

An Analysis of the Potential Market Impact of *Davis v Kentucky*

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by

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Overview

- Analysis of the validity of the *Davis v Dept. of Revenue of the State of Kentucky* (197 S.W. 3d 557) ruling is complex because underlying issues cut across multiple disciplines: law, economics, public finance and political science.
- The approach that the US Supreme Court is apt to follow in reviewing this case will most likely track the methodology employed in *United Haulers v Oneida-Herkimer Solid Waste Authority* (550 US_2007) decided April 30, 2007.

Overview

- The *United Haulers* decision reflects a disposition of the Court to adopt a *reduced level of scrutiny* when reviewing Commerce Claims against public entities. The Court held that a flow control ordinance that required private haulers to tip waste at a public landfill did not discriminate against private vendors. The Court reasoned that government entities are vested with responsibility to protect the health safety and welfare of citizens, and should be granted wide latitude under their police power to achieve these objectives.

Overview

- Support for State Autonomy: In United Haulers, Chief Justice Roberts noted that “the Commerce Clause does not elevate free trade above all other values”. A public purpose mandate distinguishes the role of government from that of private business such that “treating public and private entities the same under the Commerce Clause would lead to unbounded interference by the courts with state and local government”.
- Application to Davis v Kentucky: In reviewing the dormant Commerce Clause claim in Davis v Kentucky, the Court is apt to carefully consider

Overview

- the public benefits of state action against the burden placed upon interstate commerce.
- Market Factors: To comprehend the relative importance of market factors as a component to a Benefit-Burden Analysis, it is useful to review all key factors that the Court is likely to consider within a Benefit-Burden comparison.
- Benefits: In assessing benefits associated with Kentucky's policy of exempting in-state bonds from personal income taxation, this list would include the following:

Profile of Benefits

- a. Legal Rationale
- b. Historical Precedent
- c. Consistent with State Sovereignty
- d. Fiscal Policy Advantages
- e. Avoid Adverse Market Results

A. Legal Rationale

- In General: The policy rationale for exempting in-state bonds from state income tax is twofold: (a) to leverage federal exemption with state tax exemption to further reduce borrowing costs; and (b) to apply borrowed proceeds to a wide range of locally-defined public purposes

A. Legal Rationale

- Core Objective: The policy rationale is *not to discriminate* against other states but to use tax-exempt borrowing as a *fiscal tool* to promote economic growth. Rather than being a form of “economic retaliation”, in-state exemption represents a means of *subsidizing* development of *public infrastructure* within each jurisdiction, and at the same time, *encouraging state citizens to act as stakeholders*.

A. Legal Rationale

- Public Purpose Is Not Protectionism: The fiscal policy of states that aggressively promote development of public infrastructure is inextricably linked to its role as a market participant. Promoting internal growth of public infrastructure through tax-exempt borrowing is distinguishable from erecting local “trade tariffs”, for at least four reasons.

A. Legal Rationale

Tax-Exemption is Not a Trade Tariff

1. Not Geographic Discrimination
2. State Not Acting as Regulator
3. All States On a Level Playing Field
4. Widespread Public Support from all States

A. Legal Rationale

Tax-Exemption is Not a Trade Tariff

1. Not Geographic Discrimination: Subject only to the exception for municipal bonds issued within the State, interest earned on all other obligations, corporate and municipal, issued both within and outside the State, is subject to taxation, *regardless of geographic origin.*

A. Legal Rationale

Tax-Exemption is Not a Trade Tariff

2. State Not Acting as Regulator: The policy objective of Kentucky's tax scheme is to lower internal borrowing costs on intrastate debt, not to hinder the sale of municipal bonds from out-of-state issuers. This goal is accomplished, moreover, not by *exercising* its taxing power against out-of-state entities but by *foregoing* the right to tax obligations of issuers within *its* jurisdiction.

A. Legal Rationale

Tax-Exemption is Not a Trade Tariff

3. Level Playing Field: Kentucky's tax policy is not targeted against other entities but designed to stimulate development of public infrastructure. Moreover, the alleged victims of in-state exemption are not private vendors but other public entities with equal rights and powers. Forty-two jurisdictions have enacted similar tax policies. Any suggestion that Kentucky's fiscal policy constitutes "economic protectionism" is negated by the reciprocal right of other states to enact identical measures.

