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IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

STATE OF SOUTH CAROLINA,
Plaintiff,

v.

JAMES A. BAKER, III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA,
Defendant,

NATIONAL GOVERNORS' ASSOCIATION,
Recommended Plaintiff-in-Intervention.

REPORT OF SPECIAL MASTER

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MASTER'S REPORT: FACTUAL FINDINGS AND LEGAL ANALYSIS

I. STATEMENT OF THE CASE.

In September, 1982, President Reagan signed into law the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. No. 97-248, 96 Stat. 595. Section 310(b)(1) of TEFRA, *codified at* 26 U.S.C. § 103(j)(1982), denies an exemption from federal income tax on the interest paid on any "registration-required" obligation unless the obligation is in registered form.[1]

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[1] Section 310(b)(1) of TEFRA, 26 U.S.C. § 103(j) (1982) provides:

> **(j) Obligations must be in registered form to be tax-exempt**
>
> **(1) In general**
>
> Nothing in subsection (a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any registration-required obligation unless the obligation is in registered form.
>
> **(2) Registration-required obligation**
>
> The term "registration-required obligation" means any obligation other than an obligation which—
>
> (A) is not of a type offered to the public,
>
> (B) has a maturity (at issue) of not more than 1 year, or
>
> (C) is described in section 163(f)(2)(B) [26 U.S.C. § 163(f)(2)(B)].
>
> **(3) Special rules**
>
> **(A) Book entries permitted**
>
> For purposes of paragraph (1), a book entry obligation shall be treated as in registered form if the right to the principal of, and stated interest on, such obligation may be transferred only through a book entry consistent with regulations prescribed by the Secretary.
>
> **(B) Nominees**
>
> The Secretary shall prescribe such regulations as may be necessary to carry out the purpose of paragraph (1) where there is a nominee or chain of nominees.

Section 310(b)(1) defines registration-required obligations quite broadly to include almost all publicly offered municipal obligations[2] with maturities at issue of one year or more. Since the forfeiture of tax-exempt status would increase the interest that states and localities have to pay on their obligations by some 28% to 35%,[3] Section 310(b)(1) in effect requires the registration of all municipal bonds.

On February 7, 1983, South Carolina sought leave to file an original complaint against the Secretary of the Treasury in the United States Supreme Court. South Carolina's complaint asserted that Section 310(b)(1) of TEFRA violated both the Tenth Amendment to the United States Constitution and the doctrine of intergovernmental tax immunity.

On February 22, 1984, the Supreme Court granted South Carolina's motion. *South Carolina v. Regan,* 465 U.S. 367 (1984). The Court also determined to appoint a Special Master to develop a factual record.

In appointing a Special Master, the Court expressly disclaimed any "opinion on the merits of the State's claims." 465 U.S. at 372.[4] A plurality consisting of Justices Brennan, Marshall, White, and then Chief Justice Burger, noting South Carolina's allegation that Section 310(b)(1) of TEFRA would "materially interfere with and infringe upon the authority of South Carolina to borrow funds[,]"[5] observed "[u]nquestionably, the manner

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[2] The terms "municipal bonds" or "municipal obligations" as used in this Report refer to the debt securities of both the States and their political subdivisions.

[3] Transcript ("Tr.") 443; 618. Transcript citations separated by commas refer to the testimony of one witness; semi-colons indicate citation to a different witness's testimony.

[4] Only Justice Stevens addressed the merits; he believed that there was no merit to the States' claims. 465 U.S. at 403.

[5] *Motion for Leave to File Complaint* at 7.

in which a State may exercise its borrowing power is a question that is of vital importance to all 50 States." 465 U.S. at 382. Writing separately, Justice Blackmun stated simply that the "issue presented is a substantial one, and is of concern to a number of States." *Id.* at 384. Finally, Justice O'Connor, joined by Justice Powell and now Chief Justice Rehnquist, in reliance upon South Carolina's then uncontroverted allegations of injury, concluded that South Carolina had demonstrated injury of sufficiently "serious magnitude" to warrant invoking the Court's original jurisdiction. *Id.* at 401. Justice O'Connor also observed that "[t]he authority the State claims has significant historical basis, . . . and the injury the State alleges could deprive it of a meaningful political choice." *Id.* (citations omitted).

By order dated April 23, 1984, the Court appointed the undersigned, Samuel J. Roberts, to serve as Special Master. *South Carolina v. Regan*, 466 U.S. 948. On June 22, 1984, the National Governors' Association ("NGA")[6] filed a Motion for Leave to Intervene as Plaintiff, arguing that "the States, Commonwealths, and Territories whose chief executives are members of NGA will be bound by the judgment herein, and have a substantial interest in the outcome . . . ." *Motion of the National Governors' Association for Leave to Intervene as Plaintiff* at 2. The Supreme Court referred this motion to the Special Master on August 16, 1984. 468 U.S. 1226. After briefing and oral argument, the Special Master recommended that the NGA's Motion for Leave to Intervene be granted provided that the NGA satisfied certain conditions designed to prevent delay and duplication of proof.[7]

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[6] The NGA is an incorporated instrumentality of the States, the members of which are the chief executives of the fifty States, two Commonwealths, and three Territories. Its purpose is to represent the States in the federal system. *Brief of NGA In Support of Motion to Intervene as Plaintiff* at 13.

[7] See *Report of Special Master on Motion of National Governors' Association for Leave to Intervene as Plaintiff* (November 16,

The parties spent approximately one year in discovery, which involved numerous depositions and extensive production of documents. The proceedings before the Special Master took place over three weeks in November, 1985 and January, 1986. The parties presented the testimony of state, local, and federal government officials, representatives of the securities industry, and various experts.

II. THE ROLE OF THE SPECIAL MASTER.

In its brief *amicus curiae*, The Public Securities Association ("PSA")[8] urges the Special Master not to address the constitutional issues involved in this case.[9] PSA relies exclusively on the Supreme Court's opinion granting South Carolina's motion for leave to file its complaint for the proposition that the Master's Report should be limited to factual matters. None of the parties has urged the Special Master to limit the Report in this fashion.

In its earlier opinion, the Supreme Court plurality indicated that "the record is not sufficiently developed to permit us to address the merits. We shall therefore appoint a Special Master to develop the record." 465 U.S. at 382. In her opinion concurring in the judgment, Justice O'Connor agreed that the record was insufficiently developed to permit resolution of the merits and that a Special Master should be appointed. 465 U.S. at 402. The Supreme Court's subsequent order appointing the undersigned as Special Master stated simply that the

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1984). The NGA has subsequently met those conditions, which dealt with the timely filing of pleadings and the coordination of the presentation of proof. NGA's contribution to the fact finding process has been substantial and has materially aided the Special Master in discharging his duties.

[8] PSA is a national trade association consisting of approximately 300 banks and securities broker-dealers. Its members underwrite most of the municipal bonds sold publicly in the United States.

[9] *Brief of the PSA in Support of the Plaintiff and Plaintiff in Intervention* at 7.

"Special Master is directed to submit such reports as he may deem appropriate." 466 U.S. at 948.

Although tempted by the suggestion that the Special Master can avoid recommending conclusions on the difficult questions of law that this case presents, the Special Master finds PSA's suggestion that the Supreme Court has referred only the factual aspects of this case to be without merit. It is true that a few orders of appointment in original cases have directed Special Masters "to find the facts specially and state separately his conclusions of law thereon." *See, e.g., Arizona v. California,* 347 U.S. 986 (1954). However, the Court's more recent orders of appointment have simply directed the Special Master "to submit such reports as he may deem appropriate." *See, e.g., Texas v. New Mexico,* 454 U.S. 1076 (1981); *Maryland v. Louisiana,* 445 U.S. 1271-72 (1980); *Colorado v. New Mexico,* 441 U.S. 902 (1979); *Arizona v. California,* 439 U.S. 419, 436-37 (1979); *United States v. Maine,* 433 U.S. 917 (1977). No special significance therefore can be attributed to the Court's use of this formula in *South Carolina v. Regan,* 466 U.S. 948 (1984).

Where the resolution of legal issues has proven necessary to a recommended disposition, previous Special Masters, acting pursuant to the same form of order of appointment as used by the Court in this case, have not hesitated to address the parties' legal contentions. *See, e.g., United States v. Maine,* 469 U.S. 504, 509 (1985) (report interpreted Convention on the Territorial Sea and the Contiguous Zone to determine juridicial bay); *Texas v. New Mexico,* 462 U.S. 554, 562-64 (1983) (report addressed proper construction of interstate compact); *Arizona v. California,* 460 U.S. 605, 613, 618, 635 (1983) (report addressed a variety of legal issues, including law of the case, entitlement to water rights, and preclusive effect of Interior Department surveys); *Colorado v. New Mexico,* 459 U.S. 176, 180-81 (1982) (report applied law

of equitable apportionment to competing water uses); *Maryland v. Louisiana*, 451 U.S. 725, 734-35 (1981) (report addressed jurisdictional and standing issues as well as constitutionality of state statute).

It is well understood that the Master's report and recommendations are purely advisory. The Court itself will determine to grant or deny the ultimate relief sought. *See* R. Stern, E. Gressman, and S. Shapiro, *Supreme Court Practice* at 495 (6th ed. 1986).[10] The advisory nature of the Special Master's conclusions of law hardly suggests that the Master should abstain from presenting his recommendations on legal questions. Although the Court is obviously free to disregard those recommendations in their entirety, the Court may derive at least some benefit from the legal analysis and recommendations of the fact finder. The Special Master thus finds no merit in PSA's suggestion that he should limit his report to detailed findings of fact.[11]

The unique status of a Special Master in a matter arising under the Supreme Court's original jurisdiction does dictate some departure from the customary procedures of a trial court. The constitutional issues presented by South Carolina's complaint are difficult and intricate. The parties disagree strongly about the facts relevant to the legal issues presented. Although they have stipulated to a wide

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[10] This is not to deny that the Supreme Court has in the past accorded some deference to the Special Master's fact findings. *See, e.g., Colorado v. New Mexico*, 467 U.S. 310, 317 (1984) ("tacit presumption of correctness"); *Louisiana v. Mississippi*, 466 U.S. 96, 106 (1984).

[11] The Supreme Court's statement that it was appointing a Special Master to develop a factual record cannot reasonably be read to contain the implicit negative that PSA finds therein. The Court appoints Special Masters only in cases that require a factual development; if there are no factual issues in a case arising under its original jurisdiction, the Supreme Court can proceed to hear legal argument on the merits directly. *See, e.g., South Carolina v. Katzenbach*, 383 U.S. 301, 307 (1966).

range of facts dealing with the municipal bond market, the parties have also submitted extensive and conflicting proposed findings of fact concerning disparate subject matter areas.

In keeping with the Special Master's principal function, the development of an evidentiary record, factual findings are made on the entire range of issues that the parties have presented for resolution. The NGA correctly contends that "[i]t is central to the fact-finding purpose of this proceeding that the [facts] be catalogued to the Supreme Court for its ultimate determination as to their constitutional significance." *Reply Brief of the NGA* at 12. Therefore, the Special Master has deliberately chosen not to limit his factual findings to those facts relevant to the recommended legal conclusions. Instead, factual findings are made and factual disputes are resolved that may be relevant to a number of different views concerning the governing legal principles.[12]

FINDINGS OF FACT

III. PRIOR FEDERAL REGULATION OF MUNICIPAL BONDS AND THE LEGISLATIVE HISTORY OF TEFRA.

The parties have explored the legislative history of section 310(b)(1) of TEFRA in considerable detail. They have not done so for the usual purpose of clarifying the meaning of statutory language through an exploration of the legislative intent. Instead, plaintiffs focused upon the access of state and local government representatives to the legislative and executive branches of the federal gov-

[12] This view of the Special Master's role—in a case that presents complex and unresolved constitutional questions—requires the Special Master to find facts that appear to have little bearing on the tentative legal conclusions proposed. Although certain detailed factual findings thus will have no seeming relevance to the legal discussion presented, such findings may prove of some use to the Court or the parties under a different view of the law.

ernment to express their views and convey information about municipal bond registration. Plaintiffs also focused on the adequacy of the federal government's consideration of the benefits accruing from registration and the burdens imposed upon the States by requiring registration. The Secretary has focused on the legislative antecedents of TEFRA's registration requirement in order to establish the historical basis of the federal government's concern about bearer bonds and its historical involvement in regulation of aspects of the municipal bond market.

A. Pre-TEFRA Substantive Regulation of the Municipal Bond Market

Prior to TEFRA, the United States had taken steps to restrict the issuance of tax-exempt state and local government debt securities. In 1968, Congress enacted legislation limiting the ability of States and localities to pass along to private parties (mainly corporations intending to build plants or make other job creating investments) the ability to raise debt capital free of federal income taxation on the interest paid. See Revenue Expenditures and Control Act of 1968, Pub. L. No. 90-364, § 107, 82 Stat. 266-68.[13] Prior to 1968, these so-called "industrial development bonds" ("IDBs") or private purpose bonds were tax-exempt without any restriction.[14] Congress adopted a complicated set of rules to determine whether interest on IDBs would be tax-exempt (for example, the funds raised must be used only for certain "exempt facilities").[15] These rules have evolved continuously since that time.[16] The thrust of these rules is to limit, and place conditions upon, municipalities' use of their tax-

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[13] Federal statutes governing industrial development bonds are now codified at 26 U.S.C. § 103(b) (1982 & Supp. III 1985).

[14] *See* Tr. 834-35.

[15] *See* Tr. 835.

[16] Tr. 844-45.

exempt status to benefit private industry. IDBs constitute an important segment of the municipal bond market, and accounted for more than 50 percent of that market in 1982.[17]

In 1969, Congress severely curtailed the ability of States and localities to use the tax-exempt status of their bonds to earn a return on bond proceeds by reinvesting them in taxable securities ("arbitrage financing").[18] Prior to 1969, state and local issuers were able to earn a return substantially higher than the relatively low interest cost to them of their municipal bonds by investing the proceeds of so-called "arbitrage bonds" in taxable securities bearing a relatively high rate of interest.[19]

Apparently, municipal issuers have raised no serious question about the constitutionality of Congress's decision to regulate municipal IDBs and arbitrage bonds. These federal restrictions are substantive in nature. In limiting arbitrage bonds and IDBs, Congress has limited the scope of the federal tax exemption for municipal debt obligations, and has exerted control over the purposes to which the proceeds of tax-exempt obligations can be put.

B. Municipal Bond Registration Prior to TEFRA

Before enacting TEFRA's universal registration requirement, Congress had passed legislation requiring that certain specific types of municipal bonds be registered in order to preserve their tax-exempt status. The Crude Oil Windfall Profits Tax Act of 1980[20] provided that certain

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[17] Tr. 845-46; *see* PX 133 at 14.

[18] See The Tax Reform Act of 1969, Pub. L. No. 91-172, § 601(a), 83 Stat. 656. Federal restrictions on municipal arbitrage financing practices are currently codified at 26 U.S.C. § 103(c) (1982 & Supp. III 1985).

[19] Tr. 834-35; 904-05.

[20] Pub. L. No. 96-223, §§ 241(b)(4), 243(a)(1)(E), 244(a), 94 Stat. 281-286.

municipal energy related bonds must be issued in registered form as a condition of their tax-exempt status. Later that same year, Congress also required that tax-exempt housing or mortgage subsidy bonds be issued in registered form.[21] Interestingly, a Joint Committee on Taxation staff report that explained the registration requirement for energy bonds justified the requirement with the same tax compliance and law enforcement rationales subsequently used by Congress to justify TEFRA's universal registration requirement.[22] Moreover, the Joint

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[21] Omnibus Budget Reconsolidation Act of 1980, Pub. L. No. 96-499, § 1102, 94 Stat. 2660.

[22] The Joint Committee report gave the following reasons for requiring registration:

> Congress became aware that unregistered tax-exempt obligations were used as a vehicle to avoid Federal estate taxes. In some cases, such obligations were removed from the decedent's possession and were not included in the decedent's estate tax return. Because such obligations were not registered, it was difficult to establish that the decedent owned the obligations. Congress believed that requiring tax-exempt obligations to be in registered form would provide a method of establishing ownership by the decedent.
>
> In addition, registration will further efforts to obtain compliance with Federal and State income tax laws and to detect illegal activities. In certain cases, individuals have failed to report and pay taxes due with respect to amounts includible in gross income, especially income from illegal sources. In order to avoid detection, these individuals have purchased unregistered tax-exempt obligations with the unreported income. The fact that the obligations are not registered (and the fact that no reporting requirement exists for the interest paid on such obligations) has hampered efforts to determine correctly the taxable income of these individuals. Congress believes that registration of tax-exempt obligations will remove the use of these investments as a means of avoiding detection of illegal activities and will improve the ability of the Internal Revenue Service to administer the income tax laws.

Joint Committee on Taxation, General Explanation of the Crude Oil Windfall Profits Tax Act of 1980, 96th Cong., 2d Sess. 112 (Comm. Print 1980).

Committee's staff report also clearly foreshadowed the universal registration requirement that was to come:

> Finally, while Congress did not believe it was appropriate to extend the registration requirement to all tax-exempt obligations at this time, it believed that a registration requirement should be imposed on the new types of IDBs.

Joint Committee on Taxation, *General Explanation of the Crude Oil Windfall Profits Tax Act of 1980*, 96th Cong., 2d Sess. 112 (Comm. Print 1980). It would appear, then, that TEFRA's universal registration requirement was an outgrowth of earlier congressional concerns that bearer bonds create tax compliance and other law enforcement problems.

C. The Legislative History of TEFRA

1. *Background: The Problem of Tax Compliance*

In 1982, the burgeoning federal budget deficit prompted Congress to consider a range of revenue enhancement measures, including heightened tax enforcement. Congress was concerned with rising tax law non-compliance and the sheer magnitude of the income evading taxation. Internal Revenue Service studies presented to Congress indicated that the total "tax gap" (unreported income) from otherwise legal activities had grown from $29.3 billion in 1973 to $87.2 billion in 1981.[23] An IRS study indicated that underreported non-farm business income had almost tripled from $9.6 billion in 1973 to $26.2 billion in 1981. Unreported capital gains income had grown from $2.0 billion in 1973 to $9.1 billion in 1981 (only an estimated 56% of capital gains income was reported). Finally, estimates of unreported income from illegal activ-

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[23] *Hearings Before Subcommittee on Oversight of the Internal Revenue Service of the Senate Committee on Finance on the Compliance Gap* ("Compliance Gap Hearings"), 97th Cong., 2d Sess. 126 (1982). *See also* Tr. 840-41.

ities had increased from a range of $1.8 to $2.9 billion in 1973 to $6.1 to $9.8 billion in 1981.[24]

2. *The Legislative History of TEFRA*

In February, 1982, The Treasury Department sent a package of proposals to Congress aimed at reducing the tax compliance gap. Treasury's proposals included withholding on interest and dividend income, increased IRS information reporting requirements,[25] and the registration of all IDBs. As noted, IDBs at the time of the Administration's proposal constituted more than one-half of all state and local government tax-exempt obligations. See page 9, *supra*. Testimony given before the Special Master indicated that Treasury's IDB registration proposal was well known to state and local issuers and their representative associations (for example, the NGA and the National League of Cities). However, neither municipal bond issuers nor their representatives made any significant effort to oppose IDB registration.[26] Indeed, then Assistant Secretary of the Treasury for Tax Policy, John Chapoton, indicated that the "concerns about the registration requirement were not significant. . . ." [27] Mr. Chapoton also testified that interested state and local representatives were not at all surprised by the registration requirement in light of the prior, more limited registration requirements that Congress had imposed.[28]

Assistant Secretary Chapoton testified that the locus of state and local government concern was Treasury's proposals to limit the uses of IDBs by eliminating the tax

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[24] Compliance Gap Hearings at 126. *See also id.* at 94-123 (testimony and statement of IRS Commissioner Roscoe L. Egger); Tr. 871-88; DX 40.

[25] Information reporting requires that the payer of some form of income (such as interest or dividends) report to the IRS and the recipient the amount of the payment on IRS Form 1099.

[26] See Tr. 851-52.

[27] Tr. 852.

[28] See *id.*

exemption for many private purpose financings.[29] State and local officials objected very strongly to these proposals, and representatives of the NGA, the Municipal Finance Officers Association, and the National League of Cities met with Treasury Department representatives frequently during this period.[30] Apparently, the substantive limitation on IDBs was regarded as the primary issue, and state and local representatives did not make the registration requirement a priority item on their legislative agenda.[31]

State and local officials and their representatives had access to Treasury representatives and were in a position to make their views known. Assistant Secretary Chapoton testified that he and his staff had the utmost respect for municipal issuers and their representative organizations.[32] Indeed, the Assistant Secretary testified that the NGA and other municipal trade associations were often sources of information on Administration tax proposals before and after they were made.[33]

Both the House of Representatives Ways and Means Committee and the Senate Finance Committee held hearings on the Administration's tax proposals in the winter and spring of 1982. Numerous state and local officials, including six governors, testified at the House and Senate hearings.[34] Five of the approximately 15 state and

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[29] Among other things, TEFRA limited depreciation benefits for IDB users, prohibited the use of IDBs for certain types of business, reduced the maturity of certain types of IDBs, and imposed new reporting requirements. See PX 133 at 3. *See generally* Note, *Bedtime for [Industrial Development] Bonds?: Municipal Bond Tax Legislation of the First Reagan Administration,* 48 Law and Contemp. Probs. 213 (1985).

[30] See Tr. 851-54.

[31] See Tr. 853-54.

[32] See Tr. 928.

[33] See Tr. 853.

[34] *Hearings before the House Committee on Ways and Means Concerning the Administration's Fiscal Year 1983 Economic Pro-*

local officials testifying spoke in opposition to registration. Typically, the focus of state and local testimony was the substantive restrictions Treasury proposed to place upon the use of IDBs. However, then Governor Carey of New York opposed registration on the grounds that it would "unduly increase operational and administrative burdens, increasing the interest rate on each [municipal] issue by as much as one-quarter to one-half a percentage point." [35] Governor Bond of Missouri, speaking also as a committee chairman of the NGA, opposed the registration requirement but did not include his opposition in his summary of principal points. Governor Bond testified that requiring registration of industrial revenue bonds would increase issuance costs and interfere with the operation of state and local governments.[36]

Although the registration requirement—as opposed to the substantive restrictions on the uses of IDBs—apparently was not a priority issue for state and local government officials, Congress was clearly apprised of the arguments against registration. For example, the Chairman of the Board of the Public Securities Association, Mr. Larry Clyde, testified against registration in some detail. Mr. Clyde's testimony indicated that the registration requirement would increase borrowing costs for state and local governments, increase operational and administrative burdens, and generally be inefficient.[37] Thus, many of the arguments urged by plaintiffs here were in fact

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gram, 97th Cong., 2d Sess. (1982) ("House Hearings"); *Hearings before the Senate Committee on Finance Concerning the Administration's Fiscal Year 1983 Budget Proposal,* 97th Cong. 2d Sess. (1982).

[35] House Hearings at 1110.

[36] House Hearings at 1322, 1324.

[37] House Hearings at 1760-62.

presented to Congress in early 1982 when the Administration first proposed registration for IDBs.[38]

A registration requirement for *all* municipal bonds was first introduced in H.R. 6300, a tax compliance initiative of House Ways and Means Chairman Rostenkowski. H.R. 6300 required registration for virtually all long term (more than one year) obligations, including those issued by the United States, by municipalities and by private corporations. *See* H.R. 6300, §§ 102(a), 102(b)(1), 102(b)(2) and 102(b)(3), respectively. H.R. 6300 sought to improve upon the registration requirements imposed in 1980 by specifically permitting the use of efficient, book entry methods of recording ownership and transfer of obligations as a means of satisfying the registration requirement. H.R. 6300, § 102(b)(1).[39]

Shortly after H.R. 6300's introduction, Assistant Secretary Chapoton presented the Administration's views on the bill to the House Ways and Means Committee. Mr. Chapoton testified before the Special Master that, despite the evident importance of Treasury's position for the bill's prospects and his accessibility to concerned interest groups, no state or local government representative contacted him about the proposed registration requirement in the period prior to his congressional testimony.[40]

Mr. Chapoton told the Ways and Means Committee that the registration requirement is well suited to preventing tax evasion primarily because it enabled *taxable*

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[38] Indeed, as an *amicus* in this proceeding, PSA urges many of the arguments that its chairman presented to Congress in 1982.

[39] Section 310(b)(1) of TEFRA is essentially the same as the registration requirement proposed in H.R. 6300. In particular, 26 U.S.C. § 103(j)(3)(A) specifically states that book entry methods consistent with regulations prescribed by the Secretary of the Treasury satisfy the registration requirement.

[40] Tr. 929.

obligations to be subject to information reporting in a much more accurate and comprehensive manner, but also because both taxable and tax-exempt obligations in bearer form are used as a medium of exchange in the illegal sector.[41] The Assistant Secretary indicated that bearer obligations often represent unreported and untaxed income, and that the absence of any system of recorded ownership makes it difficult for the IRS to reconstruct the income of tax evaders. He also expressed a concern about the use of bearer obligations to avoid estate and gift taxes.[42]

Mr. Chapoton's congressional testimony indicated detailed familiarity with the proposed registration requirement. He specifically pointed to book entry systems as a means of satisfying the registration requirement that would at the same time reduce the cost of maintaining ownership records. The Assistant Secretary also stated that Treasury had had a positive experience with the registration both of United States debt and of state and local housing bonds. Mr. Chapoton did express several reservations about some aspects of the universal registration requirement,[43] but expressed no reservations about requiring registration of the municipal obligations at issue here.[44]

H.R. 6300 was not reported by the House Ways and Means Committee. In July, 1982, the Senate Finance

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[41] *Hearings Before the House Committee on Ways and Means on H.R. 6300*, 97th Cong., 2d Sess. 35 (1982).

[42] *Id.*

[43] These reservations dealt with the impact of registration on certain tax treaty exemptions and on obligations held by non-citizens of the United States. *Id.* at 35-36.

[44] Plaintiffs challenge the time spent and amount of preparation done by Assistant Secretary Chapoton prior to his testimony. *See* Tr. 931-36. The gist of this challenge is that Treasury's only empirical study of the registration requirement and its impact on

Committee combined portions of H.R. 6300 with a Senate bill that sought improved tax compliance through enhanced information reporting. S. 2198, 97th Cong., 2d Sess. (1982). This bill, which ultimately became TEFRA, incorporated the universal registration requirement of H.R. 6300, specifically defining a registration-required obligation to include "any obligation issued by a governmental entity." H.R. 4961, 97th Cong., 2d Sess. § 310(b)(2)(A) (1982).[45]

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state and local governments consisted of one study of the issuance costs entailed by a hypothetical $80,000,000 bond issue. *See* DX 42. This cost comparison indicated that issuance costs would be considerably lower if the hypothetical bond issue were in registered rather than bearer form. As discussed *infra* at 21, most municipal bond issues are significantly smaller than $80,000,000. Neither Mr. Chapoton nor his staff studied the costs associated with these smaller bond issues. However, the Assistant Secretary's congressional testimony did not draw upon the study of the hypothetical $80,000,000 bond issue.

The thrust of plaintiffs' attack on the Treasury Department's testimony is that the evidence for the propositions that the Assistant Secretary asserted was anecdotal, not empirical, in character. For example, the NGA sought to establish that the evidence that bearer bonds are used to conceal income and to evade estate and gift taxes was neither quantified nor the result of any comprehensive study. *See* Tr. 946, 952. The Special Master finds no legal support for plaintiffs' implicit argument that the constitutionality of legislation turns upon the quality of the factual underpinnings of testimony given before Congress by Administration officials.

Plaintiffs also assert that Treasury's support for registration may have been in the nature of a political accommodation to Chairman Rostenkowski and/or the securities industry. *See Plaintiffs' Proposed Findings of Fact* at ¶¶ 46-49; *Brief of the NGA* at 61-62 n.*. The record, however, is devoid of evidence that the Assistant Secretary's support for registration was anything other than a result of the IRS's long standing tax compliance concerns. More generally, there is no evidence that TEFRA's registration requirement was the result of anything other than the normal functioning of the political process, with its attendant play of interests.

[45] The Senate Finance Committee attached its bill to H.R. 4961 to comply with the Constitutional requirement that a tax bill originate in the House of Representatives. See U.S. Const. art. I, § 7, cl. 1.

The Senate Finance Committee reported out H.R. 4961 on July 12, 1982. The Senate Report provided the following justification for the universal registration requirement:

> The committee believes that a fair and efficient system of information reporting and withholding cannot be achieved with respect to interest-bearing obligations as long as a significant volume of long-term bearer instruments is issued. A system of book-entry registration will preserve the liquidity of obligations while requiring the creation of ownership records that can produce useful information reports with respect to both the payment of interest and the sale of obligations prior to maturity through brokers. Furthermore, registration will reduce the ability of noncompliant taxpayers to conceal income and property from the reach of the income, estate, and gift taxes. Finally, the registration requirement may reduce the volume of readily negotiable substitutes for cash available to persons engaged in illegal activities.
>
> The committee also recognizes the importance of preserving liquidity in the financial markets. Thus, a flexible book-entry system of registration is permitted and exceptions from the registration requirements are provided for short-term obligations, for obligations of a type not offered to the public and for certain obligations issued abroad.

S. Rep. No. 494, 97th Cong., 2d Sess. 242 (1982).

The Senate bill passed on July 23, without public hearings. Although 20 hours were allocated to Senate debate on the bill, 128 Cong. Rec. 16909 (July 19, 1982) (statement of Sen. Long), registration was never mentioned.[46]

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[46] TEFRA's registration requirement for municipal debt obligations may have been less controversial because it applied across-the-board to all debt obligations, not merely to state and local government bonds. Section 310(a) of TEFRA required registration of all long term obligations of the United States. Sections

Since the Senate bill was attached "in the nature of a substitute" to H.R. 4961, the Senate legislation moved immediately to a conference. On August 17, 1982, the Conference Committee issued its report. The conference adopted the registration requirement for all long term debt obligations. Apparently, the registration requirement was not the subject of conference debate. *See* H.R. Conf. Rep. 760, 97th Cong., 2d Sess. 564-65 (August 17, 1982). The bill passed both houses of Congress on August 19. The registration requirement was not discussed on either the House or the Senate floor.

3. *Extension of TEFRA's Effective Date*

As passed by the Congress and signed by the President, TEFRA's registration requirement was to become effective December 31, 1982. By late October of that year, however, a number of state and local government issuers indicated that they could not comply with the December deadline. Municipal representatives communicated this to the Treasury Department and to the Congress.[47] Congress responded to the request for additional time by including in the Technical Corrections Act of 1982, Pub. L. No. 97-488, a provision extending the deadline for registration of municipal obligations to June 30, 1983. *See* § 306(b)(2), 96 Stat. 2405. The municipal registration requirement became effective on that date.

IV. THE CONTEXT OF REGISTRATION: THE MUNICIPAL BOND MARKET AND THE MECHANICS OF STATE AND LOCAL BORROWING.

The significance of the registration requirement for the municipal bond market and the States as a whole

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310(b)(2) to (b)(6) of TEFRA adopted a number of sanctions for corporate bearer bond issuers and holders, thus insuring that private corporate debt obligations would be issued only in registered form. *See* Stipulation ("Stip.") ¶ 5. For a further discussion of the nondiscriminatory nature of the TEFRA registration requirement, see 182-84, *infra*.

[47] Deposition of John Chapoton at 112-14.

cannot be evaluated without an understanding of the workings of this market and of the role of municipal borrowing in state and local government finance. The parties have stipulated to many of the pertinent facts. Other facts have been established through undisputed testimony.

A. Scope, Purposes, and Kinds of State and Local Government Borrowing

Municipal borrowers are both numerous and diverse. There are approximately 47,000 issuers of municipal obligations.[48] These issuers range in size from large States and public agencies to small school and sewer districts.[49] Individual municipal bond issues can vary in size from several hundred thousand to several billion dollars.[50]

State and local borrowing has increased rapidly in recent years. Although there is no comprehensive data source on new issue activity,[51] the parties have stipulated to approximate, aggregate levels of recent municipal borrowing. In 1974, approximately $23 billion of new municipal bonds were issued. By 1983, the level of new issues had risen to $83 billion. In 1984, the first full year after TEFRA's registration requirement, $102 billion of new municipal bonds were issued. In the first nine months of 1985, States and localities issued some $91 billion of new debt,[52] which would produce an annualized issuance in excess of $120 billion.

The vast majority of the municipal bond market by dollar volume consists of large bond issues of $10 million or more. In 1983, such bond issues accounted for 83%

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[48] Stip. ¶ 11.

[49] Tr. 133.

[50] Tr. 135.

[51] PX 133 at 12. The Federal Reserve Board does, however, track the cumulative, publicly held indebtedness of state and local governments. *Id.*

[52] Stip. ¶¶ 9, 10.

of the new issue market. Bond issues of $5 million or more accounted for 92% of the new issue market while bond issues of $1 million or less accounted for only 1% of the market on the basis of dollar volume.[53]

However, viewed from the standpoint of the number of new issues of municipal bonds, small municipal bond issues of less than $10 million predominate. In 1983, for example, bond issues of less than $10 million accounted for 76% of the total number of new issues. Bond issues of less than $5 million were 62% of all new issues. Finally, bond issues of $1 million or less accounted for 20% of all new issues.[54]

The importance of the ability to borrow to state and local government finance is unquestionable. The States have traditionally used debt obligations to finance capital projects.[55] The need of States and localities to borrow increasing sums to finance infrastructure expenditures likely will continue in the years to come.[56]

The principal investors in municipal securities are commercial banks, casualty insurance companies and individuals.[57] Commercial bank ownership of municipal bonds has remained constant in recent years.[58] Commercial banks hold approximately 42% of total outstanding municipal bonds.[59]

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[53] Stip. ¶ 12.

[54] Stip. ¶ 13.

[55] Tr. 457-59. As federal funding for States and localities has leveled off, municipal reliance on borrowing has tended to increase. *See* Stip. ¶ 20; Tr. 363-64.

[56] PX 126.

[57] Stip. ¶ 90.

[58] Stip. ¶ 91.

[59] Tr. 619, 635-36.

Property and casualty insurance companies hold approximately 15-16% of the total outstanding municipal debt.[60] The remainder of the outstanding municipal securities are held by individuals.[61]

Individual ownership of municipal bonds has increased recently because of the availability of unit investment trusts and mutual funds investing in municipal securities. These devices enable smaller investors to become market participants.[62] Both devices are innovations by institutional market participants. Approximately 50-60% of all individual holdings are now held through these unit investment trusts and mutual funds.[63] Of the remaining individual municipal bond holdings, some substantial percentage (perhaps as much as 50 percent) is purchased and held by the trust departments of banks.[64]

Municipal debt obligations can be broadly categorized into two types. General obligation bonds are bonds that are backed by the full faith and credit (and the taxing power) of the borrowing government. These bonds are issued by States and municipalities that enjoy taxing power.[65]

The other major category of municipal bonds are revenue bonds. Revenue bonds are backed entirely by the revenue produced from some particular facility or activity, usually the revenue of the enterprise funded by the bond issue. Examples of revenue bonds are housing bonds supported by rental or mortgage payments on the housing, hospital bonds supported by hospital fees, road or

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[60] Tr. 641.

[61] Tr. 641-42.

[62] Stip. ¶ 92.

[63] Tr. 642.

[64] Tr. 642-43.

[65] Stip. ¶ 15; Tr. 135-36.

bridge bonds supported by tolls, student loan bonds backed by repayment obligations, etc.[66] Revenue bonds have grown steadily over the past decade and accounted for over 70% of all new municipal issues in 1983.[67]

A special type of revenue bond is the industrial development bond. All or the major portion of the proceeds of an IDB issue are used in the trade or business of a private person, and the payment of principal and interest is secured by an interest in the property used in such trade or business.[68] Governments often issue IDBs to finance job creating industrial expansion. IDBs are also used to finance certain quasi-public facilities such as convention centers and municipal airports.[69] The uses and purposes of IDBs are heavily regulated by the federal government.[70]

B. The Forms of Municipal Debt

By eliminating the tax exempt status of municipal bonds in bearer form, Section 310(b)(1) of TEFRA effectively requires state and local governments to issue their debt in registered form.[71] Prior to the effective date of TEFRA, almost all municipal bonds were issued in bearer form.[72] After the effective date of TEFRA, no

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[66] Tr. 136; Stip. ¶ 16.

[67] PX 133 at 14.

[68] Stip. ¶ 17.

[69] Tr. 201.

[70] *See* 8-9, *supra.*

[71] Stip. ¶ 6.

[72] Stip. ¶ 21. Prior to TEFRA, state and local governments had the option of issuing their debt in either form. Tr. 707-08. Apparently, many issuers had a conversion feature permitting bearer bond holders to convert their bonds to registered form if they desired. Stip. ¶ 26; Tr. 1300. Only a tiny minority of bond holders chose to convert their bearer bonds to registered form. Stip. ¶ 26; Tr. 1300-1301.

state or local government has issued debt in other than registered form.[73] Hence, much of the testimony before the Special Master was devoted to a detailed examination of the burdens and benefits of the two forms of municipal debt obligations.

Bearer bonds are characterized by their extreme ease of transfer. They are presumed by law to be owned by the holder, and are negotiated by simple transfer of physical possession.[74] Interest payments on bearer bonds are made through the use of coupons. These coupons are detached and presented, usually semi-annually, to a bank on or before the interest payment date.[75] The coupons represent the right to the interest payments, and can be detached from the bond and negotiated separately.[76]

The bank that receives the coupon forwards the coupon to the bank or other financial institution designated by the state or local issuer as its "paying agent." The paying agent inspects the coupons and provides payment to the presenting bank. The issuer, of course, will have provided funds to its paying agent prior to the payment date.[77] At maturity, the paying agent pays the bond's face value to the holder in a process parallel to that described for paying interest.[78]

The transfer of ownership and payment procedures applicable to registerd bonds are more complex. The central characteristic of a registered bond is the existence of a list, or lists, on which ownership of the bonds is recorded.[79]

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[73] Stip. ¶ 6.

