No. 06-666

IN THE

Supreme Court of the United States

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

Petitioners,

v.

GEORGE W. DAVIS AND CATHERINE V. DAVIS,

Respondents.

ON WRIT OF CERTIORARI
TO THE COURT OF APPEALS OF KENTUCKY

REPLY BRIEF FOR PETITIONERS

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REPLY BRIEF FOR PETITIONERS

The dormant Commerce Clause should not be expanded beyond laws that involve differential treatment of private businesses. A capital markets free-for-all pitting the States and their 87,000 local governmental units against each other would be politically and economically destructive.

I. The Kentucky law does not "discriminate" against interstate commerce.

A. *United Haulers* makes private business taxes and tariff analogies inapposite.

Language from pre-*United Haulers* cases which struck down tax laws treating in-state private businesses more favorably than out-of-state private business competitors, Resp. Br. 12-17, does not apply to this case. Neither the holdings nor the language of those cases impeded the Court's conclusion in *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Management Auth.*, 127 S.Ct. 1786, 1795 (2007), that laws which "benefit a clearly public facility, while treating all private companies exactly the same" do not "discriminate against interstate commerce." *United Haulers* expressly found a long line of cases invalidating local processing laws, "every one of which involved discrimination in favor of *private* enterprise" to be "readily distinguishable," and declined to extend those cases "to cover discrimination in favor of local government." *Id* at 1794 & n.4. There is no good reason to expand the language of tax cases involving private business enterprises, to a case which instead involves the financing of public projects and programs by State and local governments.

The notion that the Kentucky law is "equivalent to a tariff," Resp. Br. 18-19, similarly misses the point of *United Haulers.* If differential treatment of in-state trash processing services provided by a sovereign government, versus all other trash processing services, both in-state and out-of-state, does not constitute "discrimination against interstate commerce," then differential treatment of in-state interest paid by a sovereign government, versus all other interest paid by borrowers, both in-state and out-of-state, does not constitute "discrimination against interstate commerce."[1]

Nor does the analogy between the Kentucky law and a "protective tariff," the "paradigmatic example of a law discriminating against interstate commerce," *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 193 (1994), fit the facts of this case. The other 49 States, including all seven States that do not impose an income tax, are the out-of-state competitors whose bonds are subject to this imaginary tariff, yet they support Kentucky's position here. The in-state entity "pro-

[1] The Kentucky law thus satisfies the only prong of the four-part test of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), put in issue. The law also meets the other three requirements, *see* Pet. Br. 15-17, an observation not disputed by the Brief for Respondents. The belated suggestion that this case be remanded for a *Pike* balancing inquiry, *see* Resp. Br. 42-43, is neither warranted by the Court's decisions in tax cases over the past 30 years, *see* Pet. Br. 15 & n.14, nor necessary. The other 49 States and their local governments, as well as the Multistate Tax Commission, the National Association of State Treasurers, the Government Finance Officers Association, and the Securities Industry and Financial Markets Association, support Kentucky's position, negating any serious thought that the "burden imposed" on interstate commerce "is clearly excessive in relation to the putative local benefits" to Kentucky and its local governments of obtaining market access for their own bonds on favorable credit terms, *see Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970).

tected" by this imaginary tariff is the sovereign government of Kentucky, not private businesses in the local dairy industry, the local liquor business, or the local stock exchange. The Court has pointedly noted that the "label of protectionism [is] of little help" when, as here, a State itself participates in the relevant market as a buyer or seller, *Reeves, Inc. v. Stake*, 447 U.S. 429, 442 (1980); *accord, id.* at 447 n.1 (Powell, J., dissenting) ("By 'protectionism,' I refer to state policies designed to protect private economic interests within the State from the forces of the interstate market.")

The tariff analogy breaks down completely when we recognize that the law upheld in *United Haulers* was the exact equivalent of a "home embargo," the other chief exemplar of laws that "discriminate against interstate commerce." Similarly, the laws upheld in *Alexandria Scrap* and *White* foreclosed competition by out-of-state workers for in-state jobs just as effectively as a blockade at the state line.

