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

BRIEF *AMICUS CURIAE* OF NUVEEN INVESTMENTS, INC., IN SUPPORT OF PETITIONERS

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INTEREST OF *AMICUS CURIAE*[1]

Founded by John Nuveen in 1898 as an underwriter and trader of bonds, Nuveen Investments, Inc. has been an innovative participant in the municipal bond market for more than a century. The principal business of Nuveen Investments is asset management and related research, as well as the development, marketing, and distribution of investment products and services for the institutional and individual high-net-worth market segments.

As of June 29, 2007, Nuveen had approximately $63.6 billion in municipal assets under management. A significant portion of those assets are held in closed-end and open-end funds, which Nuveen Investments began offering in 1976. Currently, Nuveen offers state-specific closed-end and open-end bond funds, that is, funds that include tax-exempt bonds issued by a particular state and its political subdivisions, for 23 states, including Kentucky. As of June 29, 2007, Nuveen's Kentucky Municipal Bond Fund held assets valued at approximately $450 million.

As an organization with long experience and ongoing participation in the municipal bond market, Nuveen Investments is keenly interested in the issues presented in this case, and it believes that its accumulated knowledge and experience may be of assistance to the Court.

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[1] Pursuant to Rule 37.3, the parties have consented to the submission of this brief. Letters of consent have been filed with the Clerk. No party authored this brief in whole or in part, and no person or entity, other than *Amicus Curiae*, has made a monetary contribution to the preparation or submission of this brief.

INTRODUCTION AND SUMMARY OF ARGUMENT

The Kentucky Court of Appeals held that Kentucky violated the so-called dormant Commerce Clause by exempting from Kentucky income tax the interest earned on bonds issued by Kentucky and its political subdivisions, while affording no such exemption to the interest earned on bonds issued by other states. According to the Kentucky court, "Kentucky's bond taxation system is facially unconstitutional as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds." (Pet. App. A6.)

In reaching this conclusion, the Kentucky court expressly rejected the opposite conclusion reached by the Ohio Court of Appeals, which held that an identical Ohio tax exemption did not violate the dormant Commerce Clause doctrine because it did "not involve a taxation scheme whereby the citizenry of Ohio [was] provided with a competitive advantage over the citizenry of other states. Rather, the taxation scheme in the instant action benefits the state of Ohio itself." *Shaper v. Tracy*, 647 N.E.2d 550, 553 (Ohio Ct. App. 1994). The Kentucky court did not address the Ohio court's reasoning, but simply dismissed the decision on the ground that the "court failed fully to analyze the issue." (Pet. App. A7.)

The Kentucky court was unwisely dismissive of the Ohio decision. As this Court's recent decision in *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Management Authority*, 127 S. Ct. 1786 (2007), makes plain, a state necessarily retains broad discretion to adopt policies that favor itself, so long as those policies treat all private entities the same. Neither the Commerce Clause nor any other constitutional provision precludes a state from preferring its own interests to those of other states. Here, the Kentucky tax statutes treat all privately-issued bonds exactly the same, and they properly treat bonds issued by other states as if they were issued by private entities. By favoring Kentucky bonds over those issued by other states, Kentucky does not discriminate against interstate commerce. *United Haulers* confirms that the Ohio court was correct in its determination that the dormant Commerce Clause doctrine prevents a state from preferring private domestic businesses over those based in other states, but it does not prevent the state from preferring itself in competition with other states or private entities.

The Kentucky Court of Appeals acknowledged that "[n]o one could seriously argue against the principle that Kentucky acts as a market participant when it issues bonds." (Pet. App. A10.) For that reason, Kentucky is free to pay whatever rate of interest it wishes, to whomever it wishes. That should have been enough for Kentucky to prevail in this case, but the Court of Appeals erred by refusing to acknowledge the economic reality of the Kentucky exemption, that is, the fact that the exemption is the functional equivalent of an additional interest payment, and it plays an essential role in Kentucky's activities as a market participant in the raising of capital through the selling of bonds.