A. Legal Rationale

Tax-Exemption is Not a Trade Tariff

4. Widespread Public Support: Amicus briefs in support of Kentucky's position have been filed by 49 other states and by a vast collection of state and local government professional associations which include: (a) the GFOA; (b) the National League of Cities; (c) the National Governors Association; (d) the National Conference of State Legislatures; (e) the National Assoc. of Counties; (f) the Council of State Governments; (g) the US Conference of Mayors; and (h) the Int'l City/County Mgt Assoc.

B. Historical Precedent

- For nearly a century, states have maintained exemptions similar to the State of Kentucky that favor in-state bonds
- Until the *Davis v Kentucky* decision, no court in the United States, state or federal, ever held that differential tax treatment was unconstitutional
- This precedent was implicitly supported by the US Supreme Court's decision in *Bonaparte v Tax Court* (104 US 522, 1881) which held

B. Historical Precedent

- that New York, by exempting its own bonds from income taxation, could not compel the State of Maryland to do so.
- Congress has long been aware of this practice and its power to regulate state taxation of interstate commerce. Even though \$2.4 trillion bonds have been issued pursuant to differential tax treatment, Congress has never seen fit to prohibit this practice.

C. State Sovereignty

- The right of states *to adopt their own fiscal policy* is consistent with the notion of shared power between the states and federal government.
- The right *to borrow funds* to finance improvements is a power fundamental to all other aspects of state sovereignty because the provision of public goods and services depends upon financial resources.

C. State Sovereignty

- The power of states *to establish tax policy* with respect to *interest earned on in-state bonds* is a *corollary* right that should be deemed co-extensive to the right to borrow.
- This policy does *not* operate as an invidious form of *geographic discrimination* because it is directed at spurring development of internal public projects, not at discriminating against out-of-state securities.

C. State Sovereignty

- Conclusion: So long as the exercise of taxing power is not applied in a discriminatory manner, the power of states to tax, or to exempt from tax, interest earned on municipal bonds, is an essential attribute of state sovereignty that should not be limited or impaired.

D. Fiscal Policy Advantages

- Dual-Benefit: Forty-two states provide exemption of in-state bonds from state tax. This practice promotes a dual fiscal objective: (i) exemption of in-state bonds increases the taxable-equivalent yield to investors, which results in *lower borrowing costs*; (ii) the ability to tax interest on corporate bonds and out-of-state municipal securities *generates substantial tax revenue*.

D. Fiscal Policy Advantages

- If Davis v Kentucky is Affirmed: This dual financial objective would be irrevocably lost because in order to effectuate equal tax treatment, states would be required to either; (a) tax interest earned on all municipal bonds, including in-state securities; or (b) exempt interest earned on all municipal bonds, including out-of-state securities.

D. Fiscal Policy Advantages

- A. Lower Borrowing Costs: Since the exemption from state income tax increases after-tax yields, state and local issuers can borrow funds at lower effective rates.
- Note: Actual borrowing rates vary based upon many factors including differences in state marginal tax rates, borrower credit quality, bond maturity and redemption features. But, the higher the tax rate, the greater the reduction in borrowing costs.

D. Fiscal Policy Advantages

- In Practice: Actual savings to state issuers varies by jurisdiction. One report estimates in-state exemption from income tax confers a .10% (10 bp) savings for CA, an .08% (8 bp) savings for NY and a .05% (5 bp) savings for MA and VA. Another posits that reduction in borrowing costs for high tax states such as NJ, NY and CA were .20% (20 bp), .12% (12 bp) and .08% (8 bp), respectively, lower than low tax states.

D. Fiscal Policy Advantages

- In Practice: Presented below are estimated spread relationships between several large with relatively high tax rates compared to Illinois which offers no state exemption.

