Commerce Clause and the New Federalism: The Case of Discriminatory State Income Tax Treatment of Out-of-State Tax-Exempt Bonds*, 31 VAND. L. REV. 473, 546 (1978).

instill a disincentive for investors in one state to buy bonds in another[94] by lowering the yield on out-of-state bonds, thereby restricting the interstate flow of capital used to finance local projects. Determining the size of the disincentive requires an evaluation of the amount by which the out-of-state bond holder's after-tax yield is decreased compared to tax free in-state bonds. The application of state income tax can, in the highest tax brackets, impose a significant premium on out-of-state bonds. In the upper brackets, tax rates can range from 4.75% in Maryland to 7.75% in North Carolina to as high as 10.30% in California.[95] This is not to say, however, that out-of-state bonds are subject to the effect of a 10.30% tariff because municipal bond income is also exempt from federal gross income.[96]

In order to determine the cost imposed on holders of out-of-state bonds, it is necessary first to ascertain the "effective tax rate" attached to those bonds.[97] This rate is represented by the formula: Effective tax rate = (Nominal state tax rate) × (1 – Marginal federal income tax rate).[98] By way of illustration, assume that a holder of an out-of-state bond is taxed by the state in which he lives at a marginal rate of 10% and that he is subject to a federal marginal rate of 35%. His effective tax rate would be 6.5% ((0.10) × (1 – 0.35)). This is only the first step in determining a bond holder's after-tax yield. After-tax yield is derived by multiplying the current bond yield by (1 – effective tax rate).[99] Continuing the example, a person owning a 7% out-of-state bond would have an after-tax yield of about 6.5% ((0.07) × (1 – 0.065)). Therefore, with differential taxation, if a comparably priced in-state bond were available with a 7% yield, the disincentive to an investor to buy an out-of-state bond would be roughly 0.5% (0.07 – 0.065). While seemingly insignificant, the true dollar figures can add up quickly. If a large investor were to choose to purchase $1,000,000 of municipal bonds and be faced with this choice, his profit would be $70,000 on an in-state bond investment but would be $5,000 less on an out-of-state investment. This effect is magnified the larger the bond

94. *See* C. Steven Cole et al., *The Capitalization of the State Tax Exemption Benefit in Municipal Bond Yields*, 7 J. FIN. & STRATEGIC DECISIONS 67, 67 (1994).

95. LEHMAN BROS. ASSET MGMT., MUNICIPAL BONDS: CURBING THE IMPACT OF STATE TAXES 2 (2008) [hereinafter LEHMAN BROS.], *available at* http://www.nb.com/MYP/NB/PUB/28282/NFA/H/K/V/N/doc/i0245_muni_bonds_curbing_impact_of_state_taxes.pdf.

96. *See* I.R.C. § 103(a) (2006) ("[G]ross income does not include interest on any State or local bond."); Steven J. Hueglin, *State and Local Tax Treatment of Municipal Bonds*, *in* THE MUNICIPAL BOND HANDBOOK 47, 51 (Frank J. Fabozzi et al. eds., 1983).

97. Hueglin, *supra* note 96, at 51.

98. *Id.*

99. *Id.* at 59.

holder's state tax rate; "[c]onsequently, the greater a state's income tax rate, the greater the benefit from the exclusion, and the interest rate the state must offer can be lower."[100] This cost of borrowing, as determined by the market for loanable funds, can be represented graphically, as noted below in Figure 1.

Figure 1: Differential Taxation's Effect on Interest Rates[101]