The trial court, unlike the Court of Appeals, recognized that Kentucky, as a seller in the bond market, "clearly may pay a higher rate of interest to resident purchasers," and that providing a tax exemption for its own citizens is merely one way of achieving that result. (Pet. App. A18.) Theoretically, Kentucky could have done that, or it could have achieved the same financial result by other means, such as issuing tax credit coupons to all holders of its bonds, although the coupons would have had value only for Kentucky taxpayers. While those means would have been clearly constitutional, they would have been administratively burdensome and perhaps impracticable altogether. As the trial court recognized, Kentucky should not be penalized for accomplishing a constitutionally proper objective in the most efficient way.

The Court of Appeals, on the other hand, applied a purely formal analysis, artificially dividing the state's bond activities into two distinct categories: selling bonds and taxing the income from bonds. By artificially separating the state's bond activities in this way, the Court of Appeals was able to assert that the taxing of income from bonds is "a primeval governmental activity" – one whereby the government "act[s] as a market regulator" and not as a market participant. (Pet. App. A10.) But that difference is one of form rather than substance and should not render the end result unconstitutional.

Finally, the Kentucky Court of Appeals failed to consider the importance of the tax exemption to the functioning of the bond market. Bonds issued by a particular state and its subdivisions are attractive investments for citizens of that state because of the double exemption from taxation – federal and state – which such bonds enjoy. Single-state bond funds, such as Nuveen's Kentucky Municipal Bond Fund, permit investors to enjoy that double exemption from taxation, while also achieving an appropriate diversity of investment portfolio. Investors do not have to invest large amounts of capital in a few bond issues, but can participate in a broad portfolio chosen by experienced fund managers. That spreads risk. It also permits smaller municipal issuers to have access to capital markets that they otherwise might not have, or that they might have only at greater cost. The importance and popularity of such single-state funds are well-demonstrated by the fact that there are 481 of them currently available in the market from a variety of entities, including Nuveen. Investment Company Institute, 2007 INVESTMENT COMPANY FACT BOOK, 96, 98 (47th ed.).[2]

The present system has brought great benefits to the states, to political subdivisions, and to investors. The possible consequences of altering the current system cannot be fully comprehended at this point. Perhaps money will be reallocated among funds in the short term. Perhaps single-state bond funds will become less attractive investments in the long term. If so, some municipalities and other governmental units may experience higher costs; they may need to find other means of financing needed public improvements; or they may have to forego such projects altogether.

Even if the federal government had the power to set aside the current system under the Commerce Clause, that result could not be justified on the formalistic grounds invoked by the Kentucky Court of Appeals. Moreover, given the practical importance and far-reaching consequences of such a decision, it is one that should be made by Congress, and not by the courts. It certainly is not a decision for the courts to make through a further extension of the so-called dormant Commerce Clause.

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[2] Available at www.icifactbook.org.

ARGUMENT

I. THE DORMANT COMMERCE CLAUSE SHOULD NOT BE FURTHER EXTENDED TO PROHIBIT A STATE TAX-EXEMPTION THAT BENEFITS THE STATE BY FACILITATING THE SALE TO ITS CITIZENS OF ITS OWN BONDS AND THOSE OF ITS POLITICAL SUBDIVISIONS, BUT PROVIDES NO SIMILAR EXEMPTION FOR CORPORATE BONDS OR THOSE ISSUED BY OTHER STATES, AND TREATS ALL PRIVATE BUSINESSES ALIKE.

Kentucky, like other states, provides substantial benefits to itself, its political subdivisions, and, ultimately, to its citizens through the use of municipal bonds. Both the Commonwealth and its political subdivisions use bonds to generate funds for a wide range of capital projects. They use bonds to finance projects such as educational facilities, government buildings, modes of public transportation, hospitals, low-income housing, and entertainment venues. By holding that Kentucky's tax-exemption system violates the dormant Commerce Clause, the Kentucky court has reached out to make a determination normally thought to rest within the exclusive power of Congress, and has thrown up unnecessary, formalistic barriers in the face of Kentucky's efforts to provide funding for needed public projects through the sale of its own bonds, and those of its political subdivisions, to its own citizens.

