

Supreme Court of the United States

DEPARTMENT OF REVENUE OF KENTUCKY

v.

DAVIS

Argued Nov. 5, 2007.
Decided May 19, 2008.

Justice SOUTER delivered the opinion of the Court, except as to Part III-B. [Justice GINSBURG joins all but Part III-B of this opinion.]

For the better part of two centuries States and their political subdivisions have issued bonds for public purposes, and for nearly half that time some States have exempted interest on their own bonds from their state income taxes, which are imposed on bond interest from other States. The question here is whether Kentucky's version of this differential tax scheme offends the Commerce Clause. We hold that it does not.

I

A

Like most other States, the Commonwealth of Kentucky taxes its residents' income. . . . Interest on bonds issued by Kentucky and its political subdivisions is thus entirely exempt, whereas interest on municipal bonds of other States and their subdivisions is taxable.

. . . [T]he Commonwealth's tax benefit to residents who buy its bonds makes lower interest rates acceptable, while limiting the exception to Kentucky bonds raises in-state demand for them without also subsidizing other issuers.

The significance of the scheme is immense. Between 1996 and 2002, Kentucky and its subdivisions issued \$7.7 billion in long-term bonds to pay for spending on transportation, public safety, education, utilities, and environmental protection, among other things.

Funding the work of government this way follows a tradition going back as far as the 17th century. . . .

Differential tax schemes like Kentucky's have a long pedigree, too. . . .

B

. . . Respondents George and Catherine Davis are Kentucky residents who paid state income tax on interest from out-of-state municipal bonds, and then sued the tax collectors in state court on a refund claim that Kentucky's differential taxation of municipal bond income impermissibly discriminates against interstate commerce in violation of the Commerce Clause of the National Constitution. . . .

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II

. . . The modern law of what has come to be called the dormant Commerce Clause is driven by concern about “economic protectionism—that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors.” The point is to “effectuat[e] the Framers' purpose to ‘prevent a State from retreating into [the] economic isolation,’”

The law has had to respect a cross purpose as well, for the Framers' distrust of economic Balkanization was limited by their federalism favoring a degree of local autonomy. . . .

Under the resulting protocol for dormant Commerce Clause analysis, we ask whether a challenged law discriminates against interstate commerce. A discriminatory law is “virtually *per se* invalid,” and will survive only if it “advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.” Absent discrimination for the forbidden purpose, however, the law “will be upheld unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits.” [*Pike*.] State laws frequently survive this *Pike* scrutiny, though not always, as in *Pike* itself.

Some cases run a different course, however, and an exception covers States that go beyond regulation and themselves “participat[e] in the market” so as to “exercis[e] the right to favor [their] own citizens over others.” . . .

. . . State and local governments that provide public goods and services on their own, unlike private businesses, are “vested with the responsibility of protecting the health, safety, and welfare of [their] citizens,” and laws favoring such States and their subdivisions may “be directed toward any number of legitimate goals unrelated to protectionism.” [*United Haulers*.] . . . Being concerned that a “contrary approach . . . would lead to unprecedented and unbounded interference by the courts with state and local government,” we held that the ordinance did “not discriminate against interstate commerce for purposes of the dormant Commerce Clause.”

III

A

It follows *a fortiori* from *United Haulers* that Kentucky must prevail. In *United Haulers*, we explained that a government function is not susceptible to standard dormant Commerce Clause scrutiny owing to its likely motivation by legitimate objectives distinct from the simple economic protectionism the Clause abhors. This logic applies with even greater force to laws favoring a State's municipal bonds, given that the issuance of debt securities to pay for public projects is a quintessentially public function, with the venerable history we have already sketched. . . . Bond proceeds are thus the way to shoulder the cardinal civic responsibilities listed in *United Haulers*: protecting the health, safety, and welfare of citizens. It should go without saying that the apprehension in *United Haulers* about “unprecedented . . . interference” with a traditional government function is just as warranted here, where the Davises would have us invalidate a century-old taxing practice, presently employed by 41 States, and affirmatively supported by all of them.