State GO Spreads to State of Illinois

State GO	Rating		Cpn	Due	Call	Price	Spread to Illinois GO	2006 Issuance (Millions)	Approx Savings from Exemption
	Mdy's	S&P							
Illinois	Aa3	AA					--		
California	A1	A+	5.00	30 Yr	2017	100	7-10	33,834	\$24-\$34MM
New York	Aa3	AA	5.00	30 Yr	2017	100	5-8	21,070	\$10.5MM-\$17MM
New Jersey	Aa3	AA	5.00	30 Yr	2017	100	7-10	6,998	\$5MM-\$7MM
Georgia	Aaa	AAA	5.00	30 Yr	2017	100	8-10	4,532	\$3.6MM-\$4.5MM
Virginia	Aaa	AAA	5.00	30 Yr	2017	100	5-8	3,922	\$2MM-\$3.1MM
Mass	Aa2	AA	5.00	30 Yr	2017	100	5-10	6,263	\$3.1MM-\$6.2MM
Penn	Aa3	AA-	5.00	30 Yr	2017	100	5-10	10,188	\$5MM-\$10MM
No Carolina	Aaa	AAA	5.00	30 Yr	2017	100	8-12	5,197	\$4.2MM-6.2MM

Note: This data was obtained from the Van Kampen Trading desk on Oct. 15, 2007

D. Fiscal Policy Advantages

- In Practice: If state income tax exemptions were eliminated, over a 7 to 10 year time frame this would produce a present value loss of \$1.21 billion for NJ, \$2.18 billion for NY and \$2.43 billion for CA. (See also Van Kampen data on previous slide)
- B. Substantial Tax Revenue: State taxation of interest on out-of-state bonds also yields substantial tax revenue. The State of California discloses in its Oct. 5, 2007

D. Fiscal Policy Advantages

- Preliminary Official Statement that revenue derived from taxing interest on out-of-state bonds amounts to an estimated \$165 to \$170 million each year.
- Although potential state tax revenue on all municipal debt has never been calculated, it is possible to compile a rough estimate. Since total outstanding municipal debt in the US equals

D. Fiscal Policy Advantages

- \$2.4 trillion, assuming an average effective tax rate of 3%, could total \$3.6 billion dollars per year.

E. Avoid Adverse Market Results

If the right of states to exempt in-state debt from income taxation is struck down, this will result in a substantial reconfiguration of the municipal bond market. If the US Supreme Court affirms *Davis v Kentucky*, this would require a change in the tax policies of 42 separate states.

Set forth below is a more complete list of adverse market consequences.

E. Avoid Adverse Market Impact

If the right of states to exempt in-state debt from income taxation is invalidated, this could lead to several adverse consequences to the municipal market:

- a. Diminished State Revenue**
- b. Demise of Single State Funds**
- c. Reduced Market Access for Small Issuers**
- d. Market Fragmentation**
- e. Prolonged Legal and Market Uncertainty**
- f. Loss of Investor Confidence**

E. Avoid Adverse Market Results

a. Diminished State Revenue: If *Davis v Kentucky* is affirmed, states would be forced to alter fiscal policy to ensure equality of tax treatment for interest earned on all municipal bonds. This would force adoption one of two remedial policies:

Option A: Tax interest on all municipal bonds; or

Option B: Exempt interest on all municipal bonds

E. Avoid Adverse Market Results

- a. Diminished State Revenue: Adoption of *either* Option A or Option B leads to diminished state revenue. Consider the initial impact under each scenario:

Option A: If states elect to tax all municipal bonds pursuant to Option A, this will lead to higher borrowing costs on all state and local municipal bonds of +20 bp or more. Over time, this could produce added expense of perhaps \$4.8 billion annually for a debt market sized at \$2.4 trillion.

E. Avoid Adverse Market Results

- a. Diminished State Revenue: Likewise, if states instead elect to exempt all municipal bonds from personal income tax, this also entails a substantial loss.

Option B: If state tax exemption is extended to all municipal debt, states will forfeit a substantial amount of personal income tax revenue that otherwise derives from a \$2.4 trillion total market. Assuming an average marginal rate of 2.5%, this yields lost tax revenue of \$60 billion.