The Kentucky court acknowledged that "[n]o one could seriously argue against the principle that Kentucky acts as a market participant when it issues bonds." (Pet. App. A10.) However, the Kentucky court struck down the Kentucky tax-exempt statute by treating Kentucky's tax-exemptions as wholly independent from its interest in selling its bonds and acquiring funds to finance its projects. In this way, the

Kentucky court justified characterizing Kentucky as a "market regulator," rather than as a "market participant." *Id.* But that misses the point: the tax exemption does not exist to serve any "market regulatory" purpose; its purpose is to assist Kentucky in its efforts to fund needed public improvements through the sale of its bonds in the market.

It is clear from this Court's precedents that when a state acts as a market participant, it enjoys the same power of contract as any other market participant and can therefore sell its products to whomever it chooses on whatever terms it is able to negotiate. *See Reeves v. Stake*, 447 U.S. 429 (1980). There are no limits on a state's ability to operate freely within the market. *Id.* at 437.

Kentucky's purpose in granting the tax exemption is to encourage the purchase of its bonds by its own citizens, who are likely to be most interested in, and knowledgeable about, local conditions.[3] Kentucky simply wishes to make its investments more attractive to this market. It has chosen to do so by providing a tax exemption. It could have achieved the same financial result by authorizing a higher rate of interest on those bonds held by its own citizens, or by issuing bonds with a tax credit coupon attached, which it could give

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[3] Bonds may be issued by the state itself or by special and general units of local government. Even when bonds are issued by units of local government, however, the bonds are issued pursuant to delegated authority. Such authority is typically conferred by state constitution, statute, or charter, and it is commonly held that such authority may be conferred only by language that leaves no reasonable doubt as to the sovereign's intention to grant it. *See* 15 Eugene McQuillin, Municipal Corporations, §§ 43:22, 43:24 (3d ed. 2005). Such is the case in Kentucky, where Section 158 of the Constitution provides that, "Nothing shall prevent the issue of renewal bonds, or bonds to fund the floating indebtedness of any city, county, or taxing district." Ky. Const. § 158. Moreover, it is the state in every case that subsidizes the bonds by providing the exemption from taxation.

to everyone, but which would provide a real benefit only to Kentucky taxpayers. As a matter of constitutional law, either of these alternatives would be permissible.

As a practical matter, however, both alternatives would impose substantial and unnecessary administrative costs, compared to simply checking a box on an income tax return form that the taxpayer must file and the state must process in any event. Indeed, neither of these alternatives would be feasible in practice. While these alternatives might work, at least theoretically, with respect to bonds purchased and held by individual investors, it is difficult to see, as a practical matter, how the state would assure itself of the citizenship of current owners of bonds that were traded in the market. It is equally difficult, as a practical matter, to see how a coupon system could be designed and administered to accommodate changes in ownership. If those alternatives were at least theoretically feasible in the case of individual investors who wished to purchase individual bonds, it is clear that they could not work, even theoretically, for investors who sought to invest in a portfolio held by a single-state fund. Such approaches are simply inconsistent with the nature of funds.

A state's felt need to avoid such unnecessary transaction costs, and perhaps insurmountable practical barriers, should not be deemed sufficient to transform a constitutionally permissible action into one that is unconstitutional. Such interference in a state's decision as to how it will structure its marketplace transactions is unwarranted under the guise of the dormant Commerce Clause doctrine. In *Reeves*, this Court declined to involve itself in a state's decision regarding sales from a cement facility, finding that "[s]uch a holding . . . would interfere significantly with a State's ability to structure relations exclusively with its own citizens. It would also threaten the future fashioning of effective and creative programs for solving local problems and distributing government largesse. A healthy regard for federalism and good government renders us reluctant to risk these results." *Id.* at 441.

