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Fiscal News, State Budget Rules, and Tax-Exempt Bond Yields[1]

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This paper investigates how state fiscal institutions such as balanced-budget rules and restrictions on state debt issuance mediate the bond market reaction to state fiscal news. We analyze data on the yields of bonds issued by different states, as reported in the ‘‘Chubb Relative Value Survey,’’ along with data on state budget forecasts for the period 1988–1998. We find that unexpected deficits are correlated with higher state bond yields. This effect is smaller for states with tight antideficit rules than for states without these fiscal rules. Unexpected deficits have a particularly large effect in raising bond yields of states with tax limits. These results suggest that bond market participants view fiscal institutions as relevant in assessing the risk characteristics of tax-exempt bonds and that the economic significance of these institutions depends on the state's economic and fiscal circumstances. © 2001 Academic Press

During the past decade, U.S. states have experienced dramatic changes in their fiscal circumstances. In the early 1990s, many states faced fiscal difficulties, and their borrowing costs increased sharply. There have been wide interstate differences in general obligation debt yields. In 1990, for example, Massachusetts was paying more than 100 basis points more on general obligation debt than many other Northeastern states. The relative yields on debt

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issued by California and New York have varied by nearly 60 basis points. The wide disparities in state borrowing costs reflect divergent economic conditions, but they may also reflect more systematic factors such as differences in state political institutions or fiscal constitutions.

The effect of fiscal institutions on fiscal policy and economic performance more generally attracted substantial policy attention and academic research in the past decade. Discussions leading to the creation of the European Monetary Union, described for example in Von Hagen [28] and Inman [15], and U.S. fiscal experiences with federal budget deficits in the early 1990s were important stimuli to this work. An important issue in this literature is the extent to which credit markets evaluate the credit worthiness of sovereign borrowers, thereby indirectly providing a source of fiscal discipline. The notion that participants in sovereign debt markets form sophisticated views of the fiscal prospects for different jurisdictions offers an intriguing strategy for testing a range of hypotheses about the economic effects of fiscal limits. When jurisdictions differ in their fiscal rules, empirical research could in principle identify the effect of different provisions in the fiscal constitution on borrowing costs. Several previous studies, including Eichengreen [9], Goldstein and Woglom [13], Bayoumi, Goldstein, and Woglom [4], Lowry and Alt [17], and Poterba and Rueben [24], have applied this strategy to the U.S. states. The results in this literature suggest that state fiscal institutions have some explanatory power for the level of borrowing costs.

The potential endogeneity of state fiscal rules is an empirical challenge to any study of fiscal institutions and borrowing costs. It is possible that states with tight antideficit rules also have fiscally conservative electorates and that the primary factor explaining their lower borrowing costs is the electorate, not the fiscal rules. Previous efforts to find instrumental variables that are correlated with fiscal institutions, but not with fiscal policy and borrowing costs, have met with only limited success.

This paper tackles the endogeneity problem by focusing on *changes* in state borrowing costs, rather than on the level of these costs. It considers the reaction of tax-exempt bond yields to news about state fiscal conditions, particularly unexpected state deficits and surpluses. The core of the empirical analysis is a study of how state fiscal institutions mediate the bond market reaction to fiscal news. The assumption that motivates this analysis is that changes in fiscal conditions are less likely than the level of fiscal variables to be correlated with state voter preferences. Our study is designed to provide a new source of evidence on the economic effects of fiscal rules, while avoiding at least some of the endogeneity problems that may have affected earlier studies.

Our results are complementary to those in Lowry and Alt [17], who estimate models in which the state's borrowing cost depends on the current level of the state deficit, and the interaction of this deficit with the state's fiscal rules. They find that deficits matter less for bond yields in states with tight fiscal constitu-

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