. . . Viewed through this lens, the Kentucky tax scheme parallels the ordinance upheld in *United Haulers*: it “benefit[s] a clearly public [issuer, that is, Kentucky], while treating all private [issuers] exactly the same.” There is no forbidden discrimination because Kentucky, as a

public entity, does not have to treat itself as being “substantially similar” to the other bond issuers in the market.

Thus, *United Haulers* provides a firm basis for reversal. Just like the ordinances upheld there, Kentucky's tax exemption favors a traditional government function without any differential treatment favoring local entities over substantially similar out-of-state interests. This type of law does “not ‘discriminate against interstate commerce’ for purposes of the dormant Commerce Clause.”

B

This case, like *United Haulers*, may also be seen under the broader rubric of the market participation doctrine

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. . . [T]here is no ignoring the fact that imposing the differential tax scheme makes sense only because Kentucky is also a bond issuer. The Commonwealth has entered the market for debt securities, just as Maryland entered the market for automobile hulks, and South Dakota entered the cement market. . . . But when Kentucky exempts its bond interest, it is competing in the market for limited investment dollars, alongside private bond issuers and its sister States, and its tax structure is one of the tools of competition.

The failure to appreciate that regulation by taxation here goes hand in hand with market participation by selling bonds allows the Davises to advocate the error of focusing exclusively on the Commonwealth as regulator and ignoring the Commonwealth as bond seller, just as the state court did in saying that “‘when a state chooses to tax its citizens, it is acting as a market regulator[,]’ not as a market participant.”

* * *

. . . In sum, our cases on market regulation without market participation prescribe standard dormant Commerce Clause analysis; our cases on market participation joined with regulation (the usual situation) prescribe exceptional treatment for this direct governmental activity in commercial markets for the public's benefit.

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C

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. . . But what is remarkable about the issuers in this and the broader interstate market is that nearly every taxing State believes its public interests are served by the same tax-and-exemption feature, which is supported in this Court by every one of the States (with or without an income tax) despite the ranges of relative wealth and tax rates among them.

* * *

There is little doubt that many single-state funds would disappear if the current differential tax schemes were upset.

Nor is there any suggestion that the interstate markets would discover some new reason to welcome the weaker municipal issues that would lose their local market homes after a victory for the Davises here. Financing for long-term municipal improvements would thus change radically if the differential tax feature disappeared.^{FNI19}

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IV

Concluding that a state law does not amount to forbidden discrimination against interstate commerce is not the death knell of all dormant Commerce Clause challenges, for we generally leave the courtroom door open to plaintiffs invoking the rule in *Pike*, that even nondiscriminatory burdens on commerce may be struck down on a showing that those burdens clearly outweigh the benefits of a state or local practice. . . .

The Davises' request for *Pike* balancing assumes an answer to an open question: whether *Pike* even applies to a case of this sort. *United Haulers* included a *Pike* analysis, but our cases applying the market participant exception have not. We need not decide this question today, however, for Kentucky has not argued that *Pike* is irrelevant, and even on the assumption that a *Pike* examination might generally be in order in this type of case, the current record and scholarly material convince us that the Judicial Branch is not institutionally suited to draw reliable conclusions of the kind that would be necessary for the Davises to satisfy a *Pike* burden in this particular case.

* * *

What is most significant about these cost-benefit questions is not even the difficulty of answering them or the inevitable uncertainty of the predictions that might be made in trying to come up with answers, but the unsuitability of the judicial process and judicial forums for making whatever predictions and reaching whatever answers are possible at all.

* * *

The judgment of the Court of Appeals of Kentucky is reversed, and the case is remanded for further proceedings not inconsistent with this opinion.

It is so ordered.

[Justice STEVENS’s concurrence (in full) omitted.]

Chief Justice ROBERTS, concurring in part.

I join all but Part III-B of the opinion of the Court. In my view, the case is readily resolved by last Term's decision in *United Haulers*. That being the case, I see no need to proceed to the alternative analysis in Part III-B.

Justice SCALIA, concurring in part.

I join all but Part III-B and Part IV of the opinion of the Court. I will apply our negative Commerce Clause doctrine only when *stare decisis* compels me to do so. In my view it is “an unjustified judicial invention, not to be expanded beyond its existing domain.” . . .

. . . I would abandon the *Pike*-balancing enterprise altogether and leave these quintessentially legislative judgments with the branch to which the Constitution assigns them.