Respondents' argument by analogy does not advance the analysis in this case. Laws "like" home embargoes and "like" border blockades have been upheld against dormant Commerce Clause challenges in those cases where the law favored a governmental entity (*United Haulers*) or where the State or local government was a market participant (*Reeves*, *Alexandria Scrap*, and *White*). This case involves both a law which favors only a State and its local governments, and a fact pattern in which the market participation of the State and its local governments is undisputed. No doubt the tax laws of 42 States treat sister State bond interest differently than interest paid on their own bonds. The issue is whether the reasoning of *United Haulers*, which speaks directly to a law that favors the State or local government itself, should channel the inquiry here, rather than cases involving different taxation of in-state versus out-of-state private business firms.[2]

B. "Public" means sovereign.

Respondents apparently concede that Kentucky's exemption for interest paid on Kentucky bonds does not violate

[2] Amici Viard *et al.* argue that the state tax exemption for interest paid on "private activity bonds" should not be sustained under *United Haulers* because "private parties are the actual borrowers, not state or local governments." Viard Am. Cur. Br. 26. This is both an oversimplification and a non-sequitur. "Private activity bonds" issued by States and local governments finance projects and programs that serve overwhelmingly public purposes. Over 80% of all "private activity bonds" issued from 1996-2004 financed (i) tax exempt entity projects (primarily hospitals owned by 501(c)(3) entities), (ii) airports, (iii) multifamily housing projects and low-to-moderate income mortgage loan programs, and (iv) student loan programs. Belmonte, *Tax-Exempt Bonds, 2003-2004*, pp. 246, 255-256 (IRS Statistics of Income Division 2006); Belmonte, *Tax Exempt Bonds, 1996-2002*, pp. 151-158 (IRS Statistics of Income Division 2005). Congress has expressly authorized "private activity bonds" to be treated the same as "governmental bonds," *i.e.*, as a permissible use of public finance to support Congressionally specified types of projects that are in turn approved by State and local governments as means of accomplishing State and local governmental objectives. Such bonds must be approved by a State or local government, *see* 26 U.S.C. § 147(f), and are used to finance public infrastructure facilities such as docks and wharves, mass commuting facilities, solid waste disposal facilities, sewage facilities, and high-speed intercity rail facilities, *see* 26 U.S.C. § 142(a) (definition of "exempt facility bonds" classified as "private activity bonds"). The issue sought to be raised by Amici — that state tax exemptions for private activity bonds should be invalidated even though the exemption for other State and local bonds is sustained — was never raised in the courts below, and should not be considered by the Court now. Nothing in the record reveals whether the sister State bonds held by Respondents are governmental bonds or "private activity bonds," so Respondents have no standing to raise any claim related exclusively to "private activity bonds." *DaimlerChrysler Corp v. Cuno*, 126 S.Ct. 1854, 1867 (2006) ("a plaintiff must demonstrate standing for each claim he seeks to press").

the dormant Commerce Clause notwithstanding that Kentucky taxes interest paid on bonds or other debt obligations issued by all private borrowers, both in-state and out-of-state. Respondents argue nonetheless that Kentucky treats "similarly situated *public* entities" differently than Kentucky itself, Resp. Br. 24-25, an argument which begs the question whether sister States and local governments are "public" entities within Kentucky.

A sister State has no powers or responsibilities within Kentucky that are any different than the powers and responsibilities of a private business corporation in its business dealings with Kentucky creditors. The only relationship of the sister State to a Kentucky resident bondholder is contractual (debtor and creditor), not political (sovereign and citizen), just like the relationship of a private business debtor to its creditors. If the sister State defaults on its bonds, it may be sued in Kentucky just like any private business borrower.

Conversely, a sister State has none of the powers and responsibilities within Kentucky that are unique to "public" entities in Kentucky. A sister State has no police power in Kentucky, either directly through its law enforcement officers or indirectly through the extraterritorial application of its laws. A sister State cannot tax Kentucky real property or intangible property owned by a Kentucky resident.