[74] Stip. ¶¶ 22, 52; Tr. 955.

[75] Stip. ¶¶¶ 24, 62, 63.

[76] Stip. ¶ 25.

[77] Stip. ¶ 63.

[78] Stip. ¶ 74.

[79] Stip. ¶ 27.

Under registration, the municipal issuer or its designated "transfer agent" maintains a registry of the record owners of the bonds.[80] TEFRA provides that this registration requirement can be met through a book entry system of recording transfers of the right to the principal and interest on the bonds. 26 U.S.C. § 103(j). Implementing regulations of the Treasury Department provide that an obligation is registered if transfers of ownership in the debt obligation occur either by:

> (i) the surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder, or
>
> (ii) by a book-entry system where changes in ownership are accomplished through the recording of entries on the books of the issuer, its transfer agent, a securities depository, or any other entity, whether or not the actual physical securities are issued or transferred.

Temporary Income Tax Regulations under TEFRA, 26 C.F.R. § 5(f) 103-1(c) (1986).

Thus, registration can take several forms. Registered bonds can be issued in a certificated form where the debt obligations are evidenced by physical certificates. Registered bonds may also be issued and held in book entry form, which eliminates all but one "global" certificate.[81] Most registered municipal bonds have been issued in registered-certificated form.[82] In the pure book entry form, all transfers occur by book entry and investors cannot receive a physical certificate evidencing their ownership.[83] Pure book entry systems for municipal bonds antedated

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[80] Stip. ¶¶ 28, 51.

[81] Stip. ¶ 30.

[82] Stip. ¶ 32.

[83] Stip. ¶ 35.

TEFRA, but their use has been growing since TEFRA's effective date. However, pure book-entry systems still represent a small portion of the overall municipal bond market.[84]

To effect changes in the record ownership of registered bonds, a seller must contact the bond's transfer agent (either the issuer or its appointed agent) to authorize a change of ownership on the books of the transfer agent.[85] However, a seller can transfer beneficial ownership of a registered bond without going through the transfer agent. At least in the case of registered-certificated bonds, a seller can transfer ownership simply by endorsing the certificate and transferring it to the purchaser, typically with a signature guarantee.[86] Although record ownership remains the same, the beneficial ownership has changed.

Brokers or other intermediaries can also hold registered bonds on behalf of their beneficial owners. The record owner is referred to as the "nominee" of the beneficial owner. There may be a chain of nominees between the record owner of a registered bond and the beneficial owner.[87] Record owners will receive interest payments, which ultimately are forwarded to the beneficial owners.[88] Thus, the beneficial owner can have an

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[84] Stip. ¶ 36. There also exists a hybrid between pure book-entry systems and pure certificate systems. Under an "immobilized clearance" system, a large portion of an outstanding bond issue is held or immobilized in a depository's vaults, with ownership changes recorded on the books of the depository. However, a portion of the issue is held by investors in certificates, with the certificates flowing in and out of the depository according to the need for actual certificates. *See* PX 141 at 23 n.1. For a further discussion of immobilization and securities depositories, *see infra* at 28-33.

[85] Stip. ¶ 55.

[86] Stip. ¶ 54.

[87] *See* Stip. ¶ 43; Tr. 173.

[88] *See* Stip. ¶ 73; Tr. 173.

arrangement with the record owner that is not reflected on the books of the transfer agent.

C. Mechanics of Interest Payment and Redemption of Municipal Bonds

As noted, most municipal bonds pay interest semi-annually. Principal is repaid at maturity or earlier, if the bond is redeemed pursuant to a "call." [89]

Interest payments on bearer bonds require the presentation of bond coupons. Coupons must be presented to the bond issuer's paying agent, which examines the coupons and provides payment to the coupon holder. Often, the bank which receives coupons from a bearer bond holder and presents those coupons to the issuer's paying agent charges the investor a fee ranging from $3 to $7 per coupon for the processing of the coupon.[90]

Interest payments on a registered bond, on the other hand, are made automatically by check or electronic transfer of funds. These alternatives are available because record owners are always ascertainable.[91] Interest checks for registered bonds may be mailed by the issuer's paying agent several days before the interest payment date, and are commonly received several days after the interest payment date.[92] Electronic transfers can be used when bonds are immobilized in conjunction with book entry systems.[93] Either method eliminates the need to process coupons.

The redemption of municipal bonds at maturity or pursuant to a call parallels the interest payment process.

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[89] Stip. ¶ 62. A call provision in a bond allows the issuer to redeem its bonds prior to maturity.

[90] Tr. 1145; Stip. ¶ 64.

[91] Stip. ¶ 65.

[92] Stip. ¶ 66.

[93] Stip. ¶ 67.

Bearer bonds are redeemable by whoever holds them and are presented to the issuer's paying agent at maturity. Registered bonds in certificated form must be presented to the paying agent at maturity so that the registered owner receives his principal. Owners of pure book entry registered bonds or immobilized registered bonds may receive payment of principal either by check or by electronic transfer to their account.[94]

D. Processing and Storage of Municipal Bonds: Of Depositories, Book Entry Systems, and Certificates

The parties presented extensive testimony concerning the handling and storage of municipal bonds, and recent market and technological developments tending to increase the efficiency of bond processing. The parties' intent apparently was to link these processing advantages to one or another form of municipal bond issuance. Market forces, however, rather than the form of municipal bonds fuel the trend toward modernizing efficiencies.[95] Registered bonds do appear to be somewhat more adaptable to these new techniques for automated handling of securities.[96]

Securities depositories were established in the late 1960's and early 1970's to reduce the increasing expense associated with physical handling of securities. Prior to the advent of depositories, settlement of bond transactions involved physical transportation of securities from the seller to the buyer through their respective brokers.[97] Depositories permit more rapid and efficient transfer of securities among their participants through immobilization and book entry recordation of transfers.[98]

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[94] Stip. ¶¶ 74-76.

[95] Tr. 818.

[96] See notes 120-21, *infra*, and accompanying text.

[97] Stip. ¶ 38.

[98] See notes 107-10, *infra*, and accompanying text.

Depositories are non-profit cooperatives owned by securities market participants (banks, brokers and security dealers).[99] Depositories began taking steps to extend their services to the municipal bond market in 1981, when municipal bonds were still issued primarily in bearer form.[100] Depositories—especially the Depository Trust Company ("DTC") in New York City—have come to play a major role in the handling of municipal securities. As of September 30, 1985, over $144 billion in registered municipal bonds and over $99 billion in bearer municipal bonds were immobilized at DTC.[101] DTC, by far the largest securities depository in the United States, holds over 40% of all outstanding municipal bonds in the United States.[102]

Depository services are available to participants directly and to other entities on a correspondent basis. Banks and securities dealers are participants if they pay fees directly to the depository for services provided. On behalf of their customers, these institutions purchase and sell municipal securities and settle the transactions through the use of the depository.[103]

The settlement of bond transactions through a depository involves the seller's broker-dealer instructing the depository to debit its own account at the depository and to credit the account of the buyer's broker-dealer correspondingly. The transfer takes place by computerized entries in the records of the depository rather than by any physical movement of securities.[104]

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[99] Tr. 170; 1138. PX 125.

[100] Stip. ¶ 38.

[101] Stip. ¶ 41.

[102] *See* Stip. ¶¶ 8, 42; Tr. 184.

[103] Stip. ¶ 40.

[104] Stip. ¶ 44.

Transaction settlement through a depository may often involve a chain of entities. For example, if a customer of a small brokerage firm buys a bond and that brokerage firm is not a depository participant, that brokerage firm may deal with a bank or broker-dealer that is a depository participant. Using a correspondent relationship, the smaller brokerage firm has access to the services of the depository. The same may be true on the seller's side of the transaction.[105]

Both bearer and registered securities can be immobilized at depositories. The depository will sometimes exchange large quantities of smaller denomination bonds (both bearer and registered) for fewer, registered ones ("jumbo certificates") in order to save the expense of storage and coupon clipping.[106] When an issue is available in pure book entry form, the depository will hold only a single certificate representing the entirety of that issue.[107] The depository records transfers of portion of the entire issue by computerized journal entries only.[108]

Even when an issuer does not allow the exchange of outstanding bearer bonds for registered certificates, the depository can extend the advantages of immobilization to owners of bearer bonds who prefer to have them immobilized.[109] When bearer bonds are immobilized at a depository, the depository stores the coupons and performs the coupon clipping function. The depository presents the coupons to the issuer's paying agent and receives the funds from that agent on the payment date.[110]

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[105] Tr. 169; Stip. ¶ 45.

[106] Stip. ¶ 46.

[107] Tr. 1164.

[108] Stip. ¶ 46.

[109] Stip. ¶ 47.

[110] Stip. ¶ 72.

In turn, the depository forwards an interest payment check or makes an electronic transfer to the depository participants in whose names the bonds are held. If necessary, the payment may be forwarded through a chain of entities to the beneficial owners.[111]

With registered bonds, there is no need for the depository to clip and process coupons. On each payment date, the depository automatically receives the funds and forwards the interest payments to the depository participant.[112]

A depository may hold an entire municipal bond issue or only part thereof. When the depository holds the entire issue, it is completely immobilized and bond transfers take place only on the books of the depository. When an issue is partially immobilized, bond transfers can take place either on the books of the depository or some bonds can be withdrawn physically from the depository.[113] Partial immobilization meets the requirements of those investors who may desire to hold actual physical certificates. According to the DTC officer responsible for municipal bonds, immobilization and book entry services are available to all issuers regardless of their size.[114]

Bearer bonds cost more to immobilize than registered bonds because of the coupon clipping, security, insurance and storage charges incident to the bearer form.[115] DTC therefore operates a bearer-to-registered exchange program under which immobilized bearer bonds are exchanged for registered ones.[116]

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[111] *Id.*

[112] Stip. ¶ 73.

[113] Stip. ¶ 49.

[114] Tr. 1164. *See also* Tr. 655-56.

[115] Tr. 1143-45.

[116] Stip. ¶ 48.

The cost differential, from the standpoint of immobilization, for registered as opposed to bearer bonds is not insignificant. Immobilizing a $1,000,000 municipal bond issue in registered certificated form costs approximately $22 annually; the same issue in bearer form costs $148 annually. For a $20,000,000 issue, annual immobilization costs are approximately $307 for a registered-certificated issue as compared to well over $2,600 for a bearer issue.[117]

Under pure book entry systems, there will be either no physical certificates or only one global certificate evidencing the issuer's debt. A pure book entry system drastically reduces the annual cost of immobilizing securities.[118] Indeed, whether the issue is $1,000,000 or $100,000,000, the annual cost of immobilizing the entire issue (at least at DTC) is only $4.80.[119]

These automated systems involving immobilization and book entry function more efficiently with registered as opposed to bearer securities.[120] The systems function better because registered bonds do not require physical storage and processing of large volumes of certificates and coupons.[121] Although depositories can handle bearer securities, they are hampered by the storage, security, insurance and coupon clipping functions bearer bonds require.

The trend towards immobilizing newly issued securities at depositories has gained momentum since the passage of TEFRA.[122] Indeed, as Michigan State Treasurer Bow-

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[117] DX 53; Tr. 1148, 1155, 1158, 1163-66.

[118] Tr. 1164-66; 1380.

[119] DX 53.

[120] Tr. 634-35; 1141-42, 1158.

[121] Tr. 1158-59, 1175; 1276-78, 1293; 1336-37.

[122] The large volumes of registered municipal securities held by DTC in the limited period since the passage of TEFRA attest to that fact. See 29 *supra*. The effect of TEFRA has been to accelerate the use of immobilization and pure book entry. Tr. 1204; 1128-29.

man testified, the municipal bond market in all probability would have moved to a registered book entry system on its own even if TEFRA had not been enacted.[123] TEFRA merely hastened the trend toward automation.

E. Municipal Bond Underwriting

A municipal issuer desiring to sell its debt obligations generally does so through an underwriter. When an issue is large, a syndicate made up of dealers and banks is often formed to perform the underwriting function. The underwriter buys the bonds from the municipal issuer and resells them to the public.[124] Local banks will often underwrite smaller municipal bond offerings.[125]

The underwriter receives compensation for selling municipal securities to the public. The compensation is represented by a "spread" between the price the syndicate pays the municipal issuer and the price at which the municipal securities are offered to the general public.[126]

In addition to underwriting of new issues, brokers, dealers and banks are also involved in the secondary market for municipal bonds. The secondary market involves trading in previously issued bonds. This market is not a centralized one like the New York Stock Exchange; it is a less organized market along the lines of the over-the-counter market for corporate stock.[127]

Dealers generally buy and sell for their own account, accommodating buyers and sellers out of their own inventory. Brokers act as agents for others in buying and selling municipal bonds. When the same entity acts in both capacities, it is known as a broker-dealer.[128]

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[123] Tr. 817-18.

[124] Stip. ¶ 81.

[125] Stip. ¶ 85.

[126] Stip. ¶ 89.

[127] Stip. ¶ 88.

[128] Stip. ¶ 86.

V. THE BURDENS OF REGISTRATION ON THE STATES.

A. Introduction

With considerable energy, imagination and skill, the parties have attempted to create a record which will enable the Special Master to assess the actual impact of TEFRA's registration requirement upon States and localities. There are several important areas about which the parties are in apparent agreement. First, Section 310(b)(1) of TEFRA, although enacted under Congress's taxing power, has not functioned as a tax in the sense of having brought any additional revenue into the federal fisc. Rather, it functions as the linchpin of a regulatory scheme designed to insure that all publicly sold debt securities be issued exclusively in registered form. Indeed, it has come to be known as the "registration requirement" because the loss of tax exemption it threatens is a penalty of such severity that no state or local government has issued debt in other than registered form since TEFRA's enactment.[129]

Second, TEFRA has not precluded the States and localities from raising needed capital.[130] The state and local officials that plaintiffs called as witnesses acknowledged that they had neither reduced borrowings nor experienced any difficulties in raising funds subsequent to the passage of the registration requirement.[131] State and

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[129] Stip. ¶ 6; Tr. 443; 617-18.

[130] Plaintiffs have argued that the registration requirement has presented particular difficulties for smaller issuers such as, for example, irrigation districts, small towns or small school districts. However, there is no evidence in the record indicating that any small issuer has been precluded from raising any needed funds.

[131] Tr. 302; 446-47; 554; 784. These officials ranged from a City Commissioner of the City of Wichita, Kansas to the Governor of Illinois, and included several state Treasurers. Governor Thompson of Illinois, for example, testified that the registration requirement had not prevented Illinois from funding any capital project nor

local government borrowing has expanded rapidly since the enactment of the registration requirement and no witness suggested that the rate of increase in borrowing by the States and localities had been slowed in any degree by Section 310(b)(1).

The evidence thus indicates that the federal registration requirement affects the form of state and local debt issues, but does not reach the substance of state and local borrowing. The requirement does not appear to affect either the States' ability to borrow or the States' relative use of their various sources of funds (*e.g.*, borrowing, taxes and federal grants).

Plaintiffs' testimony also made clear that the form of municipal bonds—registered versus bearer—is a matter of little intrinsic significance to States and localities. As Michigan State Treasurer Bowman stated:

> The sole goal that we want to try to meet is offering securities in their preferred form. For instance, if TEFRA or certain sections of TEFRA were repealed . . . that is no admission that we would go back to bearer form. We would want to sell bonds in the preferred method for the market. So if that means that today or next month or next year that pure book-entry or book-entry system[s] was the preferred method for whatever reason, efficiency reasons or immobilization or whatever the case may be, that is the way we would offer bonds.[132]

New Jersey State Treasurer Horn agreed that, in the absence of TEFRA, New Jersey would be guided solely

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from raising any debt that it deemed necessary to raise. Tr. 411. Similarly, one of plaintiffs' market witnesses, Eugene Keilin, a general partner in the investment banking firm of Lazard, Freres & Company, stated that he knew of no case in which it was impossible to issue bonds due to the registration requirement nor of any instances where public agencies were unable to raise money because of the registration requirement. Tr. 192-93.

[132] Tr. 752.

by the demands of the market. If registration lowered interest costs or was otherwise more economical, New Jersey would issue its bonds solely in registered form.[133]

Governor Thompson of Illinois indicated that he was unaware that his State's bonds were issued in bearer form prior to the enactment of TEFRA.[134] He also indicated that he was unaware of the proposed registration requirement during the time TEFRA was under consideration.[135] Absent TEFRA, the Governor indicated that the choice between bearer and registered forms of debt would have rested solely on cost considerations.[136]

B. Legislative and Administrative Transition Costs

To comply with TEFRA's mandate that all bonds be issued in registered form, state legislators and administrators had to change laws and evolve new administrative procedures. The time and money expended to comply with TEFRA, both at the legislative and administrative levels, was not insignificant; however, the evidence taken as a whole indicates that the expenditures were not so great nor the activities so qualitatively different from those ordinarily required of state legislative and executive officials so as to detract from the accomplishment of the ordinary tasks of state and local government. The effort required to comply with TEFRA did not prevent state and local governments from accomplishing other priorities.

1. The Legislative Transition

Plaintiffs put forth the experience of four States (New Jersey, Illinois, Kansas and Michigan) as representative

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[133] Tr. 284-85. *See also* Tr. 193 (the form of municipal bonds is frequently of no concern to either the borrower or the lender).

[134] Tr. 374.

[135] Tr. 405.

[136] Tr. 381-82.

of the experience of the States as a whole.[137] New Jersey determined that 47 different statutes had to be amended in order to comply with TEFRA.[138] A lawyer in the Governor's office coordinated an effort involving several cabinet departments to make the necessary statutory changes.[139] The Debt Management Advisory Committee, a group of investment professionals who advise New Jersey concerning municipal finance issues, developed the draft legislation. The bill was circulated among the various executive departments,[140] passed at the last possible moment, and was signed into law on July 1, 1983.[141]

The Public Securities Association drafted model legislation for state use in complying with the registration requirement.[142] Although the model legislation was used by a number of States, New Jersey drafted a bill of its own that contained an option to return to bearer debt issuance. New Jersey sought to insure that if the TEFRA registration requirement were eliminated, New Jersey would not be compelled—as it would under the model statute—to issue registered debt.[143]

The evidence with regard to the legislative activities of the other States was similar, albeit less detailed. For example, the Illinois legislature had to enact two separate pieces of legislation to comply with TEFRA. The second enactment, in 1984, dealt, in part, with unresolved

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[137] The Secretary did not dispute the asserted representativeness of these States.

[138] Tr. 245-46.

[139] Tr. 246-47; 251-52.

[140] Tr. 249-51.

[141] Tr. 255-56.

[142] PX 24.

[143] Tr. 249-50.

technical problems stemming from the 1982 Act.[144] Also, the 1982 legislative debate over the purely technical legislation required to comply with TEFRA apparently became embroiled with more controversial issues having to do with the scope and size of authorized state debt.[145]

Kansas's enabling legislation for the issuance of registered municipal debt amended no fewer than 86 statutory provisions, and repealed three, in order to insure compliance with TEFRA.[146] In addition, the Kansas Attorney General issued regulations concerning format and procedures for issuing registered debt.[147]

Michigan's experience was also representative. Michigan amended its municipal bond laws to comply with TEFRA as part of an overall amendment affecting many facets of its municipal bond statutes.[148] A substantial number of staff members from the State Treasurer's office were involved in a coordinated effort to effect the transition to registration. Some of the legislative changes involved simply eliminating antiquated requirements. For example, prior to TEFRA, Michigan, as did a number of other States, required authentic signatures on every bond certificate. Since registration requires a new certificate to be issued whenever a bond changes hands, this requirement was no longer practical. Michigan thus changed its law to authorize the use of facsimile signatures.[149]

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[144] Tr. 374-376; PX 44, 136.

[145] Tr. 377-78.

[146] Tr. 540-41; PX 72.

[147] PX 73.

[148] Tr. 715. The Kansas legislation, PX 72, also accomplished a number of other purposes in addition to compliance with the registration requirement.

[149] Tr. 713-14.

2. The Administrative Transition

Plaintiffs presented similar proof concerning the States' administrative costs, activities and burdens in connection with the transition to an all registered environment. The evidence indicated that state officials (and their local counterparts) held numerous meetings and training sessions. They conferred, held seminars, and met with investment bankers and bond counsel to determine how best to accomplish the transition. In just over nine months, States and localities had to implement a registered bond system with which they had little prior experience.

New Jersey, for example, sent members of its Treasury Department to the Morgan Guaranty Bank for training. Other staff members developed the criteria to be used for selecting a financial institution to serve as New Jersey's transfer agent.[150] The State developed a bid evaluation process for selecting its registrar and transfer agent. According to the State's Treasurer, transition period work required a major part of the services of eleven temporary employees and hundreds of hours of overtime.[151]

Michigan's Treasury Department conducted a cost-benefit analysis to determine whether the Department should provide transfer agent services for local issuers or whether such services should be provided by an outside financial institution.[152] Michigan also developed a new procedure for paying the coupons on local school district bonds and grappled with a privacy problem arising from a state Freedom of Information Act request for the names of all the registered owners of Michigan bonds.[153]

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[150] Tr. 258, 260-61.

[151] PX 33; see Tr. 273-74.

[152] Tr. 717, 726.

[153] Tr. 718-20.

The proof concerning plaintiffs' other representative States—Kansas and Illinois—was less detailed. Nonetheless, the record leaves no doubt that TEFRA required numerous changes in existing state administrative procedures in order to enable state and local governments to issue registered bonds. These changes consumed personnel time and required the expenditure of computer and financial resources.

The Secretary argues that these transition costs are learning curve costs that state officials incur every year in dealing with many kinds of federal regulatory requirements. Certainly, the record does not reflect that TEFRA required state legislative and administrative officials to perform any extraordinary feats or to engage in activities different in kind from those in which they ordinarily engage when coping with new requirements. The costs involved in the transition from bearer to registered bonds were neither trivial nor extraordinary.[154]

C. The Administrative Costs of Bond Issuance

The parties contracted with the Government Finance Research Center ("GFRC") to collect data both on the original issuance costs and the subsequent administrative expenses for bearer and registered municipal bonds. The GFRC gathered data from 39 issuers of bearer and registered municipal bonds and also from 37 transfer agents. Experts from both sides assisted with the GFRC's study and jointly analyzed the study's results. The experts presented their joint findings concerning the impact of bond form on issuers' administrative costs in a joint report that has effectively resolved the factual disputes regarding this issue.[155]

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[154] Plaintiffs presented no estimates as to the aggregate costs stemming from the legislative and administrative transition required by TEFRA.

[155] JX 137, the experts' joint study, is entitled "Municipal Bond Administrative Costs." The study was prepared by Herman B.

Original issuance costs are not significantly different for registered and bearer bonds.[156] Original issuance costs include such items as printing costs, bond counsel fees, issuer activity in connection with a bond sale, financial advisory costs and bond rating costs. The experts found no evidence of a statistically significant difference in any of the direct original issuance costs between bearer and registered bonds.[157]

The results are more complex with regard to ongoing administrative costs. Ongoing administrative costs for bearer bonds involve fees paid by the issuer to its paying agent in connection with the payment of interest coupons and the retirement of principal.[158] Ongoing administrative costs for registered bonds generally reflect some minimum annual fee imposed by the transfer and/or paying agent, and an additional fee which may depend on the activity level for the particular issue in a given year.[159]

The joint study indicates that the ongoing administrative costs for registered bonds exceed those for bearer bonds for issues that are $10 million or less in size. However, the administrative costs for registered bonds are less than those for bearer bonds for issues that are $25 million or larger in size.[160] Ongoing administrative costs

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Leonard, Associate Professor of Public Policy at Harvard University (retained by the NGA), and Donald G. Puglisi, Professor of Finance at the University of Delaware (retained by the Secretary).

[156] JX 137 at 2.

[157] JX 137 at 4-5. Apparently, the reduced per unit printing costs for a registered issue are offset by a tendency to print more bond certificates. *Id.* at 5. *But see* Tr. 2152.

[158] JX 137 at 8.

[159] JX 137 at 8-9. Where activity levels for bond issues figure into ongoing administrative costs, they will be calculated based on factors such as the number of certificates redeemed in a given year and the number of transfers in that year. *Id.*

[160] JX 137 at 15-17.

are approximately equal for issues of between $15 and $18 million in size. More generally, however, within the $10 to $25 million range in issue size, the differential in cost between bearer and registered issues is both indeterminate and so small as not to matter on average.[161]

Examining the cost differences between registered and bearer bonds per $1 million dollars of bond issue reveals that the differences are greatest for the smallest size bond issues.[162] Over a projected twenty year maturity period, the cost difference per million dollars of issue size for a $575,000 bond issue is $6,500 in favor of bearer bonds.[163] The cost difference per million dollars for a $1 million bond issue is approximately $3,300 in favor of bearer bonds over the assumed twenty year life of the issue.[164] By contrast, the cost difference per million dollars of issue size for a $25 million, twenty year issue is approximately $300 in favor of registered bonds, and approximately $500 per million dollars of issue size in favor of registered bonds for a $100 million issue.[165]

Since cost differences for registered and bearer bonds vary with issue size, the impact of the TEFRA registration requirement on administrative costs depends upon whether one focuses upon the number of new issues in the bond market or the aggregate principal amount of

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[161] JX 137 at 15, 17.

[162] JX 137 at 15.

[163] JX 137, Table 1.

[164] *Id.* The Secretary points out that smaller bond issues ($1 million or less) tend to have shorter maturities than the twenty year maturity used in the joint study to calculate costs for all bond issues. *See* DX 128. Since the larger part of small issuers' ongoing costs for registered bonds consists of an annual fee, the joint study tends to overstate the cost burdens imposed upon registered issues of $1 million or less, perhaps by as much as one-half. *See* DX 157; Tr. 2147-49.

[165] *Id.*

municipal bonds issued in a given year. Plaintiffs emphasize that bond issues of $10 million or less accounted for 76% of the total number of new issues in 1983; bond issues of less than $5 million accounted for 62% of all new issues; and bond issues of $1 million or less accounted for 20% of new issues in that year.[166] The Secretary emphasizes that bond issues of $10 million or more accounted for 83% of the new issue market by dollar volume in 1983. Bond issues of $1 million or less accounted for only 1% of the 1983 new issue market by that measure.[167]

The increased costs under registration for small issues are due to the relatively high minimum annual fees charged by transfer agents.[168] Smaller issuers such as irrigation districts or small school districts do incur higher post-issuance costs. Conversely, however, state general obligation bond issues—which tend to be over $10 million in size—have lower post-issuance administrative costs.[169]

The Secretary presented evidence that smaller issuers have options available to them to reduce their ongoing administrative costs for registered bonds. In some cases, these options could enable smaller issuers to reduce their costs below the level of those incurred for comparable bearer bonds. Such options would include the use of pure book entry systems[170] and state-wide pooling arrangements.[171] However, the Secretary presented no evi-

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[166] Stip. ¶ 13.

[167] Stip. ¶ 12.

[168] JX 137 at 8-9.

[169] Tr. 279-80; 469-70.

[170] Tr. 1164-66; DX 53. There were 56 pure book entry issues between December, 1982 and October, 1985. DX 54.

[171] *See* DX 32; Tr. 781-82. Kansas is the only State that offers paying and transfer agent services to all its municipalities.

dence indicating any post-TEFRA increase in the use of these systems by smaller issuers.

The experts' joint study also focused upon differences in the amount of "float" [172] between registered and bearer bond issues. The differences in the methods of disbursing funds between bearer and registered bonds apparently result in a consistently larger float for bearer bonds.[173] Estimates of the average difference in the amount of float between bearer and registered issues range from about ½ day based on one set of data to about 1½ days based on another.[174] These differences imply that, for a hypothetical $10 million bond issue with a 10% coupon interest rate and a twenty year maturity, interest earnings on the float at 7.5% over twenty years would be from $1,200 to $3,500 higher for a bearer than for a registered bond issue.[175] However, the GFRC data indicate that only about 20% of bearer and registered issuers receive payment of interest or a reduction in their fees for float earnings; 80% of the sample respondents indicate that they receive no benefit from the float.[176]

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[172] "Float" is the earnings on the interest and/or principal deposited by issuers with their paying agents prior to or on the due date and not yet disbursed to bond holders. During the period after deposit by the issuer and before their disbursement, these funds either do or could earn interest. These interest earnings may or may not be credited to the account of the issuer. Float can be measured in "dollar-days," *i.e.*, the product of the number of undisbursed dollars and the number of days that the dollars remain undisbursed. JX 137 at 18.

[173] JX 137 at 3, 20. As a general matter, holders of registered bonds tend to deposit their interest checks (or draw upon electronically transferred funds) more rapidly than holders of bearer bonds tend to present their coupons for payment.

[174] *Id.*

[175] JX 137 at 21.

[176] JX 137 at 3, 21.

D. The Interest Rate Differential

The parties devoted considerable time and energy disputing the existence of an interest rate differential favoring bearer bonds, *i.e.*, whether the interest rate cost to a municipal bond issuer for a bearer bond would be less than the interest rate cost for an otherwise comparable registered bond in the post-TEFRA period. In its Complaint, South Carolina alleged that it would incur an interest rate penalty of 25 basis points[177] if it were forced to issue its bonds in registered rather than bearer form.[178] On the basis of an econometric analysis prepared for the hearing before the Special Master, plaintiffs now argue that the interest costs of bearer bonds are 5 to 15 basis points lower than for comparable registered bonds. The Secretary argues that municipal bond market participants do not perceive any such differential. The Secretary, relying on a different econometric study, also finds no statistical evidence to support an interest rate differential in favor of bearer bonds.

1. *The Conceptual Basis of An Interest Rate Differential Between Registered and Bearer Bonds*

a. *Introduction*

The theory that the TEFRA registration requirement imposes an interest rate penalty on registered municipal bonds rests on two closely related premises: (1) investors prefer bearer bonds over registered bonds such that (2) investors will extract an interest penalty or "premium" for state and local debt issued in registered form.[179] These premises provide the underlying rationale for the asserted registered/bearer interest rate differential. If such premises cannot be sustained, then the results of any econometric study purporting to measure the dif-

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[177] One basis point is equal to .01%, and 100 basis points are equal to 1%.

[178] Affidavit of Grady L. Patterson, Jr., ¶ 8.

[179] Tr. 449-51; 1588.

ferential should be called into question. As a leading econometrician has pointed out:

> [O]ne should make sure that the model used is constructed on sound hypotheses based on theoretical considerations generated from outside the model itself. While multiple regression and related econometric techniques are powerful tools for analyzing data, their proper use presupposes an underlying theory of the structure generating those data. While some hypotheses concerning that structure can be tested with these tools, the theory itself cannot be discovered by computer runs and data experimentation.

F. Fisher, *Multiple Regression in Legal Proceedings*, 80 Colum. L. Rev. 702, 735 (1980).

This caveat is important because the difficulties of assembling an appropriate and accurate data base and the statistical complexities of the econometric models tended to preoccupy the parties. The fundamental issue, however, is not statistical, but financial and economic: is there an investor preference for bearer bonds of sufficient strength to give rise to a measurable, consistent and continuing interest rate differential favoring bearer bonds?

b. *Investor Preferences*

Plaintiffs argue that state and local government obligations are widely purchased and held by individuals, many of whom are small investors. These individuals, plaintiffs suggest, prefer the familiar system of clipping coupons from bearer bonds over the supposedly more complex registration system.[180] "These factors, as well as habit and tradition, probably account for the investor preference demonstrated for bearer instruments." *Brief of the NGA* at 54. Plaintiffs also rely upon the overwhelming predominance of bearer municipal bonds prior to TEFRA as evidence of a market preference for bearer municipal securities.

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[180] Tr. 648.

The record does not support any strong or consistent investor preference for bearer municipal bonds. First, large institutional investors hold the majority of outstanding municipal bonds.[181] These institutions have no preference to handle bearer bond certificates and clip coupons.[182] Their concern is only to maximize the return on their investments and minimize operational problems.[183]

Second, even for individual investors, there is no convincing evidence of a preference for bearer securities. Plaintiffs hold out the example of an older, wealthy individual investor who cherishes the familiarity of the bearer system.[184] Such individuals may well exist. However, the handling of bearer securities is demonstrably more expensive and inconvenient for an investor than the handling of registered securities.[185] The concrete disadvantages of bearer securities militate against any finding of a strong individual investor preference for bearer bonds, especially a preference of sufficient strength to create an interest rate differential between bearer and registered bonds.

Moreover, individual investor participation in the municipal bond market is increasingly mediated by large institutional investors. One of plaintiffs' witnesses estimated that 50 to 60 percent of individual municipal bond holdings are actually held through institutionally sponsored municipal bond funds and unit investment trusts.[186] Perhaps as many as half of the remaining indi-

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[181] Tr. 646. See notes 57-64, *supra*, and accompanying text.

[182] Tr. 637-39, 646-47; 1336-37.

[183] See Tr. 639-40.

[184] See, e.g., Tr. 647-48.

[185] An individual holder of a bearer municipal bond must provide storage and security for an asset which is, after all, presumptively owned by its holder. The individual must also arrange for insurance, clip and present coupons semi-annually, and pay fees for the cashing of the coupons. See 27, 31, *supra*.

[186] Tr. 642.

vidual holdings are held through bank trust departments.[187] These facts reflect the "strong trend" toward the institutionalization of individual participation in the municipal bond market such that institutions increasingly hold bonds on behalf of individual investors.[188]

Where individuals invest through institutional vehicles, they do not take possession of the underlying municipal bonds.[189] Thus, the asserted strong individual investor preference for physical possession of bearer municipal bonds is inconsistent with this basic evolution in the structure of municipal bond ownership. The indifference of so many investors to physical possession of their municipal bonds undermines plaintiffs' contention that there exists an investor preference for bearer bonds of sufficient strength and breadth to give rise to an interest rate differential.

Plaintiffs' argument that the dominance of bearer bonds in the municipal market prior to TEFRA reflected investor demand for bearer bonds is not supported by the record. The municipal bond market, until quite recently, was an unregulated market that operated by custom and without central direction.[190] There were many thousands of diverse issuers. Unlike the United States Treasury and corporate bond markets, there was no issuer or institution powerful enough to break the grip of inertia on the market.[191] The dominance of bearer securities appears to have been due not to investor preference, but to the absence of an impetus or motivation to change.[192]

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[187] Tr. 642-43.

[188] Tr. 1377; *see* Tr. 1337-38.

[189] Tr. 647-48.

[190] Tr. 1269-70.

[191] Tr. 1252; 1269-70.

[192] Tr. 1244-46; 1268; 1327-28.

Even if plaintiffs did establish an investor preference for bearer municipal bonds, plaintiffs did not explain the reasons for that investor preference in any detail. This is particularly important in light of Congress's expressed intent to eliminate illegal uses of bearer bonds.[193] As discussed more fully in the Special Master's legal analysis, if the desire of some investors to use bearer municipal bonds to evade taxes or to conceal income is the source of an investor preference for bearer bonds, plaintiffs surely must explain why this desire should receive constitutional protection. See 131-32, *supra.*

2. *The Non-Econometric Testimony*

The parties elicited testimony from state government officials and municipal bond market participants concerning the possible existence of an interest rate differential. State government witnesses were divided as to whether there is an interest rate penalty for registered bonds; the market witnesses' testimony strongly suggests that there is not. Plaintiffs, however, question the reliability of any nonstatistical judgment as to the existence of an interest rate differential.

Treasurer Patterson of South Carolina testified that registration created an interest rate penalty of "up to 25 basis points."[194] However, Mr. Patterson could provide no basis for that belief other than conversations with market participants whom he could not name.[195] Treasurer Horn of New Jersey similarily opined that an interest rate differential existed, but he could provide no information about the size of the differential or any other support for his view.[196]

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[193] *See* section VI(B), *infra.*

[194] Tr. 449.

[195] Tr. 502-505.

[196] Tr. 347-49.

Interestingly, New Jersey's Assistant Treasurer and Director of Financial Management wrote Treasurer Horn a memorandum in February, 1985 stating that New Jersey's experience post-registration is that "no trading premium exists for bearer bonds vs. registered bonds. Investors are not attaching a special economic value to the bearer obligation." [197] Also, Delaware Treasurer Janet Rzewnicki stated, based on her discussion with bond underwriters and others involved in public finance, that there was no interest rate differential on Delaware bonds.[198]

The testimony of municipal bond market specialists concerning the interest rate differential was rather more specific. Plaintiffs' market witness,[199] Richard Tauber, directs the investment banking group of Morgan Guaranty Trust of New York's public finance department. Mr. Tauber testified—on the basis of his discussion with Morgan Guaranty's municipal bond traders—that there was an interest rate differential favoring bearer bonds when TEFRA first became effective in July, 1983.[200] He estimated that the initial differential was 20 to 25 basis points.[201] However, Mr. Tauber also indicated that the differential had narrowed continuously, and did not exceed 5 basis points in January, 1986.[202] The differential, according to Mr. Tauber, was "continuing to decline." [203]

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[197] DX 3 at 3.

[198] Deposition of Janet Rzewnicki at 132-34.

[199] Eugene Keilin of the Lazard, Freres investment banking firm also testified for plaintiffs, but he was not asked about the existence of an interest rate differential between bearer and registered bonds.

[200] Tr. 614-15.

[201] Tr. 615.

[202] *Id.*

[203] Tr. 648.

