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RESEARCH SUMMARY

Political Competition and Rule-Based Financing in the Municipal Bond Market

Cities, counties, and states issue municipal bonds to raise money for public projects, including new construction for education, utilities, and transportation. Securing funding for these projects could benefit politicians who are up for reelection. Is the choice of government financing instruments driven by only economic efficiency concerns, or is the choice also determined by political factors?

In "Political Competition and Rule-Based Financing in the Municipal Bond Market," Marian Moszoro finds that when mayors face a higher risk of losing office, they choose costlier local financing instruments—revenue bonds and competitive sales—to avoid referenda and public scrutiny.

KEY FINDINGS

The study combines municipal financial instrument data with proxies of political competition and provides evidence that when the probability of losing office is high, mayors are more likely to issue revenue bonds than general obligation bonds and to choose competitive bidding over negotiated sales. Both revenue bonds and competitive bidding are likely to be more expensive but easier and less politically controversial.

The results are estimated in terms of the effect of a change in electoral victory margins and a change in the number of partisan swings. The standard deviation measures how widely data are dispersed from the average, or mean, of the data. Data that are clustered closer to the mean will have a smaller standard deviation; a larger standard deviation signifies more widely dispersed data.

- Narrowing victory margins by one quintile increases the probability of debt being issued as a revenue bond by 4.2 percent, while an increase in the number of partisan swings in the past electoral races by one standard deviation increases the probability by 8.2 percent.
- Narrowing of victory margins by one quintile increases the probability of issuing bonds through competitive bids by 2.5 percent, and an increase in the number of partisan swings in the past electoral races by one standard deviation increases the probability by 2.3 percent.
- These estimates are higher for elected mayors than for city managers and higher when the next election is closer.

KEY POLICY TAKEAWAYS

This relationship can explain trends in public financing and spending. The choice of revenue bonds and competitive bidding insulates public officials from referendum checks and allegations of impropriety but requires higher interest rates and administrative costs.

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- *Local politicians trade off economically cheaper for politically safer financing instruments*. To reduce the incentive for "strategic" use of revenue bonds in politically contestable municipalities, issues above a certain amount (e.g., 2 percent of a municipality's annual tax revenues) should be subject to a referendum similarly to general obligation bonds.
- *Rating agencies should incorporate political variables into their algorithms*. Disentangling political and financial risks could help fine-tune the risk premiums for revenue bonds in politically contestable but financially stable municipalities.
- *Negotiated sales are a mechanism less subject to public control and therefore more prone to favoritism compared to competitive bids*. Both negotiated sales and private placements of municipal debt should come under increased scrutiny, especially in light of corporate contributions and possible quid pro quo deals.
- *Increased information to taxpayers about bond issues' covenants and costs will increase scrutiny and accountability of politicians in office*. This will limit their strategic behavior regarding financing instruments and sales mechanisms and, thus, lower the transfer of money from taxpayers to lenders.