That municipal bonds issued by different States may be "similar financial commodities traded in the same market," Resp. Br. 20-25, is irrelevant. The out-of-state trash processing facilities in *United Haulers* were no doubt "similar" to the in-state public facility, and were viable competitive alternatives in the market. The effort to distinguish *United Haulers* because it was a police power case rather than a tax case, Resp. Br. 31-32, is a distinction without a difference. The claim that, unlike *United Haulers*, the burden of the Kentucky law falls on those who cannot vote in Kentucky, Resp. Br. 28-29, 32-33, is mystifying. Respondents and every other Kentucky resident bondholder 18 or over who pays tax on sister State bond interest, are eligible to vote in Kentucky. The arguments that a law which favors a sovereign government versus all other entities, nonetheless treats in-state and out-of-state entities in "a facially disparate manner" and constitutes "simple economic protectionism" in violation of the dormant Commerce Clause, Resp. Br. 7, 12-17, 19-20, were considered and rejected in *United Haulers*.

Bonaparte, *Georgia v. Chattanooga*, *Nevada v. Hall*, and the Court's federalism cases, *see* Pet. Br. 29-35, apply the constitutional principle that one State is not a "public" entity within another State's jurisdiction, which Respondents try to deflect by noting that these decisions were not Commerce Clause cases. This mistakes the trees for the forest.

Bonaparte v. Tax Court, 104 U.S. (14 Otto) 592 (1881), is most instructive on the specific issue: "[I]f a State could protect its securities from taxation everywhere, it might succeed in borrowing money at reduced interest; but, inasmuch as it cannot secure such exemption outside of its own jurisdiction, it is compelled to go into the market as a borrower, subject to the same disabilities in this particular as individuals." 104 U.S. at 595.

Respondents misread this crucial holding as referring to the taxing State, rather than the borrowing State, *see* Resp. Br. 40. That *Bonaparte* referred to the borrowing State is, however, clear from its holding in the immediately preceding paragraph that "the debtor State is in no respect his [the resident of the taxing State] sovereign, neither has it any of the attributes of sovereignty as to the debt it owes." 104 U.S. at

595.[3] It is the sister State as borrower that "cannot secure such exemption outside of its own jurisdiction," i.e., within Kentucky, is "subject to the same disabilities . . . as individuals" and other private borrowers within Kentucky.

Precisely because a debtor State with no sovereign power or responsibility within Kentucky is no different than a private business borrower, the Kentucky law challenged here should be sustained by a straightforward application of the *United Haulers* analysis. *United Haulers* would have reached the same result, by the same reasoning, if the out-of-state trash processing facilities had been owned by a sister State rather than a private business entity.

II. The alleged past harms and future benefits are unsupported in the record.

The Brief for Respondents claims that the Kentucky law "harms out-of-state issuers" and "out-of-state private sellers (underwriters, individuals, and investment funds)" by "blocking their access" to capital in Kentucky; "harms the

[3] Respondents attempt to dilute *Bonaparte's* strength by pointing out that the 1876 Maryland property tax statute at issue in *Bonaparte* did not generally exempt State bonds, Resp. Br. 39-40. But no such exemption would have been necessary: Maryland had exempted its own bonds under the statutes authorizing the issuance of State bonds, *see, e.g., Proceedings and Acts of the [Maryland] General Assembly, March 30, 1868*, vol. 142, p. 2742, Laws of Maryland ch. 235 § 1 (amending and reenacting 1865 legislation authorizing Treasurer of the State "to issue bonds or certificates of debt, which said bonds or certificates of debt shall be exempt from State, county and municipal taxation . . . in the name and on behalf of the State of Maryland, to an amount not exceeding four millions of dollars"), available at Maryland Archives Online, http://aomol.net/megafile/msa/speccol/sc2900/sc2908/000001/000142/html/am142--2742.html.

