Can Discriminatory State Taxation of Municipal Bonds Be Justified?

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This report continues the authors' analysis of Department of Revenue of Kentucky v. Davis, a case scheduled for argument in the upcoming Supreme Court term. The issue in Davis is the constitutionality of Kentucky’s practice (shared by nearly all other states with an income tax) of taxing interest on federally exempt bonds issued outside the state while exempting its own municipal bonds from taxation. In this report, they skeptically evaluate several possible state interests that might be offered to justify that practice. For example, they point out that Kentucky’s assertion that the policy conserves state revenue is wrong. They also argue that if the goal is to transfer revenues from the state to local governments, exemption is inferior to direct grants.

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Table of Contents

Introduction ........................................ 153
Municipal Bonds Issued by States ............... 154
Municipal Bonds Issued by Localities .......... 156
Prognostication and Foreboding ................. 158
Concluding Remarks ............................. 159

Introduction

On November 5 the Supreme Court will hear arguments on whether the state of Kentucky can constitutionally tax interest on federally tax-exempt bonds issued outside the state while exempting tax bonds issued by Kentucky and its political subdivisions. We describe that arrangement (tendentiously, we admit) as "discriminatory exemption," to distinguish it from a tax exemption for municipal bond interest that doesn’t shut off for out-of-state municipal bonds, which we would consider nondiscriminatory. We previously reported on the broader constitutional issues raised by the case, which is now called Department of Revenue of Kentucky v. Davis (No. 06-666). The petitioners and their amici have recently filed their opening briefs defending the validity of the Kentucky scheme. In this follow-up report, we focus on an issue raised, but not thoroughly addressed, by those briefs: Exactly what state interest justifies Kentucky’s discriminatory exemption?

Our conclusion is that the case for a discriminatory tax exemption for municipal bonds is exceedingly weak. If Kentucky’s scheme is subject to anything other than the most deferential scrutiny, it should fail. Naturally, whether the Supreme Court will see things our way is an entirely different question, one we take up briefly at the end of this report in Section IV.

The petitioners offer several reasons for exempting their own bonds from taxation, but the petitioners do not describe what governmental interest might lie behind Kentucky’s policy of taxing bonds issued by other states. This omission is important because it is the discriminatory quality of the exemption that is constitutionally suspect: Accepting as thoroughly persuasive Kentucky’s reasons for exempting in-state bonds from tax (which we don’t) should be insufficient unless Kentucky can also provide an adequate justification for taxing bonds issued by other states. Perhaps the petitioners simply preferred to reserve their arguments on this front for their reply briefs.

But the more likely explanation is that there is no good reason for the discriminatory exemption. For bonds issued by the state itself, the only grounds for choosing discriminatory over a nondiscriminatory exemption are to induce Kentuckians to buy in-state bonds. This justification may sound more benign when cast in other ways

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1Ethan Yale and Brian Galle, “Muni Bonds and the Dormant Commerce Clause After United Haulers,” Tax Notes, June 11, 2007, p. 1037, Doc 2007-12884, 2007 TNT 113-46. Our earlier report also includes a more complete description of the background of the litigation, including the workings of the municipal bond market. Id. at 1037-1039.

2Unlike the petitioners, we would make an analytical distinction between state-issued bonds and those issued by political subdivisions of the state. For example, the petitioners seem to contend that the issuance of bonds by cities and counties should count as market participation by the state itself, evidently because the cities and counties are creatures of state law. That begs the question: Private corporations, too, are wholly (Footnote continued on next page.)
for instance, Kentucky frames the argument as its choice not to subsidize the projects and governments financed by non-Kentucky municipal bonds — but any way you look at it, the core of the argument remains the same: The principal purpose and effect of Kentucky’s discriminatory exemption is to retard interstate commerce in municipal bonds. Fostering economic Balkanization — whether driven by the desire of state officials to shield themselves from the consequences of bad fiscal management, by tit-for-tat economic retaliation among the states, or by other factors — is not a constitutionally sufficient justification for discrimination.4

Kentucky has a stronger case when it comes to exempting the bonds issued by Kentucky’s political subdivisions rather than by the state itself, because in the former case exemption has the effect of transferring revenue from state to local coffers. That transfer, however, comes at considerable cost, as we outline. We think it is irrational, in light of far less costly but otherwise identical alternatives, to choose exemption, and we do not think the Court should accept it as legitimate grounds for state action.

