

The Dormant Commerce Clause and the Balkanization of the Municipal Bond Market

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Outline

- Taxes/subsidies and interstate commerce
- Economic effects of selective exemption
- Legal exceptions to DCC, transition

State taxes and subsidies

- Types of sales
 - Out-of-state sales (both parties out-of-state)
 - Within-state sales (both parties in-state)
 - Interstate sales - exports, imports
- Constitutional restrictions on states
 - Cannot tax out-of-state sales
 - Neutral between within-state, interstate sales
- Import and export tariffs discriminate

Broad-based taxes

- Destination taxes neutral
 - Tax within-state sales and imports
- Origin taxes neutral
 - Tax within-state sales and exports
- Equivalence
- Internal-consistency test
 - What happens if all states adopt?
 - Test valid, regardless of what other states do

Broad-based subsidies

- Subsidies are negative taxes
- No coherent distinction
- Destination, origin subsidies neutral
- Internal-consistency test

Narrow-based taxes, subsidies

- Internally consistent taxes, subsidies may reduce interstate sales
 - Destination tax, origin subsidy on importable
 - Origin tax, destination subsidy on exportable
- Hard to evaluate

Nondiscrimination

- Between within-state and interstate sales
 - Applies to taxes and subsidies alike
- *Not* between in-staters and out-of-staters
- Out-of-state sales not taxed, subsidized
 - Taxes “discriminate” against in-staters
 - Subsidies “discriminate” against out-of-staters

State can favor in-staters, but not within-state sales

- Destination subsidy OK (imports included)
 - Encourages everyone to sell to in-staters
- Origin subsidy OK (exports included)
 - Encourages everyone to buy from in-staters
- Tariffs, within-state-sale subsidies not OK
 - Encourage in-staters to deal with each other

Camps Newfoundland (1997)

- Property tax break for camps serving residents
- Turned neutral origin tax into export tariff
- Subsidized only in-state camps serving residents
 - Not all in-state camps
 - Not all camps serving residents

Selective muni bond exemption

- Turns neutral (destination) tax on bonds into import tariff
- Subsidizes only state residents holding state's bonds (within-state holdings)
 - Not all holders of state's bonds
 - Not all residents holding muni bonds

Fatal combination

- Encourages Kentucky residents to hold Kentucky bonds
- Doesn't encourage nonresidents to hold Kentucky bonds

Effects of Kentucky subsidizing within-state holdings

- Interest rate on Kentucky bonds falls, but by less than subsidy
 - Higher returns for residents
 - Lower returns for nonresidents
- Residents substitute toward Kentucky bonds, nonresidents substitute away
- Interstate holdings reduced

Effects of Kentucky subsidizing within-state holdings

- Net Kentucky gain
 - Kentucky treasury loses - subsidies exceed interest savings
 - But, residents gain from higher returns
- Nonresidents lose from lower returns
- Net national loss

Effects of all states subsidizing within-state holdings

- Nationwide reduction in interstate holdings
- Nationwide losses
- Subsidies reinforce, not offset, each other

Balkanized, inefficient market

- Hundreds of single-state funds
- Less diversified, less liquid
- Higher expense ratios

Different from neutral subsidies

- Subsidy to all holders of Kentucky bonds
OR all muni bonds held by residents
 - No reduction in interstate holdings
- Preference for Kentucky bonds is NOT selective exemption's flaw

Market-participant, *United Haulers*

- Weak rationales
- Market-participant should not apply
 - Tax exemption, not market transaction
- *United Haulers* should not save exemption
 - Exemption doesn't pass balancing test
 - Doesn't apply to private-activity bonds

Transition

- Changes in market institutions
- Fiscal costs to states
 - Refunds
 - Extend exemption for outstanding bonds
 - Congress can offset

Outstanding bonds likely to rise
in value *if exemption extended*

- Value of outstanding bond: PDV of its after-tax payoffs (discounted using after-tax return on similar new bond)
- Outstanding bonds' after-tax payoffs rise
- Little change in new bonds' after-tax return
- Value increase likely

Conclusion

- Selective exemption is massive obstruction of interstate bond holdings
- Should be struck down under DCC

References

- Viard, *State Tax Notes*, Oct. 22, 2007
- Viard-Brill-DeMuth-Furman-Hassett-Hubbard-Smetters *amicus* brief