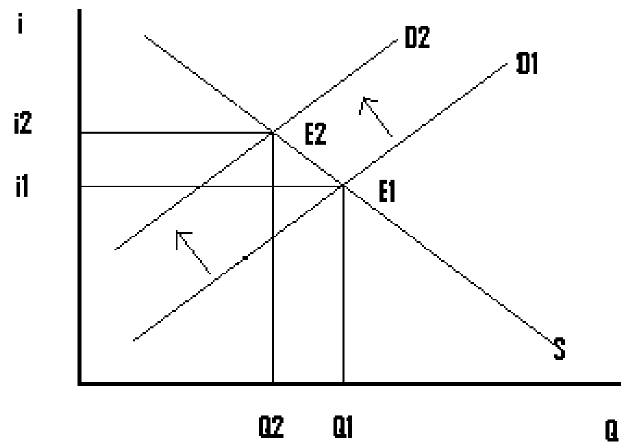

Figure 1 begins with the assumption that no state subjects municipal bond interest payments to taxation, so there is no market segmentation based on citizenship. The demand for out-of-state bonds in this state-income-tax-free world is represented by *D1*, the supply of bonds issued out-of-state is represented by *S*, the equilibrium interest rate is *i1*, and the equilibrium quantity of out-of-state bonds purchased is *Q1*. If a state imposes a tax on out-of-state bonds, as in Kentucky, the after-tax yield on those bonds decreases.

100. Posting of Joseph Henchman to Tax Foundation: Tax Policy Blog, http://www.taxfoundation.org/blog/show/23229.html (May 27, 2008).

101. *See* LAWRENCE S. RITTER ET AL., PRINCIPLES OF MONEY, BANKING, AND FINANCIAL MARKETS 56 (9th ed. 1997). Figure 1 represents a basic supply and demand for loanable funds where quantity *Q* is denoted on the x-axis and the interest rate *i* is denoted on the y-axis. *Id.* The demand-for-bonds curve is denoted by *D1* and is upward-sloping, indicating that as the interest rate for a municipal bond increases, consumers will lend more money to states and municipalities by buying more bonds. *Id.* The supply-of-bonds curve is denoted by *S* and is downward-sloping, indicating that as the interest rate (the price of borrowing) increases, states and municipalities will seek to borrow less through bond issues. *Id.* The equilibrium interest rate is at the intersection of the supply and demand curves. *Id.* This rate is termed the equilibrium point because "[a]t any other interest rate, there is an excess of either borrowers or lenders, and competitive pressure will force the rate toward its equilibrium level." *Id.*

Accordingly, the demand for out-of-state bonds decreases because investors are less willing to buy out-of-state bonds at the same level. The new demand curve for out-of-state bonds is represented by *D2*. This shift places the new equilibrium point at *E2*, which increases the equilibrium interest rate to *i2* and decreases the quantity of out-of-state bonds purchased to *Q2*. However, if the state continues to exempt in-state bonds from taxation (as nearly all states do), the equilibrium interest rate for in-state bonds would remain at the lower *i1* level. In order to compete for out-of-state lending, states must increase the demand for out-of-state bonds by raising the after-tax yield to approximate or match *i1*.

To accomplish this shift in demand, states and municipalities are forced to "offer a high enough return to compensate out-of-state investors for the tax disadvantages."[102] This increases the borrowing costs associated with raising capital for education, infrastructure, public health, and other local projects.[103] These additional borrowing costs can be calculated using "municipal equivalent yield multipliers" which are furnished by many investment banks.[104] To determine how much states must increase yield to be competitive in other states, bond issuers should multiply their current yield by the relevant state multiplier.[105] For instance, if New Jersey sought to finance an education initiative and hoped to compete for the vast number of New York investors in the highest bracket, who have the option of purchasing a similar in-state bond paying 5%, New Jersey would have to offer a yield of 5.235%,[106] raising borrowing costs by nearly a quarter of a percent. Considering that in the period from 1996–2002, New Jersey issued $27,719,000,000 in long-term government bonds,[107] this additional cost is not insignificant, even at low percentages. As a

102. Blumstein, *supra* note 93, at 546.

103. *See* Cynthia Belmonte & Emily Shammas, *Tax-Exempt Bonds, 2006*, STAT. INCOME BULL., Fall 2008, at 247, 262, *available at* http://www.irs.gov/pub/irs-soi/08fallbultebond.pdf (summarizing the uses and dollar amounts of municipal bond financing).

104. *See* LEHMAN BROS., *supra* note 95, at 2 (providing the 2008 multipliers); *see also* Morgan Stanley Smith Barney, Calculating the Taxable Equivalent Yield for Municipal Bonds, http://www.morganstanleyindividual.com/markets/bondcenter/school/tey/ (last visited Nov. 8, 2009) (providing the 2007 multipliers) [hereinafter Morgan Stanley].

105. *See* LEHMAN BROS., *supra* note 95, at 1.