Applying the so-called dormant Commerce Clause in such a rigid and mechanical way not only extends that doctrine beyond any defensible limits, but effectively forecloses Kentucky from acting most efficiently to accomplish its legitimate and important purpose of selling bonds to its own citizens, and rewarding them appropriately for supporting needed public works. Moreover, Kentucky is not alone in this respect. Each state is fully capable of raising needed funds in the same way, and providing favorable tax treatment to in-state purchasers of its own bonds. Thus, there is no discrimination against interstate commerce; there is nothing for the dormant Commerce Clause doctrine to remedy; and affirmance of the decision below would simply lead to economically absurd results.

Decisions regarding state public financing and how states participate in the bond market are matters of policy best left to the lawmaking branches of state government. *See Helvering v. Gerhardt*, 304 U.S. 405, 427 (1938) (Black, J., concurring) ("[t]he genius of our government provides that, within the sphere of constitutional action, the people - acting not through the courts but through their elected legislative representatives - have the power to determine as conditions demand, what services and functions the public welfare requires.").

Moreover, to the extent that state choices in this area are thought to raise issues under the Commerce Clause, those issues should be resolved by Congress, not the courts. In *Reeves*, this Court noted that "the competing considerations in cases involving state proprietary action often will be subtle, complex, politically charged, and difficult to assess under traditional Commerce Clause analysis . . . [thus] the adjustment of interests in this context is a task better suited for Congress than this Court." *Reeves*, 447 U.S. at 439.

In sum, the application of the so-called dormant Commerce Clause to strike down this type of tax-exemption, which is prevalent throughout the country, would be unjustified and ill-advised.

II. EXEMPTING STATE-ISSUED BONDS FROM STATE TAXATION SERVES IMPORTANT PUBLIC PURPOSES IN THAT IT ENCOURAGES STATE CITIZENS, WHO HAVE A SPECIAL INTEREST IN AND KNOWLEDGE OF LOCAL CONDITIONS, TO MAKE INVESTMENTS IN SUPPORT OF STATE AND LOCAL PROJECTS; IT PERMITS SMALL, CREDIT-WORTHY ISSUERS TO GAIN ACCESS TO THE CAPITAL MARKETS FOR NEEDED PROJECTS; AND IT REDUCES THE COST TO THE STATE AND ITS POLITICAL SUBDIVISIONS OF ISSUING BONDS.

Municipal bonds are used for a wide variety of public purposes. State and local governmental units throughout the country issue bonds to fund everything from large-scale public works projects to smaller, more localized needs. For example, Nuveen's Kentucky Municipal Bond Fund includes bonds from large issuers such as the Louisville and Jefferson County Metropolitan Sewer District, an issuer which currently has over $1 billion in municipal debt outstanding, to bonds issued by smaller issuers, such as Henderson County Residential Facilities, Pleasant Pointe Apartments, which financed the rehabilitation of a senior living facility and has only $3.5 million currently outstanding.[4] The use of debt in the form of bonds to finance public works is often

[4] *See* Form N-Q for Nuveen Multistate Trust IV, filed April 27, 2007 by Nuveen Investments, Inc., available via EDGAR at www.sec.gov.

preferable because it distributes the cost of projects with a long useful life, *i.e.*, new schools, roads, or sewer systems, across both current and future users. Robert S. Amdursky and Clayton P. Gillette, MUNICIPAL DEBT FINANCE LAW, § 1.1.3 at 10-11 (1992). On the other hand, using general tax revenues obtained at the time of the project would allow subsequent users to receive the benefit of the project without paying for the cost.

The importance of the municipal bond market to the financing of state and local government is difficult to overstate. According to the Federal Reserve, there was more than $2 trillion in state and local bonds outstanding as of March 2007. Approximately $439.2 billion in municipal assets are held by open-end and closed-end funds, making these funds the largest category of holder. *See* Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States: Flows and Outstanding First Quarter 2007* (June 7, 2007).[5]

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[5] Available at www.federalreserve.gov. Research also suggests that participation in the municipal bond markets encourage good government. Recent scholarly studies show that governments that run persistent deficits are punished in the form of higher bond costs, while governments that exercise fiscal discipline are rewarded with lower borrowing costs. *See* Morris Goldstein and Geoffrey Woglom, *Market-based Fiscal Discipline in Monetary Unions*, in ESTABLISHING A CENTRAL BANK 228-260, 232 (Matthew B. Canzoneri, et al., eds. Cambridge 1992). The same holds true for governments plagued with political corruption. *See* Alexander W. Butler, et al., Corruption, Political Connections, and Municipal Finance 26 (June 19, 2007) (unpublished manuscript, available at SSRN: http://ssrn.com/abstract=972471). The bond market, then, provides the public with important information about the quality of its governmental units.