E. Avoid Adverse Market Results

a. Comparison of Options:

Preliminary Conceptual Comparison	
Option A Tax Bonds	Option B Exempt Bonds
+ <u>Revenue</u>	+ <u>Revenue</u>
- New tax on domestic municipals	- Exemption preserves lower % costs
- Retroactive tax on domestic munis	- Retroactive tax on in-state bonds
- <u>Lost Revenue</u>	- <u>Lost Revenue</u>
- Lost exemption raises % costs	- Lost inc tax on out-of-state bonds
- Refunds on Out-of-State Bonds	- Refunds on Out-of-State Bonds
= <u>Net Change</u>	= <u>Net Change</u>

E. Avoid Adverse Market Results

- b. Demise of Single State Funds: The exemption from state income taxation is the raison d'être for the creation of Single State mutual funds.
- There is almost total overlap between the establishment of Single State funds and the existence of corresponding state income tax exemption within each state, except Florida.
 - If State tax exemption were eliminated under Option A, the incentive for maintaining Single State funds would be eliminated.

E. Avoid Adverse Market Results

- c. Reduced Market Access for Small Issuers:
Under Option A, the demise of Single State funds would also present problems for small municipal issuers which account for 50% of the total number of issuers.
- Reason: Due to restricted supply, Single State funds have strong demand for “specialty paper”, inclusive of less-liquid smaller bond issues, and serve as a ready outlet to purchase lesser known credits often ignored by large national funds

E. Avoid Adverse Market Results

- d. Market Fragmentation: If *Davis v. Kentucky* is affirmed, this will lead to greater fragmentation of the municipal market because of the multiplicity of responses that can be expected by 42 states that will be forced to amend state fiscal policy.
 - Reason: As illustrated in the following slides, the decision tree presented by invalidation of in-state bond exemption is extremely complex and entails a range of sub-choices that will create further variation and differences among the states.

E. Avoid Adverse Market Results

- d. Market Fragmentation: Set forth below is a list of sub-choices under Option A, a decision where a state elects to tax the interest on all municipals, in-state municipal bonds.

Option A Sub-Choices	
1	Tax New issued Bonds Prospectively
2	Tax New Issued + Outstanding Bonds Prospectively
3	Tax New Issued + Outstanding Bonds Prospectively and Retroactively

E. Avoid Adverse Market Results

- d. Market Fragmentation: Set forth below is a list of sub-choices under Option B, a decision where a state elects to tax exempt interest on all municipals, including out-of-state municipal bonds.

Option B Sub-Choices	
1	Exempt New Issued Bonds Prospectively
2	Exempt New Issued + Outstanding Bonds Prospectively
3	Exempt New Issued + Outstanding Bonds Prospectively and Retroactively

E. Avoid Adverse Market Results

- d. Factors Impeding Remediation: If States are ultimately required to choose Option A or Option B, several factors will complicate decision making. These include:
- Amount of existing revenue derived from taxing holders of out-of-state municipal bonds
 - Borrowing cost savings attributable to in-state exemption
 - Potential income tax refund liability if Option A is selected

E. Avoid Adverse Market Results

d. Factors Impeding Remediation:

- Consider legal process required to remove tax-exemption: (i) amend Constitution, as in California, Georgia; (ii) repeal general statute; or (iii) amend enabling statute.
- Evaluate extent and scope of any tax refund claims
- Analyze constitutional and legal restrictions governing retroactive taxation
- Analyze strength of impairment of contract claim for prospective retraction of tax-exemption

E. Avoid Adverse Market Results

- e. Legal and Market Uncertainty: Implementation of Option A or Option B will lead to legal and market uncertainty in the municipal market, for several reasons:
 - Refund Claims: If the practice of exempting interest earned on in-state bonds is declared discriminatory and unconstitutional, holders of out-of-state funds are apt to initiate actions to seek tax refunds for the previous three years, regardless of which Option is implemented. This is already transpiring in Kentucky.