Municipal Bonds Issued by States

Turning first to the possible justifications for the discriminatory exemption of state-issued bonds, the central argument we find in the briefs is revenue.5 The briefs recite at length the usefulness of bonds in leveraging state resources and spreading the costs of public projects over the lifetime of the project. The exemption, some amici add, makes this borrowing more affordable for states.6 Moreover, discriminatory exemption makes borrowing more affordable still, by ensuring that none of the tax revenues foregone by the state will benefit other states’ bonds.

That rationale is incoherent because Kentucky’s decision to exempt its own bonds cannot increase its net revenues, and is almost sure to decrease them. If we think of the state tax exemption for interest from the state’s own bond as a reduction in the state’s cost of borrowing, the foregone tax revenues will always equal or exceed the borrowing costs avoided. To see why, imagine that Kentucky must borrow $100 and that the market rate for fully taxable bonds of comparable risk is 8 percent. Suppose further that Kentucky can sell all its bonds to a single Kentucky taxpayer whose federal marginal tax rate is 25 percent, and that Kentucky’s marginal rate is 5 percent. Thanks to the federal exemption, in an efficient market Kentucky would be able to borrow from this taxpayer at a 6 percent rate.7 If Kentucky taxes its own bonds, it will pay $6 in interest this year, but collect $0.30 in tax ($6 x .05), for a net cost of $5.70. Alternatively, Kentucky can exempt its own bonds, and, again assuming the market is efficient, its interest cost will drop to 5.7 percent.

Yet for reasons not fully understood by public finance economists who have studied the question, neither the federal nor the state income tax exemptions for municipal bonds are fully impounded into their price (this is a well-known phenomenon referred to as the “muni-bond puzzle”).8 One likely reason is that states sell at least some of their bonds to buyers that aren’t in the top marginal rate bracket. To illustrate, suppose that Kentucky cannot meet all its borrowing needs by selling bonds to taxpayers who are in its highest bracket, and must also sell some bonds to those who are taxed at only 4 percent. To offer a competitive price to these buyers, Kentucky must sell bonds (under the same assumptions as in our last paragraph) at 5.76 percent because that is the point at which those buyers are indifferent, after tax, to Kentucky bonds and others.9 But there are still purchasers with a 5 percent Kentucky marginal tax rate. Those purchasers get a windfall of six basis points that comes directly out of the Kentucky fisc. Unless Kentucky is pursuing the regressive policy of aggrandizing high-bracket Kentucky holders of its municipal bonds but not lower-bracket holders, which no one has suggested, Kentucky would be better off with no exemption at all.10

4At 6 percent, the buyer is indifferent to the after-tax return he receives from Kentucky and the after-tax return, .08 - .25 x .08) he would receive on a fully taxable bond. This example simplifies considerably from actual market pricing of bonds, which is fairly complex. See National Federation of Municipal Analysts Brief (hereinafter NFMA Br.) at 8-9. NFMA filed its amicus brief in support of neither party.


6If Kentucky taxes its own bonds, it will pay $6 in interest this year, but collect $0.30 in tax ($6 x .05), for a net cost of $5.70. Alternatively, Kentucky can exempt its own bonds, and, again assuming the market is efficient, its interest cost will drop to 5.7 percent.

7Kentucky argues that “taxing interest income received by Kentucky taxpayers on Kentucky bonds . . . might reasonably be thought by the Kentucky General Assembly to be a zero sum (Footnote continued on next page.)
When the state’s tax exemption is not fully impounded into the price of its bonds, a tax on those bonds would bring in more revenue than is conserved by the exemption.\(^{11}\)

The situation is similar if some of Kentucky’s bonds are held by nonresidents.\(^{12}\) If (as is currently the case in all states with an income tax except Indiana) the foreign state does not exempt from tax Kentucky-issued bonds, then Kentucky will have to pay 6 percent interest to compete in the foreign market.\(^{13}\) Alternatively, if the foreign state has no income tax, Kentucky again will have to pay market rate because the after-tax rate of return on all states’ bonds, including the home state, will be identical. Either way, all of Kentucky’s bondholders will realize a substantial windfall at the state’s expense. If Kentucky finds itself in this situation, then it takes a bath, relative to simply choosing no exemption at all.