106. The municipal equivalent yield multiplier for the 35% federal tax bracket in New York is 1.047. *Id.* This figure therefore represents the formula (.05 × 1.047). The multiplier is even larger for lower tax brackets (1.048 for the 33% bracket and 1.052 for the 28% bracket), meaning that a state seeking lower income New York investors must offer an even higher yield to entice higher income investors. *Id.*

107. BELMONTE, *supra* note 5, at 169.

result, if the discriminatory tax schemes were to be eliminated across the country, "many governmental issuers might well be able to market their securities at a lower interest cost than they now do."[108]

This economic analysis illustrates that the interstate municipal bond market is artificially distorted by differential taxation schemes like Kentucky's because without such a tax scheme the market would function differently and produce different outcomes for both investors and bond issuers. This market distortion is not neutral, but imposes a burden on interstate commerce. These tax laws decrease the effective yield of out-of-state municipal bonds by subjecting them to state income tax and exempting similar in-state bonds from taxation. The result of this decreased yield is that the demand for bonds decreases in states that seek out-of-state capital for local projects. Because the demand for bonds decreases, the interest rate that these states must pay to compete with in-state bonds is increased, thus making borrowing across state lines more expensive. These burdens can be significant because of the vast dollar amounts involved in municipal bond debt. However, the fact that a law imposes burdens on interstate commerce is not of itself dispositive under *Pike*. To determine whether these differential schemes *impermissibly* burden interstate commerce, they must be weighed against any local benefits they provide.[109]

C. Davis *and "Putative Local Benefits"*

In *Davis*, Justice Souter identified several purported local benefits furthered by differential taxation.[110] The opinion pointed out that many small municipalities rely on "single state" bond funds to finance their relatively small-scale projects.[111] These single state funds package the bonds issued by relatively obscure municipalities normally ignored by interstate markets[112] because national funds tend not to devote the time and energy necessary to investigate or purchase bonds issued by smaller public entities.[113] These single market funds, and, by proxy, funding for small municipal projects,

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108. Blumstein, *supra* note 93, at 547.

109. *See* Dep't of Revenue v. Davis, 128 S. Ct. 1801, 1808 (2008) (quoting Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970)).

110. *Davis*, 128 S. Ct. at 1815–16.

111. *Id.* at 1816.

112. *Id.*

113. *Id.* (quoting Brief for National Federation of Municipal Analysts as Amici Curiae Supporting Neither Party at 15, Dep't of Revenue v. Davis, 128 S. Ct. 1801 (2008) (No. 06-666), 2007 WL 2115441).

benefit greatly from the development of intrastate bond markets fostered by state income tax exemptions and would be significantly harmed if forced to compete in a national market.[114] According to the Court, if they were to strike down state income tax exemption, these single state bond funds would likely disappear, limiting the funding opportunities of many smaller municipalities.[115] Should these smaller entities wish to remain competitive in an open, national market, they would undoubtedly be forced to offer higher yields to appear on the "radar" of larger bond funds, resulting in increased borrowing costs to these small entities that might be in a poor position to absorb them.[116]

Another subset of borrowers that benefits from the tax exempt status of in-state bonds is high-tax states.[117] As state income tax rates increase, the tax benefits to bond purchasers increase as well.[118] As a result, high-tax states can effectively shield their bonds from interstate competition.[119] Because the state income tax in these high-tax states adds a relatively expensive premium on out-of-state bond holdings, investors have a strong incentive to lend to in-state borrowers rather than out-of-state borrowers.[120] Differential taxation is thus a boon for high-tax states, such as California.[121] This benefit, however, comes at the expense of lower-tax states whose residents do *not* have such a strong disincentive to invest out-of-state.[122] Residents of those states have less of an incentive to lend to in-state borrowers than their counterparts in higher-tax states; thus, a flow of capital

114. *See* Brief for National Federation of Municipal Analysts as Amici Curiae Supporting Neither Party at 19, Dep't of Revenue v. Davis, 128 S. Ct. 1801 (2008) (No. 06-666), 2007 WL 2115441 [hereinafter Brief for National Federation of Municipal Analysts]. "As in other markets, the likely impact of a more national market for municipal bonds would be to tilt the market further towards larger, nationally-recognized market participants and to squeeze out or decrease the competitiveness of smaller and more obscure participants." *Id.* at 19–20.