A. The Development of Municipal Bond Funds and Single-State Bond Funds has Benefitted the Market and its State Participants.

Although the income from municipal bonds has always been exempt from federal taxation, *see* 26 U.S.C. § 103(a), it was not until the passage of the Tax Reform Act of 1976 that bond funds could pass along this benefit to fundholders. *See* 26 U.S.C. § 852(b)(5); Thomas S. Harman, *Emerging Alternatives to Mutual Funds*, 1987 DUKE L. J. 1045, 1052 (1987). That was a significant development because many consider bond funds to be preferable to individual bonds in that they permit an investor to diversify his or her portfolio and limit risk.

The 1976 change in federal tax law spurred the creation of funds specializing in municipal bonds. Nuveen started its first municipal bond fund in 1976 and now offers more than 130 different funds holding more than $50 billion in assets. Nuveen's dramatic increase in assets under management and the growth in the number of its municipal bond funds during the past 30 years reflects the general market trend during that period. In 1980, only 1.6% of municipal bonds were held by funds; by 1999, approximately 35% of municipal bonds were held by funds. The Bond Market Association, FUNDAMENTALS OF MUNICIPAL BONDS 17 (5th ed. 2001).

Municipal bonds and bond funds are thought to be appropriate investment vehicles for some taxpayers because of the effect of the exemption from federal income taxation. The desirability of such investments is enhanced in many states (particularly in jurisdictions with high tax rates) by an additional state income tax exemption. Single-state municipal bond funds permit investors to take advantage of this double tax-exemption benefit, while also diversifying their investments and spreading risks. For this reason, single-state bond funds have developed as an important subset of the municipal bond fund market.[6]

In 1984, there were only 37 single-state municipal bond funds holding approximately $4.78 billion in assets. Investment Company Institute, 2007 INVESTMENT COMPANY FACT BOOK at 96, 98. By 2006, there were 481 single-state municipal bond funds holding more than $154 billion in assets. *Id.*

As the single-state municipal bond fund market has grown, it also has become increasingly specialized, so that investors can now choose among funds specializing in different types of bonds issued by the same state. Jerry Webman, *Managing Single-State Municipal Bond Funds*, in THE HANDBOOK OF MUNICIPAL BONDS, 339-350, 340 (Susan C. Heide, et al., eds, 1994). For example, Nuveen offers three different State Municipal Bond Funds that include only California bonds: California, California High Yield, and California Insured.

The existence of a robust market for municipal bond funds greatly benefits the municipal bond market for two primary reasons. First, the entry of large, sophisticated bond funds into the municipal bond market ameliorates two of the chief challenges that face the municipal bond market: limited information and liquidity.

Unlike large corporations, which typically issue shares and debt instruments that are nationally-traded and nationally-regulated, state and local governments issue bonds that are generally traded in less centralized markets and are less intensively regulated by the Securities and Exchange

[6] Single-state or state-specific municipal bond funds invest in bonds issued by a particular state. National municipal bond funds are not limited to the bonds of a particular state.

Commission than corporate issues.[7] With respect to the bonds themselves, therefore, there is less information that is readily available in the market, and the transaction costs of acquiring information are greater than they are in the case of corporate equity and debt instruments. *See* Richard C. Green, et al., *Financial Intermediation and the Costs of Trading in an Opaque Market*, THE REVIEW OF FINANCIAL STUDIES, Vol. 20, No. 2 at 276, 308 (2007).