States by compelling them" to enact laws "that decrease their net revenues"; and imposes a tariff "on out-of-state municipal bonds" that "hoards private capital" and "impedes interstate commerce" by "creating a barrier to the sale of out-of-state municipal bonds in Kentucky." Resp. Br. 9, 3, 18, 28, 26. Nothing in the record supports this jeremiad.

The only "out-of-state issuers" are the other States and their local governmental units. Nothing in the record demonstrates that the borrowing costs of other States, or the demand for their bonds, is in any way negatively affected by the Kentucky law. The other 49 States and their local governments support Kentucky's position as Amici Curiae.

Nothing in the record shows that any transactions of "underwriters" or "investment funds," either in the national bond market or with Kentucky investors, have been negatively affected by the Kentucky law. The Securities Industry and Financial Markets Association, whose members account for 90% of the nation's municipal bond underwriting and trading activity by volume, supports Kentucky's position as Amicus Curiae, as do several large fund sponsors and underwriters.

The only "individuals" in the record are Respondents themselves, who merely alleged that they paid Kentucky income tax on interest "derived from obligations of sister states," Complaint ¶ 14, J.A. 20, held by national bond mutual funds, Resp. Br. 4. Thus the composition of Respondents own portfolio — and the holdings of the national bond funds which account for about 20% of the market, or $500 billion — disprove rather than support Respondents' unsupported allegations that "access to capital" is blocked by the Kentucky exemption.

Respondents' pollyanna prediction that "the market will adjust quickly," Resp. Br. 46, if the Court invalidates the laws of 42 States, is neither credible nor supported by anything in the record.[4] If the municipal bond market has been "distorted" for decades by the laws of 42 States, it is difficult to imagine anything less than a sudden and violent reversal of the "inefficiencies" allegedly caused by the bond interest exemption, and we can be sure that it won't be pretty. This is no time for the Court to plunge public finance into cold, deep water with no idea of where the bottom is. "[T]he Court is institutionally unsuited to gather the facts upon which economic predictions can be made, and professionally untrained to make them." *General Motors Corp. v. Tracy*, 519 U.S. 278, 308 (1997).

Nor is any precipitous action necessary. Congress exhaustively studied the effects of State taxation on interstate commerce, and was fully informed about the differential taxation of sister State bond interest by the States, yet did nothing. *See* Pet. Br. 37-39. "The clear implication is that Congress finds the benefits" of the longstanding and widespread public finance practices of the States "well within the realm of what the States may reasonably promote and preserve." *General Motors*, at 305. If something now needs to be done to protect interstate commerce, Congress can do it.

It would be reckless to ignore the assessments of industry experts about the effects of invalidating the current system, which range from "significant disruption to municipal bond markets," National Association of State Treasurers

[4] Nor are the assertions that Kentucky and the 49 other States "would all be better off" to abandon the policy decisions of their legislatures because the States "lose more revenue" through the exemption "than they gain by borrowing at lower rates," Resp. Br. 29-31.

Br. Am. Cur. 17, to "instability and price uncertainty in the national municipal bond market," Securities Industry and Financial Markets Association Br. Am. Cur. 4. Concern that "disruption to the existing municipal bond market, and the adjustment from a system that has prevailed for close to a century, would be substantial," National Federation of Municipal Analysts Br. Am. Cur. 16, is well-founded. Nor is it alarmist to fear that many local government issuers would be lost in the shuffle and might be deprived of market access altogether, with no alternative for the "funds that they otherwise would have been able to raise for needed improvements," Nuveen Investments, Inc. Br. Am. Cur. 18. In 2004, for example, almost half of the 14,419 new money long term tax exempt governmental bond issuances was for small bonds with an entire issue price of less than $1.0 million, and bonds with an entire issue price of less than $5.0 million accounted for about 75% of all issues, but only 6.7% of total proceeds. A total of 437 bond issues (3.0%) exceeded an issue price of $75 million, but the combined proceeds of this three percent comprised 59.1% of total proceeds. Belmonte, *Tax Exempt Bonds 2003-2004,* p. 252 (IRS Statistics of Income Division 2006). Hazarding the access to capital of thousands of local governments would not be judicious. "Still less is that risk justifiable in light of Congress' own power and institutional competence to decide upon and effectuate any desirable changes" in the public finance practices of the States "that [have] evolved" over the past 100 years. *General Motors,* at 309.