115. *Davis*, 128 S. Ct. at 1816.

116. *See* Cole et al., *supra* note 94, at 73 (noting that personal tax exemptions lower the borrowing costs of in-state municipalities).

117. *See* Brief for Tax Foundation as Amici Curiae Supporting Respondents at 25–26, Dep't of Revenue v. Davis, 128 S. Ct. 1801 (2008) (No. 06-666), 2007 WL 2808464 [hereinafter Brief for Tax Foundation]; Blumstein, *supra* note 93, at 546 ("The effect of the present arrangement could well be that states with large concentrations of capital [and high tax rates] are better able to retain those funds for in-state investment.").

118. Cole et al., *supra* note 94, at 73.

119. *See* Brief for Tax Foundation, *supra* note 117, at 25.

120. *Id.* at 26.

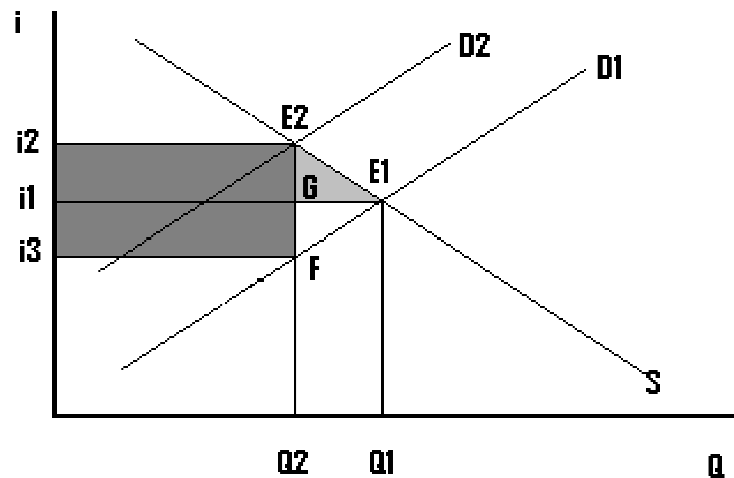
121. *See* Morgan Stanley, *supra* note 104.

122. *See* Henchman, *supra* note 100.

from low-tax states to high-tax states is more likely than a flow of capital from high-tax states to low-tax states.[123]

Furthermore, while small municipalities and high-tax states enjoy some significant benefits from differential taxation, not all local effects are beneficial. Differential taxation schemes decrease in-state borrowing costs,[124] but there is evidence to suggest that, rather than aiding states, such tax schemes adversely impact many states' bottom lines.[125] Studies indicate that the amount of foregone tax revenue that could have been collected by taxing the interest on in-state bonds sometimes exceeds any potential borrowing cost savings that in-state government entities gain.[126] In other words, the revenue that could be generated by taxing the income of in-state bondholders often exceeds the revenue actually generated from selling tax-exempt in-state bonds. The relationship between state welfare (the "bottom line") and lost revenue resulting from exempting in-state bonds from taxation can perhaps best be explained graphically, as demonstrated by Figure 2 below.

Figure 2: Foregone Tax Revenue Resulting from Differential Taxation[127]

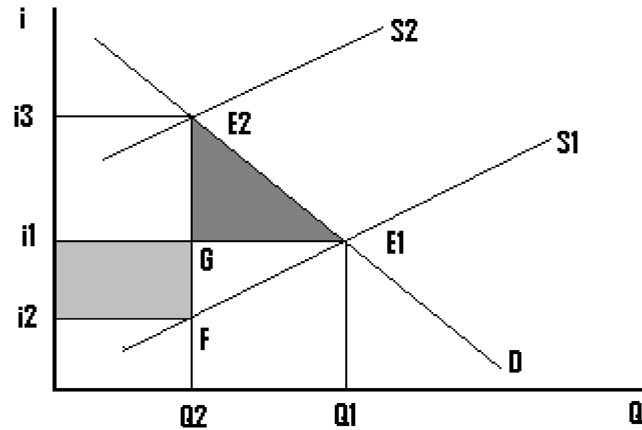


123. *See id.*
124. *See* Brief for National Federation of Municipal Analysts, *supra* note 114, at 8.
125. *See* Cole et al., *supra* note 94, at 73.
126. *See id.*
127. *See, e.g.*, DENNIS APPLEYARD ET AL., INTERNATIONAL ECONOMICS 301 (5th ed. 2006) (explaining the geometric relationship between demand, price, revenue, and deadweight loss in the context of international trade). For an explanation of the notations used in the figure, see *supra* note 101.