Although neither Mr. Tauber nor Morgan Guaranty performed any studies of the interest rate question,[204] Mr. Tauber provided a plausible explanation for his view. The July, 1983 differential, Mr. Tauber believed, was a transitional problem caused by market uncertainty concerning valuation and resale prices of registered bonds.[205] As the market adapted to the registered environment, the differential narrowed.[206]

The Secretary's market witnesses were uniformly of the view that there exists no interest rate differential between bearer and registered municipal bonds today. Ronald Readmond, general partner of Alex Brown & Sons, an investment banking firm which is a major municipal bond underwriter not located in New York City, testified "definitive[ly] and confident[ly]" that "there is no evidence of any yield differential between registered and bearer form that we can locate anywhere in the market, with the possible exception of some Florida issues, but we don't believe it is even widespread in Florida issues." [207]

Mr. Readmond also testified that the form of a municipal bond is not a factor in secondary market pricing. According to Mr. Readmond, J.J. Kenny Information Services, a municipal bond dealer which provides pricing services to holders of municipal bond inventory, does not differentiate between registered and bearer bonds in setting bond prices.[208] Also, bond traders do not inquire about the form of a municipal bond being offered

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[204] Tr. 649.

[205] Tr. 615-16; 649.

[206] Tr. 649.

[207] Tr. 1295. Mr. Readmond was not asked why a differential might exist for some Florida issues.

[208] Tr. 1296.

for sale, nor differentiate between bond forms when making a bid.[209]

George Plender, Jr., the national sales manager of the municipal bond department of Prudential-Bache Securities, a leading underwriter of municipal bonds, testified that "[t]here is no interest rate penalty" imposed on registered bonds post-TEFRA.[210] Mr. Plender corroborated Mr. Readmond's testimony that bond traders no longer ask about a bond's form and are not concerned with the registered/bearer distinction in setting prices.[211] As a general policy, Prudential-Bache does not differentiate in pricing between bearer and registered municipal bonds when it buys and sells in the secondary market.[212]

Philip Alexander, the Vice President and Treasurer of John Nuveen & Company, a municipal bond investment banker which is the largest sponsor of municipal bond unit investment trusts in the country, also stated that there is no interest rate differential based on the form of municipal bonds.[213] According to Mr. Alexander, the market simply does not recognize any price differential

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[209] *Id.* Prior to TEFRA, traders made this inquiry and discriminated against registered bonds in setting prices. Registered municipal bonds were a tiny part of the total municipal market pre-TEFRA, and the market discriminated against them. Tr. 1294. The transfer process for registered bonds in an overwhelmingly bearer environment was inefficient and time consuming. Tr. 1323. Today, the Blue List, the industry's daily catalogue of municipal bonds offered for sale, does not distinguish between registered and bearer bonds. Tr. 1709; 2029-30; DX 101-03. The only exception is for the pre-TEFRA registered bonds that trade at a penalty. Tr. 1723; 2030.

[210] Tr. 1327.

[211] Tr. 1329, 1339, 1350, 1353.

[212] Tr. 1354.

[213] Tr. 1391.

between the two categories of bonds.[214] He testified that there may have initially been some small differentials, but they have disappeared.[215] Mr. Alexander's testimony was based, in part, on discussions with John Nuveen's unit investment trust municipal bond buyer, who is the largest single purchaser of municipal bonds in the market.[216]

Plaintiffs question the probative value of the market participants' testimony. To determine if an interest rate differential exists, plaintiffs contend, one would have to compare matched pairs of registered and bearer bonds, *i.e.*, bonds similar in every respect except their form. Otherwise, price similarities may be due to other factors. Bond traders will seldom see precisely matched pairs and hence, plaintiffs argue, traders cannot make an accurate judgment as to the existence or magnitude of an interest rate differential.[217] Moreover, plaintiffs contend that an interest rate differential of 5 to 15 basis points can easily be obscured by larger daily or weekly movements in market price levels.[218]

Plaintiffs' arguments do suggest plausible reasons to temper the force of the market witnesses' testimony. A methodologically sound and carefully executed econometric study could be more precise than a trader's observations in determining whether a *particular* registered bond traded at a penalty to the otherwise prevailing market rate. However, the testimony of those who make and trade in municipal bond markets is an excellent guide to actual investor preferences and market demand. Those who make their livelihood in the municipal bond markets

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[214] Tr. 1376.

[215] Tr. 1391.

[216] Tr. 1390.

[217] *Plaintiffs' Proposed Findings of Fact* at ¶¶ 192-94.

[218] *Plaintiffs' Proposed Findings of Fact* at ¶ 195.

will familiarize themselves thoroughly with customer preferences and underlying bond price determinants or soon be out of business.[219] If the market imposed a penalty on registered bonds of sufficient size to be significant in the aggregate and over the long term, major market participants would know of the differential. Indeed, these participants would, at least in part, impose it.

The testimony of market witnesses that any initial price differential disappeared or is disappearing undermines the foundation for plaintiffs' interest rate contention. If there is an interest rate differential between bearer and registered bonds, the record does not indicate its cause. Neither investors nor traders exact such a penalty.

3. *The Econometric Studies*

a. *Introduction*

The parties employed statistical, econometric and financial experts to attempt to measure the interest rate differential, if any, between registered and bearer municipal bonds after TEFRA. The task proved exceedingly difficult. The intrinsic difficulties of the task, and the fundamental problems uncovered by the rigorous adversarial scrutiny of each party's studies by the other party's experts, indicate that the parties' econometric studies have very limited probative value. They shed little light on the question whether TEFRA's registration requirement imposed an interest rate penalty on municipal borrowing.

The goal of the econometric studies was to measure any TEFRA induced increase in the net interest costs incurred by municipal issuers in the primary market. The primary market consists of the sale of municipal bonds by the issuer to underwriters and the initial resale

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[219] As Mr. Readmond testified, "[t]his is a basic business to our firm and as a result that's a question [whether there is an interest rate penalty for registered municipal bonds] that we should have a definitive and confident answer to." Tr. 1295.

of those bonds by underwriters to investors.[220] Both sides' experts agreed that the ideal approach to determining whether an interest rate differential exists would be to compare sales of matched pairs of registered and bearer bonds in the primary market after TEFRA. These pairs would be identical with respect to all factors known to influence interest cost (credit risk, amount of the issue, maturity, call features, etc.).[221] Unfortunately, there are no bearer municipal bonds issued after TEFRA, so there are no matched pairs in the primary market that would permit a direct comparison. A primary difficulty in the econometric studies thus was the methodological complications stemming from the need to develop surrogates for a direct comparison.

The parties' second common difficulty also inheres in the nature of the problem presented. The interest rate differential that plaintiffs assert is attributable to bond form is not large in absolute terms (5 to 15 basis points is only 5 to 15 one-hundredths of one percent).[222] The econometric studies attempted to detect and measure these small differences using very imprecise data, with important features of certain bonds in the data bases uncertain and unspecified. In addition, the studies required that complex and controversial statistical adjustments be made. Small errors created large differences in the studies' results. Results changed frequently as data

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[220] See 33, *supra*.

[221] DX 100 at 3; PX 200 at 11-12.

[222] Plaintiffs' experts, Harvard University Professors Herman Leonard and John Meyer (experts in public finance, statistics and economics), stated that the differential is fairly small relative to the range in bond yields that arise from factors which typically would affect bond interest rates such as differing risk characteristics, time to maturity, coupon interest rates and call provisions. They also indicated that the differential is small relative to the daily volatility in bond yields associated with investor expectations of political events and general economic trends. PX 200 at 3.

base errors were detected and statistical, federal income tax treatment and financial assumptions proved incorrect. As explained in detail below, the Special Master finds that neither the data nor the statistical models were sufficiently reliable to permit confident judgments about the small interest rate differentials in question.

Finally, none of the studies was sensitive to the possibly transitional nature of the interest rate differential. The studies focused on the existence of an interest rate differential *vel non*. They were not concerned with the causes of the differential and were not sensitive to the possible variations in the differential over time. Thus, the studies shed little light on the possibility—testified to by municipal bond market specialists—that any interest rate differential that may have existed was a transitory phenomenon associated with the market's adjustment to an all registered environment.

b. *The Secondary Market Studies*

Plaintiffs did not attempt an econometric analysis of the primary market, concluding that controlling for extraneous factors would be infeasible.[223] Instead, plaintiffs focused upon the secondary market in which investors resell bonds subsequent to their original issuance.[224] Their secondary market study attempted to isolate "matched pairs" of bearer and registered bonds selling in the secondary market in which the only material difference—material in the sense of influencing interest rate

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[223] PX 200 at 11-12. PX 200 is Professors Leonard's and Meyer's initial study entitled "The Registered/Bearer Yield Differential For Tax-Exempt Bonds." Its results were modified by a pre-trial addendum, PX 171, and a post-trial correction, PX 201. DX 175 is the Secretary's experts' critique of plaintiffs' initial study. The Secretary's experts' rejoinder to the post-trial correction is DX 177. The documents must be read together for a full understanding of the study's results.

[224] PX 200 at 12. For a brief discussion of the primary and secondary markets, see 33, *supra*.

or price—was the bond's form. If registered and bearer bond pairs could be precisely matched, then the price or interest rate differential can be attributed to the bearer/registered difference.[225] Plaintiffs hypothesized—without adducing direct proof—that differentials between registered and bearer bond prices in the secondary or resale market could be extrapolated to differences in issuer net interest cost in the primary market.

The need to match bond pairs as precisely as possible necessitated plaintiffs' use of relatively small samples of bond pairs.[226] Plaintiffs developed three samples of bonds by inspecting the Standard & Poor's Blue Lists of "asked" prices or yields from brokerage firms for bonds available for sale on three different dates: August 8, 1983, May 31, 1985 and August 22, 1985.[227] There were 16, 22 and 27 pairs of bonds in the three original samples, respectively.[228]

In attempting to create matched pairs of registered and bearer bonds, plaintiffs viewed their first priority as matching on credit risk characteristics[229] such as identity

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[225] PX 200 at 14-15.

[226] PX 200 at 14. The three samples, originally totalling 65 pairs, shrank as a result of errors in the compilation of the data. See 66-68, *infra*.

[227] These prices represent approximations of what the offering broker seeks for the bonds. The data do not represent actual trades at the prices or yields quoted. Plaintiffs used asked prices instead of prices from actual trades because the Blue Lists were an expedient source of comprehensive and concurrent information about a large number of bonds. While recognizing that use of asked prices (as opposed to actual trades) introduces inaccuracy in the data, plaintiffs argue that the use of asked prices does not involve a systematic bias favoring one bond form or the other and hence that the inaccuracy will not affect the results. See PX 200 at 16 and n.*.

[228] PX 200, Appendix A.

[229] Credit risk is simply the creditworthiness of the borrower, *i.e.*, the probability that the borrower will repay its obligations in accordance with their terms. These differences in credit risk are

of issuer, bond rating, and insurance.[230] Matching on risk characteristics meant that there were sizable differences within the pairs on other variables that affect bond yield. The most important of these differences in other variables were the coupon rate of interest and the date to maturity.[231] Plaintiffs attempted to correct for these yield differences using three alternative but related statistical techniques which use financial theory to equate yields for bonds with differing coupons and maturities.[232]

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very difficult to measure except by using yield differences, which is precisely the variable to be measured. Hence, differences in credit risks between bonds that are reflected in interest rate differentials cannot be easily eliminated by statistical adjustments, at least where the study is testing for interest rate differentials themselves. PX 200 at 17-18. This accounts for the high priority plaintiffs attached to matching bonds on credit risk characteristics.

[230] Whether a bond can be "called," see note 89, *supra*, is an important element of risk. There was considerable confusion both in plaintiffs' study (PX 200 at 16—"absence of call provisions"; PX 200 at 17—"identical call provisions") and at the hearing concerning the degree of matching of call provisions, if any, in plaintiffs' analysis. See note 256, *infra*.

[231] PX 200 at 18. The coupon rate of interest is the interest rate paid by the issuer on the face value (par value) of the bond. The market adjusts the price of the bond to create a premium or discount as may be appropriate to produce the yield required by the current market.

[232] PX 200 at 18-22. The first method, "unconstrained multiple regression," used information from within each sample (and thus information from one day only) to attempt to correct for yield differences resulting from maturity and coupon rate differences. Plaintiffs' experts judged this the least reliable of their three correction methods. Professor Meyer frankly characterized this correction method as the poorest of the three used and indicated he had little confidence in it. *See* Tr. 1877; PX 200 at 27-28.

Plaintiffs' second correction method, "constrained regression," used information from all three samples to correct the observed yields for the effects of differing maturities and coupon rates of interest.

Plaintiffs' third method, "constrained regression using out of sample information," is the only correction technique that allowed

Plaintiffs applied two different tests of the statistical significance of their results, a somewhat crude "sign" test and a more refined "size" test, to each of their three methods of correcting for differences in coupon interest rate and maturity.[233] Plaintiffs expressed statistical significance in terms of "confidence levels" by subtracting the results of their tests of statistical significance (*e.g.*, .01 or .05) from the number one and expressing the result as a percent (*e.g.*, 99% or 95% "confidence levels").[234] This approach can be misleading in that, as one of the Secretary's experts testified, "it has a connotation that 75 percent is rather confident, and . . . if you make a decision by flipping a coin you start with 50 percent confidence because it is half and half."[235]

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for yield adjustments based upon capital gains tax differences among the bonds. Plaintiffs judged this method to be the most reliable of the three employed. *See* Tr. 1877-78. It involved deriving a hypothetical zero coupon term structure for each bond from industry yield-to-maturity curves and then applying a hypothetical (but conservative) capital gains tax rate to arrive at corrected yields.

[233] PX 200 at 22-23; DX 175 at 4-6.

[234] PX 200 at 24.

[235] Tr. 1905-06 (testimony of Professor Ingram Olkin of Stanford University). *See also* F. Fisher, *supra*, 80 Colum. L. Rev. at 717-18:

> Significance levels of five percent and one percent are generally used by statisticians in testing hypotheses. That is, given a significance level of five percent (or one percent for a stricter researcher) it is safe to assume that the true coefficient is not zero and that therefore the variable being tested has some effect on the dependent variable in question. . . .
>
> . . . [A] significance level of fifty percent would not correspond to a 'preponderance of the evidence' standard. The significance level tells us only the probability of obtaining the measured coefficient value *if* the true value is zero; it does *not* give the probability that the coefficient's true value *is zero, nor does subtracting the significance level from one hundred percent give the probability that the hypothesis is not true.* Because, even with a large sample, it is quite possible to obtain results dif-

For clarity of presentation and ease of understanding, the Special Master will present plaintiffs' results in terms of statistical significance.

The following table summarizes the results of plaintiffs' original study, prior to any corrections made by the plaintiffs:

TABLE 1

Sample	Yield Differential Favoring Bearer Bonds	Statistical Significance	
		Size Test	Sign Test
	Correction Method 1		
Aug 1983	13 basis points	.252	.227
May 1985	6 basis points	.301	.262
Aug 1985	5 basis points	.284	.061
	Correction Method 2		
Aug 1983	16 basis points	.087	.227
May 1985	11 basis points	.040	.067
Aug 1985	12 basis points	.039	.026
	Correction Method 3		
Aug 1983	28 basis points	.011	.038
May 1985	12 basis points	.015	.143
Aug 1985	13 basis points	.004	.026

Source: PX 200 at 26, 28 and 34; see DX 159.

These results formed the basis for plaintiffs' experts conclusion that there exists an interest rate differential favoring bearer bonds of from 5 to 15 basis points, and that their findings were statistically significant.[236] It should be noted, however, that the results of Correction Method 1 are uniformly not statistically significant (un-

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fering from a coefficient's true value, it is conventionally thought that there must be a very high probability that the coefficient is not zero before it can be conclusively claimed that the variable associated with the coefficient has a definite effect on the dependent variable. (Emphasis supplied.)

[236] PX 200 at 35-36. Plaintiffs did not explain how they got from their results to their conclusion that the interest rate differential favoring bearer bonds is in the range of 5 to 15 basis points. This omission adds to the imprecision inherent in the use of a range.

der either a .05 or a more stringent .01 standard). Under Correction Method 2, the results are not statistically significant for the August, 1983 sample but are statistically significant (at the .05 level) for the August, 1985 sample. For the May, 1985 sample, the results are not statistically significant under the sign test, but are statistically significant (at the .04 level) under the size test.

Under Correction Method 3—in which plaintiffs' experts place the most confidence—the results are highly significant for all three data samples under the size test and for two of the three samples under the sign test. This set of results provided the strongest support for plaintiffs' conclusions, but were soon to undergo significant changes.

The Secretary's experts, prior to correction of any of the subsequently discovered data base, computational, tax, or statistical errors, performed a "signed rank" test on the results of plaintiffs' third, and best, correction method. The signed rank test has greater predictive power than the sign test and avoids assumptions about the distribution of data (which can lead to erroneous results) that inhere in the size test.[237] The signed rank test indicated that, for two of the three samples, the results of plaintiffs' Correction Method 3 were not statistically significant at the less stringent .05 level:

TABLE 2

Statistical Significance of Results of Plaintiffs' Correction Method 3

	Signed Rank Test
August 8, 1983	.116
May 31, 1985	.040
August 22, 1985	.210

Source: DX 175 at 6; see DX 170-DX 172.

[237] DX 175 at 4-5.

Just prior to the hearing before the Special Master, plaintiffs' experts detected two errors affecting the results of their study, a series of computational errors affecting Correction Methods 1 and 2 and the erroneous inclusion of five callable registered bonds (out of a total of 16) in the August, 1983 sample (affecting all three methods' results for the August, 1983 sample).[238] As corrected, the results of plaintiffs' secondary market study are summarized in the following table:

TABLE 3

Sample	Yield Differential Favoring Bearer Bonds	Statistical Significance[239] Size Test	Sign Test
	Correction Method 1		
Aug 1983	15 basis points	.25	
May 1985	-.6 basis points[240]	"low"	
Aug 1985	6 basis points	.25	
	Correction Method 2		
Aug 1983	27 basis points	.05	
May 1985	5 basis points	.20	
Aug 1985	9 basis points	.05	
	Correction Method 3		
Aug 1983	21 basis points	"virtually identical to those . . . originally reported"[241]	
May 1985	12 basis points	.015	.143
Aug 1985	13 basis points	.004	.026

Source: PX 171.

[238] PX 171 at 1-2.

[239] Plaintiffs did not specify which test or tests of statistical significance, *e.g.*, the size test, the sign test, or both, were used to show the statistical significance of the results of Correction Methods 1 and 2.

[240] The May, 1985 sample, under Correction Method 1, showed a .6 basis point differential in favor of *registered* bonds. Plaintiffs explained only that the result "has a low level of statistical confidence". PX 171 at 2.

[241] In regard to the revised results of Correction Method 3, plaintiffs stated that they had "been unable to compute the correspond-

These corrections show a decline in the statistical significance of the results of Correction Methods 1 and 2 (including a finding of a differential favoring registered bonds in the May, 1985 sample under Correction Method 1). They also indicate that the elimination of callable registered bonds in the August, 1983 sample diminished the interest rate differential for that sample under Correction Method 3 from 28 to 21 basis points.

Plaintiffs' experts acknowledged another error affecting the results of Correction Method 3—their most reliable correction technique. Plaintiffs' experts incorrectly assumed that the Internal Revenue Service allows an investor purchasing a bond at a premium to deduct the "loss" on the redemption of the bond at maturity.[242] Correction of this error by plaintiffs resulted in lower estimates both of the interest rate differential and of the statistical significance of the results.[243] For reasons that are not entirely clear, plaintiffs restored the five callable registered bonds to the August, 1983 sample when they recalculated their Correction Method 3 results.[244] Plaintiffs previously had voluntarily deleted those bonds, and stated that their inclusion had incorrectly exaggerated the asserted interest rate differential in favor of bearer bonds.[245] Hence, the results of Correction Method 3 for the August, 1983 sample cannot be regarded as reliable.

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ing changes in the statistical significance of the method 3 results, but they will be virtually identical to those we originally reported." PX 171 at 4. Plaintiffs did not subsequently supply the Special Master with those computations.

[242] DX 175 at 20; PX 201 at 1.

[243] PX 201 at 1.

[244] DX 177 at 2.

[245] PX 171 at 3.

Plaintiffs' results after correcting for the tax treatment error are summarized in Table 4:

TABLE 4

Sample	Yield Differential Favoring Bearer Bonds	Statistical Significance	
		Size Test	Sign Test
	Correction Method 3		
Aug 1983 [246]	27 basis points	.012	.038
May 1985	6 basis points	.126	.262
Aug 1985	6 basis points	.115	.026

Source: PX 201 at 2.

Comparison of Table 3's results with those of Table 4 show that the tax treatment correction reduced the interest rate differential by 50% for the May, 1985 and August, 1985 samples. Further, the results for those samples are not statistically significant at the .05 level except for the sign test for the August, 1985 sample. Finally, as indicated, five of the 16 bonds in the August, 1983 sample should not be included, by the plaintiffs' own criterion.

Thus far, the results presented do not reflect any disputes between the parties regarding data base composition, financial assumptions, or statistical theory. The wide variations in the results do, however, indicate their sensitivity to data base and tax treatment adjustments.

The Secretary's experts [247] presented a large number of methodological problems in the plaintiffs' secondary market study. Initially, they pointed out that there is no precise relationship between bond yields as reflected

[246] The August, 1983 sample includes callable bonds (five of the 16 bonds in the sample) that plaintiffs agree should be deleted.

[247] Donald J. Puglisi is a Professor of Finance at the University of Delaware. Dr. Puglisi has expertise in the municipal bond market. Ingram Olkin is a Professor of Statistics at Stanford University.

in secondary market transactions and issuers' actual net issuance costs in the primary market.[248] The strength of the relationship may be tenuous.[249] Yields do diverge, and the extent of the difference varies over time.[250] It is quite possible that yields in the secondary market could fail to reflect declining underwriter spreads and hence reduced net interest costs for issuers in the primary market.[251] This reduces the confidence with which one can draw inferences about issuers' net interest costs from plaintiffs' secondary market study. Plaintiffs argue that there may be a distortion, but the bias is not systematically in favor of one or the other bond form.

Second, the Secretary's experts testified that the use of Blue List "asked" or offering prices—instead of actual transaction prices—introduces considerable uncertainty in the results. Use of the asked prices assumes as the plaintiffs' experts acknowledged, that differences between asked and sale prices affect bearer and registered bonds identically.[252] There is no evidence for this proposition one way or the other, and plaintiffs offered no theoretical justification for it.

There is another difficulty in the use of Blue List offering prices in lieu of transaction prices. The offering prices for the same bonds vary according to the dealer, and vary by as much or more as the asserted interest rate differential attributable to the registered/bearer distinction.[253] Hence, the results of the secondary market

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[248] DX 175 at 9; Tr. 2007-08, 2016.

[249] Tr. at 2008.

[250] DX 175 at 9.

[251] Tr. at 2008.

[252] DX 175 at 8; Tr. 2015; PX 200 at 16 n.*.

[253] DX 175 at 9. The Secretary's experts detected a 75 basis point and a 22 basis point differential in offering prices for two pairs of bonds in plaintiffs' sample that were identical (except as to the volume being offered for sale in one pair).

study can be affected by the particular offering prices selected. Pricing difficulties which inhere in the use of secondary market prices suggest caution about using Blue List data as the source of inferences about small price differentials in the primary market.[254]

The Secretary's experts also detected a large number of errors in the composition of plaintiffs' Blue List data base. The sheer number of these errors—and the resulting dramatic reduction in the reliable number of pairs in the sample—create serious questions about the reliability of plaintiffs' results. First, Professors Puglisi and Olkin pointed out that one of the bonds in the May, 1985 sample and two of the bonds in the August, 1985 sample were definitely or probably incorrectly classified as to their form.[255] That reduced the sample sizes to 21 and 25 bond pairs, respectively.

Second, a large number of additional callable bonds were improperly included in plaintiffs' study.[256] In addition to the five pairs of callable bonds that plaintiffs' experts voluntarily excluded from the August, 1983 sample prior to the hearing,[257] the Secretary's experts dis-

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[254] DX 175 at 9-10; Tr. 2017-20.

[255] DX 175 at 10-11; Tr. 2020-23. Plaintiffs did not dispute this point. See *Plaintiffs Findings of Fact* at ¶ 207.

[256] There was considerable confusion at the hearing as to the instructions given to plaintiffs' experts' research assistant regarding matching bond pairs for call provisions. Although the executive summary of plaintiffs' report indicated that they selected pairs of bonds with identical call provisions, PX 200 at S-2, the text of the report states that no bonds with call provisions were included. PX 200 at 16. At trial, Professor Meyer indicated he was unsure whether the sample ultimately included bonds with call provisions. Tr. 1878-79. Professor Puglisi testified that plaintiffs had included numerous bonds with call provisions, and that the provisions were not identical within each pair. Tr. 2101-02.

[257] As indicated, *supra* at 63, plaintiffs' post-trial correction of the results of Correction Method 3, PX 201, inexplicably included these bonds.

covered two additional pairs involving callable bonds in that sample;[258] four additional pairs involving callable bonds in the May, 1985 sample; and three in the August, 1985 sample.[259] These call provisions were materially different within pairs and likely to have an effect on observed yields.[260] Neither side's experts recalculated the interest rate differential with the affected pairs excluded. However, excluding misclassified and callable bonds leaves only nine bond pairs, 17 bond pairs, and 22 bond pairs in the August 1983, May 1985 and August 1985 samples, respectively.

There were problems encountered with plaintiffs' data base in addition to those already described. In constructing their matched pairs, plaintiffs' experts did not exclude pre-TEFRA registered bonds. Eleven of the 65 pairs of registered bonds were issued before TEFRA.[261] Plaintiffs' experts did not attempt to exclude pre-TEFRA registered bonds from their bearer/registered comparisons, as they recognized no statistically important difference between pre- and post-TEFRA registered municipal bonds.[262]

However, there was testimony at the hearing that pre-TEFRA registered bonds trade at a substantial penalty to comparable bearer bonds. These registered bonds generally formed small portions of overall bearer bond issues, and there were and are considerable delays and additional costs in negotiating them.[263] Many pre-TEFRA

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[258] DX 175 at 12; Tr. 2101-04.

[259] DX 175 at 12; Tr. 2101-04.

[260] Tr. 2101-02. Professor Leonard agreed that the effects of call provisions on yield were material and unpredictable. He believed, incorrectly, that all callable bonds had been excluded from the sample. Tr. 1607-08.

[261] DX 175 at 13-14.

[262] Tr. 1785-89.

[263] Tr. 1244-45; 1294; 1323; DX 175 at 13.

registered bonds have not been incorporated into the more efficient registered bond transfer systems that have evolved post-TEFRA.[264] Hence, pre-TEFRA registered bonds may well trade at penalties to the bearer bonds with which they are paired, but the penalty proves nothing about the effects of the TEFRA registration requirement.[265]

Once again, neither party recomputed results based on a revised sample excluding pre-TEFRA registered bonds. However, excluding those bonds from the sample (and avoiding double-counting of previously excluded bonds) reduced the sample sizes to six bond pairs for the August, 1983 sample; 17 pairs for the May, 1985 sample; and 16 bond pairs for the August, 1985 sample.[266] In addition, inclusion of pre-TEFRA registered bonds in a sample would constitute an error as to which there is no doubt that the direction of the bias distorts the results toward an interest rate differential favoring bearer bonds.

The Secretary's experts testified that there were a number of other financial and statistical difficulties in the plaintiffs' secondary market study.[267] Many of these criticisms were uncontroverted. Taken together, the data base, statistical, and financial difficulties discussed are such as to deprive the plaintiffs' secondary market study of sufficient probative value to form the basis of a finding

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[264] DX 175 at 13.

[265] Professor Leonard did state that the results for the pre-TEFRA registered bond pairs "seem to be different," Tr. 1789, but did not elaborate.

[266] DX 175 at 14; Tr. at 2031.

[267] *E.g.*, DX 175 at 14; Tr. 2031-33 (no correction for volume of bond issues); DX 175 at 14-15; Tr. 2033-35 (no correction for lack of "seasoning," or interest rate effects of newly issued bond issues); DX 175 at 17-18; Tr. 2042-44 (Correction Methods 1 and 2 fail to adjust for effects of differentials in coupon interest rates).

that there is an interest rate differential in favor of bearer bonds.[268]

The Secretary's experts also performed a secondary market study[269] as a supplement to their primary market study, upon which they placed principal reliance.[270] This study was carried out with considerably less rigor than plaintiffs' secondary market study.[271] The Secretary's experts contracted out the task of acquiring basic data and developing criteria for matching pairs of registered and bearer bonds to an outside organization, Standard & Poor's.[272] They apparently did not verify the accuracy of

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[268] Plaintiffs argue that the similarity of their results from the three correction methods for the three sample dates provides support for their conclusion that an interest rate differential favoring bearer bonds exists. See, e.g., PX 200 at 35-36. This argument would have force if one believed that the analysis for each sample date had probative value. However, the fundamental flaws discussed above infect all three sample dates. For example, the inclusion of misclassified, callable, and pre-TEFRA registered bonds cuts across all three samples and undermines the reliability of the results derived from each. Thus, the fact that the results of three clearly defective samples lie in the same direction is of no help to plaintiffs.

Nor are plaintiffs helped by their various combinations of the data from the three samples within each correction method. Plaintiffs chose not to pool the data from the three samples using Correction Method 1, see PX 200 at 26 (Exhibit C); to pool the data from the two 1985 sample dates using Correction Method 2, see PX 200 at 28 (Exhibit D); and to pool the data from all three sample dates using Correction Method 3, see PX 200 at 34 (Exhibit E). Plaintiffs did not explain or justify their pooling of the data, nor did they provide any explanation for their selectivity in doing so. Putting aside the selectivity problem, the absence of justification for the pooling methods used is a fatal flaw. *See* Tr. 1910.

[269] The Secretary's secondary market study comprises pages 33-48 of DX 100, "Effect of the Registration Requirement on Municipal Bond Interest Cost."

[270] Tr. 2006-07, 2082.

[271] *See, e.g.*, Tr. 2082-88.

[272] DX 100 at 40-43; Tr. 2091-92.

either the data base or the matching bond pairs until after plaintiffs' experts pointed out a large number of data base errors.[273]

Plaintiffs' experts analyzed the Secretary's secondary market study and detected a large number of gross data base errors.[274] Plaintiffs' experts corrected the gross errors they detected in the Secretary's secondary market study and argued that the Secretary's study provided statistically significant evidence of an 8.5 basis point differential favoring bearer bonds.[275] The Secretary's experts abandoned their study and argued that the data base and other errors rendered it fundamentally unreliable.[276]

The Special Master finds that the Secretary's secondary market study was performed with far less care than plaintiffs'. If, as the Special Master finds, plaintiffs' study is insufficiently reliable to provide probative evidence of

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[273] Tr. 2088-90, 2099.

[274] The overwhelming majority of the Secretary's bond pairs were from one issuer, the Intermountain Power Authority ("IPA"). Tr. 1642. On analysis, it turned out that approximately ten of the matched pairs of IPA bonds were in fact from another issuer, the Municipal Electric Authority of Georgia. The criteria by which those bonds had been matched remained unclear. Tr. 1650-53. A number of other bonds had been coded incorrectly and failed to satisfy the Secretary's experts matching criteria. Tr. 1656.

Moreover, a large number of IPA bonds turned out, upon further analysis, to be insured bonds with AAA credit ratings. These had been matched with uninsured bonds with far lower A credit ratings. Tr. 1658-62. These bonds generated large differentials favoring registered bonds which, obviously, cannot be attributed to the fact of registration. The plaintiffs' experts also observed a variety of other bond pairs in which they judged the interest rate differential to be simply too large to reflect a bearer form versus registered form effect. Plaintiffs' experts believed that these, too, should be eliminated from the Secretary's study.

[275] Tr. 1663-65; PX 158, 167.

[276] Tr. 1947; 2007-12, 2083-94.

an interest rate differential favoring bearer bonds, no amount of adjustment of a markedly less reliable study performed by the Secretary can bolster plaintiffs' conclusions.

First, the matching criteria used by the Secretary's experts were not rigorous.[277] Those criteria had to be modified to meet practical limitations and became even less rigorous.[278] On their face, the matching criteria did not even indicate that the bonds had been matched by issuer or by credit rating.[279]

The coupon rate of interest on matched pairs was allowed to vary by as much as 2.5% or 250 basis points.[280] The maturities of the matched bond pairs were permitted to vary by one, two, or more years, depending on the length of the maturities of the paired bonds.[281] Finally, the Secretary's criteria allowed bonds with call provisions to be matched with those lacking call provisions, a fundamental mistake.[282] In short, the Secretary's

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[277] These criteria were supplied by Standard & Poor's, and their expertise to perform the task of specifying matching criteria was not established. DX 100 at 42.

[278] DX 100 at 42-43.

[279] DX 100 at 42. Plaintiffs' experts, placed in the somewhat awkward position of defending and rehabilitating a study that they did not perform, argued that the Secretary's experts *must* have matched according to those criteria—even though the Secretary's study did not expressly indicate that—because otherwise the study would be fundamentally unreliable. Tr. 1604-05.

[280] DX 100 at 42. Plaintiffs' experts stated this was a fairly substantial difference, and they would want to correct for it. Tr. 1612.

[281] DX 100 at 42; Tr. 1602-06. The Secretary's maturity matching criteria were much less rigorous than those used by plaintiffs. *Id.*

[282] Tr. 1607-08. The Secretary's experts noted the importance of call features to bond yield in their primary market study, DX 100 at 10-11, but ignored the presence or absence of call features in their secondary market study.

study attempted to determine if very small interest rate differentials could be attributed to the form of bonds by using bond pairs that were materially different in other respects.

Second, the Secretary's experts performed no corrections for differences in maturity or coupon interest rates within the bond pairs.[283] They apparently believed—although their study did not address the question—that their matching criteria were rigorous enough to allow them to dispense with the corrections made by plaintiffs' experts. There is no support in the record for that conclusion. The great efforts made by plaintiffs' experts to correct for these differences—deploying three distinct and complex correction methods—testifies to the importance of making these "duration" corrections.[284]

Third, the Secretary's study used pairs of actual bond transactions, instead of pairs of Blue List offering prices. However, the paired transactions did not necessarily occur on the same day—they may have occurred as many as five calendar days apart.[285] Recognizing that daily market fluctuations could introduce substantial differences in the bearer/registered pair comparison, the Sectary's experts made an adjustment for each pair traded on different dates. They multiplied the registered bond's

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[283] DX 100, Appendix F.

[284] Indeed, plaintiffs' experts—with regard to their own study—insisted that comparisons of raw data regarding yields to maturity prior to adjustments for coupon rate and maturity differences lacked all probative value. Tr. 1704-07; 1726-28. Professor Leonard stated that "[y]ield to maturity itself is not a basis for making inference or judgment or any conclusion about the difference between bearer and registered bonds." Tr. 1728. Yet, plaintiffs suggest that the Secretary's study, which used uncorrected yields to maturity, has substantial probative value.

[285] DX 100 at 42; Tr. 1611.

price by the ratio of the Bond Buyer Municipal Bond Index of 50 bonds for the two trade dates.[286]

Nothing in the record validates this adjustment technique—and it is not even explained by the Secretary's experts. Bond prices vary daily and weekly frequently by amounts similar in magnitude to the interest rate differential allegedly attributable to the bearer/registered difference.[287] These fluctuations in market prices have little to do with the intrinsic characteristics of individual bonds. By comparing transactions from differing dates, the Secretary's study introduces considerable imprecision into its comparisons and an adjustment based on a rough indicator of overall market movement may or may not compensate for that imprecision.

Finally, the Secretary's secondary market study, even if it were carefully done and methodologically sound, suffers from many of the inherent problems affecting plaintiffs' study. There was no study indicating that secondary market results should be regarded as a reliable basis for inferences about the primary market.[288] There were no corrections made for "seasoning" of bonds[289] nor for the yield differentials caused by differentials in the coupon interest rates of paired bonds.[290] These defects make the Secretary's secondary market study an unreliable guide to determining whether registered/bearer bond differentials exist in the primary market.

Thus, plaintiffs' effort to use the Secretary's secondary market study to corroborate or confirm an interest rate differential in the primary market is to no avail. A study

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[286] DX 100 at 43.

[287] PX 200 at 4; Tr. 1591.

[288] Tr. 1892-93.

[289] Tr. 2011-12. See note 267, *supra.*

[290] *See* notes 231-32 and 284, *supra.*

less precise, less careful, and less rigorous than plaintiffs' flawed study cannot corroborate that study.

c. *The Secretary's Primary Market Study*

The principal focus of the Secretary's econometric experts was a multiple regression analysis of the determinants of issuers' net issuance costs in the primary market. Professors Puglisi and Olkin examined 4,220 pre-TEFRA new bearer bond issues from January, 1981 to June, 1983 and 2,377 post-TEFRA new registered bond issues from July, 1983 to April, 1985.[291] They identified the factors that, according to standard finance literature, influence the issuers' net interest cost.[292] They used regression analysis to determine the effect of all these factors on interest costs of both types of bonds in their respective periods.[293] After accounting for the effect of these variables on interests costs, the Secretary's experts hypothesized that any interest cost differences between the two forms of bonds across the two time periods could be attributed to the bearer/registered difference.[294]

The Secretary's experts calculated predicted net interest costs for both types of bonds from the regressions for alternative levels of the numerous variables in question. At the average level of all variables, the predicted net interest costs of bearer bonds *exceeded* those of the registered bonds. In fact, the study indicated that "the range for which predicted net interest costs on bearer bonds exceeds those on registered bonds covers almost the entire range of actual issues." [295] Thus, if anything, the study on its face indicated that issuer costs were lower

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[291] DX 100 at 12-14; Tr. 1931.

[292] DX 100 at 5-11.

[293] DX 100 at 19-21.

[294] DX 100 at 5, 11-12.