Consequently, the putative fiscal rationale for discriminatory exemption quickly unravels. Discriminatory exemption is said to reduce the amount of revenue a state must forego to obtain the fiscal benefits of exempting its own bonds. As we have just shown, however, there are no meaningful fiscal benefits to the state’s decision to exempt its bonds.\(^{14}\) This rationale should fail even rational basis scrutiny.

Several amici offer a slightly different argument. They claim that discriminatory exemption encourages the development of mutual funds that invest only in the bonds of a single state. Those single-state funds, in turn, supposedly help smaller states to attract investors and generate value from the specialized knowledge fund managers and investors have about the public projects and fiscal condition of the issuers.\(^{15}\)

The premises of that argument are contradictory. If local investors have superior information about the creditworthiness and other factors that influence the price of local bonds, one would expect them to trade on that information, just as hedge funds have exploited their insights into market mistakes about firm value to reap superior returns. Local investors should need no additional incentive to buy local bonds. Similarly, if fund managers of state-specific bond funds develop valuable expertise in the bonds held by their fund, they should be able to command a premium for their services. State-specific funds, under this logic, will continue to exist regardless of whether there is discriminatory exemption.\(^{16}\) In any event, we simply do not believe the unsubstantiated claim that “small” jurisdictions cannot attract investment without state-specific funds. States raised money from the bond market long before there were state-specific funds.\(^{17}\)

The amicus brief filed on behalf of the Government Finance Officers Association et al. (GFOA) raises another justification for the discriminatory exemption.\(^{18}\) Granting select tax benefits to Kentucky residents, GFOA claims, encourages Kentucky residents to become “personally invested” in their state’s infrastructure, and to become literal “stakeholders” in their commonwealth.\(^{19}\) Although that sounds wonderful, the incentives of stakeholders to take a free ride on the efforts of other stakeholders is the same, whether the state is as a voting citizen or a bondholder, or both. For the average citizen who will hold only a tiny fraction of all outstanding bonds, there is no reason to believe that owning those bonds will increase her participation in local government.\(^{20}\) Moreover, as we just noted, there are already ample incentives for residents to purchase local bonds, regardless of tax advantage.

\(^{11}\)It is possible that some taxpayers irrationally purchase tax-exempt bonds — that is, they buy bonds that pay less after tax than would taxable bonds. We are told by industry experts that there is some anecdotal evidence of this practice, but that it is not widespread. Cf. Federal Reserve Statistical Release Z1, tbl. F.211 at p. 44, available at http://www.federalreserve.gov/releases/z1/Current/z1r-3.pdf (noting that vast majority of muni-bond holders are funds). It would take a very large volume of irrational purchasers to overcome the negative revenue effects we describe in this paragraph of the main text and the next.

\(^{12}\)This situation is common. NFMA Br. at 9-12. (“Demand for bonds issued in a specific state from taxpayers within such state may not be sufficient to absorb all bonds issued by such state’s issuers. . . . The national market is the predominant market for municipal bonds as a whole.”)

\(^{13}\)However, if the foreign state exempted interest on Kentucky’s bonds, then Kentucky might incur little or no additional cost, depending on the tax rate in the foreign state. Because this would represent a fiscal transfer from that state to Kentucky, it is unsurprising that states rarely adopt such a tax scheme. We examine the details of these interrelationships in more detail below.

\(^{14}\)Kentucky is thus mistaken when it asserts, “It would make no sense for Kentucky to tax its own interest payments to bondholders as a means of raising revenue.” Pet. Br. at 29.
investors may hail from many different jurisdictions, some with competing interests in the use of a bond-funded project.


23We remain skeptical that individual bondholders will exercise this opportunity rather than free-riding on the expected efforts of other investors. In this paragraph, however, we accept for the sake of argument the possibility that bondholders are more likely than citizens at large to overcome the collective action problems that plague voters.

24We note that this possibility offers a reason to support section 103, the provision authorizing federally tax-exempt municipal bonds, while opposing exemption at the state level. The federal deduction, in this view, encourages states to select bonds over other means of financing, a choice that leads to more efficient provision of spillovers. In contrast, discriminatory state exemption tends to increase the costliness, and reduce the appeal, of state bonds relative to other financing options.