Justice THOMAS, concurring in the judgment.

I agree with the Court that Kentucky's differential tax scheme is constitutional. But rather than apply a body of doctrine that “has no basis in the Constitution and has proved unworkable in practice,” I would entirely “discard the Court's negative Commerce Clause jurisprudence.”

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JUSTICE KENNEDY, with whom JUSTICE ALITO joins, dissenting.

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I

The Court defends the Kentucky law by explaining that it serves a traditional government function and concerns the “cardinal civic responsibilities” of protecting health, safety, and welfare. This is but a reformulation of the phrase “police power,” long abandoned as a mere tautology. It is difficult to identify any state law that has come before us that would not meet the Court's description. That is why, with the unfortunate recent exception of *United Haulers* the Court had ceased to view the concept as saying anything instructive. . . .

The police power concept is simply a shorthand way of saying that a State is empowered to enact laws in the absence of constitutional constraints; but, of course, that only restates the question. . . .

* * *

Even if the Court were correct to say the relevant legal framework is bond issuance, not taxation of bonds already issued, its conclusion would be incorrect; for the discrimination against out-of-state commerce still would be too plain and prejudicial to be sustained. The insufficiency of the Court's reasoning is even more apparent, however, because its own premise is incorrect. The challenged state activity is differential taxation, not bond issuance. . . . It is the tax that matters; and Kentucky gives favored tax treatment to some securities but not others depending solely upon the State of issuance, and it does so to disadvantage bonds from other States.

. . . The tax imposed here is an explicit discrimination against out-of-state issuances for admitted protectionist purposes. It cannot be sustained unless the Court disavows the discrimination principle, one of the most important protections we have elaborated for the Nation's interstate markets.

* * *

In the only part of the Court's opinion that commands a majority the main point is that validation of Kentucky's tax exemption follows from the Court's opinion last Term in *United Haulers*. But that overlooks the argument that was central to the entire holding of *United Haulers*. There the Court concluded the ordinance applied equally to interstate and in-state commerce-and so it applied without differentiation between in-state and out-of-state commerce-because the government had monopolized the waste processing industry. Nondiscrimination, not just state involvement, was central to the rationale. That justification cannot be invoked here, for discrimination against out-of-state bonds is the whole purpose of the law in question. . . .

The Court's next argument is the police power argument, returning to the idea that revenue-raising is important for a State's own essential projects. This argument has two major flaws. First, it is a replay of the circularity inherent in the police powers, health, safety, and welfare rhetoric. . . . Second, the argument ignores the fact that all protectionist laws, by definition, can be justified to further some local interest.

* * *

The majority concludes its central framework by saying the market for Kentucky's bonds is not similar to the market for private issuers because it is the Commonwealth's own discrete market. So, it says, Kentucky can discriminate if it chooses. . . . The argument that Kentucky bonds are in a discrete market has no basis in the record. . . .

* * *

That the people in each of 49 States that joined a brief in support of Kentucky are alleged to want the law is irrelevant. Protectionist interests always want the laws they pass, even if their fellow citizens bear the burden, for they are positioned to profit from the barrier. . . .

* * *

The Court's categorical approach would seem to allow States to discriminate against out-of-state, government bonds in other ways. Nothing in the Court's rationale justifying this scheme would stop Kentucky from taxing interest on out-of-state bonds at a high rate, say 80%, simply

to give its own bonds further advantage. . . .

II

In a part of the opinion joined only by a plurality the analysis concludes the differential taxation scheme is a sufficiently diluted regulatory scheme so that the market-participant exception applies. This needs little comment. It suffices to note that a “tax exemption is not the sort of direct state involvement in the market that falls within the market-participation doctrine.”

III

Throughout the Court's argument is the concern that, were this law to be invalidated, the national market for bonds would be disrupted. The concern is legitimate, but if it is to be the controlling rationale the Court should cast its decision in those terms. The Court could say there needs to be a *sui generis* exception, noting that the interstate discrimination has been entrenched in many States and for a considerable time. . . .

For these reasons, in my view, the judgment of the Court of Appeals of Kentucky should be affirmed.

[Justice ALITO's dissent omitted.]