[295] DX 100 at 21-22.

after TEFRA—after accounting for all variables that influence issuers' net interest costs.[296]

There was, however, a fundamental methodological difficulty with the Secretary's primary market study. The regression equations are intended to estimate issuers' net interests costs for bearer and registered bonds. To accomplish this, however, equations were estimated in two different time periods. The record indicated unequivocally that there were important, statistically significant changes over time in the *effects* of key variables (e.g., issuer credit rating, average maturity) in the Secretary's primary market regression equations.[297] These changes in the effects of the variables can be seen in the changes in the estimated regression coefficients for the key variables in the regression equations for the pre-TEFRA bearer bonds and the post-TEFRA registered bonds.[298] Thus, we are presented with two equations purporting to relate variables to interest rates for two different forms of bonds for two different time periods.

The Secretary contends that the only explanation for the differences in the equations over the two time periods is the change in the form of the bonds from bearer to registered.[299] However, more than simply the form of municipal bonds changed between the two time periods; with the passage of time, many relationships changed, and with them the effects of other, key variables. To the extent that the effects of these variables on predicted net interest costs changed over time—for example, if the

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[296] DX 100 at 29 (Table 2.3).

[297] Tr. 1680, 1685-86; PX 168. Professor Olkin conceded this point. Tr. 1988-89.

[298] DX 100 at 28 (Table 2.2).

[299] Indeed, the Secretary contends that at the average level of all variables, the predicted net interest costs on bearer bonds exceeded those on registered bonds by 31 basis points. See DX 100 at 21, 29 (Table 2.3).

market valued higher issuer credit ratings or shorter average dates to maturity differently across the two periods—the Secretary's contention that all of the change in predicted net interest costs between the two time periods can be attributed to the change in bond form is undercut.[300]

It is impossible to determine whether the Secretary's comparison of pre-TEFRA bearer bond interest costs and post-TEFRA registered bond interest costs reveals a shift in the effects of the variables, the change in bond form, or some combination of the two.[301] Careful scrutiny of the Secretary's study and of the testimony reveals no convincing basis for selecting bond form as the sole explanation for the differences in the equations. The Secretary's study simply confounds two phenomena: the change in the form of municipal bonds and the changes in the effects of the other variables across the two time periods.

Professor Puglisi suggested that the model's use of the market interest rate variable might control for the changes in effects of the variables over time.[302] However, he was unable to specify how the time-sensitive changes in the levels of one variable would account for changes in the effects of that and other variables. Moreover, use of the market interest rate variable as a control variable is highly problematic in that the market interest rate in the two periods would reflect the very differential—bearer versus registered form—that the study was testing for in the first instance.

d. *Conclusion*

Each of the econometric studies rested on assumptions that ultimately proved unreliable or unsupported. The

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[300] The clearest explanation of this problem was provided by Professor Leonard's testimony. *See* Tr. 1675-78; 1828-32.

[301] Tr. 1676-77, 1686-88; 1976-78. *See also* 2133-37.

[302] Tr. 2130-33; *but see* Tr. 2135.

studies attempted to measure a very small and perhaps ephemeral effect with highly imprecise data and tools that proved too blunt for the task. Ultimately, the various studies performed by both sides do not provide an unequivocal or definitive answer to the question whether the registration requirement resulted in an interest rate penalty for municipal issuers.

E. The Diminution of State Sovereignty

Plaintiffs have argued that a separate and independent cost of the TEFRA registration requirement has been a diminution in the sovereign status of the States. Although plaintiffs' "sovereignty costs" are not readily susceptible to measurement, it is beyond peradventure that the powers of taxation and spending associated with the right to raise funds through debt issuance are essential to the States' ability to exercise sovereignty within the federal system.[303] Any federal regulation in this area, the States argue, diminishes the independence of the States within the federal system.[304]

The importance of debt issuance to the States is reflected in the detail in which state constitutions, statutes and ordinances prescribe the procedures by which debt may be incurred and issued. Offering New Jersey as a representative State, plaintiffs presented extensive proof regarding the detail in which New Jersey regulates the authorization and funding of bond issues.[305]

There also is no doubt that TEFRA did change the form in which state debt is issued. In the absence of

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[303] *See, e.g.*, Tr. 283; 710.

[304] Tr. 384-87. Although a number of state and local government officials indicated their displeasure with the TEFRA registration requirement, the gravamen of their complaint appeared to be the fact of regulation, not the subject matter being regulated. *See, e.g.*, Tr. 384; 448; 549-50; 747.

[305] *See* Tr. 210-21.

the TEFRA requirement, certain smaller issuers would probably still be issuing their debt in bearer form.[306] However, the decision to issue debt in one form or another is essentially a practical one: it is tied to the issuer's perception of the desires of the marketplace.[307] The totality of the record indicates that, prior to TEFRA, the States did not attach any special importance to the form in which their bonds were issued. The core state concerns were their ability to raise capital at the lowest possible cost and their underlying fiscal integrity.

The Secretary attempted to minimize the impact of the registration requirement on state autonomy in two ways. First, the Secretary pointed out that federal funds continue to provide a very substantial source of revenue to the States.[308] Even if federal grants to the States have declined somewhat in recent years, federal funds often exceed the amount of debt capital raised by States in a given year.[309]

Second, the Secretary elicited testimony indicating that the States often are required to take certain actions, or accept certain conditions, in order to receive federal funding.[310] Prominent examples of such federal conditions are the 55 mile per hour highway speed limit and the minimum drinking age for alcoholic beverages.[311] Governor Thompson of Illinois agreed that there are many instances where States accept restrictions on their autonomy in order to receive federal funds or federal benefits.[312]

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[306] *E.g.*, Tr. 449-50.

[307] Tr. 752.

[308] DX 30.

[309] Tr. 330; 787.

[310] Tr. 400-05.

[311] Tr. 401.

[312] Tr. 402.

F. The Benefits of Registration to Municipal Bond Market Participants

In an effort to offset plaintiffs' claims that the registration requirement imposes substantial burdens upon States and localities, the Secretary presented evidence that the registration requirement benefits market participants. The thrust of this evidence is that the individuals and institutions that invest in municipal bonds, as well as the intermediaries that process and trade municipal bonds, benefit from the efficiencies inherent in the registration process. Much of this evidence has been discussed above in the section dealing with immobilization and book entry systems. See Section IV(D), *supra.*

With regard to investors, the evidence indicated that investors save coupon cashing fees associated with bearer bonds;[313] investors receive their interest income more rapidly under a registered system;[314] investors holding bonds in registered form will receive notice of bond calls and the proceeds of their called bonds more promptly;[315] and registered bonds are more easily replaced if lost or stolen than bearer ones.[316]

The benefits of registration to financial intermediaries have been previously discussed. Registered bonds are more adaptable to the immobilization and book entry techniques used by securities depositories.[317] In general, registration apparently has enabled the bond market to handle efficiently substantial increases in the number and size of municipal bond issues in the 1983-1985 period.[318]

Plaintiffs correctly point out that the bulk of these advantages accrue not to bond issuers directly but to other

[313] Tr. 1145.

[314] Tr. 342; 511-12.

[315] Tr. 178-79; 1284.

[316] Tr. 1158; 1281-82.

[317] See 32, *supra.*

[318] Tr. 1292-93.

market participants.[319] Since it is State and local issuers who are challenging registration, benefits to market participants are of no relevance unless the benefits are passed along to municipal issuers. Although in a perfect market one would expect that market efficiencies would redound to the benefit of issuers, there is no direct evidence of this in the record.

There is one exception to this generalization with respect to market efficiencies. The spreads between the prices paid by bond underwriters to municipal issuers and the offering prices of bonds to the public have narrowed substantially since the passage of TEFRA.[320] Several of the Secretary's witnesses opined that underwriting competition has insured that the cost savings of registration have been passed along to municipal issuers.[321] Plaintiffs' experts categorically deny that the registration requirement had anything to do with the decline in underwriting spreads.[322]

Neither party quantified the cost savings to municipal issuers from the post-TEFRA decline in spreads. The evidence indicates that the decline in spreads is a function of competition among underwriters, the great demand for municipal bonds, the general overall decline in interest rates, and, to some uncertain and unquantified degree, the decline in costs caused by registration.[323] The portion of this decline in spreads attributable to cost savings flowing from registration is unclear; however, it seems unlikely that registration would account for the major part of these issuer savings.

VI. THE PUBLIC INTEREST IN REGISTRATION.

Plaintiffs question whether there is an overriding public interest in requiring municipal bond registration.

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[319] *Brief of the NGA* at 55.

[320] Tr. 188; 1280.

[321] Tr. 1280; 1379-80.

[322] Tr. 201.

[323] Tr. 200; 1379-82.

They dispute the claim that bearer bonds pose a national tax compliance and law enforcement problem. Assuming that bearer bonds do pose such a problem, plaintiffs argue further that the registration requirement is not an effective remedy. A brief discussion of the tax aspects and information reporting requirements pertinent to municipal bonds will assist in the evaluation of the factual predicate for these arguments.

A. Background

1. *Tax Status of Municipal Bonds*

The interest earned on municipal bonds is ordinarily not subject to federal income taxation.[324] In other tax respects, however, municipal bonds are not unlike any other asset. Thus, gains on the sale or disposition of municipal bonds are subject to federal income tax, although capital gains rates often apply. In addition, municipal bonds are like any other security in that they are subject to federal estate and gift taxation.

Although municipal bond interest income is generally exempt from federal income tax, situations sometimes arise in which municipal bond interest becomes taxable. Congress has placed complex limitations on the tax-exempt status of industrial development bonds and municipal arbitrage bonds.[325] Where the issuer fails to comply with those limitations, interest on the bonds loses its tax-exempt status. The IRS will then attempt to locate the bonds' owners in order to collect taxes on the interest income received. The ownership records attendant a registration system facilitate identification and location of bond owners.[326] Although certain municipal bonds have lost their tax-exempt status in the manner described, the record contains no evidence of the frequency with which this has occurred or the amount of income tax that the IRS has recovered in such circumstances.

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[324] 26 U.S.C. § 103(a) (1982).

[325] 26 U.S.C. §§ 103(b) and (c) (1982 & Supp. III 1985). See 8-9, *supra.*

[326] Tr. 874-76.

2. *Information Reporting on Municipal Bonds*

Internal Revenue Service information reporting requirements do not apply to municipal bond issuers paying tax-exempt interest.[327] Payers of taxable interest must file such information reports. These reports (IRS Form 1099-INT) set forth the amount of interest paid and the name and address of the recipient. Registration of taxable bonds facilitates IRS information reporting in that the payer must have a record of the recipient of the interest payment.[328]

As part of TEFRA's effort to improve tax law compliance, Congress enacted additional information reporting requirements. When a securities broker sells securities (including municipal bonds) for customers, TEFRA requires the broker to file an IRS information return listing the customer's name and address and the gross proceeds of the sale.[329] Congress also empowered the Treasury Department to issue regulations requiring any other person who, for consideration, regularly acts as a middleman in securities transactions to provide gross proceeds information reporting.[330]

Unlike securities brokers, transfer agents for registered municipal bonds currently do not provide information reports to the IRS regarding bond transfers. Transfer agents are not considered brokers for purposes of the Internal Revenue Code's information reporting requirements because they do not have information about gross proceeds.[331] Transfer agents do provide information reports to the IRS when bonds are redeemed at maturity or prior to maturity pursuant to a call provision.[332]

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[327] 26 U.S.C. § 6049(b)(2)(B) (1982).

[328] 26 U.S.C. § 6049(a) (1982 & Supp. III 1985).

[329] TEFRA § 311, 96 Stat. 600-01, *codified at* 26 U.S.C. § 6045(a) (1982).

[330] 26 U.S.C. § 6045(c)(1)(C) (1982).

[331] Stip. ¶ 59.

[332] Stip. ¶ 60.

The information reporting requirements on the sale of municipal bonds are the same for bearer and registered bonds.[333] Thus, when a municipal bond is sold through a broker, the broker must file an IRS Form 1099-B information report whether the bond is bearer or registered.[334] When a bond is sold without a broker, no information report is filed.[335] Both bearer and registered bonds can be transferred without a broker.[336] Although transfer agents for registered bonds are not now required to file IRS information reports,[337] both IRS and Treasury Department officials believe they have the authority under existing statutes to require information reporting by transfer agents when and if it is deemed necessary.[338]

B. Registration, Tax Compliance and Law Enforcement

Congress had a number of interrelated goals when it adopted the registration requirement for all debt securities, including municipal bonds. As relevant to tax-exempt municipal debt, these purposes include: (1) the reduction of estate, gift and capital gains tax avoidance on the transfer of ownership of municipal securities; (2) the reduction of the use of municipal bonds as a mechanism for concealing unreported taxable income; and (3) the ultimate elimination of a readily negotiable substitute for cash for persons engaged in criminal activities. Congress also may have believed that the elimination of

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[333] Tr. 939; 26 U.S.C. § 6045 (1982 & Supp. III 1985).

[334] Tr. 938-39.

[335] Tr. 1028.

[336] Tr. 939-40.

[337] Stip. ¶ 59.

[338] Tr. 940; 990. These officials point to the breadth of the Internal Revenue Code's definition of a "broker" for information reporting purposes. *See* 26 U.S.C. § 6045(c)(1)(C). The statute empowers the Secretary to establish information reporting requirements for anyone falling within the broad ambit of the statutory definition of a broker.

bearer municipal securities would contribute to a more comprehensive system of IRS information reporting.[339]

Plaintiffs do not dispute the magnitude of the tax evasion problem at the time Congress adopted TEFRA's registration requirement. However, they argue that there is no evidence that bearer municipal securities form a significant part of the tax compliance problem. Plaintiffs are indeed correct that there is no evidence in the record quantifying estate and gift tax evasion, capital gains tax evasion, or the concealment of legal or illegal income for tax evasion purposes relating exclusively to bearer municipal bonds.

However, as one of plaintiffs' expert economists noted, the fundamental attributes of bearer bonds are enormously helpful to individuals desiring to evade the tax laws and to conceal unreported income. Bearer bonds are convenient to transport and hide, are easily negotiable at published prices, involve anonymity and minimal reporting requirements, and are capable of supporting substantial amounts of cash.[340] Moreover, bearer municipal bonds—unlike other cash substitutes—earn interest, and tax-exempt interest at that.[341]

When bearer bonds are bought and sold there need be no record of the transaction. This contrasts sharply with registered municipal bonds, which entail records relating to ownership, transfers, and interest and principal payments.[342] Given the inherent characteristics of bearer bonds, Congress's conclusions that they facilitate tax avoidance and income concealment seem altogether reasonable.

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[339] *See* S. Rep. No. 494, 97 Cong., 2d Sess. 242 (1982). However, Congress clearly believed that the advantages of enhanced information reporting would pertain mostly to taxable securities. *Id.*

[340] Tr. 1866-69.

[341] Tr. 1868-69. The payment of tax-exempt interest is doubly advantageous to tax evaders and other criminals. First, IRS information reporting requirements do not apply. Second, the interest bearing nature of municipal bonds offsets the potentially devaluing effects of inflation. Tr. 1061, 1067.

[342] Tr. 997; 1073.

With regard to estate and gift tax evasion, the registration records for municipal bonds create an audit trail which will enable tax authorities to trace the ownership of municipal bonds for estate and gift tax purposes.[343] With regard to capital gains tax evasion, registration enables the IRS to calculate the taxpayer's cost basis in the bond for capital gains purposes.[344] Plaintiffs point out, however, that registration has not changed the information reporting requirements for bond sales—they are the same whether the bond is bearer or registered.[345] Brokers must file information reports regardless of the form of the bond. Currently, the great preponderance of municipal bond sales are brokered.[346] However, both registered and bearer bonds can be transferred without a broker.[347] Thus, plaintiffs argue that registration does nothing to foster greater capital gains tax compliance. The taxpayer can still fail to report his gain.

These arguments have some force. However, registered bonds, unlike bearer securities, require guarantees of the authenticity of the transferor's signature. They also require extensive information about the owner for processing purposes. It is thus far more difficult to transfer registered bonds without a broker.[348] Registration complicates matters considerably for one who seeks to transfer municipal bonds without triggering IRS information reporting. Bearer bonds can more easily be used by those who would evade information reporting and thereby taxation of capital gains realized on the sale of municipal securities.[349]

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[343] Tr. 889.

[344] Tr. 889; 1073.

[345] Brokers must file information reports; at present, transfer agents are not required to do so.

[346] Tr. 940; 1539.

[347] Tr. 939-40.

[348] Tr. 332-34; 974-75.

[349] Moreover, the IRS could require information reporting by transfer agents to make tax evasion even more difficult in the

With regard to the use of bearer bonds for the concealment of taxable income, the Secretary presented no systematic empirical study or other evidence quantifying the extent of the problem.[350] The Secretary did, however, present anecdotal evidence that bearer bonds can be and have been used to conceal large amounts of unreported taxable income. Owing to the particular experience of the law enforcement experts called as witnesses, the testimony involved significant cases in only one State, New Jersey.[351]

In the largest case discussed, *United States v. J.B. Hanauer & Co.*, Crim. No. 84-275 (D.N.J. 1984), the IRS discovered that one office of a New Jersey bond firm purchased more than $12 million of bearer municipal bonds using cash from customers that consisted mostly of unreported taxable income.[352] In another case, *United States v. Cornelius Gallagher*, Crim. No. 72-243 (D.N.J. 1972), an Internal Revenue Service investigation resulted in the conviction of a United States Congressman for concealing more than $300,000 in taxable income in bearer municipal bonds.[353] In another case, *United States v. Genser*, 582 F.2d 292 (3d Cir. 1978), *cert. denied*, 444 U.S. 928 (1979), an IRS investigation resulted in the conviction of several businessmen for concealing over $2

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case of registered bonds. See note 338, *supra*, and accompanying text.

[350] The Secretary did provide the NGA, under seal, with an IRS investigation of the use of bearer bonds to conceal income. This material did not find its way into the record.

[351] There is nothing in the record suggesting that New Jersey was either typical or atypical as a locus of income concealment through the use of bearer bonds.

[352] Tr. 1055-65. Plaintiffs point out that *Hanauer* was an instance in which dishonest municipal bond brokers were at the center of a tax evasion scheme enabling numerous customers to evade taxes. The brokers violated a number of laws, including currency transaction reporting requirements. Plaintiffs argue that it is possible under these circumstances to conceal income in any security, be it bearer or registered. *See* Tr. 1536-37, 1546-47. See discussion at 87-88, *infra*.

[353] DX 105, 147, 148. *See* Tr. 1561-65.

million in unreported taxable income through the purchase of bearer municipal bonds. The income was concealed by some 100 bond transactions over a five year period.[354] These cases do not document the extent of the use of bearer bonds to conceal unreported income, but they do illustrate the manner in which bearer bonds lend themselves to misuse.[355]

Plaintiffs also challenge the efficacy of registration as a means of eliminating income concealment. Provided that other laws are broken, they argue, it is possible to conceal income using registered bonds as well as bearer bonds.[356] Nonetheless, it is clear that the registration requirement makes concealment of income more difficult by requiring at least one additional layer of criminal activity. Individuals desiring to conceal income will prefer to use unregistered assets instead of assets with ownership records that would have to be further falsified to conceal true ownership.[357]

Plaintiffs also point out that other assets—gold, antiques, stamps and coins—have some of the traits of bearer securities. They can be easily transported and can be negotiated without any information reporting requirements.[358] Thus, those bent on tax evasion can use these substitutes and continue to evade taxation.[359] However, a comparison of the asserted substitutes with bearer bonds suggests that few have all the advantages of municipal bearer securities (and none are interest bearing).

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[354] *See* 582 F.2d at 296; Tr. 1552-53.

[355] In its brief, the Secretary cites a number of other cases of bearer bond misuse. *Brief for the Defendant* at 61-62 n.11. These cases range from tax evasion to larceny to avoidance of currency transaction reporting requirements.

[356] Tr. 1546-48.

[357] Tr. 897; 1067-68; 1548.

[358] Tr. 859; 1858-59.

[359] Tr. 1857.

Finally, plaintiffs question the utility of the registration record to law enforcement officials conducting tax investigations. They point out that the owner of a registered bond can retain equitable ownership but maintain record ownership in another's name.[360] They also point out that the registration record is useful only when law enforcement officials know the identity of the bond owner and the specific identity of the bond. Only this information enables the IRS to locate the specific transfer agent which will have the helpful information.[361] These criticisms do highlight certain imperfections in the regulatory scheme.

Although there are limitations to the utility of the registration requirement as an aid to tax enforcement, the testimony clearly demonstrates that registered bonds are helpful to tax enforcement authorities in their collection efforts. In examining an individual taxpayer, the IRS avails itself of two basic techniques: investigation of the individual's net worth, and investigation of specific items.[362] The net worth method is particularly useful in detecting illegal income where authorities are unable to establish the source of income but can see an increase in wealth.[363] Using the net worth method, the IRS compares the taxpayer's total wealth at the beginning and end of a tax period in order to determine the increase. Bearer bonds may be used to frustrate net worth investigations because the IRS may not be able to ascertain when the taxpayer acquired the bonds.[364] Registered securities, on the other hand, do provide some additional information concerning when changes in ownership occurred.[365]

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[360] Stip. ¶¶ 54, 55.

[361] Tr. 1541-42.

[362] Tr. 1544.

[363] Tr. 1072.

[364] Tr. 1071-73; 1544-45.

[365] Tr. 1072-73. The ability to transfer registered bonds without notifying the transfer agent immediately, Stip. ¶ 54, would of

LEGAL ANALYSIS

VII. AN ANALYSIS OF FEDERALISM RESTRAINTS ON NATIONAL REGULATORY POWER AFTER *GARCIA v. SAN ANTONIO METROPOLITAN TRANSIT AUTHORITY.*

A. Introduction: The Amorphous Structure of Federalism

Plaintiffs challenge the registration requirement of Section 310(b)(1) of TEFRA on two related grounds. First, they question whether the federal government can require the registration of municipal bonds consistent with constitutional principles of federalism. Second, even if the end of registration is permissible, plaintiffs argue that the means chosen by Congress to implement registration are not. Specifically, plaintiffs assert that Congress's denial of tax-exempt status for interest paid on bearer municipal bonds runs afoul of the doctrine of intergovernmental tax immunity.

Plaintiffs' twofold challenge to the registration requirement implicates two bodies of constitutional doctrine that have, in large measure, evolved separately. The first body of doctrine deals with the affirmative limits that our constitutional structure places upon the ability of Congress to exercise its delegated, enumerated powers to affect the States and their political subdivisions.[366] Most

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course complicate the inquiry. Nonetheless, it cannot be denied that there will be additional information available to investigators stemming from registration.

[366] As a matter of convenient labeling, it is sometimes said that the Tenth Amendment places limitations upon the ability of Congress to intrude upon state sovereignty. A more precise statement would be that the Tenth Amendment reflects a constitutional structure and a federal system which may place limits upon Congress's powers. The issue presented here has thus been phrased by the Special Master as arising under the structure of the Constitution and the federal system, rather than the Tenth Amendment alone. *See Garcia v. San Antonio Metropolitan Transit Authority,* 469 U.S.

recently, this body of federalism doctrine has been worked out in a line of cases under the Commerce Clause running from *Maryland v. Wirtz*[367] to *National League of Cities v. Usery*[368] and back again in *Garcia v. San Antonio Metropolitan Transit Authority*.[369]

Plaintiffs' challenge to Congress's choice of means for bringing about registration—the threatened forfeiture of tax-exempt status for the interest paid on bearer bonds—brings the intergovernmental tax immunity doctrine into play. This doctrine shields the States from federal taxation on the theory that the power to tax can be used to undermine state sovereignty. Plaintiffs rely upon the Court's holding in *Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429 (1895), for the proposition that a federal income tax on the interest derived from municipal bonds is a tax on the power of the States to borrow money and thus repugnant to the Constitution.

Although the doctrine of limits on Congress's delegated powers flowing from state sovereignty and the doctrine of intergovernmental tax immunity have developed separately, they have a common source. Their source is the Constitution's recognition of the separate and independent existence of the States. An act of Congress—regardless of the power employed—which would threaten "the utter destruction of the State[s] as sovereign political entit[ies]" is inconsistent with the constitutional schema. *Wirtz*, 392 U.S. at 196. The importance of the

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528, 556 (1985) (discussing affirmative limits derived from structure of Constitution); see also *id.* at 585 (O'Connor, J., dissenting) (discussing spirit of the Tenth Amendment); *Fry v. United States*, 421 U.S. 542, 557 (1975) (Rehnquist, J., dissenting) (Tenth Amendment by its terms does not prohibit congressional action; it reflects principles of federalism).

[367] 392 U.S. 183 (1968).

[368] 426 U.S. 833 (1976).

[369] 469 U.S. 528 (1985).

intergovernmental tax immunity cases to contemporary federalism doctrine has been recognized in the recent decisions of the Supreme Court. *See, e.g., National League of Cities*, 426 U.S. at 843 & n.14 (intergovernmental tax immunity doctrine a recognition of state sovereignty limits on Congress's delegated powers); *Garcia*, 469 U.S. at 539-45 (comparing evolution of tax immunity and regulatory immunity doctrines).

The recognition by both the *National League of Cities* and the *Garcia* majorities of the fundamental importance of the intergovernmental tax immunity doctrine for the analysis of state immunity from regulation by Congress reflects the common roots of both doctrines. At bottom, the doctrines of state regulatory and state tax immunity derive from a structural analysis of the role of the States in our constitutional system. Put simply, the tradition of "Our Federalism" [370] places limits on the ability of the federal government to regulate or to tax the States.

Unfortunately, the precise contours of those limits are nowhere defined in the Constitution. The States are recognized in the Constitution, and the Constitution presumes the subsistence of the States.[371] Yet, with very few exceptions, the Constitution does not touch upon the

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[370] *See Younger v. Harris*, 401 U.S. 37, 44 (1971) (Black, J.).

[371] Thus, members of the House of Representatives shall be chosen by the people of the several States. U.S. Const. art. I, § 2, cl. 1. The census shall be taken by State, art. I, § 2, cl. 3, and representatives apportioned among the States according to the results of the census. *Id.* The Senate shall be composed of two members from each State. Article I, § 3, cl. 1. Each State is entitled to a number of Electors to select the President equal to the number of its Senators and Representatives. Article II, § 1, cl. 2. A State has the power to invoke the original jurisdiction of the Supreme Court. Article III, § 2, cl. 2. Finally, the United States guarantees to every State a republican form of government, and protects each of them against invasion, and, on application, against domestic violence. Article IV, § 4.

structure of state government or the legitimate scope of state activities. In a document designed to constitute a national government, this is hardly surprising.

The Constitution does place a few express limits on federal power over the States. The principal limitations are designed to protect the States' territorial integrity and to insure their political representation in the Union. Thus, Article IV, § 3, cl. 1 denies Congress the power to join or divide States without their consent. Article V limits the process of amending the Constitution by providing that "no State, without its consent, shall be deprived of its equal Suffrage in the Senate." The other explicit limits on federal power are: the States are reserved the right to appoint and train the officers of any militia that Congress may organize and discipline;[372] the States cannot be taxed on their exports;[373] and Congress may not discriminate among State ports in any regulation of commerce or revenue.[374]

The language of the Tenth Amendment—"[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people"—is unlike the foregoing provisions of the Constitution. The Tenth Amendment contains no express limitations on the power of Congress over the States. It declares that ours is a government of delegated powers, and assumes that there are some powers not delegated to the federal government that remain in the hands of the States, or of the people. The drafters of the Constitution obviously believed that there are some powers—unspecified—that the States retain, and these are powers upon which the national government may not intrude. Thus, the Tenth Amendment re-

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[372] U.S. Const. art. I, § 8, cl. 16.

[373] U.S. Const. art. I, § 9, cl. 5.

[374] U.S. Const. art. I, § 9, cl. 6.

flects, amorphously, "principles of federalism" [375]: "[t]he [Tenth] Amendment expressly declares the constitutional policy that Congress may not exercise power in a fashion that impairs the States' integrity or their ability to function effectively in a federal system." [376]

Throughout our history, these constitutional provisions have served to secure a place for the States in our system of government. They have been construed to require the national government to respect the "sovereignty" of the States. However, the sovereignty of the States has sometimes been misapprehended. The States do not enjoy any supremacy over the national government that permits them to frustrate the national government in the exercise of its delegated powers. Rather, the national government is constrained to respect the autonomy and independence of the States as governmental actors. To exist as independent governmental actors, the States, at a minimum, must be able to raise and expend funds; to administer public law; to provide public services; and to reflect and express the popular will. All this, however, is subject to the supremacy of the national government when the national government lawfully exercises its delegated, constitutional powers: "[t]his Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, anything in the Constitution or Laws of any State to the Contrary notwithstanding." U.S. Const. art. VI, § 2.

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[375] *Fry v. United States*, 421 U.S. 542, 556 (1975) (Rehnquist, J., dissenting).

[376] *Id.* at 547 n.7. *See Garcia*, 469 U.S. at 585 ("The *spirit* of the Tenth Amendment, of course, is that the States will retain their integrity in a system in which the laws of the United States are nevertheless supreme.") (O'Connor, J., dissenting) (emphasis in original) (citation omitted).

B. The Roots of Modern Federalism Doctrine

The Supreme Court has long interpreted the Constitution to require respect for state sovereignty in the sense of the States' political autonomy and independence. In *Texas v. White*, 74 U.S. (7 Wall.) 700, 725 (1869), Chief Justice Chase observed that "[t]he Constitution, in all its provisions, looks to an indestructible Union, composed of indestructible States." More broadly, the Chief Justice explained:

> [T]he people of each State compose a State, having its own government, and endowed with all the functions essential to separate and independent existence.
> . . .
> [I]n many articles of the Constitution the necessary existence of the States, and within their proper spheres, the independent authority of the States, is distinctly recognized.

Lane County v. Oregon, 74 U.S. (7 Wall.) 71, 76 (1869).

In *Veazie Bank v. Fenno*, 75 U.S. (8 Wall.) 533 (1869), the Supreme Court had occasion to consider the limits on Congress's power when it acted within its constitutionally delegated power to provide a national currency. *Id.* at 548. To eliminate non-federal currency, Congress had enacted a prohibitive tax on the circulation as money of any notes not issued under its own authority (*e.g.*, notes issued under state authority). The plaintiff, a state chartered bank, challenged Congress's power to impose a tax with the effect of destroying a state granted franchise to issue bank notes.

Construing the broad language of the taxing power,[377] the Court read into this power the limitations that inhere in our constitutional structure: "[t]here are, indeed, certain virtual limitations, arising from the principles

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[377] "Congress shall have power to lay and collect Taxes, Duties, Imports and Excises . . . ." U.S. Const. art. I, § 8, cl. 1.

of the Constitution itself. It would, undoubtedly, be an abuse of the power if so exercised as to impair the separate existence and independent self-government . . . of the States, or if exercised for ends inconsistent with the limited grants of power in the Constitution." 75 U.S. at 541 (citation omitted). The Court specified that this state sovereignty limit on Congress's taxing power exempted certain "reserved rights" of the States from impairment by federal taxation:

> It may be admitted that the reserved rights of the States, such as the right to pass laws, to give effect to laws through executive action, to administer justice through the courts, and to employ all necessary agencies for legitimate purposes of State Government, are not proper subjects of the taxing power of Congress.

Id. at 547. Since the regulatory tax at issue in *Veazie Bank* was nothing other than an appropriate means to an indisputably constitutional end—the securing of a sound and uniform national currency—the tax was undoubtedly constitutional. The state granted franchise to issue bank notes was not within the narrowly defined "reserved" powers of the States.

The national government has only infrequently acted to invade state sovereignty in the sense of failing to respect the autonomy and independence of the States as governmental entities. *Coyle v. Smith*, 221 U.S. 559 (1911),[378] presents an important and instructive example of such a failure. In *Coyle*, Congress had, in an enabling act admitting Oklahoma into the Union, attempted to fix the location of the new State's capital for a seven year period. The Supreme Court held that the constitutional power of admitting new States into the Union did not

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[378] The majority in *Garcia* cited *Coyle v. Smith* with approval as an example of the "affirmative limits the constitutional structure might impose on federal action affecting the States under the Commerce Clause." *Garcia*, 469 U.S. at 556.

embrace the authority to condition admission in this manner. Since Congress lacked authority to deprive a State of its ability to choose its seat of government, *id.* at 565, the Court reasoned that Congress could not place a State upon a plane of inequality with its sister States as a condition of admission. *Id.* at 565-67. An inherent part of that "residuum of sovereignty not delegated to the United States by the Constitution itself[,]" *id.* at 567, is "[t]he [State's] power to locate its own seat of government, and to determine when and how it shall be changed from one place to another, and to appropriate its own public funds for that purpose . . . ." *Id.* at 565. These are, the *Coyle* Court affirmed, "essentially and peculiarly state powers." *Id.*

C. Federalism Before *National League of Cities*

Until *National League of Cities v. Usery*, 426 U.S. 833 (1976), our constitutional jurisprudence required no additional limitations of Congress's delegated powers in the name of preserving state autonomy and independence. It cannot be gainsaid, however, that for a lengthy period, ending in approximately 1937, the Supreme Court gave a miserly construction to the scope of congressional power under the Commerce Clause. *See generally E.E.O.C. v. Wyoming*, 460 U.S. 226, 246-49 (1983) (Stevens, J., concurring); *National League of Cities*, 426 U.S. at 867-68 (Brennan, J., dissenting). As Justice Brennan pointed out, the Court usually relied upon the Due Process Clause to invalidate federal regulation, but occasionally resorted to the Tenth Amendment. The Court reasoned that, since the regulatory power at issue was not within the scope of the commerce power, it was not a power delegated to Congress, but instead was reserved to the States. *See National League of Cities*, 426 U.S. at 868 & n.9. The endpoint of this line of cases was *Carter v. Carter Coal Co.*, 298 U.S. 238 (1936) (commerce power did not authorize federal regulation of hours, wages and working

conditions of coal miners; these are internal matters reserved to the States).[379]

Starting in 1937, with its epochal decision in *National Labor Relations Board v. Jones & Laughlin Steel Corp.*, 301 U.S. 1 (1937) (National Labor Relations Act a permissible exercise of congressional power to protect interstate commerce by preventing labor strife), the Supreme Court abandoned its restrictive interpretation of the Commerce Clause and held that Congress can regulate intrastate activities that affect interstate commerce. *See also United States v. Darby*, 312 U.S. 100 (1941) (commerce power extends to fixing of minimum wages and maximum hours of employees engaged in production of goods for interstate commerce). The Court has subsequently held that "[e]ven activity that is purely intrastate in character may be regulated by Congress, where the activity, combined with like conduct by others similarly situated, affects commerce among the States or with foreign nations." *Fry v. United States*, 421 U.S. at 547 (1975). Such a rule obviously brings within the scope of federal regulatory power many purely local activities that, taken by themselves, have little apparent impact on interstate commerce. *See, e.g., Perez v. United States*, 402 U.S. 146 (1971) (local loan shark's activities within class of activities affecting interstate commerce); *Katzenbach v. McClung*, 379 U.S. 294 (1964) (race discrimination by local restaurant within commerce power because of impact upon interstate flow of food); *Wickard v. Filburn*, 317 U.S. 111 (1942) (federal wheat marketing quota applicable to wheat grown wholly for on-farm consump-

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[379] *See also Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935) (commerce power did not authorize federal codes establishing industry wages, hours and trade practices); *Hammer v. Dagenhart*, 247 U.S. 251 (1918) (commerce power did not authorize federal regulation of child labor, a local matter reserved to the States by the Tenth Amendment); *United States v. E.C. Knight Co.*, 156 U.S. 1 (1895) (commerce power does not allow prohibition of monopoly in manufacturing, a matter reserved for state control).

tion because of impact of sum of such production on national supply of wheat). As the Supreme Court has noted, "[i]f it is interstate commerce that feels the pinch, it does not matter how local the operation which applies the squeeze." *United States v. Women's Sportswear Manufacturing Association*, 336 U.S. 460, 464 (1949).[380]

The revitalized commerce power has both allowed and stimulated an enormous expansion of the federal regulatory domain. The growing sphere of federal regulatory activity has necessarily encroached upon the areas otherwise left to the States' police powers. As early as 1825, Thomas Jefferson complained:

> I see . . . with the deepest affliction, the rapid strides with which the federal branch of our government is advancing toward the usurpation of all rights re-

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[380] This more recent and expansive view of Congress's power under the Commerce Clause amounted to nothing more (or less) than a restoration of the original understanding of Congress's commerce power as expounded by Chief Justice Marshall. In *Gibbons v. Odgen*, 22 U.S. (9 Wheat.) 1, 196-97 (1824), Chief Justice Marshall wrote:

> [The commerce power] is the power to regulate; that is, to prescribe the rule by which commerce is to be governed. This power, like all others vested in Congress, is complete in itself, may be exercised to its utmost extent, and acknowledges no limitations, other than are prescribed in the constitution. . . . If, as has always been understood, the sovereignty of Congress, though limited to specified objects, is plenary as to those objects, the power over commerce with foreign nations, and among the several States, is vested in Congress as absolutely as it would be in a single government, having in its constitution the same restrictions on the exercise of the power as are found in the constitution of the United States. The wisdom and the discretion of Congress, their identity with the people, and the influence which their constituents possess at election, are, in this, as in many other instances, as that, for example, of declaring war, the sole restraints on which they have relied, to secure them from its abuse. They are the restraints on which the people must often rely solely, in all representative governments.

> served to the States, and the consolidation in itself of all powers, foreign and domestic; and that too, by constructions which, if legitimate, leave no limits to their power.