25If legal restrictions on the use of bond proceeds were a significant constraint on state planning, then the use of the exemption might have another potential use as a form of precommitment device. That is, by devoting its resources to bonds rather than general revenues, the state would be pledging itself to spend funds only on those purposes consistent with the legal limitations on the uses of those bonds. However, because the legal limits at present are extremely loose, we think that this account is unlikely to offer much reason to favor bonds. See Robert S. Andursky and Clayton P. Gillette, Municipal Debt Finance Law: Theory and Practice 126-136 (1992) (summarizing case law interpreting public use restrictions on municipal bonds).

26The Davis facts do not appear to implicate, and no party has yet raised, the question of local tax exemptions for state or local bonds. Local income taxes are relatively rare, however.

27GFOA Br. at 21. (Footnote continued in next column.)
size of the transfer increases as the locality takes on more debt. Also, it could be argued that tax exemptions make financial planning for local governments easier because the municipality need not guess whether the exemption will be budgeted each year.

As Prof. Edward Zelinski has argued, it is straightforward to design a grant that duplicates those effects. For example, a grant can be enacted as an entitlement, so that it is automatically awarded each year. The amount of the grant can be tied to local spending efforts, as has been done in transfers to the Canadian provinces, as well as domestically in many statewide education funding programs. Similarly, to the extent that small municipalities face high transaction costs in issuing debt, a state-level grant could easily overcome that obstacle.

We would add that a well-designed grant could also largely eliminate the fiscal responsibility externality. For instance, states might set a cap on their grant amount, readjusted at suitable times, based on the marginal tax rate of marginal bond buyers and the average nationwide rate for municipal bonds of a given credit rating. In our Kentucky hypothetical, then, Kentucky might award its municipalities a grant of no more than 0.3 percent of their total bond interest payments: the 5 percent marginal tax rate times the 6 percent nationwide average for investment-grade municipal bonds.

Even if the fiscal transfer rationale were a persuasive account of the general exemption for locally issued municipal bonds, Kentucky would still need some additional justification for its discriminatory exemption. A Kentucky exemption for bonds issued by subdivisions of every state would still enable Kentucky’s political subdivisions to borrow at a reduced rate from Kentucky taxpayers. This strategy could be costly, however, in that Kentucky would also forego revenue that would flow to municipalities outside Kentucky. Thus, it appears that the key rationale for Kentucky’s discriminatory exemption is to permit fiscal transfers to Kentucky’s political subdivisions while economizing on the foregone tax revenue that flows from taxing other states’ bonds.

Yet the Supreme Court has been reluctant to approve state-imposed burdens on interstate commerce when the sole justification offered by the state is its own fiscal bottom line. And for good reason. The dormant Commerce Clause protects our national interests in interstate harmony and an open, efficient economy. At the same time, the Court has been concerned that state policies that might in fact enhance overall national welfare or that may simply embody a different ideal of justice or wise policy. The corresponding burdens on national interests can then be justified as the price we pay for the opportunity to select among different local communities and their policies. So state policies that serve some avowed purpose other than simply enriching the state are at least defensible. But we cannot see why the Court would want to give states the power to, in effect, award themselves grants from the pool of national wealth as long as Congress stands occupied elsewhere. The power to extract funding from the national pool would generate a major fiscal externality, inducing state and local governments to supply inefficient levels and forms of local services.

Further, the discriminatory exemption in many ways causes rather than cures the supposed danger of outflows of state wealth. If every state were to enact a nondiscriminatory exemption, funds would flow not only out of but also back into Kentucky. Just as Kentucky would forego revenue in favor of municipal bonds from Tennessee or Ohio, so too would Ohio and Tennessee forego revenue in favor of municipal bonds from Kentucky.