Figure 2 represents the supply and demand curves for imported (i.e., out-of-state) municipal bonds. The demand for bonds by out-of-state investors is illustrated by *D1* and the supply for out-of-state bonds is illustrated by *S*. Without differential taxation, the equilibrium point of lending and borrowing is at *E1* and the equilibrium rate of interest is at *i1*. If the state in which the lender resides enacts a differential taxation scheme whereby the state exempts in-state bonds but does not exempt out-of-state bonds, the demand for bonds by out-of-state investors decreases, representing a decreased willingness by investors to purchase out-of-state bonds. The new equilibrium point is at *E2*, representing a decreased flow of capital out-of-state, and the new equilibrium interest rate is increased to point *i2*, representing the higher yield that out-of-state borrowers must offer to compete. The state enacting the differential tax scheme realizes revenue in the amount of the shaded area, *i3i2E2F*,[128] while investors in out-of-state bonds experience a "deadweight loss" measured by the shaded area *GE2E1*.[129] The state's welfare, however, will be decreased if the "deadweight loss" exceeds the area *i1i3FG*, which is the cost of the differential tax borne by out-of-state borrowers.[130] Empirical evidence suggests that indeed differential state taxation schemes diminish in-state welfare.[131] This result is approximated by Figure 3. This figure is the same graphical representation as Figure 2. It has been altered to emphasize the allocation of the costs of differential taxation as between in-staters and out-of-staters.

128. *See* APPLEYARD ET AL., *supra* note 127, at 301.
129. *See id.*
130. *Id.*
131. *See* Cole et al., *supra* note 94, at 73.

Figure 3: Diminished Welfare Caused by Differential Taxation[132]



While there are certain situations in which differential taxation provides putative local benefits, as in the case of small municipalities,[133] research suggests that the net effect on state welfare is actually negative.[134] An economic analysis of differential taxation of the type described by *Pike* thus indicates that differential taxation of interstate municipal bonds imposes a burden on interstate commerce and might actually harm local interests by reducing tax revenue. *Pike*, however, requires that a differential taxation scheme produce a *positive* net benefit.[135] Accordingly, the Kentucky law might well be unconstitutional under *Pike*.

CONCLUSION

According to long-established dormant Commerce Clause precedent, if a statute is facially discriminatory, it is "virtually *per se* illegal."[136] Differential taxation schemes, which tax out-of-state

132. *See* APPLEYARD ET AL., *supra* note 127, at 301. For an explanation of the notations used in the figure, see *supra* note 101. The darkly shaded triangle, *GE2E1*, is larger than the lightly shaded area, *i1i2FG*.

133. *See* Dep't of Revenue v. Davis, 128 S. Ct. 1801, 1816 (2008); Brief for National Federation of Municipal Analysts, *supra* note 114, at 11.

134. Cole et al., *supra* note 94, at 73.

135. *See* Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

136. *Davis*, 128 S. Ct. at 1808 (quoting Or. Waste Sys., Inc. v. Dep't of Envtl. Quality of Or., 511 U.S. 93, 99 (1994)); *accord* City of Philadelphia v. New Jersey, 437 U.S. 617, 624 (1978) (declaring that economic protectionism elicits a per se rule of invalidity).

business activity differently than in-state activity, have historically been struck down by the Supreme Court as unconstitutional,[137] especially when, as here, a law "forecloses tax-neutral" decision making by investors.[138] The *Davis* Court, however, held that disparate tax treatment of in-state and out-of-state bond interest "is not susceptible to standard dormant Commerce Clause scrutiny owing to its likely motivation by legitimate objectives [rather than] . . . economic protectionism."[139] The Court upheld the tax regime based on the benefits derived by local governments, explaining that "[f]inancing for long-term municipal improvements" would be harmed if the scheme were to be struck down.[140] The Court thus analyzed the Kentucky statute as a non-discriminatory "government function" law.[141] Generally, the long-established principle outlined in *Pike v. Bruce Church* requires that a balancing test weigh the "putative local benefits" of the challenged statute against the "burden imposed on [interstate] commerce" when analyzing a "government function" statute.[142] However, the Court failed to analyze the law under the *Pike* balancing test normally reserved for such laws.