Letter from T. Jefferson to W.B. Giles (1825), *reprinted in* S. Padover, *Thomas Jefferson on Democracy* 54 (1961).[381]

The deep structural causes of expanding federal regulation—an increasingly integrated national, indeed world, economy in which advances in transportation and communication foster ever greater interdependence—have not abated. "The last two decades have seen an unprecedented growth of federal regulatory activity . . ." *Garcia*, 469 U.S. at 587 (O'Connor, J., dissenting). An examination of the course of federal regulatory expansion leaves little basis for believing that the profound causes of that phenomenon will lessen in the foreseeable future. *See generally* H. Friendly, *Federalism: A Foreword*, 86 Yale L.J. 1019 (1977) (tracing growth of federal regulatory power).

An integral aspect of the post-1937 revolution that allowed the federal government to use the Commerce Clause to address national economic problems was the abandonment of any notion contained in the pre-1937 jurisprudence that the Tenth Amendment set internal limits on the scope of Congress's delegated powers. Thus, in *United States v. Darby*, 312 U.S. 100 (1941), the Court brushed aside Tenth Amendment objections to the Fair Labor Standards Act:

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[381] In 1955, Justice Jackson observed "we have been in a cycle of rapid centralization, and Court opinions have sanctioned a considerable concentration of power in the Federal Government with a corresponding diminution in the authority and prestige of state governments." R. Jackson, *The Supreme Court in the American System of Government*, 65-66 (1955), *quoted in* B. Schwartz, *National League of Cities Again—R.I.P. or a Ghost That Still Walks?*, 54 Fordham L. Rev. 141, 143 (1985).

> The amendment states but a truism that all is retained which has not been surrendered. There is nothing in the history of its adoption to suggest that it was more than declaratory of the relationship between the national and state governments as it had been established by the Constitution before the amendment or that its purpose was other than to allay fears that the new national government might seek to exercise powers not granted, and that the states might not be able to exercise fully their reserved powers. . . .
>
> From the beginning and for many years the amendment has been construed as not depriving the national government of authority to resort to all means for the exercise of a granted power which are appropriate and plainly adapted to the permitted end.

Id. at 124 (citations omitted); *accord Case v. Bowles*, 327 U.S. 92, 102 (1946) (Tenth Amendment does not operate as a limitation upon the powers, express or implied, delegated to the national government).

These and other cases, *see e.g.*, *Fernandez v. Wiener*, 326 U.S. 340 (1945), eliminated any claim that Congress's regulatory powers might be limited by a domain in which state regulatory power was sacrosanct and sovereign. The Supreme Court's rejection of its pre-1937 jurisprudence, holding to the contrary, is "now universally regarded as proper." *E.E.O.C. v. Wyoming*, 460 U.S. 226, 249 (1983) (Stevens, J., concurring). *See Garcia*, 469 U.S. at 581-84 (O'Connor, J., dissenting) (recognizing generous scope of modern Commerce Clause interpretation due to need to insure national government can deal with national economic problems); *E.E.O.C. v. Wyoming*, 460 U.S. at 266 (Powell, J., dissenting) (Court properly has construed Commerce Clause to accommodate changes in transportation and communication).

The abandonment of this pre-1937 jurisprudence has had great consequences for the States. Vast spheres previously subject only to state regulation have now come under federal control. Yet, no one would deny that the pre-1937 state sovereignty limitations on Congress's delegated powers form no part of our constitutional jurisprudence today: "that chapter in our judicial history has long been closed." *E.E.O.C. v. Wyoming*, 460 U.S. at 247-48 (Stevens, J., concurring).[382]

The Supreme Court's federalism decisions after 1937 elaborated a vision in which national action was supreme, but always hedged about by an abiding respect for the autonomy and independence of the States as governmental actors. This meant, above all, that the three branches of the federal government would respect the integrity of state institutions and not lightly intrude upon their internal functioning. When national imperatives required an intrusion upon internal state operations, the intrusion would be tailored to achieve national purposes without unnecessary controls on state operations. Justice Black eloquently summarized this concept of federalism in *Younger v. Harris*, 401 U.S. 37, 44 (1971) (absent bad faith, harassment, or other extraordinary circumstances, comity requires that federal courts not enjoin lawfully brought, pending state criminal prosecutions):

> '[C]omity,' [entails] a proper respect for state functions, a recognition of the fact that the entire country is made up of a Union of separate state governments, and a continuance of the belief that the National Government will fare best if the States and their institutions are left free to perform their separate functions in their separate ways. This . . . is referred to by many as 'Our Federalism'[.] . . .

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[382] Thus, *National League of Cities* relied upon no portion of this pre-1937 jurisprudence for its holding that the autonomy and the independence of the States as States placed certain external limits on the scope of Congress's Commerce Clause powers.

> [Our Federalism] does not mean blind deference to 'States' Rights' any more than it means centralization of control over every important issue in our National Government and its courts. The Framers rejected both these courses. What the concept does represent is a system in which there is sensitivity to the legitimate interests of both State and National Governments, and in which the National Government, anxious though it may be to vindicate and protect federal rights and federal interests, always endeavors to do so in ways that will not unduly interfere with the legitimate activities of the States.

Prior to *National League of Cities*, judicial review of congressional regulation affecting the States was limited to protecting the fundamental interests of States as States. In *Maryland v. Wirtz*, 392 U.S. 183 (1968) (upholding extension of Fair Labor Standards Act to schools and hospitals operated by States and their political subdivisions), the Court emphasized that the federal government, when acting within a delegated power, may override countervailing state interests whether these interests be described as "governmental" or "proprietary" in character. *Id.* at 195. The Court also emphasized that the challenged legislation was nondiscriminatory. Congress had done nothing more than subject the States to the same restrictions imposed upon a wide range of other employers, including privately operated schools and hospitals. *Id.* at 194. Finally, the Court assured the States that it had ample power, if needed, to prevent "the utter destruction of the State as a sovereign political entity." *Id.* at 196.

The Supreme Court's basic approach of granting Congress broad discretion to override state autonomy in order to achieve national goals while, at the same time, retaining a reserve of judicial power to prevent drastic inroads on state autonomy and independence, was also evident in *Fry v. United States*, 421 U.S. 542 (1975) (upholding Economic Stabilization Act of 1970 as applied to freezing

salaries of state and local governmental employees). The Court noted that the federal regulation at issue in *Fry* was even less intrusive than the statute at issue in *Wirtz*, and that the effectiveness of the federal legislation would have been drastically impaired if state and local government employees had been exempted from the wage freeze. However, the Court cautioned that the Constitution does not countenance drastic invasions of state autonomy and independence by Congress: "[t]he [Tenth] Amendment expressly declares the constitutional policy that Congress may not exercise power in a fashion that impairs the States' integrity or their ability to function effectively in a federal system." *Id.* at 547 n.7.

D. *National League of Cities* and Its Progeny

National League of Cities v. Usery, 426 U.S. 833 (1976), sought to expand the sphere of state autonomy and independence from otherwise lawful congressional regulation. The *National League of Cities* Court invalidated the 1974 amendments to the Fair Labor Standards Act ("FLSA") extending the Act's coverage to virtually all state and local government employees. The Court drew a fundamental distinction between the authority of Congress to regulate private individuals and businesses necessarily subject to the "dual sovereignty" of state and national governments, on the one hand, and the ability of Congress to regulate the States as States on the other. Without doubting the authority of Congress under the Commerce Clause to extend minimum wage and maximum hour regulations, the Supreme Court emphasized that the federal system of government imposes affirmative limitations upon Congress's authority to regulate the States. *Id.* at 841-42.

The *National League of Cities* Court reasoned that the States' power to determine the wages and hours of those whom they employ to carry out their traditional governmental functions was essential to their separate and independent existence as States. *Id.* at 845. Although the

Court set forth the allegedly substantial cost increases required of the States by the federal regulation, the Court seemed more concerned with federal displacement of state policies regarding the manner in which the States would structure delivery of the governmental services that their citizens require. *Id.* at 847-50. The Court thus stressed that particularized assessments of actual impact were not crucial to its resolution of the case. *Id.* at 851. The dispositive factor was the federal attempt to displace the States' ability to structure employment relationships in areas of traditional operations of state and local governments. *Id.* at 851 & n.16. Limiting its holding to Commerce Clause legislation, the Court stated that "insofar as the challenged amendments operate to directly displace the States' freedom to structure integral operations in areas of traditional governmental functions, they are not within the authority granted Congress. . . ." *Id.* at 852 & n.17.

In *Hodel v. Virginia Surface Mining and Reclamation Association*, 452 U.S. 264 (1981), the Court clarified important aspects of its decision in *National League of Cities*. The *Hodel* Court synthesized the reasoning of *National League of Cities* into a four part test and made it clear that invalidating congressional legislation enacted pursuant to the Commerce Clause required a balancing of the burdens imposed upon the States with the nature of the federal interest advanced. *See* 452 U.S. at 287-88 & n.29.[383]

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[383] In *National League of Cities*, Justice Rehnquist's majority opinion did not explicitly adopt a balancing requirement; one could, however, infer a balancing analysis from the opinion's failure to overrule *Fry v. United States*, 421 U.S. 542 (1975). The Court declined to overrule on the grounds that the statute in *Fry* was both less intrusive and more urgently necessary than that involved in *National League of Cities*. *See* 426 U.S. at 853. Most important, Justice Blackmun, whose concurring opinion provided the crucial fifth vote for the *National League of Cities'* majority, explicitly embraced a balancing approach under which the importance of

Another critical aspect of *Hodel* was its reaffirmation that *National League of Cities* applied only to regulations affecting the "States as States"; the doctrine had no application to a federal statute that governed "only the activities of coal mine operators who are private individuals and businesses." 452 U.S. at 288. *National League of Cities* in no way limited congressional power to preempt or displace state regulation of private activities affecting interstate commerce. *Id.* at 289-90. Under no view of the law did Congress invade state autonomy simply by exercising its Commerce Clause powers in a manner which displaced the States' exercise of their police powers. *Id.* at 291.

Hodel also discussed the limits of federally mandated federal-state regulatory cooperation. Under the Surface Mining Act, the States had an option to enact and enforce laws implementing federal surface coal mining standards or to withdraw from the field entirely and allow the federal government to shoulder the regulatory burden. *See* 452 U.S. at 268-72. Since the Act did not compel the States to enforce federal standards or participate in the federal regulatory program, the Court reasoned that "there can be no suggestion that the Act commandeers the legislative processes of the States by

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the federal interest and the necessity for state regulation would be weighed against the degree of intrusion upon state autonomy. *See id.* at 856.

The *Hodel* Court made this balancing an integral aspect of its four part test. In order to succeed, a claim that legislation enacted pursuant to the commerce power was invalid had to show first that the challenged statute regulated the States as States. Second, the federal regulation had to address matters that were indisputably attributes of state sovereignty. Third, the States' compliance with the federal regulation had to directly impair their ability to structure integral operations in areas of traditional governmental functions. After having met those three requirements, there still had to be a fourth showing that the nature of the federal interest advanced did not justify state submission to regulation. 452 U.S. at 287-88 & n.29.

directly compelling them to enact and enforce a federal regulatory program." *Id.* at 288 (citations omitted).[384]

In *Hodel*, the Court established the parameters of the *National League of Cities* decision and developed a framework for its application in future cases. However, the unifying element of the doctrinal development subsequent to *Hodel* is the Supreme Court's consistent refusal to apply or extend *National League of Cities*, culminating in that decision's reversal in *Garcia*.

In *United Transportation Union v. Long Island Railroad Co.*, 455 U.S. 678 (1982), the Court determined that *National League of Cities* did not require invalidation of federal regulation of a State's passenger railroad. The Court reasoned that, since railroad operation is not among the functions traditionally performed by States, federal regulation could not impair the States' ability to function. *Id.* at 686.

The Court's analysis in *Long Island Railroad* foreshadowed the conceptual difficulties that led the *Garcia* majority to abandon *National League of Cities*. Although the Court employed an historical analysis to determine that railroad operation was not among the functions traditionally performed by state and local governments, the Court was at pains to stress that *National League of Cities*' traditional functions test "was not meant to impose a static historical view of state functions generally immune from federal regulation." *Id.* at 686. The Court was unable, however, to suggest another method

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[384] The Court contrasted the program of cooperative federalism embodied by the Surface Mining Act with certain Clean Air Act amendments which ordered the States to enact statutes and to establish and administer programs to enforce federal regulations directly against their citizens. Three Courts of Appeals had invalidated federal attempts to commandeer state regulatory powers, personnel, and resources to administer and enforce federal regulatory programs against owners of motor vehicles. All of these cases were vacated for consideration of mootness in *E.P.A. v. Brown*, 431 U.S. 99 (1977).

that would separate protected, "traditional" functions from unprotected ones. On the contrary, the Court insisted that a tradition of federal statutory regulation in an area was of great importance in determining the applicability of *National League of Cities*. *See id.* at 687-88. Ultimately, the Court stated that the purpose of the *National League of Cities'* inquiry was to determine whether the federal regulation affects basic state prerogatives in such a way as to hamper the state government's ability to fulfill its role in the Union and to endanger its "separate and independent existence." *Id.* at 687 (quoting *National League of Cities*, 426 U.S. at 851).

F.E.R.C. v. Mississippi, 456 U.S. 742 (1982), involved a challenge by Mississippi to the Public Utility Regulatory Policies Act of 1978. The critical provisions of this Act required state public utility commissions to "consider" the adoption of specific regulatory standards regarding rate structures and the terms and conditions of consumer service. The Public Utility Act also directed state commissions to follow certain procedures in considering the federal standards (involving public notice, hearing and a written statement of reasons). Although the Act did not prescribe penalties, it directed the States to consider the standards within two years and to decide whether to adopt the standards within three. The Public Utility Act did not require the States to adopt the federal standards, but did establish an annual reporting requirement respecting the States' ongoing consideration of the standards. The reporting requirement applied for ten years. *See id.* at 746-49.[385]

The Court's decision in *F.E.R.C. v. Mississippi* rejecting the State's challenge to this legislation is instructive.

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[385] Congress authorized federal grants to state regulatory authorities to assist them in carrying out these provisions. *See* 456 U.S. at 751 n.14.

Initially, the Supreme Court acknowledged that "having the power to make decisions and to set policy is what gives the State its sovereign nature." 456 U.S. at 761. The Court inferred from that premise that the ability of a state legislative or administrative body to consider and promulgate laws and regulations of its own choosing is central to a State's role in the federal system. *Id.* The Court added that it had never explicitly sanctioned a federal command to the States to promulgate and enforce laws and regulations, *id.* at 761-62, and noted that in a previous decision it had expressed doubt as to whether a state agency may be ordered to promulgate regulations having effect as a matter of state law. *Id.* at 762 n.26 (citing *Washington v. Washington State Commercial Passenger Fishing Vessel Association*, 443 U.S. 658, 695 (1979)).

The Court eschewed a decision between competing views of the federal government's power to compel state regulatory activity. The Court considered this issue not presented for resolution. In its view, Congress's undoubted power entirely to preempt the States from regulating private utilities necessarily embraced a lesser power to require the States to consider proposed federal regulations as a condition of allowing continuing state regulation of the area. *Id.* at 764-65. The Court viewed directing the States to consider certain proposals to be far less intrusive than congressional preemption of the entire field. *Id.* at 765. Importantly, the Public Utility Act did not involve the compelled exercise of the State's sovereign powers, did not set a mandatory agenda to be considered in all events by state decision makers, and did not purport to authorize the imposition of general affirmative obligations on the States. *Id.* at 770 & n.32.

The Court in *F.E.R.C. v. Mississippi* acknowledged the essentially coercive nature of the choice put to the States: either abandoning utility regulation altogether or

considering the federal standards.[386] The Court sanctioned imposing such a choice upon the States, in part, by reference to its spending power decisions. The Court noted that in *Oklahoma v. Civil Service Commission*, 330 U.S. 127 (1947), it had upheld Congress's power to condition state highway funding on state compliance with Hatch Act prohibitions on partisan political activity by state highway officials. The Court reasoned that, since the spending power cases allow the United States to condition its financial assistance even where the condition involves activities with which the United States is not concerned and has no power to regulate, *id.* at 766 (quoting *Oklahoma v. Civil Service Commission*, 330 U.S. at 143), requiring state consideration of federal standards in an otherwise preemptible field is no more restrictive of state autonomy and independence.

The Supreme Court supported Congress's requirement that state utility commisisons follow certain notice and comment procedures when considering the proposed federal standards with the same analysis, focusing upon Congress's even more intrusive power to preempt state law. Since Congress could preempt the field entirely, it could certainly condition continuing state involvement upon state compliance with certain procedural minima as a State considers proposed federal regulations. *Id.* at 770-71.

The Court's decision in *E.E.O.C. v. Wyoming*, 460 U.S. 226 (1983), foreshadowed *Garcia*'s explicit return to a pre-*National League of Cities* approach to state regulatory immunity. In *E.E.O.C. v. Wyoming*, the Court up-

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[386] The Court recognized that this was particularly true where Congress had failed to provide an alternative regulatory scheme in the event of a decision by a State not to act as contemplated by Congress. The challenged statute—unlike the Surface Mining Act involved in *Hodel*—did not provide an alternative mechanism. 456 U.S. at 766.

held Congress's extension of the Age Discrimination in Employment Act ("ADEA") to the States. Although the ADEA's prohibition of age discrimination by state employers is not functionally dissimilar to the Fair Labor Standards Act's wages and hours requirements at issue in *National League of Cities*, the Court held that the ADEA did not impair the State's ability to structure integral operations in areas of traditional governmental functions. *Id.* at 239.

The Court emphasized that the purpose of the *National League of Cities* doctrine was "not to create a sacred province of state autonomy," but instead to protect the States from federal intrusions that might threaten their separate and independent existence. *Id.* at 236. The Court concluded that the degree of federal intrusion in applying the ban on age discrimination to the States was less serious than that involved in *National League of Cities*, and hence that it was unnecessary "to override Congress' express choice to extend its regulatory authority to the States." *Id.* at 239.

The Court conducted a "generalized inquiry, essentially legal rather than factual, into the direct and obvious effect of the federal legislation on the ability of the States to allocate their resources." *Id.* at 240. The Court found no wide ranging financial or social policy effects from applying the ADEA in lieu of Wyoming's involuntary retirement statute. *Id.* at 241-42. Beyond the immediate managerial goals inherent in the State's retirement statute, the ADEA displaced no state policies or programs. Moreover, the ADEA allowed the State to assure the physical preparedness of its employees to perform their duties—the goal of the State's statute—merely by meeting a "reasonable federal standard" which required the State to establish that age is a "bona fide occupational qualification" for the position under the ADEA. *Id.* at 240.

E. *Garcia*: A Return to Constitutional Structure

In *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985), the Court decided that the *National League of Cities* approach to state regulatory immunity under the Commerce Clause was both unworkable and inconsistent with established principles of federalism. *Id.* at 531. The Court reasoned that fundamental conceptual and structural problems preclude the development of judicially manageable standards for applying the *National League of Cities* approach to state regulatory immunity. Given the sterility of the *National League of Cities* approach, the Court elected to abandon a case-by-case elaboration of its doctrine. Instead, the Court overruled *National League of Cities* and returned to the mainstream of its post-1937 federalism jurisprudence.[387]

State regulatory immunity under *National League of Cities* had been limited by the requirement that state compliance with the federal command must "directly impair [the States'] ability 'to structure integral operations in areas of traditional governmental functions.'" *Hodel*, 452 U.S. at 288 (quoting *National League of Cities*, 426 U.S. at 852). The requirement that federal regulations interfere with traditional governmental functions was of critical importance: it served to delimit the sphere of state "sovereignty" upon which federal regulations could

[387] See section VII(C), *supra*. *Garcia* presented the Supreme Court with a ready alternative to overruling *National League of Cities* if the Court believed that that case had continuing vitality. The lower court in *Garcia* had concluded that municipal ownership and operation of a mass-transit system was a traditional governmental function and thus was exempt from the requirements of the Fair Labor Standards Act. This decision conflicted with the Court's holding in *United Transportation Union v. Long Island Railroad Co.*, 455 U.S. 678 (1982), that a state owned commuter railroad did not constitute a traditional governmental function. Thus, the *Garcia* Court might well have reversed the court below without overruling *National League of Cities*.

not intrude. Yet, the Court's extensive review in *Garcia* of lower court decisions defining traditional state functions failed to discern a rational organizing principle. *See* 469 U.S. at 538-39. The Court's own cases recognized the difficulties of defining traditional state functions or basic state prerogatives, but had made little headway in resolving these difficulties. *Id.* at 543-44.

The *Garcia* majority's decision to pretermit further development of the traditional state functions test rested on the belief that this quest was inherently futile. The need to reconcile state and federal interests in the field of intergovernmental tax immunity demanded that state tax immunity not be unlimited; however, forty years of jurisprudence in the tax area dedicated to developing a principled distinction between "governmental" (protected) and "proprietary" (unprotected) state functions had proven unavailing. The Court disclaimed any further reliance on any such distinction in *New York v. United States*, 326 U.S. 572 (1946). *See Garcia*, 469 U.S. at 540-43.

The *Garcia* Court considered and rejected both historical and nonhistorical approaches[388] to defining those state functions which were immune from federal control. At bottom, any attempt to carve out a sphere of state regulatory immunity based on important governmental functions cannot lead to consistent results. There are no standards by which the judiciary can evaluate the importance of particular state functions. A State's freedom to engage in particular activities should not be made to de-

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[388] In addition to a purely historical approach, the Supreme Court also discarded functional methods based on the definition of uniquely governmental or necessary governmental functions. 469 U.S. at 545-46. The same critique would apply to efforts to confine state regulatory immunity to "essential," "non-commercial," "traditional," or "integral" state functions. The proliferation of adjectives reflects a conceptual inability to fashion a principled, objective distinction.

pend upon the predilections of the federal courts. Basing state regulatory immunity on the importance of the functions regulated thus leads to unacceptable results: "[a]ny rule of state immunity that looks to the 'traditional,' 'integral,' or 'necessary' nature of governmental functions inevitably invites an unelected federal judiciary to make decisions about which state policies it favors and which ones it dislikes." *Garcia*, 469 U.S. at 546.[389] The absence of judicially manageable criteria for analyzing important state functions is not problematic because:

> [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.

Id. (quoting *Helvering v. Gerhardt*, 304 U.S. 405, 427 (1938) (Black, J., concurring)).[390]

Garcia's rejection of the *National League of Cities* approach to state regulatory immunity was based on other

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[389] In his concurring opinion in *Helvering v. Gerhardt*, 304 U.S. 405 (1938), Justice Black made a similar point about the use of an essential functions test to determine state immunity from federal taxation. "Testing taxability by judicial determination that State governmental functions are essential[,]" Justice Black declared, "contributes much to the existing [doctrinal] confusion." *Id.* at 426. He added that "[c]onceptions of 'essential governmental functions' vary with individual philosophies. Some believe that 'essential governmental functions' include ownership and operation of water plants, power and transportation systems, etc. Others deny that such ownership and operation could ever be 'essential governmental functions' on the ground that such functions 'could be carried on by private enterprise.'" *Id.*

[390] By way of analogy, one of the "dominant considerations" that renders a political question non-justiciable is "the lack of satisfactory criteria for a judicial determination." *Baker v. Carr*, 369 U.S. 186, 210 (1962) (quoting *Coleman v. Miller*, 307 U.S. 433, 454-55 (1939)).

considerations besides the elusiveness of objective criteria for defining traditional state functions. Any effort to single out the underlying, unchanging elements of state sovereignty founder on a fundamental, structural consideration: "the sovereignty of the States is limited by the Constitution itself." *Id.* at 548. Although the States do retain a sigfinificant measure of sovereign authority, they do so only to the extent that the Constitution has not divested them of their powers and transferred these powers to the federal government. *Id.* at 549. And, as the *Garcia* Court's discussion of the applicable constitutional provisions demonstrates, many sovereign powers have been withdrawn from the States. Since the Constitution, with rare exceptions, does not carve out express elements of state sovereignty that Congress cannot employ its delegated powers to displace, there are few defined frontiers beyond which federal regulatory power cannot pass. *Id.*[391] Congress's ability to use its delegated powers to extend its authority leaves the Court "no license to employ freestanding conceptions of state sovereignty when measuring congressional authority under the Commerce Clause." *Id.* at 550.

Garcia eschews primary reliance upon continued judicial deference to an unchanging and ill defined realm of state sovereignty to insure the separate and independent existence of the States in the federal system. Instead, the States' first line of defense lies in the structure of the federal government itself. The representation of the

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[391] Thus, as the national government employs its duly delegated commerce power, in conjunction with the Supremacy Clause of Article VI, to regulate larger and larger portions of our interdependent society, it continually displaces contrary state legislation. Yet, no member of the Court has questioned the constitutionality of this continued expansive use of the commerce power. *But cf. Hodel,* 452 U.S. at 307-13 (Rehnquist, J., concurring) (pointing out that commerce power is limited to activities *substantially* affecting interstate commerce). *See generally* section VII(C), *supra.*

States in the federal system, and the States' role in selecting the President,[392] afford the States systematic protection from federal overreaching.[393]

Judicial review of claims of state immunity from federal intrusion must henceforth be attuned to the procedural safeguards that inhere in the structure of the federal system. Thus, any subsequent judicial restraint on

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[392] *See* note 371, *supra.*

[393] The *Garcia* Court's view of the efficacy of the political safeguards of federalism is supported by a considerable body of legal scholarship. In his seminal article *The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government,* 54 Colum. L. Rev. 543 (1954), Professor Herbert Wechsler urged great judicial deference to congressional legislation affecting the allocation of power between the national and state governments. As Professor Wechsler explained, "[f]ar from a national authority that is expansionist by nature, the inherent tendency in our system is precisely the reverse, necessitating the widest support before intrusive measures of importance can receive significant consideration, reacting readily to opposition grounded in resistance within the states." *Id.* at 558.

More recent scholarship supports the Wechsler thesis. Professor Choper has written: "[c]ases that allege an excessive act by the central government are presented to the Court only after the act has attained the broad consensus that is required to overcome the inertia and the various negative features of the national lawmaking process. . . . [N]ational legislation affecting states' rights must have the widespread support of those affected. Under these conditions, the need for judicial review is at its lowest ebb." *The Scope of National Power Vis-a-Vis the States: The Dispensability of Judicial Review,* 86 Yale L.J. 1552, 1570 (1977). *See also* D. La Pierre, *The Political Safeguards of Federalism Redux: Intergovernmental Immunity and the States as Agents of the Nation,* 60 Wash. U.L.Q. 779 (1982); Stewart, *Pyramids of Sacrifice? Problems of Federalism in Mandating State Implementation of National Environmental Policy,* 86 Yale L.J. 1196 (1977). For a recent attempt to reformulate the Wechsler thesis based on the notion that nondiscriminatory legislation insures the accountability of Congress to legitimate state concerns, see D. La Pierre, *Political Accountability in the National Political Process—The Alternative to Judicial Review of Federalism Issues,* 80 Nw. U.L. Rev. 577 (1985).

Congress's exercise of its Commerce Clause powers "must be tailored to compensate for possible failings in the national political process rather than to dictate a 'sacred province of state autonomy.'" *Id.* at 554 (quoting *E.E.O.C. v. Wyoming*, 460 U.S. at 236).

Applying this more deferential standard of review to the facts before it, the *Garcia* Court perceived nothing troubling in compelling San Antonio's mass transit authority to comply with the minimum wage and overtime requirements of the Fair Labor Standards Act. The FLSA in no way discriminated against the States. Moreover, although federal financial assistance to state mass transit systems was not deemed of controlling importance, the massive amounts of federal transit aid to the States reinforced the Court's conviction that the national political process amply protects the States. *Id.* at 555-56 & n.21.

Consistent with the Supreme Court's pre-*National League of Cities* approach to state regulatory immunity, *Garcia* was careful to retain a reserve of judicial power in order to insure the special position of the States in our constitutional system. *Garcia* did not require the Court "to identify or define what affirmative limits the constitutional structure might impose on federal action affecting the States under the Commerce Clause." *Id.* at 556. The Court felt no need to go beyond what was required for a reasoned disposition of the application of the FLSA to the States since, on the facts presented, the internal safeguards of the national political process had obviously performed as intended. *Garcia* departs from pre-*National League of Cities* jurisprudence only in its emphasis that judicial review must be tailored to compensate for the possible failure of the national political process adequately to represent the States.[394]

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[394] The Special Master does not interpret *Garcia* as abdicating all judicial review of Commerce Clause legislation affecting the

VIII. THE TEFRA REGISTRATION REQUIREMENT DOES NOT INVADE THE SEPARATE AND INDEPENDENT EXISTENCE OF THE STATES.

The Supreme Court decided *Garcia v. San Antonio Metropolitan Transit Authority* in February, 1985—subsequent to its decision to grant South Carolina leave to file its complaint in this matter. *Garcia* altered the landscape of federalism jurisprudence, but left the judicial mapping of the new terrain of federalism to future cases. The registration requirement of Section 310(b)(1) of TEFRA—requiring the States to issue their bonds in registered form or forfeit the tax-exempt status of the interest they pay thereon—provides an occasion to survey the new terrain. However, the facts established during the hearing indicate that adjudication of the federalism questions presented here does not, in the opinion of the Special Master, require an extensive probe of uncharted areas. Under well established principles, TEFRA's registration requirement is a permissible exercise of federal regulatory power over the States.

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autonomy and independence of the States. *But see* B. Schwartz, *National League of Cities Again—R.I.P. or a Ghost That Still Walks?*, 54 Fordham L. Rev. 141 (1985); W. Van Alstyne, *The Second Death of Federalism*, 83 Mich. L. Rev. 1709 (1985). *Garcia* merely suggests that the courts view the national political process with deference, and deploy the shield of the Constitution sparingly, in a field notable for its absence of well defined judicial standards. Nothing in *Garcia* suggests that Congress is free to legislate without considering the legitimate interests of the States. Neither does *Garcia* suggest that judicial intervention will not be forthcoming in an appropriate instance: the extraordinary case in which the national political process fails to respect the autonomy and independence of the States. Such an approach is consistent with the "great delicacy and difficulty" of the judicial role in preserving the balance between the national and state governments. *South Carolina v. United States*, 199 U.S. 437, 448 (1905).

A. The Limited Impact of the Registration Requirement on the States

1. *The Burdens of TEFRA: An Overview*

Unlike prior congressional regulation of municipal industrial development bonds and arbitrage financing practices,[395] the registration requirement has not had any substantive effect on the ability of States and localities to raise debt capital.[396] Nor has TEFRA limited the States in their ability to choose the purposes to which they will dedicate the proceeds of their tax-exempt borrowing.[397] Finally, TEFRA has had no effect on the political processes by which a State decides to issue debt.[398] In short, TEFRA has not changed how much the States borrow, for what purposes they borrow, how they decide to borrow, or any other obviously important aspect of the borrowing process.

What is more, the foregoing is undisputed. No state official or other witness testified that any particular debt issuance had been impeded by TEFRA—even during the transition period during which TEFRA became effective.

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[395] See notes 13-19, *supra*, and accompanying text.

[396] See notes 130-131, *supra*, and accompanying text.

[397] This contrasts markedly with congressional regulation of municipal industrial development bonds. These bonds constituted more than 50% of the municipal bond market in 1982. See note 17, *supra*, and accompanying text. In regard to IDBs, Congress has specified which state activities may benefit from tax-exempt financing and which may not. *See* 26 U.S.C. § 103(b)(4).

[398] By contrast, Congress has required the States to gain public approval prior to issuing tax-exempt industrial development bonds and has specified that public approval requires approval by an appropriate elected government representative after a public hearing following reasonable notice or an actual voter referendum in the relevant governmental unit. *See* 26 U.S.C. § 103(k)(2)(A) and (B). *Cf. F.E.R.C. v. Mississippi*, 456 U.S. 742 (1982) (upholding statute mandating consideration of federal proposals and prescribing procedures for their consideration).

The post-TEFRA ability of municipal bond issuers to raise debt capital is precisely what it was prior to TEFRA.

What has changed is that States and localities, desiring to preserve the tax-exempt status of their bonds, no longer issue their bonds in bearer form. TEFRA does not even dictate how municipal bonds are to be registered, leaving the decision how to accomplish registration to the States.[399] Thus, the post-TEFRA municipal bond environment is largely identical to the pre-TEFRA environment, with one exception: States and localities (or their agents) must, in some form or another, maintain a list of the owners of their bonds.

The States allege that the change to registered bonds has forced them to incur five categories of costs. Of these, two categories—the legislative and administrative time and energy needed to effect the change to registration—have already been fully expended. There is no evidence of ongoing federal expropriation of state legislative or administrative resources.

Two more categories of cost—increased bond transaction costs and an alleged interest rate differential—are purely financial in nature. Plaintiffs failed to establish that the allegedly increased administrative and interest costs were of such a magnitude as to threaten the States' "separate and independent existence." *Coyle v. Smith*, 221 U.S. 559, 580 (1911) (quoting *Lane County v. Oregon*, 74 U.S. (7 Wall.) 71, 76 (1869)).

The final category of burden alleged—"sovereignty costs"—dealt with the States' diminished capacity to make decisions independent of federal regulation. However, plaintiffs did not demonstrate any connection be-

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[399] See notes 80-84, *supra*, and accompanying text for a discussion of the options available to the States in effecting registration.

tween the decision to issue bonds in bearer form and any aspect of state autonomy or independence; indeed, there was nothing in the record to suggest that, from the standpoint of the States, the form of municipal bonds is anything other than a technical detail designed to facilitate bond sales and accommodate the desires of the market. States continue to sell their bonds without impediment after TEFRA. Since municipal bond form does not affect the States' revenue raising function in any material way, and since bond form does not appear to be linked to any other important aspect of state governmental operations, the Special Master cannot conclude that federal control over the form of municipal bonds threatens to impair state autonomy and integrity in any meaningful sense.

2. *The Legal Significance of Plaintiffs' Cost Contentions*

Before analyzing each of plaintiffs' five categories of cost contentions in more detail, it is appropriate to determine the legal significance of particularized cost contentions in light of the Court's holding in *Garcia*. *Garcia* heralds a return to deferential judicial review—at least where the States brandish the shield of the Constitution—of congressional regulation under the commerce power.[400]

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[400] Plaintiffs assert that Congress is entitled to less judicial deference when, as here, it acts pursuant to the taxing power rather than the commerce power. To the extent this contention has force, it can only be because the exercise of the taxing power runs afoul of the intergovernmental tax immunity doctrine or some other limitation on the national taxing power. *See, e.g., Haynes v. United States*, 390 U.S. 85 (1968) (registration component of firearms tax statute violates Fifth Amendment); *Marchetti v. United States*, 390 U.S. 39 (1968) (registration component of gambling tax statute violates Fifth Amendment). Plaintiffs' contentions that Section 310(b)(1) of TEFRA violates intergovernmental tax immunity and is also an impermissible regulatory tax are examined *infra* in Sections IX(B) and IX(D). Unless those contentions afford plaintiffs some independent grounds for relief, there is nothing in the mere fact that Congress has used its taxing

This more deferential approach required by *Garcia* is best illustrated by contrasting the *Garcia* Court's approach to the burdens imposed on the States by the Fair Labor Standards Act with that taken in *National League of Cities.*

Even in *National League of Cities,* the Court eschewed measuring the lawfulness of congressional legislation by a quantitative evaluation of the costs imposed on the States. Noting the disagreement between the parties as to the actual effects of the FLSA's wages and hours requirements,[401] the Court stated that "particularized assessments of actual impact are [not] crucial to resolution of the issue presented . . ." 426 U.S. at 851. The Court focused upon the qualitative impact of the statute upon the States' ability to choose the manner in which they would structure delivery of vital services. *Id.* at 847. *National League of Cities* took pains to spell out "a virtual chain reaction of substantial and almost cer-

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power, instead of its commerce power, to regulate the States that would justify a more searching review of Congress's action. *See New York v. United States,* 326 U.S. 572, 578 (1946) ("Surely the power of Congress to lay taxes has impliedly no less a reach than the power of Congress to regulate commerce.") *Cf. Fullilove v. Klutznick,* 448 U.S. 448, 474-75 (1980) (Burger, C.J., plurality opinion) (since Congress's spending power is at least as broad as its regulatory power under the Commerce Clause, Congress can use spending power to accomplish regulatory objectives otherwise lawful under the Commerce Clause). *See also La Pierre, supra,* 60 Wash. U.L.Q. at 878-92 (criticizing arbitrary linedrawing based on particular congressional power exercised). A challenge to congressional regulation allegedly impairing state autonomy and independence must be measured against the standards of *Garcia,* and *Garcia* does not suggest that the particular power pursuant to which Congress has chosen to act is relevant as a matter of law to analyzing whether the challenged action does impair autonomy and independence.

[401] It should be recalled that *National League of Cities* came to the Supreme Court on an appeal from a successful motion to dismiss. *See* 426 U.S. at 839.

tainly unintended consequential effects on state decision-making." *E.E.O.C. v. Wyoming*, 460 U.S. at 240. The progeny of *National League of Cities* always maintained that mere financial burdens or ultimate economic effects on the States could not be determinative. *F.E.R.C. v. Mississippi*, 456 U.S. at 770 n.33; *Hodel*, 452 U.S. at 292 n.33. *See E.E.O.C. v. Wyoming*, 460 U.S at 240 (focusing on ability of States to allocate their resources)

In *Garcia*, adjudicating the application of the FLSA to a public mass transit system was deemed not to require an extensive analysis of qualitative or quantitative effects. The financial burdens of minimum wage and overtime compensation and the costs inherent in the reordering of state decisions concerning the methods of providing governmental services—even if they might be considerable—were deemed insubstantial as a matter of law. The Court perceived "nothing in the overtime and minimum-wage requirements of the FLSA, as applied to [the transit authority], that is destructive of state sovereignty or violative of any constitutional provision." *Garcia*, 469 U.S. at 554.