This mutual interflow is greatly diminished because of the enactment of discriminatory exemptions. Indeed, the enactment of a discriminatory exemption in any state undermines nondiscriminatory exemptions in every state. In a pairing of any state with a discriminatory provision and any other state without one, revenues will flow from the nondiscriminator to the discriminator. The only way for the nondiscriminator to stanch the flow is to negotiate with the discriminator to change its law, or to enact its own discrimination provision. The second option involves fewer transaction costs, and the transaction

32 We note that one of us has elsewhere expressed some skepticism about the complete equivalence of tax benefits and grants. Galle, supra note 28, at 694-695. That skepticism rested largely on the claim that individual taxpayers may perceive taxes as especially onerous, and therefore welcome tax cuts more warmly than direct grants. Because municipal bonds are traded in a thick, sophisticated market, we doubt that those kinds of cognitive biases would affect the relative pricing of bonds supported by exemptions or grants. But we are open to persuasion by empirical evidence to the contrary.
33 These non-Kentucky municipalities might or might not benefit from Kentucky’s largesse, depending on whether they were able to meet all their borrowing needs in states that exempted their bonds from taxation.
costs of negotiation would grow exponentially as the number of interacting states increases. Thus, the tit-for-tat retaliation strategy is dominant. That this is the same dynamic at play in the nearly universal adoption of discriminatory provisions is strongly implied by the existence of provisions, such as Utah has enacted, offering mutual nondiscrimination to states that will reciprocate. It is just those interstate antagonisms that the Commerce Clause seeks to prevent.

In short, we see little justification either for discriminatory exemption of locally issued municipal bonds or for the exemption more generally. Indeed, we think there is a plausible argument that it should fail even rational basis scrutiny. Technically, however, rational basis scrutiny usually eschews a comparison of the policy under consideration with other alternatives, and it is by comparison with grants that discriminatory exemption looks especially pointless. However, to the extent that Pike balancing is truly a balancing test and not simply a recapitulation of due process/rational basis scrutiny review, we think Kentucky’s scheme would have to fall.

The possibility of elevated scrutiny also helps to distinguish exemption of bonds at the state level from the federal exemption granted under section 103. We agree with earlier commentators that section 103 has many unappealing features. But we doubt the Supreme Court would be willing to strike it down as irrational. It follows that any argument that state exemption is unconstitutional would have to explain why Congress may do what the states cannot.

For us the main answer is that state regulations affecting capital markets are justifiably subject to greater scrutiny than are similar laws enacted by Congress. Commerce Clause scholars have long articulated why that should be so. Exemption distorts the nationwide market for investment dollars in ways that may be harmful to the economy as a whole. The federal government is more to be trusted on matters crossing state boundaries because only at the federal level are all of the affected interests directly represented in the political process. In contrast, absent some strong in-state political faction whose interests happen to align with out-of-state interests, we cannot realistically expect state actors to internalize the harms they may cause for outsiders. Therefore, the extremely high deference to legislative outcomes that rational basis scrutiny embodies is probably inappropriate for economically distortive state legislation. That is even truer in this case, when the effect of the challenged legislation is to shield state officials from the electoral consequences of their fiscal choices. So the state exemption should be held unconstitutional, even while section 103 is not, because the states must be made to answer to a higher standard.

Prognostication and Foreboding

Readers who have followed closely the recent controversy over Davis have no doubt noticed that we seem more bullish on the Davises’ chances to prevail than most other commentators. To be clear: We think that they should prevail and that they will prevail if the Court is fastidious in applying its precedents, but — in the end — we doubt they will (although we think it is a close case and know predictions can be hazardous).

The main reason we are skeptical regarding the Davises’ chances before the Court is that, even though we think they have the better side of the arguments based on both policy and precedent, in United Haulers there were only three votes in favor of a position much like the one we have articulated. The Court could easily reverse the Kentucky Court of Appeals simply by extending the rule of United Haulers to cover Davis.

We think extending United Haulers to Davis would be risky for the Court given the law of unintended consequences. Perhaps the most obvious way to extend United Haulers would be to conclude that Kentucky and the other states aren’t similarly situated — any claim of discrimination presupposes that whatever people or things are being compared are similar in some relevant sense. The petitioner’s main argument before the Court is that Kentucky and other states that issue municipal bonds aren’t similarly situated. It is of course true, as the petitioner argues, that there is only one Kentucky — and thus the use of the proceeds of Kentucky municipal bond sales and the revenue sources for the repayment of those bonds are wholly unique. But the appropriate question, we think, is whether Kentucky’s bonds, when evaluated as an investment, are similar to the bonds issued by other states. The Court’s most detailed explication regarding what makes entities “similarly situated” for dormant Commerce Clause purposes is whether they compete against one another in the marketplace. The “dormant Commerce Clause protects markets and participants in markets” that is, it protects the efficient functioning of the interstate market for investment capital and investors like the respondents. The Kentucky tax

