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PERSPECTIVE

Why Public Debt Management Matters

BY JUSTIN MARLOWE

It's helpful to occasionally step back from the daily grind of local public finance and ask: why does what we do matter? Some obvious answers come to mind right away. A well-managed financial operation saves taxpayer dollars. An effective budget process ensures that local government spending reflects local values and priorities. Revisiting policies and practices can also help address past wrongs, like the way in which property tax assessment practices can lead to chronic overtaxing of properties owned by people of color. GFOA's own Code of Ethics reminds us that effective administration of public finances can bolster trust in government by making people feel that their government is reliable and working in their best interests.

In public debt management, though, we tend to ask this question less often. For most of us, effective debt management is synonymous with reducing borrowing costs. Shaving a few basis points off of a new bond issue can save tens or hundreds of thousands of dollars in debt service over time. Earning a credit rating upgrade can also reduce borrowing costs and bolster community pride. And, of course, good debt management matters to elected officials. Less money tied up in debt service means lower taxes and/or more money for projects and priorities this year. It also makes it possible to buy now but pay later, namely when someone else is in office. As the influential economist James Buchanan once said, "Elected politicians enjoy spending public monies on projects that yield some demonstrable benefits to their constituents. They do not enjoy imposing taxes on these same constituents."

All this adds value, but it adds value mostly in the near term. Budgeting helps us align long-term values with long-term investments. Revenue administration, when done well, can ensure that the tax code treats taxpayers in a fair and transparent way over time. But we know far less about the long-term value proposition of effective public debt management. Fortunately, some new research sheds light on this classic question.

Mainstream economics and finance theory tells us that, in fact, public debt management doesn't matter in the long run. When local governments operate in "efficient" capital markets it doesn't matter if they pay for their capital investments with debt or taxes. In the long run, taxpayers adjust their behavior, and the economy is no better or worse off. But that theory comes with a big caveat. It assumes that state and local government borrowing doesn't fundamentally change the way taxpayers decide where and how to spend their money. Until recently, that caveat was rarely challenged. It's difficult, after all, to study how local debt management practices affect whether a family decides to take a vacation or whether a local business decides to hire new workers. Or, in the parlance of economics, we don't know much about how public debt management affects the "real economy."

Fortunately, some recent research does just that. Perhaps surprisingly, it rejects the prevailing academic view that public debt management does not matter. But it also shows that local debt management practices can help and hurt local economies.

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For instance, a recent paper by European scholars Omar Rachedi and Vahid Saadi explores the complicated role of commercial banks in local public finance. Commercial banks are key investors in municipal bonds, including and especially the bonds issued by their nearby governments. What's less clear is whether banks' investments in municipal bonds expose them to unique financial risks, like the risk of fluctuations in local property taxes that repay those municipal bonds. In the face of those heightened risks, we would expect banks to take steps to manage those risk exposures, and one such way to manage those risks is to lend less money within the own communities. Rachedi and Saadi study this question directly and find that, in fact, commercial banks that hold comparatively high levels of municipal bonds tend to originate fewer mortgages within their own states. In short, municipal bonds can indirectly restrict the supply of local mortgage lending.

Another emerging stream of research suggests that investor sentiment toward municipal bonds can directly and indirectly affect the performance of local companies. For instance, University of Iowa Professor Foti Grigoris shows that interest rates on municipal bonds predict the stock prices of firms within those same states. He suggests that relationship exists because some investors use municipal bond interest rates as a leading indicator of local economic conditions. In a related study, Natee Amornsiripanitch of the Philadelphia Federal Reserve shows that in the collapse of municipal bond insurance industry following the Great Recession, a huge blow to local government credit quality led to a ten percent reduction in aggregate local government spending that will almost certainly reduce economic output over time.

A team of researchers from Penn State University, Michigan State University, and the University of Tennessee have produced several studies pointing to the counterintuitive finding that local government credit upgrades can lead to noticeable declines in local economic indicators like employment levels, wages, and spending. The reason: because local governments often respond to a higher credit rating by borrowing more money and, in turn, increasing local taxes for debt service. That encourages taxpayers to live and work in nearby jurisdictions with lower tax burdens.

These findings also extend to statewide policies that shape local debt management choices. A study by researchers at Texas Christian University, University of Nevada Los Vegas, and the University of Georgia shows that local economic outcomes are weaker in states with stronger protections for investors in distressed municipal bonds. This is because those stronger investor protections often result in prolonged debt service and other fiscal obligations for communities least able to manage them. A similar analysis by European researchers Stefano Rossi and Hayong Yun documents a different finding in the nonprofit hospital sector. That analysis indicates that when a state adopts stronger municipal bankruptcy laws, borrowing costs for nonprofit hospitals decrease, hospitals invest more in capital facilities, and local economies grow, especially following new construction of those facilities.

We've known for a long time that public debt management matters a lot to taxpayers and elected officials. Now we know it matters for local economies, too—that's all the more reason to do it well.

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