Garcia provides the benchmark against which subsequent federal regulation affecting the States must be measured. Clearly, congressional legislation imposing burdens or costs less substantial than mandated minimum wage and overtime expenses for state employees must be viewed with great deference. More important, inroads on autonomous state decision making less extensive than those made by the FLSA—which limited the States' ability to structure employment relationships in areas of vital governmental functions—cannot be the basis of a successful constitutional challenge. In short, *Garcia* indicates that judicial redress is unavailable unless the challenged regulation substantially impairs the autonomy and independence of the States as governmental actors. Minimum wage and overtime requirements fall far short of compromising the States' independent ex-

istence, and thus are held by *Garcia* to be immune from judicial review.

3. *The Minimal Costs of Registration*

With one exception, none of plaintiffs five particularized cost contentions purport to demonstrate such a qualitative impact on state autonomy and independence as to require judicial intervention under *Garcia*. With regard to the purely quantitative effects of the registration requirement, the Secretary is clearly on firm ground in arguing that "if Congress may directly regulate the wage and salary expenses incurred by the States in providing key governmental services . . . Congress may surely impose the far less significant compliance costs incurred by the States in issuing their bonds in registered form." *Brief For the Defendant* at 41.

Plaintiffs argue, however, that the "sovereignty costs" of the registration requirement are so great as to offend principles of constitutional federalism. This "sovereignty costs" argument, as one of plaintiffs' counsel stated at oral argument,[402] is extremely difficult to define. *But see Coyle v. Smith*, 221 U.S. 559 (1911) (Congress may not prescribe location of state capital). The core of plaintiffs' argument here appears to be that TEFRA invades a uniquely and peculiarly sovereign function—the raising of revenue—and does so without achieving its intended national purpose of facilitating federal tax compliance.[403]

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[402] "We talked about the affront to Government. This is really what we've been talking about throughout this argument. And I don't know how to describe it, but it is a separate burden. . . ." Oral Argument, Tr. at 37.

[403] Plaintiffs also assert that their sovereignty is impaired due to federal commandeering of their legislative and administrative resources. This is not, however, an impairment of their sovereignty in any way distinct from their argument about legislative and administrative costs of compliance. The Special Master considers that argument *infra* at 128-130.

Plaintiffs' challenge to federal regulation of their revenue raising function misses the point. Revenue generation is undoubtedly critical to state autonomy and independence, but the intrinsic importance of the function being regulated does not, without more, create a judicially cognizable infringement on state autonomy.[404] Here, plaintiffs acknowledge that their ability to borrow by selling bonds continues undiminished; indeed, the record establishes that municipal borrowing increased rapidly after passage of TEFRA.[405] Moreover, there is no suggestion that control over the form of their bonds was of any intrinsic significance to the States. Control over municipal bond form has none of the symbolic resonance for state autonomy that, for example, controlling the location of the state capital has. *See Coyle v. Smith*, 221 U.S. at 565.

Absent the federal registration requirement, States would choose the form of their bonds solely according to considerations of efficiency and market demand.[406] Even under a *National League of Cities* level of scrutiny, these facts would militate against judicial intervention. *See E.E.O.C. v. Wyoming*, 460 U.S. at 238 n.11 ("we are not to be understood to suggest that every state employment decision aimed simply at advancing a generalized interest in efficient management—even the efficient management of traditional state functions—should be considered to be an exercise of an 'undoubted attribute of state sovereignty.' ").

The other aspect of plaintiffs' sovereignty cost argument contends that the registration requirement does not further an important national purpose, and thus any

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[404] *Cf. Case v. Bowles*, 327 U.S. 92, 101 (1946) (State's authority to raise revenue for public education by selling timber on public lands held subject to congressional power to fix timber prices).

[405] *See supra* at 20.

[406] *See supra* at 35-36.

diminution of state independence and autonomy is unjustifiable. Plaintiffs argue that bearer municipal bonds do not pose a significant problem for federal tax compliance and, even if they did, that registration would not rectify the problem.

The Special Master has previously examined the factual foundations of these contentions, and found them to be without adequate support.[407] In any event, moreover, the judiciary is not empowered to undertake a free wheeling inquiry into the adequacy of the evidence before Congress or its political motives in passing legislation.[408] In *Maryland v. Wirtz*, 392 U.S. 183 (1968), the States argued that there was no factual predicate for extending the FLSA to state schools and hospitals. The Court summarily rejected this contention: "[w]e are not concerned with the manner in which Congress reached its factual conclusions." *Id.* at 190 n.13. *Cf. Katzenbach v. McClung*, 379 U.S. at 304 (judicial inquiry limited to whether Congress had rational basis for finding regulatory scheme necessary to protecting commerce); *Heart of Atlanta Motel, Inc. v. United States*, 379 U.S. at 262 (court should do no more than assure that means chosen by Congress are reasonably adapted to end permitted by Constitution). As the *Hodel* Court cautioned, "the effectiveness of existing laws in dealing with a problem iden-

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[407] *See supra* at 83-88.

[408] Plaintiffs suggest that the registration requirement may have been motivated primarily by a desire to benefit the securities industry. *Brief of the NGA* at 61 n.*. The record does not support such a finding. See note 44, *supra*. In any event, the Supreme Court has declined to void otherwise valid legislation on the grounds that a wrongful motive lay behind congressional action, even where the allegedly illicit motive was the infringement of expression protected under the First Amendment. *See United States v. O'Brien*, 391 U.S. 367, 383-84 (1968). After *Garcia*, it would be anomalous in the extreme to apply more rigorous scrutiny to a State's regulatory immunity claim. *See United States v. Carolene Products Co.*, 304 U.S. 144, 152 n.4 (1938).

tified by Congress is ordinarily a matter committed to legislative judgment." *Hodel*, 452 U.S. at 283. Nothing in the record suggests to the Special Master that this is a case in which judicial review of Congress's factual predicate for TEFRA's registration requirement is appropriate or required. In short, the Special Master believes that both a failure of proof and the judicial deference required in reviewing the efficacy of congressional action combine to produce a conclusion that plaintiffs' sovereignty costs arguments should be rejected.

Plaintiffs' sovereignty costs contention also rests on a mistaken premise: that TEFRA coerces the States into surrendering their sovereign ability to decide the form of their bonds. Even if the ability to decide to issue bearer bonds was critical to maintaining state autonomy, TEFRA leaves the States free to issue bearer bonds; TEFRA merely alters the economic calculus underlying that decision.[409] If a State chooses to issue its bonds in bearer form, it must forego the benefits attendant the ability to pay tax-free interest on those bonds. Unless the tax-exempt status of municipal bond interest is sacrosanct and entirely beyond the authority of Congress,[410] the Supreme Court's Spending Clause cases provide a powerful analogy supporting the congressional regulation as not restricting state autonomy or independence.

Cases arising under the spending power have long recognized that Congress may fix the terms on which it disburses federal funds to the States. *Pennhurst State School & Hospital v. Halderman*, 451 U.S. 1, 17

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[409] The Special Master notes that the Tax Reform Act of 1986 has reduced the marginal tax rates for both individual and corporate taxpayers. This reduction in rate will presumably reduce the economic value of tax-exempt interest to municipal bond holders and increase the interest costs required for municipal bonds, thus reducing the economic value to the States of the ability to issue tax-exempt bonds.

[410] This is discussed *infra* at 142.

(1981); *Fullilove v. Klutznick*, 448 U.S. 448, 474 (1980). In return for receiving the benefit of federal funds, the States agree to comply with federally imposed conditions. The cases do require that the federal government impose the conditions explicitly and unambiguously. The requirement that Congress clearly state the conditions of its funding insures that the States understand the burdens of their participation and are able to make an informed choice. *Pennhurst*, 451 U.S. at 17.

The spending power cases recognize that Congress may use its ability to place conditions on its subsidies to the States in order to enlist the States in effecting legitimate national goals—even where Congress could not accomplish those goals directly by regulation. In *Oklahoma v. Civil Service Commission*, 330 U.S. 127 (1947), the United States sought to achieve better public service in the administration of funds for national needs. It thus conditioned federal grants-in-aid to the States on the abstention from partisan political activity of state and local officials employed in activities financed by those grants. The Supreme Court upheld the condition although "the United States is not concerned and has no power to regulate local political activities as such of state officials, . . ." Id. at 143. The condition was permissible because it was "plainly adapted" to a "permitted end": improved administration of funds supplied by the federal government. *Id.* [411]

In TEFRA, Congress has offered the States a choice, albeit an unpalatable one, either to issue bonds in registered form or to forego certain tax benefits. The legis-

[411] There are limits on Congress's power to impose conditions on the States pursuant to the spending power. *See Pennhurst*, 451 U.S. at 17 n.13; *Lau v. Nichols*, 414 U.S. 563, 569 (1974). Congress could not, for example, use its spending power to induce a State to violate the constitutional rights of its citizens or to move its capital to a federally selected location. *Cf. Coyle v. Smith*, 221 U.S. 559 (1911).

lative history of TEFRA demonstrates that Congress could have concluded that the movement of bearer bonds in interstate commerce facilitates tax evasion and the transportation of illegally earned, untaxed income.[412] Had Congress chosen to do so, it could have invoked the Commerce Clause to prohibit the movement of bearer bonds in interstate commerce. *See United States v. Darby*, 312 U.S. 100, 114 (1941) (Congress may exclude from interstate commerce articles injurious to public welfare). Instead, Congress has chosen a less intrusive course to induce the States not to issue bearer municipal bonds by continuing to offer a tax benefit for refraining from doing so. As indicated, unless the tax benefit enjoys constitutional protection on other grounds, the spending power cases sanction such a procedure. Like Oklahoma in *Oklahoma v. Civil Service Commission*, the States remain free to adopt the " 'simple expedient' of not yielding" to what they may view as federal coercion. 330 U.S. at 143. Surely, the States cannot be heard to complain that Congress offered even a modest choice, when Congress was not required to extend any at all.

Having disposed of plaintiffs' sovereignty costs contention, the factual findings make it unnecessary to tarry long over plaintiffs' remaining contentions as to burdens. Plaintiffs' legislative and administrative transition costs contentions[413] complain of the legislative and administrative time and resources needed to effect the change to a registered system. Plaintiffs failed to show, however, that these costs—by definition already fully expended—detracted from the States' ability to perform any significant governmental functions, much less from achieving critical priorities of the States or any of their political subdivisions. If there was any adverse impact on state-local governmental performance during the TEFRA

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[412] See *supra* at 11-19, 83-88.

[413] See *supra* at 36-40.

transition period, it cannot be discerned from the present record.

Plaintiffs attempt to compare the legislative and administrative transition costs generated by the need to comply with TEFRA to a concern expressed, but not resolved, by the Court in *F.E.R.C. v. Mississippi*: the constitutionally permissible scope of federal authority to compel state regulatory activity. *See* 456 U.S. at 764. In *F.E.R.C.*, the federal government required the States to consider certain federal proposals as a condition to permitting continued state regulation in the field. Since total federal preemption was possible, and was deemed by the Supreme Court to be more intrusive than a requirement merely to consider federal proposals, the Court deemed it unnecessary to determine the permissible scope of federal power to compel state regulatory activity. The Court did note, however, that it had never "sanctioned explicitly a federal command to the States to promulgate and enforce laws and regulations . . ." *Id.* at 762 (citing *E.P.A. v. Brown*, 431 U.S. 99 (1977)).

The concerns expressed by the Court in *F.E.R.C.* have no proper application here. As in *Hodel*, "there can be no suggestion that the Act commandeers the legislative processes of the States by directly compelling them to enact and enforce a federal regulatory program." 452 U.S. at 288. Instead, TEFRA gives the States a choice either to take the necessary steps to issue bonds in registered form or to relinquish the tax-exempt status of the interest paid thereon. State legislatures and agencies took steps to accomplish registration, but there was no federal control over legislative/administrative agendas. The States were not compelled to take any action.

To preserve their tax benefits, the States legislated in their own fashion and developed administrative methods of their own choosing to issue registered bonds. The time and funds expended in connection with these legislative

and administrative activities were one-time costs; there is no ongoing requirement that the States expend their limited time and resources to implement a federal regulatory scheme. Most important, there was no evidence produced at the hearing which suggested that the time and energy required impaired any State or locality's ability to address any state or local problem or perform any other functions efficiently and effectively.

Beyond these purely transitional burdens, plaintiffs complain of two categories of continuing costs: increased administrative transaction costs and an alleged 5 to 15 basis point interest rate increment in the cost of registered bonds as compared to bearer bonds. Problems of proof aside, see pages 40 to 77, *supra*, these burdens are purely financial in nature. Plaintiffs made no effort to demonstrate that the economic effects of the registration requirement, such as they may be, have had or will have any consequential or "ripple" effects on any State or locality that are legally cognizable.[414] Of themselves, increased costs traceable to federal regulation are insufficient to establish a threat to state autonomy and independence.[415]

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[414] *Cf. National League of Cities*, 426 U.S. at 847-50 (emphasizing impact of increased costs on state policies and state-local decisionmaking).

[415] The Supreme Court's decisions subsequent to *National League of Cities* stressed that the nature of the federal action and its impact on the States' abilities to allocate their resources—not the immediate economic effects of the federal action—were determinative. *See supra* at 121-22. The Court's Commerce Clause decisions have recognized that "when Congress does act, it may place new or even enormous fiscal burdens on the States." *Employees of Dep't of Pub. Health & Welfare v. Dep't of Pub. Health & Welfare*, 411 U.S. 279, 284 (1973). At oral argument, one of plaintiffs' counsel doubted that the interest rate increment, standing alone, would be a sufficient basis for invalidating the registration requirement. *See* Oral Argument, Tr. at 38-39.

Although the original issuance costs of registered bonds do not differ significantly from bearer bonds,[416] plaintiffs did establish that the ongoing administrative costs for registered bonds are higher for issues under $10 million in size. The cost differential is greatest for the smallest issues—those of $1 million or less.[417] However, plaintiffs did not demonstrate any qualitative impact of any kind resulting from these increased costs. This lack of proof may stem from the fact that the aggregate increase in costs for a typical $1 million registered bond issue is, at most, $3,300 and is paid out over a twenty year period.[418] Under these circumstances, plaintiffs' inability to produce a single example of a qualitatively injured small issuer is not surprising.

With regard to the interest rate differential, plaintiffs failed to carry their burden of proving a 5 to 15 basis point increment for registered bonds.[419] Nonetheless, even if their statistical studies had carried the day on this issue of fact, plaintiffs should not prevail. Assuming *arguendo* that plaintiffs had shown that, on average, registered bond issues comparable in all other respects to bearer bond issues carry a 10 basis point differential, increased interest costs for registered bonds are as likely as not a result of a preference for bearer securities by tax evaders and those seeking to conceal proceeds of illegal activities in anonymous, interest bearing instruments.[420] Plaintiffs cannot be heard to complain that TEFRA deprived them of their modest share of the benefits of the very unlawful activities that Congress sought to minimize.

Plaintiffs presented no plausible theory explaining investors' alleged preference for bearer bonds. Their lim-

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[416] See notes 156-57, *supra*, and accompanying text.

[417] See notes 162-64, *supra*, and accompanying text.

[418] See note 164, *supra*, and accompanying text.

[419] See notes 177-302, *supra*, and accompanying text.

[420] See note 193, *supra*, and accompanying text.

ited testimony on this point suggested only that certain categories of individual investors prefer clipping and presenting bond coupons to having interest checks mailed to them or electronically credited to their accounts.[421] On the other hand, Congress believed—and the legislative history of TEFRA and the testimony at the hearing before the Special Master supports that belief—that a not insubstantial number of investors prefer bearer bonds because they facilitate tax evasion and concealment of illegal income. If the statistical studies had indicated a market preference for bearer bonds resulting in lower interest costs to issuers, that preference could just as easily have resulted from the demand for bearer bonds by the portion of the investing community attempting to evade taxes or conceal income than from any lawfully motivated, individual investor preference for coupon clipping.

In short, the record does not support a generalized investor preference for bearer bonds. If it did, however, the evidence suggests that the illegal users of those bonds are the most likely source of any such preference. It is surely no infringement of state autonomy or independence to deny the States any interest benefits that may accrue to them from unlawful investor use of or demand for their bearer debt securities. Congress's power to prevent such abuses cannot be diminished by the incidental fiscal impact on state and local issuers.[422]

In summary, the registration requirement's impact on the States and localities would appear to be minimal.

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[421] *Cf.* notes 89-94, *supra,* and accompanying text *with* note 180, *supra,* and accompanying text.

[422] Research did not disclose any case law directly addressing whether a State has a constitutionally protected sovereignty interest in the cost savings which might result from facilitating either federal tax evasion or concealment of the proceeds of criminal ventures. However, the mere statement of this proposition suggests its lack of merit.

Plaintiffs' proof of TEFRA's costs and burdens does not indicate a threat to the States' separate and independent existence, or any danger to their ability to fulfill their role in the federal system. Nor, as shall be discussed below, is there any reason to believe that the political process failed to heed or respect vital state interests.

B. The Federal Political Process Has Not Failed to Protect Legitimate State Interests

In analyzing the legal significance of the registration requirement, *Garcia* instructs us to look beyond the immediate impact of the requirement to its political context. This is not to suggest that *Garcia* requires an empirical examination of the actual workings of the political process, the adequacy of the evidence for congressional fact findings, or Congress's motives in passing the legislation. See note 408, *supra*, and accompanying text. *Garcia* merely suggests that judicial review must be attuned to possible failings in the national political process. *See Garcia*, 469 U.S. at 554.

In this case, putting questions of burden to one side, there are a number of aspects of the legislative process eventuating in Section 310(b)(1) of TEFRA that indicate that the process did not fail to protect legitimate state interests. First, Congress unequivocally expressed its intent to regulate the form of municipal bonds. Second, there is a history of state acceptance of federal regulation of municipal bonds, including regulation that is more substantial than that challenged here. Third, the federal regulation does not discriminate against municipal bond issuers; it reaches essentially all issuers of publicly sold debt securities with maturities of more than one year.

Congress clearly stated its intent to require registration of municipal bonds early in the legislative process.[423] State and local officials had ample opportunity to testify

[423] See *supra* at 15-16.

against registration before Congress and to make their opposition known to Treasury Department officials.[424] *Garcia* places primary reliance on state participation in the political process to protect state interests. Congress's early and explicit statement that it intended to pass legislation requiring registration of securities and affecting the States insured the States ample opportunity to resort to the political process to protect their vital interests.

Arguing that *Garcia* requires that legislation affecting the States must contain an explicit statement to that effect, Judge Higginbotham has pointed out that only such a clear statement will insure that the States are aware of intrusive legislation and able to draw their political weapons; silent or ambiguous legislation risks sidestepping *Garcia*'s protections and sandbagging the States. See *Welch v. State Dept. of Highways & Public Transp.*, 780 F.2d 1268, 1275-76 (5th Cir. 1986) (en banc) (Higginbotham, J., concurring), *cert. granted*, —— U.S. ——, 107 S.Ct. 58 (1986).[425] In the present

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[424] See *supra* at 12-15.

[425] In a variety of contexts, the Supreme Court has insisted that Congress clearly state its purpose to affect the States before allowing regulation altering the federal-state balance. In *United States v. Bass*, 404 U.S. 336 (1971) (construing federal criminal statute narrowly to avoid defining as a federal crime conduct readily denounced as criminal by the States), the Court declared: "unless Congress conveys its purpose clearly, it will not be deemed to have significantly changed the federal-state balance." *Id.* at 349. Justice Marshall observed that the requirement of a clear statement assures that the legislature has faced, and intended to bring into issue, the sensitive and critical matters involved.

Similarly, in *Parker v. Brown*, 317 U.S. 341 (1943) (holding Sherman Act inapplicable to the States), the Court stated "an unexpressed purpose to nullify a state's control over its officers and agents is not lightly to be attributed to Congress." *Id.* at 351. *See also Atascadero State Hospital v. Scanlon*, 473 U.S. 234 (1985) (Congress does not abrogate States' Eleventh Amendment immunity from suits by individuals in federal court unless it explicitly says

case, Congress's unequivocal action easily satisfies any clear statement requirement and Congress's express choice to regulate the States heightens the inference that the political process worked as intended.

Moreover, there is a history of federal regulation in this field. Congress began regulating municipal industrial development bonds in 1968. Congressional regulation—extended in 1969 to municipal arbitrage financing practices—has entailed intricate and complex substantive restrictions on the ability of States and localities to issue debt securities the interest on which is free of federal income tax.[426] These federal restrictions are demonstrably more intrusive upon the States' ability to raise revenue in the amounts and for the purposes that they see fit than TEFRA's registration requirement.[427] Yet, until South Carolina's original complaint in this action in February, 1983, the States had not challenged federal regulation in this area. Seemingly, the States accepted these federal regulations as the price of their ability to minimize their own interest costs by issuing federal tax-exempt bonds.

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so). *See generally* L. Tribe, *Intergovernmental Immunities in Litigation, Taxation, and Regulation: Separation of Powers Issues in Controversies About Federalism*, 89 Harv. L. Rev. 682, 695 (1976) (rule requiring clear statement by Congress of intent to affect the States, by ensuring that attempts to limit state power are unmistakable, would structure legislative process to allow Congress the greatest opportunity to protect state interests).

[426] Of course, the States remain free to issue bonds that do not comply with the restrictions on industrial development bonds and arbitrage financing practices; however, such non-compliant issues would not afford their purchasers tax-exempt interest. Similarly, the States may also issue bearer bonds after TEFRA, if they wish. It is the additional interest costs the States would have to pay lenders to compensate them for the loss of the tax-exempt status of their interest that prevents the States from doing so.

[427] See notes 13-19, *supra*, and accompanying text.

The history of state acquiescence weakens the States' contention that requiring registration is destructive of their sovereignty, and that the political process failed to perform as intended. In *United Transportation Union v. Long Island Railroad Co.*, 455 U.S. 678 (1982), the Court analyzed whether application of the Railway Labor Act to a state owned railroad was consistent with state sovereignty. When the State purchased the railroad, it had acknowledged that it was subject to federal regulation and, in an initial response to the union's suit, acknowledged that the Railway Labor Act applied.[428] The Court found this history of decisive importance:

> The State knew of and accepted the federal regulation; moreover, it operated under federal regulation for 13 years without claiming any impairment of its traditional sovereignty. . . . It can thus hardly be maintained that application of the Act to the State's operation of the Railroad is likely to impair the State's ability to fulfill its role in the Union or to endanger the 'separate and independent existence' referred to in *National League of Cities v. Usery*, 426 U.S. at 851 . . .

Id. at 690. *Cf. Willcuts v. Bunn*, 282 U.S. 216, 232-33 (1931) (constitutionality of a tax burdening the States supported, in part, by history of state acquiescence in the tax).

The States, of course, have never accepted the TEFRA registration requirement. However, they have accepted

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[428] In *Long Island Railroad Co.*, the Court applied the four part test of *Hodel v. Virginia Surface Mining & Reclamation Ass'n, Inc.*, 452 U.S. 264 (1981), which, in turn, was derived from *National League of Cities v. Usery*. *See Long Island Railroad Co.*, 455 U.S. at 684 & n.9. This does not detract from the relevance of the prior history of regulation. Indeed, to the extent that *Garcia* signals greater judicial deference to the political process, a history of state acceptance of later challenged federal regulation greatly strengthens the case for finding that regulation consistent with the fundamental aspects of state sovereignty.

without challenge 15 years of far more intrusive congressional regulation of analogous aspects of their debt issuance functions. Thus, there is little reason to suspect that the TEFRA registration requirement resulted from some extraordinary political process failure requiring judicial intervention.

The case against judicial intervention is further weakened by the fact that TEFRA's registration requirement is even handed: it applies to all issuers of long term, publicly sold securities, including the United States.[429] In light of *Garcia*'s focus on "possible failings in the national political process" as the key to judicial protection of state sovereignty, 469 U.S. at 554, the fact that TEFRA requires registration of bonds issued by private corporations and by the United States takes on undeniable importance.

If Congress singles out the States for special regulatory burdens that are not imposed on other constituencies, the inference that the national political process has failed to protect state sovereign interests is heightened. However, where Congress—in pursuit of a general regulatory objective—legislates universally and fails to exempt the States, it is far more difficult to contend that the political process has failed to protect vital state interests.[430] Thus, after emphasizing that the national po-

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[429] See *supra* note 46 and *infra* 182-84.

[430] This is not to say that all nondiscriminatory federal regulation affecting the States is *per se* permissible. It is possible to imagine a federal regulation neutral in its application to various constituencies that—because of the special status of the States—would have a disproportionate impact on their separate and independent existence. *Cf. New York v. United States*, 326 U.S. 572, 587 (1946) ("a federal tax which is not discriminatory as to the subject matter may nevertheless so affect the State, merely because it is a State that is being taxed, as to interfere unduly with the

litical process is the first line of defense for state interests, the Court in *Garcia* considered the nondiscriminatory nature of the congressional legislation of especial importance: "[the transit authority] faces nothing more than the same minimum-wage and overtime obligations that hundreds of thousands of other employers, public as well as private, have to meet." 469 U.S. at 554.

The *Garcia* Court's emphasis on the political process as the basic guarantor of the States' integrity militates in favor of judicial deference to nondiscriminatory congressional legislation. Nondiscriminatory legislation (*i.e.*, legislation of broad or universal application) minimizes the possibility of arbitrary federal action designed to impair the functioning of the States as States. Such legislation also insures that the States were not isolated in the national political process culminating in the legislation. While legislation aimed at the States alone risks the isolation of state actors in the national political process and a possible sacrifice of state institutional interests, broad legislation insures that state lobbyists and interests will not be deprived of allies in resisting burdensome measures. Justice Jackson's explanation of this point in the context of equal protection doctrine is as relevant to the States as it is to individual political actors:

> The framers of the Constitution knew, and we should not forget today, that there is no more effective practical guaranty against arbitrary and unreasonable government than to require that the principles of law which officials would impose upon a minority must be imposed generally. Conversely, nothing opens the door to arbitrary action so effectively as to allow those officials to pick and choose only a few to whom they will apply legislation and thus to

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State's performance of its sovereign functions of government.") (Stone, C.J., concurring).

> escape the political retribution that might be visited upon them if larger numbers were affected. Courts can take no better measure to assure that laws will be just than to require that laws be equal in operation.

Railway Express Agency, Inc. v. New York, 336 U.S. 106, 112-13 (1949) (Jackson, J., concurring).

This is not to suggest that the States as political actors can be compared to individuals or individual entities in the national political process. "[T]he composition of the Federal Government was designed in large part to protect the States from overreaching by Congress." *Garcia*, 469 U.S. at 550-51 (footnote omitted). The presumption that *Garcia* establishes that the political process is adequate to protect vital state interests is at its strongest where Congress has legislated broadly and has affected state and non-state actors equally.

The clarity of Congress's intent to regulate the States, the political history of prior substantive congressional regulation of municipal bond issuance, and the breadth of application of the TEFRA registration requirement leave little room for an inference that TEFRA's municipal bond registration requirement is a product of the federal political process's failure to heed or safeguard vital state interests. In addition to these general characteristics of the legislation, two specific aspects of TEFRA's implementation strongly suggest that the political process heeded the legitimate interests and concerns of the States.

First, Congress did not attempt to dictate to the States regarding the manner in which they should comply with the registration requirement. Section 310(b)(1) of TEFRA specifically sanctioned the use of book entry methods of recording ownership and transfers—a new and more efficient method of keeping this information

than the transfer-of-certificates method.[431] The statute's recognition of this option reflects a solicitude for the States' interests in minimizing the costs of registration; leaving to the States the choice of means to comply with registration reflects a proper respect for state autonomy. That this was Congress's choice provides further evidence that the political safeguards of federalism functioned properly here. Given the federal mandate of registration, the States were left free to fashion a response which would minimize the costs and disruption attendant the change.

Second, when the time Congress initially alloted the States to comply with the registration requirement proved to be inadequate, Congress promptly responded to state requests for additional time by postponing the effective date of the municipal bond registration requirement six months.[432] As far as the record shows, no municipal bond issuer sacrificed the tax-exempt status of any bond because of its inability to meet the requirements of TEFRA. This provides further support for the conclusion that the federal political process was attuned to the needs of the States.

In summary, an examination of both the general structural features of the legislation and the specific aspects of its implementation confirm that the political process performed as intended. This analysis of the political process confirms and corroborates the Special Master's analysis of TEFRA's minimal impact on the States. Both analyses converge to support the conclusion that, in adopting the registration requirement, Congress accorded appropriate respect for the States' legitimate interests in their autonomy and independence.

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[431] See *supra* at 15, 25-26.

[432] See *supra* at 19.

IX. CONGRESS'S EXERCISE OF ITS TAXING POWER TO ENFORCE THE REGISTRATION REQUIREMENT IS CONSISTENT WITH THE CONSTITUTION.

A. Introduction

Plaintiffs challenge the constitutionality of Section 310(b)(1) of TEFRA on grounds in addition to the alleged illegitimacy of the goal of registration. Congress has offered the States a draconian choice: issue bonds in registered form or suffer the loss of federal tax exemption on the interest paid on non-conforming securities. Since the forfeiture of tax-exempt status would increase the interest that states and localities have to pay on their obligations by some 28% to 35%,[433] "[a]s a practical matter, this requirement will force [the States] to issue [their] bonds in registered form." *South Carolina v. Regan*, 465 U.S. 367, 404 (1984) (Stevens, J., concurring in part and dissenting in part). *See id.* at 384 (Congress's acknowledged purpose in enacting § 310(b)(1) of TEFRA was to encourage States to issue registered securities.) (Blackmun, J., concurring).

While there can be no doubt that Congress's purpose was to regulate the form in which the States sold debt obligations rather than to raise revenue, Congress chose to implement its regulatory scheme by using its taxing power. The linchpin of the statutory scheme thus is the threatened tax on the interest income paid by municipal bonds. Congress's choice of means to implement its goals—a tax sanction—presents separate constitutional questions.

The States present three arguments suggesting that a regulatory scheme anchored by a tax on the interest generated by municipal bonds violates the Constitution. First, the States argue that the tax sanction violates the doctrine of intergovernmental tax immunity. Second,

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[433] See note 3, *supra*, and accompanying text; see also note 409, *supra*.

the States contend that the ancillary costs and burdens of complying with TEFRA are an impermissible tax laid directly upon the States. These two arguments are interrelated. Third, the States assert that the tax sanction is an impermissible regulatory tax. Each of these contentions will be treated in turn.

B. The Tax Sanction of TEFRA's Registration Requirement Does Not Violate the Doctrine of Intergovernmental Tax Immunity

1. *Plaintiffs' Argument and the Actual Contours of the Question Presented*

Plaintiffs' fundamental contention is that the holding of *Pollock v. Farmers Loan and Trust Co.*, 157 U.S. 429 (1895), prohibits any burden or limitation whatsoever upon the States' right to issue bonds the interest upon which is free of federal income taxation. In its Complaint, South Carolina claimed that Congress "has no power whatsoever to impose an income tax upon the interest" that the States pay to the holders of their debt obligations. Complaint, ¶ 9. Plaintiffs tried this case consistently with that theory. Although the States created a substantial record concerning the burdens of municipal bond registration, plaintiffs presented no evidence concerning the burdens that a tax on municipal bond interest would create for the States.[434] This tactical choice is consistent with the underlying statutory reality: "there can be no serious argument that the disposition of South Carolina's claim will have much effect, if any at all, upon federal tax revenues. If South Carolina loses, it will register its securities." 465 U.S. at 383 (Blackmun, J., concurring).

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[434] The States did present estimates of the amount of interest savings that the federal tax exemption affords them. See note 3, *supra*. However, the States presented no testimony concerning the impact the elimination of this exemption would have on their ability to borrow or on their ability, more generally, to function as governmental entities.

This does not mean, as the Secretary contends, that "the question whether Congress can constitutionally tax municipal bond interest is here a purely hypothetical one." *Brief for the Defendant* at 14. It does mean, however, that the question presented for resolution is more narrow than whether Congress can, consistent with the Constitution, abolish the federal tax exemption for municipal bond interest for all purposes. Congress has not taken that action, and the question whether the Constitution forbids such action is not presented in this case. The more narrow issue presented is whether the intergovernmental tax immunity doctrine requires Congress to maintain the exemption for municipal bond interest intact and sacrosanct—regardless of the burden (or lack thereof) imposed upon the States by the use, as a regulatory incentive, of the threatened loss of that exemption.

South Carolina's argument[435] is consistent with this view of the nature of the question presented. "From the outset, South Carolina has contended that the sanction, rather than registration itself, is the fatal flaw of Section 310(b)(1)." *Brief of Plaintiff* at 24. Plaintiffs argue that Congress violates the intergovernmental tax immunity doctrine simply by asserting "the power to impose a sanction of taxability as to municipal bond interest. . . ." *Reply Brief of Plaintiff* at 2. Consistent with this theory, plaintiffs argue "that no assessment of burden or gauging of the degree of interference [with the States] is necessary where the tax is imposed on the sovereign's contract in pursuance of its borrowing power. . . ." *Brief of Plaintiff* at 15.

The argument that the tax sanction violates the Constitution without regard to its impact upon the States

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[435] Plaintiff South Carolina assumed principal responsibility for briefing and arguing the intergovernmental tax immunity issues; the NGA, as plaintiff-in-intervention, briefed and argued the regulatory immunity issues.

rests on plaintiffs' fundamental contention that the twentieth century development of the intergovernmental tax immunity doctrine has left unchanged that aspect of *Pollock*'s reasoning. Plaintiffs' challenge to Congress's choice of means to enforce the registration requirement rests upon the continuing vitality not of the *Pollock* holding—an issue not presented by this case—but upon an aspect of *Pollock*'s rationale. As summarized by South Carolina, for plaintiffs to prevail they must show that "the inability of either sovereign to tax the interest paid on obligations issued by the other results from the lack of power (or sovereignty) in that respect; for that reason, the attempt, without more, by either sovereign to use such a taxing power [impermissibly] burdens the other." *Brief of Plaintiff* at 21.

The development of contemporary intergovernmental tax immunity doctrine does not present a clear answer to the question whether Congress may exercise its taxing power to impose an unconditional, revenue raising tax on the interest that States and localities pay on their municipal bonds. The resolution of that issue might well require the development of a full factual record concerning the impact of such a tax on the States' ability to raise revenue and maintain their separate and independent existence. This case and this record, however, present a far narrower question: whether Congress may seek to strengthen federal income tax compliance by conditioning the tax exemption of municipal bond interest on State compliance with a registration requirement.

2. *An Initial Summary*

Simultaneously with the passage of the Sixteenth Amendment[436] in 1913, Congress provided—in the first modern federal income tax law—an explicit exemption

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[436] "The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. Const. amend. XVI.

from federal income tax for the interest upon state and local bonds.[437] This general exemption for the interest paid by municipal bonds has continued in force without interruption since that time.[438] Thus, the Supreme Court has had no occasion which would have required it to reconsider the holding in *Pollock* that a general federal income tax of two percent on the net profits of a company, which profits included the income it derived from certain municipal bonds, was unconstitutional as applied to such income.

However, much has changed in the analysis of intergovernmental tax immunities since *Pollock*. The Supreme Court's cases applying the implied doctrine of state immunity from federal taxation have abandoned the sweeping abstractions and grand formalisms that characterized the doctrine in the heyday of *Pollock* and its progeny. The Court will no longer invalidate a federal tax as a *per se* infringement of state sovereignty in the absence of an analysis of the specific burdens the tax imposes upon the States and the impact of those burdens

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[437] The Act of October 3, 1913, ch. 16, § II(B), 38 Stat. 114, 168 provided in pertinent part: "That in computing net income under this section there shall be excluded the interest upon the obligations of a State or any political subdivision thereof. . . ."

[438] For a discussion of the limitations Congress has placed upon the States' and localities' ability to use the tax exemption for so-called private purpose or industrial development bonds, see 8-9, *supra*. For a discussion of the limits Congress has placed on their ability to use tax-exempt bonds for arbitrage purposes, see 9, *supra*. The Special Master knows of no constitutional challenge to Congress's power so to circumscribe the exemption.

There have been a number of unsuccessful attempts to repeal the general exemption for municipal bond interest. Indeed, one survey catalogued no less than 11 unsuccessful attempts to repeal the exemption (through 1981). *See* A. Goldberg, *A Call to Action: State Sovereignty, Deregulation and the World of Municipal Bonds*, 13 Urb. Law. 253, 259 n.14 (two proposed constitutional amendments, in 1924 and 1933, and nine attempts at statutory repeal).

on the States' ability to function as autonomous governmental entities.[439] Instead, absent a tax discriminating either against state functions or against those receiving income from the States, the crux of the decision to afford the States immunity is the "actual and substantial" burdens of the tax, and the concrete "protection which [immunity] affords to the continued existence of the State." *Helvering v. Gerhardt*, 304 U.S. 405, 421 (1938).[440] Judicial review is designed to ensure that a federal tax "neither precludes nor threatens unreasonably to obstruct any function essential to the continued existence of the state government." *Id.* at 424. Nothing in the development of the intergovernmental tax immunity doctrine subsequent to *Helvering v. Gerhardt* detracts from that conclusion. And the Supreme Court's

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[439] A plurality of four Justices in *Massachusetts v. United States*, 435 U.S. 444 (1978), appeared, implicitly at least, to question "the present vitality of the doctrine of state tax immunity. . . ." *Id.* at 454. *See Brock v. Washington Metropolitan Area Transit Authority*, 796 F.2d 481, 484 & n.6 (D.C. Cir. 1986) (present vitality of state tax immunity unsettled and open to question). However, no Supreme Court holding suggests that the doctrine would not be applied in appropriate circumstances to invalidate a federal tax that impinged upon the States' separate and independent existence.