39See Pet. for Cert. at 7-8, Kentucky v. Davis, No. 06-666, filed Nov. 9, 2006.
41Admittedly, however, we are not aware of a prior case in which the Court has applied Pike balancing to a state tax provision.
42We offer an additional distinction in note 24 supra.
46General Motors v. Tracy, 519 U.S. 278 (1996).
47Id. at 300.
law at issue treats otherwise identically situated Kentuckians differently based only on the identity of the issuer of the municipal bonds they hold. The idea that Kentucky bonds and bonds of sister states aren’t competing alternatives — in other words, the idea that they aren’t similar in the constitutionally relevant sense — strikes us as incredible. If the Court accepts Kentucky’s argument that its bonds are not similar in the constitutionally relevant sense to the municipal bonds issued by other states, the Court might be plunging dormant Commerce Clause doctrine into a new realm of indeterminacy. Future courts and litigants in dormant Commerce Clause cases will have to grapple with defining market boundaries and assessing the presence and intensity of competition between different entities and the products and services they sell.48

Another approach to extending United Haulers to fit the facts of Davis would be to acknowledge the self-evident fact that municipal bonds and the states that issue them are essentially similar to each other, but to conclude nonetheless that states are free to discriminate in their own (and in their political subdivisions’) favor.49 The logic for such an approach has already been at least partially worked out in the context of the market participation doctrine case law, and, to a greater degree, in academic commentary on the principles that underlie that doctrine.50 The difficulty, however, as we have previously explained, is that the court has refused to extend the market participation doctrine protection to regulatory market interventions, including tax laws. Thus if the Court decides the case on this basis, it will solidify that part of United Haulers establishing the ability of states to discriminate with impunity against out-of-state interests. Although the United Haulers Court was content that states wouldn’t start to open up for-profit businesses that are able to compete on favorable terms against out-of-state commercial interests,51 we’re not so confident.

The Court mollified itself on this point by hypothesizing that “major in-state interests adversely affected by” such state participation would be a safeguard against abuse.52 But what happens when states and local private businesses join together in cooperative ventures to take on out-of-state competitors? Just such a cooperative venture was at issue in C&A Carbone,53 and the court decided the facility was private because a private entity held title to the facility, even though the benefits and burdens of ownership were, in reality, held by the municipality. Apparently the case would have come out differently if a state organ held title, even if the facility continued to be operated by the private firm as a subcontractor. If this is right, then far from acting as a political check on the state, local businesses will be lining up to do business with the state and its subdivisions so they too can gain the benefits of the state’s privileged status (through sale-leaseback arrangements or some other formal contrivance designed to qualify discriminatory regulations favoring their co-venture with the putative state-business dormant Commerce Clause exemption). As long as all significant local business is part of the cartel, there is no real in-state political check.

Concluding Remarks

There are still more doctrinal maneuvers the Court could use to reverse the lower court’s decision in Davis and preserve the status quo in the municipal debt market. In the end, we believe the question is closer than others say, not only for the many reasons we have offered here and in our earlier report, but also because of our reading of the justices’ deeper philosophical commitments. Justices Souter and Ginsburg were in the majority in United Haulers. Yet to judge by their past writing, both are strongly committed to the notion that genuine democracy requires that states be held to account for decisions that undermine the national interest, even when — indeed, especially when — that accountability comes at a price to the state treasury those officials watch over.54

48To a limited extent, this problem might already have begun. Smith v. N.H. Dep’t of Rev. Admin., 813 A.2d 372, 379 (N.H. 2002). Issues of this sort are among the most vexing in all of antitrust law. United States v. E.I. du Pont de Nemours & Co., 351 U.S. 377, 391-392 (1956). Emphasizing those issues in dormant Commerce Clause adjudication would preclude many future opportunities to settle the issues once and for all.

49We are not sure whether the record shows that the Davises owned only state bonds, only bonds issued by political subdivisions, or some of each. If the Davises owned only bonds falling into one of those categories, the Court could avoid addressing the others, although we would regret this as a lost opportunity to settle the issued once and for all.

50See Yale and Galle, supra note 1, at 1040-1041 notes 32-43 (collecting citations).

51127 Sup. Ct. at 1797 n.7.

52Id.