III. A tax exemption for bond interest received is equivalent to the payment of additional interest.

The economic reality of the municipal bond market is that both the federal exclusion and any applicable state level exemption are treated by creditor bondholders, debtor governments, and all other market participants as the payment of additional interest.

A. All market participants treat the exemption as additional interest.

All the borrowers are sovereign States or their political subdivisions. Their chief financial officers regard the tax exemption as the payment of additional interest. *See* Br. Amicus Curiae National Association of State Treasurers 10 ("Kentucky's tax exemption is economically equivalent to a higher interest rate for Kentucky taxpayers.") All the lenders are bondholders, each of whom regards the exemption as the payment of additional interest. *See* Br. Amicus Curiae State of North Carolina, et al. 2 ("Bond purchasers . . . are motivated by the net return on the investment (i.e., the income stream produced by the bond less taxes imposed on this income).").

Municipal bond analysts, investment bankers, and other industry professionals all evaluate municipal bond investments by comparing the effective "taxable equivalent" yield or the "net after tax" yield on bonds to the returns available from competing investments. Temel, The Bond Market Association, *The Fundamentals of Municipal Bonds*, 28-29 (5th ed. 2001). That comparison treats the federal exclusion and the applicable state exemption as additional interest paid by the issuing State. *See* Br. Amicus Curiae Nuveen Investments, Inc. 3 ("the economic reality of the Kentucky exemption . . . is the fact that the exemption is the equivalent of an additional interest payment").

Respondents apparently agree. "Kentucky citizens are willing to accept less interest because they pay no state income tax on their earnings." Resp. Br. 6. That is, the tax exemption is a substitute for additional interest. Respondents' industry source confirms that "the yields on [bonds] are therefore often articulated in terms of the taxable interest rate that would be required to provide the same after tax interest rate," and provides a "formula for determining the equivalent taxable interest rate."[5]

B. Economic substance is the touchstone.

The Court has often remarked that "it is the substance of the transaction, rather than the label attached to it, that governs Commerce Clause analysis," *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 99 n.11 (1984); "eschewed formalism for a sensitive, case-by-case analysis of purposes and effects," *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 201 (1994); and focused on the "practical operation" of a statute, *Best & Co. v. Maxwell*, 311 U.S. 454, 455-456 (1940).

The economic reality and practical effect of the exemption for bond interest should not be ignored. Rather, where a tax exemption applies directly and exclusively to the payment of money by a State to a third party, such as the payment of interest on the State's own debt obligations, the exemption should be treated as the payment of additional money by the State for Commerce Clause purposes, not as a "discriminatory tax."

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[5] Van Bergen, *Weighing the Tax Benefits of Municipal Securities,* Investopedia.com (July 28, 2004). The same formula to determine the equivalent taxable interest rate is illustrated and explained by the National Association of State Treasurers in its Amicus Curiae Brief in Support of Petitioners, at pages 5-6.

C. The exemption-equals-subsidy issue is not implicated here.

The Court's reluctance to equate tax exemptions for in-state private businesses, with direct subsidies to in-state private businesses, derives from the ineluctable tension between the "essential purpose" of state government and the principal objectives of dormant Commerce Clause adjudication. On the one hand the "essential and patently unobjectionable purpose of state government [is] to serve the citizens of the State." *Reeves, Inc. v. Stake*, 447 U.S. 429, 442 (1980). Hence "a pure subsidy funded out of general revenue ordinarily imposes no burden on interstate commerce, but merely assists local business." *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 199 (1994). On the other hand are the dark side scenarios that if tax exemptions, standing alone, are (i) treated as a purchase of some service or product by the State "the 'market participant' exception would swallow the rule against discriminatory tax schemes," *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 594 (1997), or (ii) treated as direct subsidies, then tax exemptions for in-state private business that are denied to out-of-state private business entities or transactions could claim constitutional shelter under the rule that "direct subsidization of domestic industry does not ordinarily run afoul" of the dormant Commerce Clause, *New Energy Co. v. Limbach*, 486 U.S. 269, 277 (1988).