[440] The abandonment of abstract intergovernmental immunity analysis described in the text does not mean that contemporary tax immunity doctrine would sustain federal taxes that cripple State autonomy, not by imposing a fiscal burden, but rather by depriving the States of their dignity as independent governmental entities. *Cf. Coyle v. Oklahoma*, 221 U.S. 559 (1911) (Congress may not fix the location of State capital). Thus, a federal tax levied upon the process of promulgating state laws or judicial decisions would doubtless be repugnant to the Constitution—regardless of its fiscal burden upon the States. The prohibition of discriminatory taxation in the modern doctrine would suffice to capture such measures.

This category of *per se* unconstitutional federal taxes upon the States is doubtless quite narrow. And, as the absence of progeny of *Coyle v. Oklahoma* attests, Congress does not often adopt legislation of that kind.

decision in *Garcia*, to the extent it may be deemed relevant, can only reinforce the view that the question presented under the more recent intergovernmental tax immunity cases is the nature and extent of the burden of the tax, not the mere fact of the tax *per se*.

This development of the intergovernmental tax immunity doctrine undercuts plaintiffs' challenge to the tax sanction that underlies Section 310(b)(1) of TEFRA. Congress has not revoked the tax-exempt status of municipal bonds, and the Special Master has no record upon which to judge the consequences for the States and their political subdivisions were Congress to do so. Instead, Congress merely has conditioned its grant of a tax exemption upon State acquiescence in a requirement designed to insure that the grant of tax exemption does not otherwise impair federal tax compliance. The burdens of the registration requirement have been considered at length,[441] and are not such as to threaten the States' separate and independent existence..[442] Unless the doctrine of intergovernmental tax immunity renders Congress powerless to affect the exemption for municipal bond interest in any way and without regard to the magnitude of the burdens imposed upon the States, Congress's resort to a tax sanction to enforce the TEFRA registration requirement is within its constitutional powers.[443] The Special Master believes that the modern doc-

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[441] See *supra* at 34-78.

[442] See *supra* at 123-33.

[443] The Special Master notes that Congress has hitherto substantively limited its grant of tax-exempt status for municipal bond interest. Congress does not allow the proceeds of tax-exempt issues to be used for many purposes it deems private; it prohibits the States from engaging in arbitrage with tax-exempt proceeds; and it also provides detailed procedures for the States to follow in issuing private purpose, tax-exempt securities. See 8-9, 118, *supra*. If Congress lacks all power to regulate or tax the interest income from State and local bonds, all these measures would be presumptively unconstitutional.

trine of intergovernmental tax immunity does not render Congress powerless and thus admits of no conclusion other than the constitutionality of the TEFRA registration requirement.[444]

3. Predecessors and Progeny of *Pollock v. Farmers Loan and Trust:* Abstract Formalism in the Analysis of Intergovernmental Tax Immunity

The doctrine of intergovernmental tax immunity derives from *M'Culloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819). *M'Culloch* dealt not with state immunity from federal taxation, but with federal immunity from state taxation. The State of Maryland sought to impose a tax directly on the Baltimore branch of the Bank of the United States.[445] The Supreme Court, in its classic opinion written by Chief Justice Marshall, first held that the Bank of the United States was a lawful means of carrying into execution the powers vested by the Constitution in the United States. More importantly, for present purposes, the Court also held that the States had no power whatsoever to tax the Bank, a governmental entity created to carry out the powers of the United States.

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[444] The fact that no State or locality has issued a registration-required obligation in bearer form does not, as the Secretary contends, make the constitutionality of the tax sanction a purely hypothetical question. The statutory sanction is real and exercises a powerful effect upon the States. If Congress is not entitled to wield that sanction because the Constitution prohibits any interference with the tax exemption for municipal bond interest, then Congress must find another method of requiring registration. Congress's choice of means—no less than its chosen ends—must comport with the Constitution.

[445] The tax was, in fact, discriminatory in that it applied only to "banks or branches thereof . . . not chartered by the [Maryland] legislature." 17 U.S. at 320. Only the Baltimore branch of the Bank of the United States, chartered by Congress in 1816, met the statutory description.

Two strands of *M'Culloch*'s reasoning figure importantly in the evolution of the intergovernmental tax immunity doctrine. Chief Justice Marshall's emphasis on the Supremacy Clause as the source of federal tax immunity, and on the political safeguards preventing excessive federal taxation of the States, evolved over time into important elements in the contemporary approach to intergovernmental tax immunities. At the same time, *M'Culloch*'s abstract analysis of the awesome nature of the governmental taxing power—captured for all time in Chief Justice Marshall's dictum that "the power to tax involves the power to destroy"—provided the conceptual foundation for an expansive interpretation not only of federal immunity from state taxation, but also of state immunity from federal taxation. This expansive interpretation, which swept aside the limiting principles inherent in *M'Culloch*, soon emerged dominant, and did not give way until well into the Great Depression of the 1930's.

In *M'Culloch*, the Court began by recognizing that no express provision of the Constitution requires, by its terms, federal immunity from state taxation. Federal immunity derives from the "great principle" that "the Constitution and the laws made in pursuance thereof are supreme; that they control the Constitution and laws of the respective states, and cannot be controlled by them." 17 U.S. at 426. Federal supremacy necessarily implies that the sovereignty of the States, in regard to taxation, is subordinate to and controlled by the United States Constitution. *Id.* Federal supremacy, the *M'Culloch* Court declared, removes all obstacles to federal action within the government's sphere, and thus modifies every power vested in the States as may be necessary to exempt federal operations from State control. *Id.* at 427.

The State of Maryland argued in *M'Culloch* that, although it could not directly resist a law of Congress, it remained free to exercise its original and acknowledged

power of taxation so as to affect federal legislation. The Supreme Court rejected this assertion. The Court reasoned that the political checks against erroneous and oppressive taxation by a State of its citizens are absent when a State attempts to tax the federal government or its instrumentalities. In the typical case, the Court explained, security against the abuse of the taxing power is found in the structure of the government itself. In imposing a tax, a legislature acts upon its constituents; the influence of the constituents over their representatives is "in general a sufficient security against erroneous and oppressive taxation." *Id.* at 428. However, the national government and its instrumentalities are not represented in the legislatures of the individual States and accordingly have no such security against oppressive taxation by the legislatures of particular States. *See id.*

The national government and its instrumentalities are created by the people of all the States for the benefit of all the States; therefore, they can be subject to taxation only by that government which belongs to all the people. *Id.* at 429. According to the *M'Culloch* Court, the national government alone can levy taxes upon the means created by the national government to execute its powers:

> In the legislature of the Union alone, are all represented. The legislature of the Union alone, therefore, can be trusted by the people with the power of controlling measures which concern all, in the confidence that it will not be abused.

Id. at 431.

From this analysis of sovereignty and the restraints of representation, Chief Justice Marshall inferred that the sovereignty of a State cannot extend to those means which are employed by Congress to execute powers conferred upon Congress by the people of the entire nation. The people of a single State cannot confer a sovereignty

which would extend over the powers given by the people of the United States to a government whose laws they have declared to be supreme. *Id.* at 429. Measuring the power of taxation residing in a State by the extent of sovereignty which the people of a single State can possess, the Court found an absolute want of power on the part of the States to tax the federal government. *Id.* at 429-30.

M'Culloch's argument for federal tax immunity based on political structure had obvious implications concerning the extent to which state immunity from federal taxation differed from federal immunity from state taxation. These implications became explicit when the Supreme Court rejected Maryland's argument that a State's right to tax the Bank of the United States was the reciprocal of the United States' right to tax state chartered banks. The *M'Culloch* Court distinguished the two cases easily:

> The people of all the states have created the general government, and have conferred upon it the general power of taxation. The people of all the states, and the states themselves, are represented in Congress, and, by their representatives, exercise this power. When they tax the chartered institutions of the states, they tax their constituents; and these taxes must be uniform. But, when a state taxes the operations of the government of the United States, it acts upon institutions created, not by their own constituents, but by people over whom they claim no control . . . . The difference is that which always exists, and always must exist, between the actions of the whole on a part, and the action of a part on the whole—between the laws of a government declared to be supreme, and those of a government which, when in opposition to those laws, is not supreme.

Id. at 435-36. Whatever the scope of state immunity from federal taxation, *M'Culloch* emphasized that state immunity rested on different principles from federal im-

munity, and could not be derived as a mere reciprocal of federal immunity.

The *M'Culloch* opinion carefully limited the extent of its holding. The States remained free, the Supreme Court declared, to tax the real property of the Bank of the United States in common with other real property within the state. *Id.* at 436. Importantly, the States also remained free to impose a tax on the interests which their citizens might hold in the Bank of the United States, as long as the tax was part of a general tax on property of the same description throughout the state. *Id.*[446]

Despite these limitations, other aspects of *M'Culloch* planted the seeds of a broad theory of reciprocal state and federal tax immunities. First, Chief Justice Marshall's abstract view of the illimitable nature of the taxing power militated in favor of the broadest possible construction of tax immunity. The Chief Justice's apodictic declarations concerning the nature of the taxing power[447] lay the foundations of a broad conception

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[446] The subsequent expansion and generalization of the tax immunities established in *M'Culloch* ignored these limitations on the *M'Culloch* holding. *See United States v. New Mexico*, 455 U.S. 720, 731 (1982).

[447] "That the power to tax involves the power to destroy; that the power to destroy may defeat and render useless the power to create; that there is a plain repugnance, in conferring on one government a power to control the Constitutional measures of another, which other, with respect to those very measures, is declared to be supreme over that which exerts the control, are propositions not to be denied." *M'Culloch v. Maryland*, 17 U.S. at 431. As soon as the States were deemed to enjoy a sphere over which they reigned supreme, *see, e.g., Abelman v. Booth*, 62 U.S. (21 How.) 506, 516 (1859), it was inevitable that the assertedly illimitable aspect of the taxing power would require that the States be deemed to enjoy a reciprocal immunity from federal taxation as broad as that enjoyed by the federal government from state taxation.

of state immunity from national taxation. Second, the *M'Culloch* Court expressed a profound skepticism concerning the ability of judicial review to keep the taxing power within bounds. This also militated in favor of an absolutist conception of immunity, since such a bright line would allow the courts to avoid "the perplexing inquiry, so unfit for the judicial department, what degree of taxation is the legitimate use, and what degree may amount to the abuse of the power." *Id.* at 430.

Ten years later, in *Weston v. City Council of Charleston*, 27 U.S. (2 Pet.) 449 (1829), the Supreme Court, again in an opinion authored by Chief Justice Marshall, built upon the more abstract aspects of *M'Culloch* to expand the sphere of federal tax immunity. *Weston* involved the claim of a private individual that his ownership of 6 and 7 percent stock of the United States was exempt from taxation by the City of Charleston.[448] Although the tax was to be paid by the private citizen owners of the United States stock, the *Weston* majority—almost unreflectively—extended the United States' immunity to its lenders: "The tax in question is a tax upon the contract subsisting between the government and the individual . . . . The power operates upon the contract the instant it is framed, and must imply a right to affect that contract." *Id.* at 465.[449]

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[448] The tax involved payment of 25 cents upon every $100 of bonds, notes, insurance stock, 6 and 7 percent stock of the United States, or other obligations upon which interest was paid over and above the interest paid out by the taxpayer. *Id.* at 450. The stock of the United States referred to in the statute was evidence of a federal debt created by federal borrowing. *Id.* at 465.

[449] The notion that a tax upon the recipient of income from dealings with the government—because assertedly a tax on a government contract—was a tax on the government itself was a vital aspect of the subsequent expansion of intergovernmental tax immunities, both state and federal. Under this theory, any tax upon income derived from the government, regardless of the actual burden the tax imposed upon the government, was an impermissible attempt to tax the government directly. The modern theory of

Chief Justice Marshall's majority opinion in *Weston* applied *M'Culloch*'s view of the illimitable nature of the taxing power to the assumption that a tax on the income received from the government is a tax on the government itself.[450] If any state power to tax United States' contracts to borrow money could be admitted, the State might destroy entirely the United States' power to borrow. *Id.* at 466-67. The supremacy of the United States could not countenance such a result. *Id.* at 466.

Weston expanded the limited holding of *M'Culloch* into a general theory of tax immunity which itself was of almost unlimited scope. Under that general theory, any tax upon one dealing with the government, which tax increased the government's cost of doing business, might be invalidated. As the Court explained,

> The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence on the contract. The extent of the influence depends on the will of a distinct government. *To any extent, however inconsiderable, it is a burden on the operations of government.* It may be carried to an extent which shall arrest them entirely.

Id. at 468 (emphasis supplied). One need only substitute for the phrase "the power to borrow," the phrases "the power to hire employees, to purchase goods, to lease lands", etc., to have created a survey of the future course of the development of the doctrine of federal tax immunity.[451]

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intergovernmental tax immunity repudiates this notion entirely: "The theory, which once won a qualified approval, that a tax on income is legally or economically a tax on its source, is no longer tenable . . . ." *Graves v. New York ex rel. O'Keefe,* 306 U.S. 466, 480 (1939).

[450] "If the right to impose the tax exists, it is a right which in its nature acknowledges no limits." 27 U.S. at 466.

[451] The Court did attempt to distinguish the power to tax debt securities from the power to tax government land sales. When

The *Weston* decision swept aside *M'Culloch*'s suggestion that governmental functions could be adequately protected by a tax immunity that merely required state taxes to treat government property identically to similarly situated private property, and that allowed private interests in government entities to be taxed equally with similarly situated, purely private property. Even if income earned on government loans and private loans were taxed in a nondiscriminatory fashion, "[t]he tax on government stock is thought by this court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States, and consequently to be repugnant to the Constitution." *Id.* at 469.[452]

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lands are sold, the Court reasoned, no connection remains between government and purchaser. Once sold, the lands become a part of the general mass of property with no implied exemption from taxation—in a fashion similar to the fully repaid principal of a government loan. Taxing interest paid on government debt still due a lender, however, involves a continuing burden on the government's borrowing power. *See id.* at 468-69.

This distinction between completed sales contracts and continuing contracts (loans, leases, employment arrangements) persisted into the 1930's. *See, e.g., Group No. 1 Oil Corp. v. Bass,* 283 U.S. 279, 282-83 (1931) (federal tax on sale of oil and gas produced under state leases upheld because state law, upon execution of leases, deemed the oil and gas in place to be "sold" to its lessee). The *Bass* decision makes transparent the purely formal nature of the distinction made in *Weston,* a distinction which was completely unrelated to the economic reality of the burdens imposed by the tax on the government's ability to function. Contemporary intergovernmental tax immunity doctrine focuses on concrete burdens on government and ignores such formalistic distinctions. See discussion at 164-81, *infra.*

[452] Both dissenters in *Weston* sharply criticized the majority for ignoring *M'Culloch*'s "anti-discrimination principle," which limited the scope of tax immunity for private dealings with the government to discriminatory taxes. *See id.* at 473 (Johnson, J., dissenting) ("Why should not the stock of the United States, when it becomes mixed up with the capital of its citizens, become subject to taxation in common with other capital?"); *id.* at 480 (Thompson, J., dis-

Dobbins v. Commissioners of Erie County, 41 U.S. (16 Pet.) 435 (1842), completes the trilogy of federal immunity decisions underlying *Pollock*. In *Dobbins*, the Supreme Court invalidated a county tax on the "office" of the captain of a federal revenue cutter, which tax was based on the captain's compensation. *Id.* at 444-45. Since a federal officer or employee was a means of carrying into effect the powers of the United States, the county tax was an unconstitutional attempt to lay a tax upon the means chosen by the United States to execute its powers. *Id.* at 449. There was, in the Court's view, no distinction between a tax upon the income paid a citizen and a tax upon the office, or "means," of the United States. *See* id. at 445-46.

In *Collector v. Day*, 78 U.S. (11 Wall.) 113 (1871), the Supreme Court took the critical next step in the development of the intergovernmental tax immunity doctrine.[453] The Court had under review a United States tax on the salary of a Massachusetts probate and insolvency judge, *i.e.*, the converse of *Dobbins*, and the Court applied an identical analysis to invalidate the tax. The critical assumption of *Collector v. Day* and its progeny, including *Pollock*, is that state immunity from federal taxation corresponds precisely—in the nature of a reciprocal—to state immunity from federal taxation.[454]

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senting) ("considering that the tax in question is a general tax upon the interest of money on loan, I cannot think it is a violation of the Constitution . . . to include therein interest accruing from stock of the United States.").

[453] *Collector v. Day* was overruled in *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466 (1939).

[454] *See* 78 U.S. at 124 ("upon the same construction of [the Constitution as in *Dobbins*], and for like reasons, [the United States] is prohibited from taxing the salary of the judicial officer of a state."); *Id.* at 127 ("[a]nd if the means and instrumentalities employed by [the United States] to carry into operation the powers granted to it are necessarily, and, for the sake of self-preservation,

The reasoning of *Collector v. Day* inexplicably ignored one of the two grounds the *M'Culloch* decision recognized as the twin bases of federal tax immunity. First, federal immunity was necessary because none of the political checks preventing oppressive taxation operated on a state legislature when it taxed all the people, *i.e.*, the national government or its instrumentalities. Second, immunity was necessary because the power to tax was by its nature illimitable (and certainly illimitable by the judiciary); allowing any state taxation could destroy the federal government. *Collector v. Day*, by focusing upon the illimitable nature of the taxing power in the abstract, elevated state tax immunity to the same plane as federal tax immunity.[455]

The *Collector* Court reasoned that a state judicial officer was a means of carrying out the State's judicial functions. *Id.* at 126. Without considering the impact of a nondiscriminatory federal income tax on the salary of all citizens, including state employees, the Court declared that the State's means must be left free and unimpaired, not liable to be "defeated by the taxing power of another government, which power acknowledges no

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exempt from taxation by the States, why are not those of the states, depending upon their reserved powers, for like reasons equally exempt from Federal taxation?").

[455] The *Collector* opinion did not so much as acknowledge *M'Culloch*'s statement that federal immunity from state taxation stemmed from the Supremacy Clause. U.S. Const. art. 6, § 2. Instead, noting the reciprocal absence in the Constitution of express prohibitions of intergovernmental taxation, Justice Nelson declared that "[i]n both cases the exemption rests upon necessary implication, and is upheld by the great law of self-preservation; . . ." *Id.* at 127.

Contemporary intergovernmental tax immunity doctrine recognizes that state and federal tax immunity rest on entirely different footings; federal immunity from state taxation is a function of the Constitution's explicit declaration of federal supremacy. *See, e.g., West v. Oklahoma Tax Comm'n*, 334 U.S. 717, 723 (1948); *S.R.A., Inc. v. Minnesota*, 327 U.S. 558, 561 (1946).

limits but the will of the legislative body imposing the tax." *Id.* at 125-26. Thus, according to the reasoning used in *Collector*, the federal tax could not stand.[456]

The reasoning and holding of *Collector v. Day* supplied the basis for the holding in *Pollock v. Farmers Loan & Trust Co.*, 157 U.S. 429 (1895), upon which plaintiffs principally rely. In *Pollock*, the Supreme Court reviewed a challenge to a two percent federal tax on the income derived by a corporation from, *inter alia*, municipal bonds.[457] Once again, the Court did not find it necessary to analyze the impact of the federal tax on the ability of States and localities to issue debt or otherwise to raise revenue. Instead, the Court began its analysis with the conclusion of *Collector v. Day*: just as the States cannot tax the powers, operations, or property of the United States, reciprocally, the United States cannot tax the instrumentalities or property of a State. *Id.* at 584 (citing *Collector v. Day*, 78 U.S. (11 Wall.) 113 (1871)).

The *Pollock* Court, consistent with the approach taken in *Weston* and *Collector*, refused to recognize a distinc-

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[456] In dissent, Justice Bradley vainly pointed out that state and federal immunities were not at all reciprocal: the United States "is the common government of all alike; and every citizen is presumed to trust his own government in the matter of taxation." *Id.* at 128. While political representation in the national legislature protected the States from abuse, the converse was not true: "[State] taxation [of the federal government] involves an interference with the powers of a government in which other states and their citizens are equally interested with the state which imposes the taxation." *Id.* at 128-29.

[457] In the interim between *Collector v. Day* (1871) and *Pollock* (1895), the Supreme Court had held that a municipal corporation was a state instrumentality for the purposes of intergovernmental tax immunity. *United States v. Baltimore & Ohio R.R. Co.*, 84 U.S. (17 Wall.) 322, 332 (1872) (revenues of municipal corporation immune from federal income tax). The Court had also found state and local bonds to be means for implementing governmental functions and thus their issuance immune from federal taxation. *Mercantile National Bank v. City of New York*, 121 U.S. 138, 162 (1887).

tion between a tax on the properties or revenues of the States and their instrumentalities, on the one hand, and a tax on the income derived by private individuals from state and local securities, on the other. *Id.* at 585. The Court found that "the same want of power to tax the property or revenues of the states or their instrumentalities exists in relation to a tax on the income from their securities, and for the same reason[s] . . . given by Chief Justice Marshall in *Weston v. City Council,* [27 U.S.] (2 Pet.) 449, 468 . . . ." *Id.* at 585-86.[458] The Court applied the *Weston* holding literally, finding it "obvious" that taxation on the interest from municipal securities "would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract, and that the tax in question is a tax on the power of the states and their instrumentalities to borrow money, and consequently repugnant to the Constitution." *Id.* at 586.

The *Pollock* decision, then, rests on two foundations. First, that the immunity of States and localities from federal taxation is coextensive with the immunity of the federal government from state taxation. Second, that any burden on the operation of state government, "however inconsiderable," is impermissible because it depends on the will of a different government and may be carried to an extent which could cripple the state government

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[458] The Court then quoted *Weston*:

> The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence on the contract. The extent of this influence depends on the will of a distinct government. To any extent, however inconsiderable, it is a burthen [sic] on the operations of government. It may be carried to an extent which shall arrest them entirely . . . The tax on government stock is thought by this Court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States, and consequently to be repugnant to the constitution.

157 U.S. at 586 (quoting *Weston v. City Council*).

entirely. Hence, the *Pollock* Court reasoned, the impermissibility of a federal tax on municipal bond interest is absolute and does not depend upon the extent of the burden which the federal tax would impose on State and local operations.

These twin pillars, in turn, rest upon an even more basic foundation: Chief Justice Marshall's abstract assumption that the power to tax involves the power to destroy. The notion of an inherently illimitable taxing power—invulnerable to judicial limitation—drove the judiciary to assimilate federal immunity from state taxation with state immunity from federal taxation in an effort to preserve the States from destruction by federal taxation. It also moved the judiciary to regard any consideration of actual burdens imposed by a tax as unnecessary: even if the burden of a tax was slight, sanctioning the tax could serve only to open the floodgates. Finally, the abstraction of an illimitable taxing power caused the Supreme Court to erase the distinction between the immunity of the government itself and the immunity of recipients of income from the government. Viewed abstractly, an unrestrained taxing power could so burden those dealing with the government as to eliminate the government's ability to carry on those operations entirely.[459]

The sweeping abstractions of *Weston, Collector* and *Pollock* served to invalidate a wide range of federal, as well as state, taxes until well into the 1930's. In *Ambrosini v. United States*, 187 U.S. 1 (1902), for example, the Supreme Court decided that state surety bonds required of those licensed to sell intoxicating liquors were means and instrumentalities by which the state exercised its police powers and hence those taking

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[459] Only such an assumption can explain the Court's conclusion that the salaries that a state pays its employees, for example, must be deemed "inseparably connected" with the State itself. *See Collector v. Day*, 78 U.S. at 122.

out the bonds must be deemed immune from federal taxation. *Id.* at 7.[460]

In *Panhandle Oil Co. v. Mississippi ex rel. Knox*, 277 U.S. 218 (1928), a divided Court held that a state tax upon a vendor's sale of gasoline to the United States infringed the constitutional independence of the United States in respect of such purchases.[461] *Id.* at 222. Without regard to the actual burden on the United States, a state "may not lay any tax upon transactions by which the United States secures the things desired for its governmental purposes." *Id.* at 221.

In a vigorous dissent, Justice Holmes (joined by Justices Brandeis and Stone) argued in *Panhandle Oil* that the interference with the federal government occasioned by the tax on the gasoline vendor was altogether too remote to warrant judicial intervention. *Id.* at 225. More importantly, for present purposes, Justice Holmes recognized the distorting effect of Chief Justice Marshall's dictum concerning the taxing power. "[T]his Court," Justice Holmes declared, "can defeat an attempt to discriminate or otherwise go too far without wholly abolishing the power to tax. The power to tax is not the power to destroy while this Court sits." *Id.* at 223.

Justice Holmes' view, however, was not to prevail for another decade. In *Indian Motocycle Co. v. United States*, 283 U.S. 570 (1931), the Court applied *Panhandle Oil* to invalidate a federal tax upon the sale of motorcycles to a state agency. A state agency's purchase of equipment to carry out its governmental functions enjoyed the same immunity from federal taxation as did a federal agency's from state taxation. *Id.* at 579. The deci-

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[460] The Court technically resolved *Ambrosini* on statutory, rather than constiutional, grounds by construing a statutory exemption for state governmental functions to include private citizens paying for state required surety bonds. *See id.* at 8.

[461] *Panhandle Oil* was overruled in *Alabama v. King & Boozer*, 314 U.S. 1 (1941).

sion rested, in part, on the "established principle" that state and federal immunities were equal and reciprocal. *Id.* at 575. The *Indian Motocycle* Court also observed that, where immunity applies, "it is not affected by the amount of the particular tax or the extent of the resulting interference, but is absolute." *Id. See also Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393 (1932) (invalidating federal tax on income from property leased from State on grounds that it would constitute a tax on state lease, impermissibly burdening state performance of governmental functions).[462]

Concluding the analysis of the intergovernmental tax immunity jurisprudence of this period, the Special Master need only observe that the passage of the Sixteenth Amendment in 1913—when the abstract, formal approach to intergovernmental tax immunities reigned unchallenged—had no limiting effect upon the scope of state immunity from federal taxation. The language in the Amendment that Congress shall have power to tax income "from whatever source derived," without apportionment or enumeration, worked no expansion in the scope of the federal taxing power as applied to the States. In *Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1 (1916), the Court surveyed the background of the Sixteenth Amendment and declared:

> It is clear on the face of the text . . . that the whole purpose of the Amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived . . . [T]he Amendment provides that income taxes, from whatever source the income may be derived, shall not be subject to the regulation of apportionment.

Id. at 17-18. *Accord Peck & Co. v. Lowe*, 247 U.S. 165, 172 (1918). *See also Metcalf & Eddy v. Mitchell*,

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[462] *Burnet v. Coronado Oil & Gas* was overruled in *Helvering v. Mountain Producers Corp.*, 303 U.S. 376 (1938).

269 U.S. 514, 521 (1926) (collecting cases holding that the Sixteenth Amendment did not extend the federal taxing power to any new class of subjects).[463]

The turn away from abstraction in the analysis of intergovernmental tax immunity was a gradual and uneven process. It was accomplished over several decades and, as is discussed in the following section, involved several decisions touching upon the tax-exempt status of municipal bonds. By 1939 the judicial rejection of unbending abstraction was, for all intents and purposes, complete. Although the decisions involving state tax immunity since 1939 cannot be distilled into a single test or standard, they leave no doubt that the abstract and complete immunity upon which plaintiffs must perforce rely is gone, a vestige of a bygone era of constitutional analysis.

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[463] It is also the case that the principal sponsors of the Sixteenth Amendment took pains to assure the Congress that passage of the Sixteenth Amendment would not, in and of itself, authorize federal taxation of municipal bonds. *See* 45 CONG. REC. 1694-98 (Feb. 10, 1910) (statement of Sen. Borah); 45 CONG. REC. 2245-47 (Feb. 23, 1910) (statement of Sen. Brown). Senator Brown, for example, stated: "The amendment does not alter or modify the relation today existing between the States and the Federal Government . . . . It is conceded by all that the Government cannot under the present Constitution tax state securities or state instrumentalities." *Id.* at 2246.

Contrary to the assertions of plaintiffs and certain *amici*, the understanding of the sponsors of the Sixteenth Amendment concerning the constitutional stature of the immunity of municipal bond interest from federal taxation offers no support for plaintiffs' position in this case. As discussed in the text above, the Sixteenth Amendment did not purport to address the scope of the federal taxing power as applied to activities of the States. That the sponsors of this constitutional amendment shared the then prevailing view of the scope of intergovernmental tax immunity is not surprising; however, their endorsement of that interpretation can neither transform the Sixteenth Amendment into an adoption of that interpretation, given the wholly unrelated purpose of the Amendment, nor detract from the contemporary cases limiting the scope of intergovernmental tax immunity.

4. *The Emergence of Modern Intergovernmental Tax Immunity Doctrine: The Importance of Concrete Burdens and Political Safeguards.*

Metcalf & Eddy v. Mitchell, 269 U.S. 514 (1926), represented the Supreme Court's initial, albeit tentative, step toward the reconceptualization of intergovernmental tax immunities. In *Metcalf & Eddy*, the Court sustained a federal income tax on the funds paid to independent contractors employed by a State. The Court's reasoning reflected an uneasy coexistence between conflicting approaches to tax immunity.

The Court in *Metcalf* began by cataloguing its repeated holdings that the instrumentalities through which the state and federal governments directly exercise their governmental powers are absolutely immune from taxation. *Id.* at 522. The immunity of such instrumentalities extends also to income they may provide to private persons. *Id.* (citing, *inter alia*, *Pollock*). However, the *Metcalf* Court cautioned, not every person who uses his property in conjunction with or derives a profit in dealings with the government may avail himself of governmental tax immunity. *Id.* at 522-23.

In attempting to distinguish taxable recipients of government income from those possessing immunity from taxation, the Supreme Court drew back from an exclusive focus upon "the effect of the tax upon the functions of the government alleged to be affected by it. . . ." *Id.* at 524. Instead, some instrumentalities (such as public employees and debt securities) are of such a character, or are so intimately connected with the exercise of governmental powers, that any taxation of them would be deemed *per se* impermissible. *Id.* The independent contractors asserting immunity in *Metcalf & Eddy*, however, were not such instrumentalities:

> [H]ere the tax is imposed on the income of one who is neither an officer nor an employee of government

> and whose only relation to it is that of contract, under which there is an obligation to furnish service, for practical purposes not unlike a contract to sell and deliver a commodity. The tax is imposed without discrimination upon income whether derived from services rendered to the state or services rendered to private individuals. In such a situation it cannot be said that the tax is imposed upon an agency of government in any technical sense, and the tax itself cannot be deemed to be an interference with government, or an impairment of the efficiency of its agencies in any substantial way.

Id. at 524-25.

Despite *Metcalf*'s retention of residual categories of abstract tax immunity—immunity not based upon an analysis of the burdens or effects of the challenged tax—three novel elements of its approach to the resolution of tax immunity issues signaled the eclipse of the abstract and formal approach. First, the Supreme Court emphasized the importance of nondiscriminatory taxation of state and private services. Second, the Court recognized that giving unbridled scope to the doctrine of intergovernmental immunity threatened to impair the legitimate exercise of the taxing government's power. *See id.* at 523-24. Finally, with the above mentioned categorical exceptions, the Court stated that a tax would be sustained absent a showing of substantial impairment of governmental functions. *See id.* at 526.

The ferment in the Supreme Court's evolving approach to intergovernmental tax immunity, while not reaching the holding of *Pollock*, did not leave the tax immunity of municipal bonds unscathed. In *Greiner v. Lewellyn*, 258 U.S. 384 (1922), the Court held that Congress could tax the value of municipal bonds transferred upon the holder's death. *Id.* at 387. *Greiner* manifested no concern for any possible diminution in the value of municipal bonds or increase in the cost of municipal borrowing resulting from the application of federal estate taxes.

More important, *Willcuts v. Bunn*, 282 U.S. 216 (1931), upheld a federal tax on the capital gains derived from the sale of municipal bonds, notwithstanding the tax's potential impact on the value of the bonds. Building on *Metcalf & Eddy*, Chief Justice Hughes explained that careful limitation of the intergovernmental tax immunity principle is important to the success of our system of dual governments:

> The power to tax is no less essential than the power to borrow money, and, in preserving the latter, it is not necessary to cripple the former by extending the constitutional exemption from taxation to those subjects which fall within the general application of nondiscriminatory laws, and where no direct burden is laid upon the governmental instrumentality, and there is only a remote, if any, influence upon the exercise of the functions of government.

Id. at 225.[464]

Willcuts distinguished the absolute immunity of the interest paid on municipal bonds from the taxability of sales thereof by resorting to several formalistic, nonsubstantive distinctions. First, the Court reasoned, the sale of bonds is a transaction distinct from the contracts made by the government with respect to the bonds themselves. *Id.* at 227. Second, the tax upon interest is levied upon the return which comes to the owner of the bond without any further transactions on his part. The tax upon profits from sales is an excise upon the result of the combination of several factors, including capital investment, sagacity and skill. *Id.* at 227-28. The connec-

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[464] In excepting from intergovernmental tax immunity nondiscriminatory taxes of general application, the *Willcuts* Court resuscitated *M'Culloch*'s exclusion from immunity of nondiscriminatory taxes on government agencies' property or citizen holdings therein. *See id.* at 226 (citing *M'Culloch*, 17 U.S. (4 Wheat.) at 436).

tion between these distinctions and protecting a State's ability to borrow was not explained by *Willcuts*.

All that remained of substance was the *Willcuts* Court's (somewhat abstract) insistence that government could not tax income "inseparably connected with the exercise of the borrowing power of the State." *Id.* at 228.[465] *Greiner*'s holding that Congress could tax the testamentary transfer of municipal bonds, however, would seem to have laid to rest any contention that the sale of such bonds must be deemed "inseparably connected" to municipal borrowing. *See id.* at 229-30.

Noting that the Taxing Clause certainly authorized the capital gains tax at issue, the Supreme Court in *Willcuts* stated that it would not restrict the federal taxing power unless it "clearly appear[s] that a substantial burden upon the borrowing power of the State would actually be imposed." *Id.* at 231. However, not unlike the incidental compliance burdens required to avoid the TEFRA tax sanction,[466] "[N]o facts as to actual consequences are brought to our attention, either by the record or by argument, showing that the inclusion in the federal tax of profits on sales of state and municipal bonds casts any appreciable burden on the State's borrowing power." *Id* at 230.[467]

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[465] The *Willcuts* Court did not cite *Collector v. Day* in this regard, but its analysis clearly echoed that decision. See note 459, *supra*.

[466] See 185-87, *infra*.

[467] The Supreme Court's concern that the expanding sphere of State activities might vitiate the federal taxing power caused it to restrict state tax immunity in another fashion. In a series of decisions beginning in 1905, the Supreme Court confined state immunity from federal taxation—even taxes laid directly upon the State and payable out of the State treasury—to "strictly" governmental functions, excluding instrumentalities "used by the State in the carrying on of an ordinary private business." *South Carolina v. United States*, 199 U.S. 437, 461 (1905) (upholding federal tax on state sales of liquor). *Accord Allen v. Regents of University of*

A series of Supreme Court decisions in the period 1937 through 1941 establish beyond doubt that no category of recipients of state income (*e.g.*, employees, lessees, holders of bonds) retain *per se* immunity from federal taxation. These decisions hold that tax immunity for such "instrumentalities" of government, if it is to be found to exist, requires a showing that taxation of the instrumentality would actually and substantially impair the performance of governmental functions essential to the State's continued existence. In that regard, the Supreme Court stressed that purely economic burdens—even a showing that the State might bear the full brunt of the tax—would not invalidate a tax.

The first of these decisions is *James v. Dravo Contracting Co.*, 302 U.S. 134 (1937). In *Dravo*, the Supreme Court upheld a nondiscriminatory state tax upon the gross receipts of an independent contractor doing busi-

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Georgia, 304 U.S. 439 (1938) (sustaining federal tax on admissions to state university athletic events); *Helvering v. Powers*, 293 U.S. 214 (1934) (approving tax on state railroad); *Ohio v. Helvering*, 292 U.S. 360 (1934) (tax on state liquor production, distribution and sales monopoly constitutional); *Flint v. Stone Tracy Co.*, 220 U.S. 107, 172 (1911) (suggesting that federal government might lawfully tax state provision of transportation, illumination and water).

This line of precedent, although it evolved independently of *Metcalf & Eddy* and *Willcuts*, also weakened the hitherto prevailing wisdom that intergovernmental tax immunity involved bright lines and absolute distinctions, rather than considerations of degree. Unable to delineate precisely which state activities required immunity and which could be taxed, the Supreme Court decided "not, by an attempt to formulate any general test, [to] risk embarrassing the decision of cases in respect of municipal activities of a different kind which may arise in the future." *Brush v. Commissioner*, 300 U.S. 352, 365 (1937) (holding municipal water supply a governmental function immune from federal taxation). Thus, even if federal taxes might be laid directly upon the States, the States would have to rely upon case-by-case adjudication for their protection.

ness with the United States. Following the "practical criterion" of *Metcalf & Eddy v. Mitchell*,[468] the Court held that the tax did "not interfere in any substantial way with the performance of federal functions. . . ." *Id.* at 157, 161.

Dravo was important less for its holding, which followed closely from *Metcalf & Eddy*, than for its reasoning. *Dravo* questioned the "close distinctions" that prior intergovernmental immunity analysis had required in order "to maintain the essential freedom of government" to perform its functions without unduly limiting the "equally essential" taxing powers of the state and federal governments. *Id.* at 150. As an example, *Dravo* specifically pointed to the distinction between interest income from governmental securities (exempt) and profits from the sale of such securities (taxable). *Id.*

In analyzing the specific question presented, the *Dravo* Court applied the practical test of *Metcalf & Eddy* and thus determined whether the challenged tax worked a substantial impairment of the taxed government function. Nonetheless, in discussing the immunity of municipal bond interest income, Chief Justice Hughes continued to believe that this aspect of immunity rested upon the "direct effect of a tax which 'would operate on the power to borrow before it is exercised,' and which would directly affect the government's obligation as a continuing security." *Id.* at 153 (quoting *Pollock*, 157 U.S. at 586).

