THE HAMILTON PROJECT

Advancing Opportunity, Prosperity, and Growth

Lowering Borrowing Costs for States and Municipalities Through CommonMuni

State and municipal governments borrow in the municipal bond market to finance local infrastructure projects that have large up-front costs and long-term benefits such as schools, roads, and hospitals. All sizes and levels of government—from the largest states to the smallest school

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districts—rely on this market to make investments in America's future. In the aggregate, these governments issue roughly $500 billion in municipal bonds each year. Because these bonds are tax-exempt, the largest buyers of municipal bonds are ordinary household investors. To meet the needs of government borrowers and their investors while keeping costs low, it is essential for this market to operate efficiently.

Recent evidence suggests, however, that the municipal bond market is inefficient and that borrowers and investors pay billions each year in unnecessary fees, transaction costs, and interest expenses. The market for bonds is illiquid, meaning it is hard for bondholders to sell at short notice at a price close to the bond's intrinsic value. As a result, municipal borrowers pay more in interest to compensate for this illiquidity risk. Liquidity requires gathering many buyers and sellers who want to trade the same product. However, the wide variety of municipal bonds from many different borrowers makes it hard for buyers and sellers of the same municipal bond to find each other. Furthermore, information on borrowers is hard to find; without enough information, borrowers find it difficult to "comparison shop" because they do not know what similarly situated

borrowers pay on their loans. Without comparable financial statements, investors face uncertainty regarding the value of their municipal bond holdings. Compounding this illiquidity and lack of information, some borrowers incur large fees and transaction costs by choosing complex services and financial products that may be unnecessary. This combination of illiquidity, insufficient information, and high-fee financial products raises borrowing costs for states and municipalities, increases uncertainty for market participants, and results in high transactions costs for ordinary investors. The liquidity cost alone represents approximately $30 billion per year on the current $2.9 trillion stock of outstanding bonds. High municipal borrowing costs are especially worrisome in light of the budget crunch affecting state and local governments across America.

The market for municipal bonds can be improved by centralizing the collection and dissemination of financial information and coordinating borrowers to improve liquidity—steps that would benefit borrowers and investors, but that no single actor would choose to undertake on her own. In addition, advice on best practices would help some borrowers avoid high fees.

Andrew Ang of Columbia University and Richard Green of Carnegie Mellon University propose creating a nonprofit institution, "CommonMuni," to offer objective advice to states and municipalities; gather and disseminate information on the municipal bond market for state officials, investors, and taxpayers across the country; and coordinate market participants to ensure a depth of sellers and buyers and to enhance liquidity. At a modest startup cost of $25 million, CommonMuni could be a powerful advocate for reducing state and local borrowing costs for needed long-term investments, unlocking billions in taxpayer and investor value.

The Challenge

States and municipalities borrow money through the municipal bond market to finance important investments in schools, roads, bridges, public buildings, even water and electrical infrastructure. A growing body of evidence, however, suggests that state and local borrowing costs are too high. Given that the value of municipal bonds outstanding is roughly $2.9 trillion, municipal borrowers and their investors are leaving billions of dollars on the table every year because of borrowing costs, fees, and other transaction costs. These costs are a drain on state budgets; make investments in education, infrastructure, healthcare, and utilities more expensive; and reduce investment returns for investors.

These high borrowing costs result from a combination of poor information, illiquidity, and failure to follow best practices. Liquidity, which describes how easy an asset or security is to sell for close to its intrinsic value at short notice, requires gathering together many buyers and sellers who want to trade the same product. However, there are more than 1.5 million different municipal bonds issued by 50,000 different borrowers. Unlike a standard common stock, each bond may include different complex features or financial covenants. If bonds were standardized into a uniform product—a "plain vanilla" bond—or if small bond issues were pooled together, it would be easier to match buyers and sellers for the common product. Similarly, centralizing trading would gather buyers and sellers in the same place. However, it is difficult for municipalities operating independently to converge on a standardized product or create a centralized trading network. Compounding this illiquidity, both investors and borrowers struggle to find information. Financial reports are nonstandard: it is difficult to compare reports from different municipalities. Reporting is infrequent and often delayed, and accounting standards are less stringent than those that apply in the private sector. What information is available is hard to find; there is no centralized database as there is for corporate financial statements. Finally, some municipal borrowers pay high fees for financial products that other borrowers do without. Spreading information on best practices and advising individual borrowers can help borrowers avoid certain high-fee services and high-cost products like superfluous derivatives.