The *Davis* decision holds that " '[c]ourts as institutions are poorly equipped to evaluate with precision the relative burdens of various methods of taxation.' "[143] The real effect of Justice Souter's opinion is to uphold the challenged law because of putative benefits without analyzing the burdens of the statute on interstate commerce. The Supreme Court punted on *Pike*, first by saying *Pike* might not apply,[144] and second by holding that even if *Pike* did apply, the Court was not in a position to apply it because it lacked economic expertise.[145] This indecisive holding leads to two possible conclusions. First, the Court could be overturning the *Pike* balancing test. Second, the Court might be unsure when and how to apply the *Pike* balancing test. This confusion led to a tangled decision, where the Court

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137. *See* Fulton Corp. v. Faulkner, 516 U.S. 325, 346 (1996); Associated Indus. v. Lohman, 511 U.S. 641, 648–49 (1994); New Energy Co. v. Limbach, 486 U.S. 269, 274–75 (1988); Bacchus Imp., Ltd. v. Dias, 468 U.S. 263, 271 (1984); Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 329 (1977); Hale v. Bimco Trading, Inc., 306 U.S. 375, 379 (1939).

138. *See Boston Stock Exch.*, 429 U.S. at 331.

139. *Davis*, 128 S. Ct. at 1810 (citing United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth., 550 U.S. 330, 343 (2007)).

140. *Id.* at 1816.

141. *Id*. at 1810.

142. *Id.* at 1808 (alteration in original).

143. *Id.* at 1818 (quoting Fulton Corp. v. Faulkner, 516 U.S. 325, 342 (1996)).

144. *Id.* at 1817.

145. *Id.* at 1818.

weighed one factor then retreated, rejecting the balancing of putative local benefits against any other factor. Ultimately, the *Davis* decision leaves uncertain where the dormant Commerce Clause and the *Pike* balancing test stand.

Had the Court engaged in a *Pike* analysis, there is a serious question as to whether the challenged tax scheme would have passed constitutional muster. First, by analyzing the putative local benefits of differential taxation, it is apparent that small municipalities and some high-tax states benefit. However, evidence also suggests that the loss realized by these states as a result of foregone tax revenue from in-state bond interest outweighs the benefits.[146] Second, by analyzing the impact on interstate commerce, it appears that the tax scheme discourages interstate capital flows and increases borrowing costs to states aiming to borrow from out-of-state bond holders.[147] Whether the "burden imposed on interstate commerce is *clearly* excessive in relation to the putative local benefits"[148] is not certain, but the question is close enough not to be rhetorical; that is to say, the question demands an answer.

By waffling on the *Pike* question, the Court unnecessarily complicates and confuses dormant Commerce Clause jurisprudence and permits state regulation that frustrates the basic purpose of the Constitution by distorting the interstate bond market, licensing state protectionism, and fostering national economic inefficiency. This fails the spirit of long established dormant Commerce Clause jurisprudence promoting union and efficiency and contravenes the principles handed down in previous differential taxation cases.[149] Given that this decision blurs the Commerce Clause analysis for laws such as the Kentucky tax scheme, the Court should reconsider the *Davis* decision to clearly follow or denounce the *Pike* analysis and clarify dormant Commerce Clause jurisprudence.

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146. Cole et al., *supra* note 94, at 73.
147. *See* Blumstein, *supra* note 93, at 547.
148. *Davis*, 128 S. Ct. at 1808 (quoting Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970)) (emphasis added).
149. *See* Fulton Corp. v. Faulkner, 516 U.S. 325, 346 (1996) (striking down a differential taxation scheme). For other examples of the Court striking down differential taxation schemes, see Bacchus Imp., Ltd. v. Dias, 468 U.S. 263, 273 (1984); Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 331 (1977); Baldwin v. G.A.F. Seelig, Inc., 294 U.S. 511, 523 (1935).