The municipal bond market is also relatively illiquid, when compared to the equity markets. *See* Lawrence E. Harris and Michael S. Piowar, *Secondary Trading Costs in the Municipal Bond Market*, THE JOURNAL OF FINANCE, Vol. 61, No. 3 at 1361 (2006). One significant consequence of this relatively lower liquidity is that, at the retail level, "estimated trading costs are smaller for the bonds of large issuers than of small issuers." *Id.* at 1392. However, bond funds, as institutional investors, are able to trade in larger quantities, and thus spread information costs over a larger number of transactions. The net result is that institutional-size research and trades are less costly. *Id.* at 1393.

Municipal bond funds, like funds holding equity securities, facilitate investment by small investors. Funds lower trading costs and permit investors to make investment decisions without having to undergo the expense of researching individual issues. That level of research is done by the funds, and more informed investment decisions are therefore possible. In addition, of course, funds also diversify risk by spreading it across a greater number of investments.

Second, state-specific bond funds also reduce some of the cost-disparities between small and large issuers because they

[7] The Securities Act of 1933 exempted municipal bonds from its registration statement requirements. *See* 15 U.S.C. § 77c(a)(2).

create demand for bonds on a geographic basis, as well as on purely price and cost bases. The creation of this demand benefits small, credit-worthy issuers whose bond issues might be overlooked in a broader market, or which might at least experience greater relative costs in being brought to market. Thus, a broader cross-section of large and small communities will be able more efficiently to finance projects appropriate to their sizes and resources. In other words, there is a demand for Kentucky bonds, whether from large or small issuers, because large funds have created Kentucky-specific funds that maximize tax benefits for Kentucky residents. The same is true, of course, for other single-state funds throughout the nation. Absent the double exemption, a major market motivation for single-state funds would disappear, however, and opportunities for small issuers would be lessened as a result.

In sum, the participation of professionally-managed municipal bond funds in the bond market has a net positive effect on the market itself, as well as for the issuers of the bonds. Furthermore, the presence of state-specific municipal bond funds assists small issuers by increasing demand for their bonds.

B. Eliminating the State's Power to Exempt Its Own Bonds from Taxation While Taxing Other States' Bonds Will Cause Uncertainty in the Municipal Bond Market.

When a state foregoes its right to tax municipal bond income, the state effectively provides a subsidy for the projects deemed necessary or desirable by its political subdivisions. The state could have secured this revenue for itself, but it has decided to forego this revenue so that its political subdivisions can raise money at a lower cost to accomplish their projects. Of course, each state is capable of making such decisions, and each state may decide for itself whether it wishes to make that contribution to the well-being of its local governmental units.

The present system has provided substantial benefits to the states, to their political subdivisions, and to the citizen-investors who choose to invest in this way in projects thought desirable by their elected officials. The precise effects of denying each of the states the power to exempt income from its own bonds, and those of its subdivisions, from taxation, without also exempting income from the bonds of its sister states, cannot now be predicted with a high degree of accuracy, but such a dramatic change in the current legal landscape will undoubtedly affect both the market and the operations of state and local government throughout the country.

The current structure of the municipal bond fund market is predicated on the long-held understanding that states may choose to create a tax-exemption applicable only to their own bonds. At present, single-state municipal bond funds are economically sensible because they provide investors with an after-tax return that reflects the double tax exemption (from federal and state income tax) accorded on the income earned by the portfolio. Such funds also provide an after-tax return that is at least comparable to that available from national municipal bond funds. The importance and popularity of such single-state bond funds is well-demonstrated by the fact that 481 such funds currently exist in the market. *See* Investment Company Institute, 2007 INVESTMENT COMPANY FACT BOOK at 98.

Any conceivable alteration of the state income tax exemption based on the reasoning of the decision below necessarily would alter the economics of bond fund investments, with the potential to shift billions of dollars in value. The state would then have to choose whether, in light of the new economic situation, it would (1) pay a higher rate of interest to state residents to offset the taxes, (2) require state residents to pay the taxes, or (3) forego collecting taxes on all municipal bonds, regardless of the state of origin.