If the Court respects the economic reality of the bond market, it would do no violence to *New Energy*, *Camps Newfound*, or *West Lynn*, the three Commerce Clause cases in which the exemption-as-direct subsidy issue has been raised, or to the results or the reasoning of *Boston Stock Exchange*, *Bacchus*, or *Fulton Corp.*, all of which involved taxes on transactions between third parties or on property owned by third parties, not transactions in which a State was directly involved.

D. Economic reality shows no market harms and no "discrimination."

Attention to the economic reality of the market should allay any concerns that the principal purposes of the dormant Commerce Clause are threatened or that there is any "discrimination" against interstate commerce.

At the very least, the economic reality of the bond market scuttles the notion that the exemption "distorts" or "balkanizes" the market. Investment capital seeks the highest "taxable equivalent yield" or "net after tax return" in any market, not just the municipal bond market. Investing to generate capital gain rather than ordinary income, and investment through a nontaxable ERISA account rather than a taxable brokerage account, are two familiar examples. This is no "distortion" or "inefficiency," it is economic reality. Capital is not "hoarded" if it seeks the highest "taxable equivalent yield," whether that yield is produced by the state bond interest exemption or the federal exclusion for bond interest. "Economic balkanization" is properly invoked only when subdivision of larger market territory produces weakness and instability. Yet the bond market functions well in providing the Nation's 87,000 local governments with essential financing.

At a greater magnification, an economic reality analysis forces the question whether a tax exemption applicable exclusively to the payment of interest owed by a borrower State, can ever correctly be said to "burden" or "discriminate" against interstate commerce. If Kentucky simply increased the contract interest rate on its bonds, and gave

Kentucky residents first dibs, it could not be seriously maintained that the dormant Commerce Clause would be transgressed. The economic substance and practical effect of the bond interest exemption — treated by all market participants as additional interest — are no different.

E. A *quid pro quo* tax exemption is not a "penalty."

The suggestion that the Kentucky exemption "penalizes" Respondents for their "participation in interstate commerce," Resp. Br. 4, misconceives the quid pro quo relationship between borrower States and creditor bondholders. The bondholder provides credit to Kentucky on favorable terms, and Kentucky in return makes cash interest payments to the bondholder and pays additional interest equal to the value of the tax exemption. By comparison, if a Kentucky resident chooses to loan money to California, there is no benefit to Kentucky, no quid pro quo, for which the tax exemption should be granted.[6]

IV. A market participant State may use its tax power as part of a quid pro quo.

Respondents apparently concede that Kentucky is a "market participant" in the municipal bond market (without reference to the tax exemption in issue). Language yanked out of context from *New Energy, South-Central Timber,* and

[6] The same quid pro quo analysis undermines the argument for a "principle of competitive neutrality which prohibits States from taxing activity out of state while not taxing identical activity in state." The Tax Foundation Am. Cur. Br. 3-5. This idea has no application here: the out-of-state activity (a loan made to another State or any other debtor, for which Kentucky receives no consideration) is not identical to the activity in-state (a loan which makes capital available to Kentucky itself at favorable terms).

Camps Newfound, Resp. Br. 36-39, is therefore not helpful: those cases dealt exclusively with the question whether the State was a participant in the relevant market, not whether the dormant Commerce Clause limits the means by which the economic terms of that participation may be implemented.

South-Central Timber answers that question: "Our cases make clear that if a State is acting as a market participant . . . the dormant Commerce Clause places no limitation on its activities." 467 U.S. at 94.