In *Helvering v. Mountain Producers Corp.*, 303 U.S. 376 (1938), the Supreme Court, again in an opinion written by Chief Justice Hughes, continued its reconstruction of intergovernmental tax immunity doctrine. *Mountain Producers* held that a private corporation was subject to federal income tax on the income it received

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[468] 269 U.S. 514 (1926) (sustaining federal tax upon independent contractors with a State).

from an oil and gas lease from the State of Wyoming. *Id.* at 387. In so holding, the Supreme Court extended the "practical criterion" of *Metcalf-Willcuts-Dravo* to another category of recipients of state income hitherto absolutely immune, *i.e.*, the lessees of state lands.[469] This analysis required the *Mountain Producers* Court to overrule two cases the holdings of which rested upon the abstract, *per se* approach to intergovernmental immunity: *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393 (1932) (income derived from lease of school lands exempt from federal tax); and *Gillespie v. Oklahoma*, 257 U.S. 501 (1922) (income derived from lease of restricted Indian lands exempt from state tax).[470]

Surveying the broad range of tax immunity decisions, Chief Justice Hughes synthesized them into "the controlling view":

> immunity from nondiscriminatory taxation sought by a private person for his property or gains because he is engaged in operations under a government contract or lease cannot be supported by merely theoretical conceptions of interference with the functions of government. Regard must be had to substance and direct effects. And, where it merely appears that one operating under a government contract or lease is subjected to a tax with respect to his profits on the same basis as others who are engaged in similar businesses, there is no sufficient ground for holding that the effect upon the government is other than indirect and remote.

Id. at 386-87.

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[469] It made no difference to the analysis that the State's receipts from its share of the income produced under the lease were devoted to the support of public education, the lands in question being "school lands." *See id.* at 382.

[470] The intergovernmental tax immunity analysis followed in both *Gillespie* and *Burnet* differed in no material respect from that employed in *Pollock*.

The import of this "controlling view" is as plain as the breadth of its application. A private person cannot prevail upon a claim of derivative, governmental tax immunity without a factual demonstration that the tax would have a substantial and direct effect upon governmental functioning. *Mountain Producers* eliminated one category of *per se* immunity (that belonging to recipients of income from state leases), and, by undermining their conceptual foundation, promised to eliminate the remaining categories.

The at least partial fulfillment of *Mountain Producers'* promise was not long in coming. In *Helvering v. Gerhardt*, 304 U.S. 405 (1938), the Supreme Court upheld a federal income tax on the salaries of employees of the Port of New York Authority, a bi-state corporation created by a compact between New York and New Jersey. Although the Court did not expressly overrule *Collector v. Day*,[471] it left *Collector* an empty shell. *See id.* at 424.

Much of *Gerhardt*'s analysis was dedicated to explaining the differences between federal immunity from state taxation and state immunity from federal taxation. *See id.* at 411-13 and nn. 1-3. Denying the premise of reciprocal tax immunities, *Gerhardt* revived *M'Culloch*'s emphasis upon the political restraints preventing oppressive federal taxation of the States—restraints absent when a State undertakes to tax the federal government. *Id.* at 412, 416.

In attempting to delimit the scope of state immunity from federal taxation, *Gerhardt* declared that the animating principle of that implied immunity was "the continued existence of the states as governmental entities, and their preservation from destruction by the national taxing power." *Id.* at 414. Presumably, the parameters of this implied immunity should be no wider than neces-

[471] This task was accomplished during the Court's next term in *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466 (1939).

sary to protect those state governmental functions "essential to [the States'] continued existence." *Id.*[472] From this basic principle, the Supreme Court in *Gerhardt* derived two "guiding principles" of limitation to confine state tax immunity to its proper function. The first principle excludes from immunity activities deemed inessential to the preservation of state governments, even if the tax be collected directly from State coffers. *Id.* at 419.[473] The second principle, applicable where a tax laid on private individuals affects the State only insofar as the private individuals shift the tax's burden to the State, prohibits immunity where the burden on the State is speculative and uncertain. *Id.* at 419-20.

Applying this latter principle to taxation of state employees' salaries, the Supreme Court reasoned that a nondiscriminatory tax laid on net income, in common with the income of private sector employees, could, "by no reasonable probability," preclude the performance of state functions:

> Even though, to some unascertainable extent, the tax deprives the states of the advantage of paying less than the standard rate for the services which they engage, it does not curtail any of those functions which have been though hitherto to be essential to their continued existence as states. At most it may be said to increase somewhat the cost of the state governments. . . .

Id. at 420. Thus, the *Gerhardt* Court concluded, a tax immunity "devised for protection of the states as govern-

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[472] The resonance of these principles of state tax immunity with the analysis of state regulatory immunity in *Garcia v. San Antonio Metropolitan Transit Authority* are worth noting. *See generally* Section VII, *supra.* What is striking is *Gerhardt*'s anticipation of *Garcia*'s political safeguards thesis in its discussion of the "cogent reasons" for a narrow construction of state tax immunity. *See Gerhardt,* 304 U.S. at 416.

[473] See cases collected at note 467, *supra.*

mental entities" cannot shelter the income of state employees. *Id.* at 421.

In *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466 (1939), the Supreme Court sustained a state income tax on an employee of a United States corporate instrumentality. In reaching its decision, the Court recognized the differing source, nature and extent of federal and state tax immunities. *Id.* at 478. Nonetheless, *Graves* represented a simple extrapolation from *Gerhardt* since "[t]he burden on government of a nondiscriminatory income tax applied to the salary of the employee of a government or its instrumentality is the same, whether a state or national government is concerned." *Id.* at 485.[474]

The trilogy of *Metcalf & Eddy, Mountain Producers* and *Gerhardt* withdrew the *per se* protection of intergovernmental tax immunity from state government independent contractors, state government lessees and state government employees. After *Graves*, it was law that, in order to invalidate a federal tax on the income derived by private parties from dealings with the States, the Supreme Court would require a specific demonstration that the federal tax would jeopardize the performance of the functions of state government. In *Alabama v. King &*

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[474] The *Graves* decision in no way departed from *Gerhardt*'s emphasis on the underlying functional justification of state tax immunity—the preservation of the separate and independent existence of the States. *See id.* at 484. Thus, the concluding dictum in *Graves* that

> [s]o much of the burden of a nondiscriminatory general tax upon the income of employees of a government, state or national, as may be passed on economically to that government, through the effect of the tax on the price level of labor or materials, is but the normal incident of the organization within the same territory of two governments, each possessing the taxing power

id. at 487, cannot be fairly interpreted as dispensing with the requirement, in an appropriate case, of an empirical analysis of the concrete burdens imposed by a particular tax measure.

Boozer, 314 U.S. 1 (1941), the Court also withdrew the protection of tax immunity from vendors selling goods to the federal government. The Supreme Court held that a state sales tax levied on a cost-plus contractor with the federal government did not infringe the government's constitutional[475] tax immunity, even though, under the terms of the contract, the economic incidence of the tax fell entirely on the United States. *See id.* at 8-10. Neither federal immunity from state taxation nor state immunity from federal taxation implies "immunity from paying the added costs, attributable to the [nondiscriminatory] taxation of those who furnish supplies to the Government and who have been granted no tax immunity." *Id.* at 9. *See also Massachusetts v. United States*, 435 U.S. 444, 461 (1978) (plurality opinion) ("an economic burden on traditional state functions without more is not a sufficient basis for sustaining a claim of immunity.")

Nothing in the post-World War II development of the intergovernmental tax immunity doctrine detracts from the force of these principles as they relate to plaintiffs' claim that the tax sanction of Section 310(b)(1) of TEFRA violates the doctrine of intergovernmental tax immunity. Indeed, the parties' briefs and the Special Master's research reveal a paucity of recent cases brought by the States challenging federal taxation under the intergovernmental tax immunity doctrine.[476] The dearth of such challenges may reflect Congress's restraint in imposing burdensome taxation on the States. Doubtless,

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[475] Congress had declined to pass legislation, under the Supremacy Clause, immunizing its cost-plus contractors from state taxation. *See* 314 U.S. at 8.

[476] *See Massachusetts v. United States*, 435 U.S. 444 (1978) (upholding federal user fee applied to state aircraft); *New York v. United States*, 326 U.S. 572 (1946) (upholding federal excise tax on state sale of mineral waters); *see also Wilmette Park Dist. v. Campbell*, 338 U.S. 411 (1949) (upholding federal admissions tax imposed on park district's beach patrons).

however, this phenomenon also reflects the crystallization of doctrinal principles: a State's challenge to federal taxation can prevail only upon a showing that the tax discriminates against the States or poses a threat to the States' continued existence.

In *New York v. United States*, 326 U.S. 572 (1946), the Supreme Court sustained a federal excise tax on the State's sale of mineral waters. The majority opinions declined to decide the case solely on the narrow ground that the Constitution does not proscribe direct taxation of the States when the States engage in commercial activities or perform proprietary functions.[477] *Id.* at 574-75 (Frankfurter, J.); *id.* at 586 (Stone, J., concurring). The distinction between governmental and proprietary functions was deemed "untenable," *id.* at 586 (Stone, J.), and "too shifting a basis for determining constitutional power and too entangled in expediency to serve as a dependable legal criterion." *Id.* at 580 (Frankfurter, J.)

Prior to *New York v. United States*, the Supreme Court had analyzed direct federal taxes on the States solely in terms of the governmental/proprietary distinction, and had originally analyzed taxes on private parties dealing with the States separately, under different standards.[478] In *New York v. United States*, the Supreme Court sought to unify the intergovernmental tax immunity doctrine, at least with regard to federal taxes on the States, by establishing a general test. Although the majority could not agree on a single test, all the Justices agreed that a tax that discriminated against the States or against state functions must fail. Out of concern that a standard formulated only in terms of a ban on discriminatory taxation might allow the federal gov-

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[477] For a survey of decisions involving commercial activities or proprietary functions, see note 467, *supra*.

[478] See note 467, *supra*.

ernment to tax "sovereign" state functions, the concurring Justices insisted that the Court retain a reserve of power to deal with nondiscriminatory federal taxes that would "interfere unduly with the State's performance of its sovereign functions of government." *Id.* at 587.

Justice Frankfurter, in an opinion joined by Justice Rutledge, began with the proposition that "for Congress to tax State activities while leaving untaxed the same activities pursued by private persons would do violence to the presuppositions derived from the fact that we are a Nation composed of States." *Id.* at 575-76. Justice Frankfurter also believed that there was no judicially manageable standards with which to adjudicate claims by the States of immunity from federal taxation other than a rule against discrimination.[479] Thus, Justice Frankfurter would allow the federal government to levy taxes—even if their economic and legal incidence falls on a State—"so long as Congress generally taps a source of revenue by whomsoever earned and not uniquely capable of being earned only by a State, . . ." *Id.* at 582.

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[479] Justice Frankfurter's concern with the justiciability of state claims of tax immunity parallels that expressed by the Supreme Court in *Garcia* with regard to state claims of regulatory immunity. Justice Frankfurter stated that

> [recent cases] also indicate an awareness of the limited role of courts in assessing the relative weight of the factors upon which immunity is based. Any implied limitation upon the supremacy of the federal power to levy a tax like that now before us, in the absence of discrimination against State activities, brings fiscal and political factors into play. The problem cannot escape issues that do not lend themselves to judgment by criteria and methods of reasoning that are within the professional training and special competence of judges. Indeed the claim of implied immunity by States from federal taxation raises questions not wholly unlike provisions of the Constitution, such as that of Art. IV, § 4, guaranteeing States a republican form of government, . . . which this Court has deemed not within its duty to adjudicate.

Id. at 581-82 (citation omitted).

Justice Frankfurter's opinion in *New York v. United States* recognized that there are state activities and state property, such as obtaining income through taxation and maintaining a state capitol, that "partake of uniqueness from the point of view of intergovernmental relations." *Id.* at 582. Regarding these activities to be of the essence of government, Justice Frankfurter believed that such activities could not be included for purposes of federal taxation in any abstract category of taxpayers without engaging in the presumptively impermissible act of "taxing the State as a State." *Id.*

Justice Stone, for the plurality of four concurring Justices, pointed out that a simple ban on discriminatory federal taxation did not solve the problem of judicially manageable standards. Under a test that prevented only discriminatory taxes, a State's capitol or tax revenues might lawfully be included, respectively, in a general, nondiscriminatory real estate tax or an income tax laid upon all alike—a result that all Justices agreed was constitutionally impermissible. *Id.* at 587. According to the plurality in *New York v. United States*, "a federal tax which is not discriminatory as to the subject matter may nevertheless so affect the State, merely because it is a State that is being taxed, as to interfere unduly with the State's performance of its sovereign functions of government." *Id.* Thus, the Supreme Court must retain the ability to invalidate even a nondiscriminatory tax that unduly interferes with the performance of the State's functions of government. *Id.* at 588.[480]

Massachusetts v. United States, 435 U.S. 444 (1978), provides the only other substantial, recent discussion of

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[480] To Justice Frankfurter's justiciability concerns, Justice Stone replied that "[t]he problem is not one to be solved by a formula," *id.* at 589, but by "a practical construction which permits both [governments] to function with the minimum of interference each with the other . . . ." *Id.* (quoting *Metcalf & Eddy v. Mitchell*, 269 U.S. at 524).

the principles governing state immunity from federal taxation. This case, like *New York v. United States*, involved a direct tax upon the State, rather than a tax on private persons with indirect impact upon the State. The United States imposed a nondiscriminatory registration tax or user fee on all civil aircraft, including its own, to help defray the cost of the national airway and airport system.[481] The Supreme Court held that a State enjoys no constitutional immunity from a nondiscriminatory revenue measure which operates so as to ensure that all members of a class of beneficiaries of a federal program pay a fair approximation of their share of its cost. *Id.* at 454. The majority reasoned that, where a user fee does not discriminate against state functions, is based on a fair approximation of system use, and is structured so as to yield revenues not in excess of total federal costs, there was no possibility that the fee would "control, unduly interfere with, or destroy a State's ability to perform essential services." *Id.* at 467.

In a portion of the opinion joined by four members of the Court, Justice Brennan in *Massachusetts v. United States* outlined the general contours of state tax immunity. The plurality's discussion found cogent reasons for narrowly limiting state immunity. Since any state immunity impairs the national taxing power, enlarging that immunity beyond that needed to protect the States' continuing ability to function burdens the federal government without promoting constitutionally protected values. *Id.* at 456. Morever, recalling *M'Culloch*'s political safeguards thesis, Justice Brennan pointed out that the national political process provides an inherent check against abusive federal taxation of the States. The States' representation in that process made it "uniquely adapted" to balance national revenue demands

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[481] Congress exempted the States from aircraft fuel, tire and tube taxes, which taxes would have imposed a heavier burden than the registration tax. *See* 435 U.S. at 450 n.8, 452.

and the need to preserve the independence of the States. *Id.*

Surveying the Supreme Court's decisions restricting the scope of state immunity, the plurality highlighted the absence of discrimination against the States in the tax measures found to be constitutional. The insistence that taxes levied be nondiscriminatory is common both to the decisions upholding federal taxation of state revenue generating activities similar to those traditionally engaged in by private persons, and to the cases sustaining federal taxation of private persons earning income derived from activities associated with state governments. *See id.* at 457-59. Besides heightening the ability of the political process to protect the States, broad and nondiscriminatory taxation ensures that the "revenue measures could never seriously threaten the continued functioning of the States. . . ." *Id.* at 460. The States are not immune from such revenue measures because the purpose of immunity is not to reduce state costs but "solely to protect the States from undue interference with their traditional governmental functions." *Id.* at 459.

The bulk of the Supreme Court's more recent decisions in the intergovernmental tax immunity field deal with the federal government's immunity from state taxation. As discussed, the sources and scope of federal immunity differ from those of state immunity.[482] However, the Supreme Court's recent teaching concerning the derivative tax immunity of those dealing with the federal government sheds considerable light on a State's assertion of immunity on behalf of those dealing with it.

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[482] The Supremacy Clause has long been held to require an absolute prohibition of state taxes laid directly upon the United States. See *United States v. New Mexico*, 455 U.S. 720, 733 (1982). Federal immunity transcends a mere prohibition of discriminatory state taxation. *Id.* The implied immunity of the States has not been construed to require a similarly absolute immunity from direct taxation.

The principal focus of the Supreme Court's federal immunity jurisprudence is insuring the nondiscriminatory treatment of those deriving income from the federal government. In *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983), the Supreme Court stated: "where . . . the economic but not the legal incidence of the tax falls on the Federal Government, such a tax generally does not violate the constitutional immunity if it does not discriminate against holders of federal property or those with whom the Federal Government deals." *See United States v. City of Detroit*, 355 U.S. 466, 473 (1958) (tax invalid, although not falling directly on the United States, where it operates so as to discriminate against the government or those with whom it deals). Thus, in *Garner* the Supreme Court invalidated a state tax on bank earnings which discriminated against federal obligations by including interest paid on federal obligations in the tax base while excluding income from otherwise comparable state and local obligations. *Id.* at 398.

The Supreme Court's decision in *United States v. County of Fresno*, 429 U.S. 452 (1977), elucidated the political underpinnings of the emphasis in federal immunity doctrine on preventing discrimination. Recounting that the state tax in *M'Culloch v. Maryland* discriminated against the United States, the Supreme Court pointed out that the inherent political safeguards ordinarily operative against abusive taxation are absent when the State's tax measure operates only against the federal government. *Id.* at 458-59. Generally, confining derivative tax immunity for private parties dealing with the federal government to cases where the tax is discriminatory, *i.e.*, is not imposed equally on others similarly situated, reinforces those political safeguards and adequately protects federal interests.[483] As Justice White explained,

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[483] The Court in *County of Fresno* used concrete examples to illustrate the relationship between the presence of political safeguards and the absence of discrimination:

"The political check against abuse of the taxing power found lacking in *M'Culloch* . . . is present where the State imposes a nondiscriminatory tax only on its constituents or their artificially owned entities; . . ." *Id.* at 463.

In the present case, plaintiffs challenge the tax sanction underlying the TEFRA registration requirement. Modern intergovernmental tax immunity doctrine teaches that plaintiffs cannot prevail merely by showing some burden, or a speculative burden, resulting from the threatened tax. Nor does the current state of the case law sanction invalidating a tax measure on the now discredited grounds that certain categories of taxpayers deriving income from a State enjoy absolute immunity regardless of the burdens imposed on the State.

To prevail on their claim that the tax sanction violates the State's constitutional tax immunity, plaintiffs must show that the sanction operates to discriminate against the States. Failing that, plaintiffs might still prevail if they could demonstrate that the actual impact of the sanction threatens the continued existence of the States or inerferes unduly with their ability to perform essential government functions.

5. *The Analysis Applied: The TEFRA Tax Sanction Does Not Violate Intergovernmental Tax Immunity*

Since plaintiffs have shown neither discrimination against the States nor a danger to the States' continued

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> A tax on the income of federal employees, or a tax on the possessory interest of federal employees in Government houses, if imposed only on them, could be escalated by a State so as to destroy the federal function performed by them either by making the Federal Government unable to hire anyone or by causing the Federal Government to pay prohibitively high salaries. This danger would never arise, however, if the tax is also imposed on the income and property interests of all other residents and voters of the State.

429 U.S. at 463 n.11.

existence as a result of the TEFRA tax sanction, their challenge to Congress's choice of means to implement the registration requirement fails. Contrary to plaintiffs' contention, the bare holding of *Pollock*, whatever its present vitality, offers them no support.

Plaintiffs do not contend that the tax sanction itself threatens the continued existence of the States. They do argue that the economic burdens of compliance with the registration requirement—the "price" that the States must pay to avoid the tax sanction—constitute an impermissible direct tax upon the States. These compliance costs, however, fall far short of threatening the continued existence of the States as governmental entities.[484]

Even if the TEFRA tax sanction does not cripple a State's ability to perform its governmental functions, Section 310(b)(1) of TEFRA would still violate the doctrine of intergovernmental tax immunity if the registration requirement discriminated against the States. However, the argument that the sanction is discriminatory is entirely unpersuasive.

In enacting TEFRA, Congress sought to insure that *all* publicly sold debt obligations with a maturity (at issue) of more than one year would be issued in registered form. Section 310(a) of TEFRA, 96 Stat. 595, 31 U.S.C. § 3121(g)(1982), requires that all such obligations of the United States be issued in registered form. Sections 310(b)(2)-(b)(6) of TEFRA, 96 Stat. 596-99, enacts a comprehensive system of bond issuer and bond holder penalties that insures that all publicly sold, private corporate debt obligations with maturities at issue of more than one year are issued in registered form. In short, Congress applied the registration requirement to all issuers of debt obligations without discrimination.[485]

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[484] This argument is considered in Section IX(C), *infra*.

[485] South Carolina contends that the United States and many private issuers already issued their bonds in registered form. Even if true, this does not demonstrate that the requirement

Nor is the TEFRA sanction applied against the States and localities discriminatory as compared to the sanctions applied to other types of bond issuers. To insure that municipal bonds are registered, Congress adopted a stern sanction against the holders of unregistered bonds: the loss of the tax exemption on their interest. To insure that private corporate bonds are registered, Congress adopted a number of equally severe sanctions against both the holders *and* the issuers of bearer corporate bonds. In addition to denying corporate issuers of bearer bonds a deduction for the interest they pay on such obligations, Section 310(b)(2) of TEFRA, 96 Stat. 596, 26 U.S.C. § 163(f), Congress denied corporate issuers an adjustment on their earnings and profits for such interest, Section 310(b)(3) of TEFRA, 96 Stat. 597, 26 U.S.C. § 312, and imposed an excise tax on bearer bond issuance. Section 310(b)(4) of TEFRA, 96 Stat. 597-98, 26 U.S.C. § 4701. Holders of unregistered corporate obligations are denied deductions for their losses, Section 310(b)(5) of TEFRA, 96 Stat. 598, 26 U.S.C. § 165(j), and capital gains treatment for their gains. Section 310(b)(6) of TEFRA, 96 Stat. 599, 26 U.S.C. § 1232(c).

These sanctions, although varying according to the type of issuer, are equally well adapted to their intended task of enforcing the universal registration requirement adopted in TEFRA. In fact, the sanctions enforcing the registration requirement for corporate bonds, taken together, are probably more severe than those for municipal bonds. And, Congress has asked no more of the States than it has required of its own Treasury Department.

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operates discriminatorily. Plaintiffs did not show that any characteristics of municipal securities make them peculiarly difficult or expensive to register such that a registration requirement inherently discriminates against municipal bonds.

The Special Master finds no evidence of discrimination in Congress's tax sanction as applied to the States.

In short, plaintiffs' intergovernmental tax immunity contention rests upon a slender reed: the contention that the *Pollock* holding continues to preclude any burden upon the right established in *Pollock* to issue municipal bonds free of federal taxation upon their interest. The doctrinal evolution subsequent to *Pollock* undermines that contention.[486] Since tax immunity for their bond holders cannot be regarded as abstract and complete, as it was when *Pollock* was decided, the States are required to show that the tax sanction was discriminatory or destructive of their independent existence. They have not carried that burden.

The Special Master turns next to the States' claim that their costs incurred in avoiding the tax sanction constitute an impermissible direct tax.

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[486] The Special Master's disposition makes unnecessary an analysis of the continuing vitality of *Pollock*'s holding that the federal government may not, under any circumstances, impose a tax directly upon the interest income generated by municipal bonds. The Special Master notes, however, that the constitutionality of an unconditional tax on municipal bond interest income would depend, absent a showing of some kind of discrimination, upon an assessment of the actual burdens such a tax would impose on the States' ability to borrow. Although more costly borrowing would surely result, increased costs would not alone require invalidation of the tax. However, the States would be free to attempt to show that increased costs, combined with excessive demand for loan capital, overcrowded and unstable financial markets, and any other relevant factors, might cripple their ability to borrow without the tax exemption. Although this may seem an unlikely scenario, the question is factual and not capable of resolution abstractly. The ability of the States to survive without the municipal bond interest exemption cannot be deduced abstractly from their now demonstrated ability to withstand the withdrawal of the tax-exempt status of their employees, lessees, and independent contractors.

C. The Compliance Burdens of TEFRA Do Not Constitute An Impermissible Tax Imposed Directly Upon the States

Plaintiffs argue that the compliance costs [487] associated with issuing registered bonds in and of themselves constitute a tax levied directly upon the States.[488] South Carolina concedes, as it must, that "higher costs do not themselves ordinarily constitute a tax," but argues that these costs become a tax "when they are incurred because the alternative is an explicit tax so severe that it forces the issuer to comply." [489]

South Carolina is correct in the limited sense that the costs of complying with federal regulation are not, and have never been, conceived of as a direct tax upon the States. A tax is an " 'enforced contribution to provide for the support of government[,]' " *United States v. State Tax Commission of Mississippi*, 421 U.S. 599, 606 (1975) (quoting *United States v. La Franca*, 282 U.S. 568, 572 (1931)). *See United States v. Baltimore & Ohio Railroad Co.*, 84 U.S. (17 Wall.) 322, 326 (1872) (tax is a charge or pecuniary burden for the support of government). If the compliance costs of TEFRA are viewed as a direct tax upon the States, then any number of federal regulatory statutes that impose such costs upon the States must be viewed as tax measures. The Supreme Court has never viewed the costs of statutory compliance or the regulatory statutes themselves in that light. *See, e.g., E.E.O.C. v. Wyoming*, 460 U.S. 226 (1983) (compliance costs of Age Discrimination in Employment Act not analyzed as a direct tax); *F.E.R.C. v. Mississippi*, 456 U.S. 742 (1982) (compliance costs of Public Utilities Regulatory Policies Act of 1978 not analyzed as a direct tax). Indeed, viewing state regulatory compliance costs

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[487] See 36-77, *supra*.

[488] See *Brief of the NGA* at 76; *Brief of Plaintiff* at 22-23.

[489] *Brief of Plaintiff* at 23.

as direct taxes—a step for which plaintiffs have cited no precedent—could call into question an enormous amount of hitherto unchallenged federal legislation.[490]

The States did incur regulatory compliance costs as an alternative to absorbing the impact of a more severe tax sanction. To some extent, then, plaintiffs' argument would appear to boil down to the contention, considered and rejected in Section VIII, *supra*, that the costs of the registration requirement threaten the separate and independent existence of the States. Otherwise, plaintiffs' argument would appear to be an assertion that, because the costs of statutory compliance result from Congress's exercise of its taxing powers, these costs must perforce be a direct tax upon the States. However, as the Secretary points out, Congress routinely imposes administrative and regulatory costs upon the States in order to bolster federal income tax compliance. Thus, the States must withhold federal income taxes from their employees and remit those taxes to the Treasury;[491] they must process W-4 and W-2 forms for their employees;[492] and they must report state and local income tax refunds to the Internal Revenue Service and to their residents.[493] There is no basis for regarding these costs of assisting federal income tax collection and compliance as anything other than the incidental burdens of governmental coexistence. As long as these costs do not rise to a level that threatens the States' separate and independent existence—and there has been no showing that they do—there is no basis for

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[490] Although the Supremacy Clause prohibits any direct taxation of the federal government by the States, see note 482, *supra*, there is no equivalent prohibition in the implied doctrine of state tax immunity. The constitutionality of a direct tax upon the States depends upon the state function taxed and the impact of the tax on the States' ability to execute that function.

[491] See 26 U.S.C. §§ 3402(a), 3404 (1982).

[492] See 26 U.S.C. §§ 3402(f), 6051(a) (1982).

[493] See 26 U.S.C. § 6050E (1982).

considering them an impermissible direct tax upon the States.

D. The Tax Sanction Is Not An Impermissible Regulatory Tax

Plaintiffs also contend that Section 310(b)(1) of TEFRA is an unconstitutional regulatory tax because it raises no revenue, but instead imposes a penalty on activities not subject to federal regulatory power. If requiring municipal bonds to be issued solely in registered form were otherwise beyond Congress's power, plaintiffs' contention would have force. Thus, as plaintiffs point out, "[p]enalty provisions in tax statutes added for breach of a regulation concerning activities in themselves subject only to state regulation have caused this Court to declare the enactments invalid." *United States v. Kahriger*, 345 U.S. 22, 31 (1953), *overruled on other grounds, Marchetti v. United States*, 390 U.S. 39 (1968).

The problem with plaintiffs' regulatory tax contention is the absence of a vital predicate: the area Congress seeks to regulate is not otherwise beyond Congress's power. The Constitution does not prohibit so-called "regulatory taxes" merely because a tax has a regulatory effect; indeed, all taxes—by burdening the activities upon which they are levied—inevitably have some ancillary regulatory effect (discouraging the taxed activity or encouraging a substitutable, untaxed activity). As the Supreme Court explained in *Sonzinsky v. United States*, 300 U.S. 506, 513 (1937), "a tax is not any less a tax because it has a regulatory effect."

The Court in *Kahriger* upheld a tax on those accepting wagers, with an ancillary requirement that the taxpayers file their names, addresses and places of business with the government, against an allegation that Congress had infringed police powers reserved to the States. *Kahriger* argued that Congress, under the pretense of exercising its power to tax, had attempted to penalize illegal intra-

state gambling, an area supposedly within the exclusive domain of the States. The Supreme Court recognized that, if a federal tax measure is a mere pretext for extending regulatory power to areas not authorized by the Constitution, it is an invalid "regulatory" tax:

> Should Congress, in the execution of its powers, adopt measures which are prohibited by the Constitution; or should Congress, under the pretext of executing its powers, pass laws for the accomplishment of objects not entrusted to the government, it would become the painful duty of this tribunal, should a case requiring such a decision to come before it, to say that such an act was not the law of the land.

M'Culloch v. Maryland, 17 U.S. (4 Wheat.) 316, 423 (1819), *quoted in Kahriger*, 345 U.S. at 29.

In *Kahriger*, however, there was no need to address the scope of federal power to regulate intrastate gambling. Regardless of the possible federal motive to discourage gambling, the statute was defensible because it generated not insubstantial revenue.[494] "Unless there are provisions, extraneous to any tax need, courts are without authority to limit the exercise of the taxing power. All the provisions of this excise are adapted to the collection of a valid tax. . . . All that is required is the filing of names, addresses, and places of business. . . . Such data are directly and intimately related to the collection of the tax and are 'obviously supportable as in aid of a revenue purpose.'" *Kahriger*, 345 U.S. at 31-32 (quoting *Sonzinsky*, 300 U.S. at 513).

All parties to the present litigation agree that Section 310(b)(1) of TEFRA is calculated to raise, and will raise, no federal revenue whatsoever. Contrary to plaintiffs' contention, however, a tax that is purely regulatory in purpose and effect is not, for that reason alone, un-

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[494] *See Kahriger*, 345 U.S. at 28 n. 4 ($4.3 million in annual revenue).

constitutional. The tax is invalid only if the regulatory goal sought to be fostered is otherwise beyond Congress's power.[495] In *Veazie Bank v. Fenno*, 75 U.S. (8 Wall.) 533 (1869), the Supreme Court upheld a prohibitive ten percent tax on currency issued by state banks although the sole purpose and effect of the federal tax was to drive non-federal bank notes out of circulation.[496] The *Veazie Bank* Court reasoned that, since Congress had "undisputed constitutional powers" to provide for a national currency under Article I, § 8 of the Constitution, "it cannot be questioned that Congress may, constitutionally, secure the benefit of [a national currency] to the people by appropriate legislation." *Id.* at 549. A tax driving out of circulation all non-federal currency was "necessary and proper for carrying into Execution" Congress's undisputed power to establish a national currency. U.S. Const. art. I, § 8, cl. 18. Thus, a purely regulatory tax can be sustained as a means of implementing another power delegated to Congress by the Constitution.

Minor v. United States, 396 U.S. 87 (1969), also indicates that a regulatory tax can be sustained if Congress could have achieved the same regulatory objectives under another power such as, in *Minor*, the commerce power. The *Minor* Court sustained a provision of a narcotics regulation statute that required dealers to pay an occupational tax, purchase tax stamps, and make all narcotics transfers pursuant to a written order form. The Court noted that "[a] statute does not cease to be a valid tax measure because it deters the activity taxed, because the revenue obtained is negligible, or because the activity is otherwise illegal." *Id.* at 98 n. 13. Rejecting the argument that the order form requirement could not be enforced as a part of a revenue measure, the Court declared: "Even viewing [the requirement] as little more than a

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[495] *See* L. Tribe, *American Constitutional Law* § 5-9 (1978).

[496] Like the tax at issue here, the tax in *Veazie Bank* was so "excessive" as to insure that it would raise no revenue whatsoever.

flat ban on certain [heroin] sales, it is sustainable under the power granted Congress in art. I, § 8." *Id.* (citing, *inter alia, United States v. Darby*, 312 U.S. 100 (1941)).

Section 310(b)(1) of TEFRA can be sustained as a permissible exercise of Congressional regulatory power. As discussed,[497] Congress could have invoked its Commerce Clause powers to prohibit all movement of bearer bonds in interstate commerce.[498] Thus, it is well within Congress's powers to employ a tax sanction to achieve the identical result, albeit in a less coercive manner.

Moreover, Section 310(b)(1) can be sustained as a necessary and proper means of protecting the national taxing power. Congress found that bearer bonds weakened compliance with the federal income tax laws. Congress also found that requiring registered bonds would bolster estate, gift and capital gains tax reporting while eliminating a convenient mechanism for the concealment of unreported income from both legal and illegal sources. Congress's exercise of its taxing power to strengthen income tax compliance and prevent tax evasion is clearly a necessary and proper means of carrying into execution its power to lay and collect taxes. U.S. Const. art. I, § 8. As such, it is a permissible regulatory tax. *See Doremus*

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[497] See *supra* at 127-28.

[498] It is possible that there might be some small difference in the scope of Congress's power to require bond registration when using the Commerce Clause as opposed to the Taxing Clause. Conceivably, some very minor portion of the municipal bond market consists of purely local bond issues that neither move in, nor—when aggregated with the totality of other purely local bond issues—have any significant impact upon interstate commerce. However, there is no evidence of any such bond issue in the record, and plaintiffs have not argued that Congress's power in this area is limited by any purely local aspect of the municipal bond market. Moreover, the TEFRA registration reqirement applies only to bonds of a type offered to the public, further diminishing the possibility that purely intrastate activities or local bonds have been caught up in TEFRA.

v. United States, 249 U.S. 86, 93 (1919) (legislation cannot be invalidated if it bears "some reasonable relation to the exercise of the taxing authority conferred by the Constitution. . . .")

X. CONCLUSIONS AND RECOMMENDATIONS.

In requiring the States to issue their bonds in registered form, Congress sought to eliminate a ready means of federal tax evasion without imposing undue costs upon the States. Congressional regulation of tax-exempt municipal bonds in order to protect the federal tax base is not without precedent. Indeed, the TEFRA registration requirement, when viewed against the backdrop of federal restrictions on the States' ability to provide a tax exemption for private purpose and arbitrage financing, would appear to be the least significant aspect of Congress's legislation in this field.

The form in which municipal bonds are issued, *i.e.*, bearer or registered, is a purely technical aspect of the States' borrowing function. The States' interest in the form of their bonds does not transcend a desire to accommodate the demands of the marketplace. Yet, the market has welcomed registered municipal bonds. It is not simply that the municipal bond market has flourished in the all registered environment produced by TEFRA; market participants credit the registration requirement with facilitating the market's growth.

The burdens of establishing and maintaining a system of registered municipal bonds do not weigh heavily upon the States. The required legislative and administrative changes necessary to implement TEFRA were neither qualitatively nor quantitatively extraordinary. The only increase in ongoing State administrative costs attributable to registration pertains to a category of small issues. These cost increases are not substantial, may be avoidable and, in any event, were not shown to have any qualitative impact on the ability of any municipal issuer to borrow.

The parties devoted much time and energy to plaintiffs' contention that market preferences for bearer bonds have caused plaintiffs' borrowing costs to rise by 5 to 15 basis points in an all registered environment. The econometric studies brought to bear on this question proved inconclusive, however. More important, plaintiffs failed to prove that any market preference for bearer bonds that may exist is not a result of the same untoward uses of bearer bonds that Congress seeks to eradicate. If this is true, and it may well be, plaintiffs cannot be heard to assert a constitutional right to a share in the market demand generated by a desire of a limited segment of the market to use bearer bonds for unsavory purposes.

The registration requirement does not violate any federalism restraints on national regulatory power. The truly limited impact of requiring States and localities to issue registered bonds indicates that Section 310(b)(1) of TEFRA would not have warranted judicial intervention even under the standards of *National League of Cities v. Usery*. Under the more deferential review of congressional power mandated by *Garcia v. San Antonio Metropolitan Transit Authority*, the constitutionality of the registration requirement seems beyond peradventure. Moreover, Congress's evident solicitude for the States' legitimate concerns in implementing the registration requirement confirms that the political process functioned properly here.

Congress's choice of means for enforcing the registration requirement—the tax sanction—does not violate any other constitutional requirement. The modern intergovernmental tax immunity doctrine does not require that the exemption for municipal bond interest income be preserved inviolate. The minimal burdens imposed by the TEFRA registration requirement upon the States' ability to issue tax-exempt bonds is not a cause for concern under that doctrine. Finally, since the goal of requiring registration is not otherwise beyond Congress's power, the

tax sanction does not constitute an impermissible regulatory tax.

RECOMMENDATIONS

Based upon the foregoing findings of fact and legal analysis, the Special Master RECOMMENDS that the Supreme Court enter an order granting judgment for the DEFENDANT.

This report is respectfully submitted.

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