The first option could not be applied to existing funds. In addition, to the extent that it could be applied at all, it would impose higher costs on the state in the form of administrative expenses. Most important, the first option would not work in the case of bonds held by funds, and it is difficult to see how it could apply to bonds held by individuals, to the extent that such bonds are traded and change ownership. The second option makes municipal bonds less attractive to in-state investors because it reduces the after-tax return on investment (and puts the balance of the reduction back in the state's pocket). The third option would require the state to grant a subsidy, not just to its own political subdivisions, as it does currently, but to all of its sister states and their political subdivisions.

At this point, it is probably impossible to say precisely what effects would follow if the decision of the Kentucky Court of Appeals were to be affirmed. Clearly, single-state funds would become relatively less desirable to in-state investors because either the current double exemption would no longer exist, or it would apply categorically to the bond issues of all states. Both the need for, and the value of, state-specific funds likely would decrease. Whether the value of national funds would increase to the same extent is open to question. Of course, these observations apply only to existing funds, and to the possible readjustments that would be applicable to them.

The effect of such a ruling on new funds is even less clear. Perhaps money will simply be allocated among future municipal funds in different ways. Perhaps national funds will benefit, while state-specific funds will suffer because a major market motivation for single-state funds will disappear. But that assumes that a constant amount (or percentage) of money will continue to be allocated to municipal bond funds, as opposed to other investments. That may or may not be the case. It may be that municipal bonds will suffer as a class, and that investors will choose to invest their money in other ways.

The reality, of course, is that any such reallocation of investment priorities would cause dislocations in the existing capital market, but, even more important, any such reallocation could also increase costs for issuers. It might even deprive some units of local government of any access to funds that they otherwise would have been able to raise for needed improvements. That would cause a serious dislocation, not only to capital markets, but also to the plans and priorities of local government units. Frugal governmental units, which have been planning needed improvements for many years, may suddenly find themselves with more limited access to the needed resources. If there is a decline in the amount of money available for investment in state and local government bonds, state and local governments will either have to do without the improvements they have thought necessary or desirable, or they will have to find alternative methods for financing them. In today's world, when many clamor to cut taxes and government expenditures, that would present a clearly unnecessary challenge.

One thing is certain. Whatever changes are likely, the changes are most likely to have the greatest effect on the smaller issuers that currently benefit in a special way from the availability of single-state municipal bond funds. As previously noted, issuer costs are relatively higher for smaller, credit-worthy issuers. One virtue of the single-state municipal bond fund is that it allows small issuers access to a larger pool of investors through bond funds that choose bonds based, at least in part, on geography. Thus, a small, creditworthy issuer in Kentucky will be an attractive investment to a bond fund specializing in Kentucky-issued bonds, even though it may be too small to be noticed by a nationally-focused fund. If the tax incentive to create and maintain single-state bond funds is eliminated, however, the geographic component of the small issuer's value will be eliminated. The small issuer must then compete with larger issuers, which have the benefit of economies of scale and therefore experience lower transaction costs. To compensate for the cost differential, the small issuer will be required to offer greater returns in the form of higher interest rates. The net effect, then, is either to increase the entry costs for small issuers or to prevent the small issuer from entering the market altogether.

Currently, small issuers throughout the country play a significant role in the single-state bond market. For the first half of 2007, for example, Kentucky issuers priced 106 municipal bond deals, only 39 (or 37%) of which were for amounts greater than $10 million. Eliminating the state tax-exemption that makes the single-state bond fund attractive to in-state investors will likely impose significantly increased costs on the small issuers.

In sum, the precise effects of eliminating the power of states to exempt their own bonds (and only their own bonds) from in-state taxation cannot be predicted with certainty, but affirming the Kentucky court's opinion certainly will cause substantial dislocation in the $2 trillion municipal bond market. Even if that result were within the power of the federal government to accomplish, the wisdom of doing so would properly be a matter for Congress to decide, after extensive study and debate. It is not something to be done by this Court's further extension of the so-called dormant Commerce Clause doctrine. Too much is at stake for the vitality of our state and local governments, and too great is the possibility of unintended consequences in this complex area of state and local finance and governance.

CONCLUSION

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

Respectfully submitted,

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