E. Avoid Adverse Market Results

e. Legal and Market Uncertainty:

- Retroactive Taxation: If no action is taken to redress past discrimination by attempting to retroactively tax holders of in-state bonds, States face the prospect of higher refund liability from holders of out-of-state bonds.
 - Ability to proceed depends upon state law
 - Some legal precedent to support such action
 - Extent permissible, however, is unclear and certain to trigger immediate litigation

E. Avoid Adverse Market Results

e. Legal and Market Uncertainty

- Retroactive Taxation:

- Any attempt to retroactively tax in-state bonds would jolt the municipal market by injecting a new risk of taxability never before considered by investors

- Prospective Taxation: The extent to which States can prospectively tax pre-existing debt is also unclear, will vary from state to state and is likely to lead to litigation, uncertainty and price erosion

E. Avoid Adverse Market Results

e. Legal and Market Uncertainty

- Prospective Taxation:
 - Bonds are considered a contract under US Contract Clause
 - State tax-exemption is arguably an element of the contract, although case law is sparse
 - Any attempt to prospectively tax pre-existing debt is likely to spur impairment of contract claims in multiple jurisdictions

E. Avoid Adverse Market Results

- f. Loss of Investor Confidence: If forty-two States are forced to alter fiscal policy with respect to exemption of in-state municipal debt, this would represent an unfair surprise to the ordinary reasonable investor and undermine confidence in the municipal market
 - Imprudent Policy:
 - Investor trust is a crucial component of an orderly efficient market
 - Loss of confidence could lead to investor disaffection and weaker market

Profile of Burdens

- a. Market Efficiency
- b. Discrimination against Other States
- c. Windfall to High Bracket Taxpayers
- d. Minimal Savings to Issuers

Burdens

- a. Market Inefficiency: Supporters of *Davis v Kentucky* argue that the state subsidy provided by in-state exemption is inefficient because foregone tax revenue lost by the exemption exceeds the value of reduced borrowing costs

Burdens

- b. Discrimination v Other States: Supporters of *Davis v Kentucky* argue that the allocation of investment capital is distorted and the flow of capital funds across jurisdictions is actively discouraged due to widespread use of preferential in-state tax exemption.

Burdens

- c. Windfall to High Bracket Taxpayers: Supporters of *Davis v Kentucky* argue that due to what might simply be understood as “bracket-gap” wherein high-bracket investors are unable to absorb all municipal bonds, bonds must be sold at taxable-equivalent rates that are calibrated somewhat higher to appeal to lower bracket investors, thereby aggrandizing wealthy investors.

Burdens

- d. Inefficient Fiscal Transfer: Economists argue that state tax-exemption is also an inefficient way to promote intergovernmental fiscal transfer from the state to local government. A better way to subsidize local government would be through the creation of a program of direct grants from the state.

Final Observations

- Law of Unintended Consequences: Rather than promote a more uniform national market, if Davis v Kentucky is affirmed this could lead to greater differences and fragmentation in the municipal market and unleash a set of adverse consequences not adequately foreseen.
- Decision to Reconfigure Municipal Market Better Left to Legislature: The use of state tax exemption to subsidize the development of public infrastructure is a practice long enjoyed by a wide cross-section of the nation, backed by the legislatures of forty-two state governments. Tax-exempt financing is a fiscal tool that is perceived

Final Observations

- by public administrators to be an essential attribute of state sovereignty and is a practice that has received the tacit approval of Congress. The far sweeping change in tax policy implicit in the Davis v Kentucky decision is a matter best left to resolution by the legislative branch.
- Political Realities Trump Economics: Although not entirely efficient, tax-exemption is a fiscal tool that is easy to administer and enormously popular with state and local government. At a time when the nation's public infrastructure is in need of enormous additional investment, tax-exempt financing provides public administrators with a pragmatic means to address vital public needs.

Final Observations

- Dormant Commerce Clause: The fact that Davis v Kentucky is predicated upon a constitutional provision known as the “Dormant Commerce Clause” is extremely apt. Over the course of nearly an entire century, \$2.4 trillion of municipal securities have been issued without mention of this supposed violation of the Constitution. To interject a violation of this magnitude at this juncture calls into question the validity and seriousness of the supposed legal grievance.