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INFLUENCE PEDDLING IN MUNICIPAL BOND MARKETS

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The municipal bond market is currently a topic of SEC scrutiny, courtroom debate, congressional investigation and media investigation in both the financial and general press. Rule G-37 (MSRB, 1994) prohibits any player in the bond market from doing business with a state or local government or their funding entities for 2 years after that firm's dealers, bond professionals or political action committee(s) contribute to an officeholder in those governments. This rule was prompted by the widespread perception that influence over municipal bond transactions is routinely used by elected officials to extract contributions from market players. This rule has also exposed the MSRB to intense criticism that it is *de facto* interfering in the political process. This research project addresses one aspect of the controversy: the reputed relation between political contributions and municipal bond transactions. We use elected officials and related bond issues in the State of Louisiana as the study subject. Our results provide only weak support for a connection between contributions from market players and the cost of public issues.

Introduction

Municipal bonds, frequently called tax-free municipal bonds or just "munis", have been the subject of SEC scrutiny, courtroom debate, congressional investigations, and media investigation in both the financial and general press. There is a general concern that politicians may be awarding contracts to the bond market players that contribute to their personal well being (i.e. make campaign fund contributions). This research project addresses one aspect of the ongoing controversy: the reputed relation between political contributions and municipal bond transactions. The importance of this issue is demonstrated by the 1994 ruling (G-37) from the

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Municipal Securities Rulemaking Board's (henceforth MSRB), the agency of the federal government regulating municipal securities.

Rule G-37 prohibits any player in the bond market from doing business with a state or local government or their funding entities for 2 years after that firm's dealers, bond professionals or political action committee(s) contributed to an officeholder in those governments. This rule was prompted by the widespread perception that influence over municipal bond transactions is routinely used by elected officials to extract contributions from market players. This rule has also exposed the MSRB to intense criticism that it is *de facto* interfering in the political process.

Regulation and research, including this study, focuses on methods of influence amenable to discovery—that is, cash contributions to political campaigns. There are myriad other avenues available to those wishing to provide off the record support for candidates. Thus the weak results found in this study do not rule out influence peddling. They do, however, indicate that Rule G-37 may not have much affect on any influence peddling that does exist since it only restricts the avenue of disclosed cash contributions.

Both the MSRB and the SEC have vigorously defended Rule G-37. Both maintain their intention to continue targeting undue influence in the municipal bond marketplace. They continue to emphasize Rule G-37 despite stories in the press of workarounds sculpted by players in the municipal bond market that conform to the letter of G-37 while allowing players to continue supplying funds to candidates. These workarounds may be as simple as providing resources for campaign fundraising events or as complex as providing for third party contributions (e.g. employing an independent political consultant who contributes heavily).

To date, the MSRB has mandated disclosure of contributions by market players and their consultants. It has also imposed restrictions on market players' freedom to participate in transactions with state or local governments whose elected officials accepted campaign contributions from them or their consultants. Market players, meanwhile, protest that the government has yet to provide any authentication of their claims about influence peddling.

Theoretic Background

Tax-exempt bonds have historically been investment vehicles bought and sold in relative obscurity. When the business media discussed these bonds at all, it was in relation to changes in the tax code. In addition, the lack of transaction volume makes the provision of pricing information problematic. Federal regulatory agencies have treated bonds as a locally regulated issue, opting to stay out of the process. This has effectively left disclosure an open question usually answered by underwriters. In this information scarce environment opportunism can and arguably does flourish.

Keim and Zardkoohi (1988) provide a cogent analysis of the solicitation and influence of PAC contributions. Snyder (1990) uses data from open-seat races for the US House of Representatives during the period 1980–1986 to validate a simple model based on the idea of campaign contributions as investments. Results of the