The assertions that the market participation cases only "allow the State the rights of private parties," and only apply when "the State [is] acting as if it were a private party," Resp. Br. 3, 36, read *Reeves* backwards. *Reeves* held that when a State participates in a market as a buyer or seller (in that case, of state-manufactured cement), the State then "shares" with "private market participants" their "existing freedoms from federal constraints, including the inherent limits of the Commerce Clause." 447 U.S. at 439. There is no good reason this rule should suddenly be suspended when other States, each of which has the power to tax, are market participants as well. The contentions that "the Court has confined" the market participation doctrine to situations where the State participates "on the same terms as a private party," and that the Court "has held" the doctrine inapplicable when "the State imposes conditions only a state actor could impose," Resp. Br. 36, are not supported by citation to authority, because the Court has never said any such thing in its opinions.

To be sure, *New Energy* held that a tax credit, standing alone, could not constitute market participation by a State which was neither a buyer or a seller of a product, and referred to the "assessment and collection of taxes" as a "primeval governmental activity." 486 U.S. at 277. The word "primeval" means "primordial" or "from the first," and it was in this context that *New Energy* rejected Ohio's attempt to treat naked taxation of sales of a product, as "participation" in the sale. *New Energy* simply held that exercise of a power that governments have always exercised, such as the taxing power or the police power — does not constitute "participation" by a State in a market in which the State is neither a buyer nor a seller of products or services.

Where, as here, Kentucky's market participation as a buyer or seller (without reference to the tax exemption in question) is uncontroverted, the dormant Commerce Clause simply does not apply. *See, e.g., White v. Massachusetts Council of Construction Employers*, 460 U.S. 204, 209-210 (1983). All the participants in the relevant market economically treat the tax exemption as additional interest or yield to the bondholder. It blinks reality to invoke the dormant Commerce Clause and prevent Kentucky (or any other State) from using its taxing power to pay, in part, for the use of capital. The Court has been careful to confirm that its cases involving private businesses do "not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry," *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 336 (1977). That limit on those cases applies even more forcefully when the States structure their tax systems to help them obtain essential financing for public projects and public works.

If the Commerce Clause does not constrain the States' use of their tax systems to compete with each other for new industry, or the widespread use of State tax incentives for job creation, urban revitalization, or agricultural diversification,[7] then it would be anomalous indeed if the Commerce Clause prevents States from structuring their tax systems, vis-à-vis each other, to facilitate financing for public projects and programs.

V. Respondents' Import-Export Clause argument is neither timely nor applicable to interstate commerce or to interest payments.

Respondents' Import-Export Clause argument was neither presented to nor decided by the state courts, and should not be entertained by this Court on certiorari. *See, e.g., Kentucky v. Stincer*, 482 U.S. 730, 747 n.22 (1987). This is no "exceptional case" that might justify a departure from the rule. *McGoldrick v. Campagnie Generale*, 309 U.S. 430, 434 (1940) (refusing to consider respondents' Import-Export Clause argument raised for the first time on certiorari review of state court dormant Commerce Clause decision).

The longstanding construction of the Import-Export Clause is that the Clause applies only to imports from and exports to foreign countries, not to interstate commerce. *Woodruff v. Parham*, 75 U.S. (8 Wall.) 123 (1868). Even if this precedent were revisited, the scope of the Clause would extend only to (i) "imposts" and "duties" on (ii) "imports" and "exports." An income tax on annual interest from an in-

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[7] *See* Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 Harv. L. Rev. 377 (1996); Philip M. Tatarowicz & Rebecca F. Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879 (1986); Walter Hellerstein and Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 Cornell L.Rev. 789, 806-09 (1996).

tangible already owned by a resident bears little relationship to an "impost," which was "a tax levied on *goods* at the time of *importation*," *Camps Newfound*, 520 U.S. at 637 (Thomas, J., dissenting), or a "duty," which "though broader than an impost, which still a tax *on* particular *goods* or written instruments" such as bills of lading, *id.* at 639. Payment of a monetary obligation is not an "export" of money from the debtor's state or an "import" of money into the creditor's state.

CONCLUSION

The judgment of the Kentucky Court of Appeals should be reversed.

Respectfully submitted,

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