Information and coordination are a classic public good. They would benefit all 50,000 borrowers and millions of investors, but the benefit is small to each individual—so no single issuer or investor can cover the costs of providing information for the entire market on his own. Innovations and changes that might disrupt the status quo are public goods, meaning they are shared by everyone, but a single innovator bears the costs of failing alone. In addition, few municipalities or states want to be the first to change common practices and risk public controversy. Finally, there are limits to federal involvement, and consequently any federal government regulation would have to involve the voluntary participation of the states.

These constraints prevent individual borrowers and the federal government from resolving problems in the municipal bond market. They suggest that new thinking is needed to bring together states and municipalities to change the status quo and reform this market.

A New Approach

Ang and Green propose creating a nonprofit organization called CommonMuni to provide individualized, independent, high-quality advice at fair market rates to municipal borrowers; to coordinate market participants to promote liquidity; and to gather and disseminate information about the municipal bond market. CommonMuni initially could be created entirely with private grants, which would allow it to operate without assistance from governments or market participants, freeing it from the potential for conflicts of interest, and providing a platform for offering independent advice. This combination of independent advice, coordination of market participants to enhance liquidity, and greater information dissemination could reduce borrowing costs for states and municipal governments while improving returns for ordinary investors. We outline below how the authors propose that CommonMuni would play these roles and how this new organization would interact with states and municipalities.

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Provide Independent, Objective Advice to Municipalities on Best Practices and Appropriate Issuance Strategies

As a nonprofit funded by private grants, CommonMuni's advice would be free of conflicts of interest. Hiring CommonMuni would be voluntary; any municipality would be free to hire or retain any advisor they chose. CommonMuni would provide a range of independent advice on a variety of issues, including these:

- **Use derivatives appropriately.** Some municipalities issue bonds with complex embedded derivatives. In some cases, this practice reflects municipalities' underlying needs. However, in other cases the derivatives unnecessarily complicate the bonds, making them harder to value and trade, and reducing transparency.

- **Discourage advanced refunding.** Municipal borrowers use advance refunding to remove high-interest rate bonds from their balance sheets in an exchange that involves issuing lower-rate bonds. However, in most cases advanced refunding is not economically advantageous for states and municipalities. Limiting this practice could result in savings for states and municipalities.

- **Act in borrowers' interests.** CommonMuni's nonprofit status and grant-funded endowment give it a level of independence and objectivity that few government or private firms can achieve. Additionally, the endowment would give CommonMuni the cushion to provide advice to small borrowers that private firms may refuse to advise because of high fixed costs.

- **Minimize issuance costs:** From 1978 to 2010, the proportion of municipal bonds sold through noncompetitive negotiated sales rose from 54 percent to 90 percent.[1] Well-established research dating back to Reuben Kessel in 1971 suggests that these noncompetitive sales impose significant costs on taxpayers.[2,3] CommonMuni would encourage states to issue municipal bonds through competitive auctions rather than through negotiations whenever possible.

1 Levitt, Arthur, 2009, Taxpayers Fleeced When Leaders Tap Muni Market, Bloomberg, Oct 21, 2009.
2 Kessel, Reuben, 1971, A Study of the Effects of Competition in the Tax-exempt Bond Market,Journal of Political Economy 79, 706-738.
3 Robbins, Mark D., 2002, Testing the Effects of Sale Method Restrictions in Municipal Bond Issuance: The Case of New Jersey, Public Budgeting & Finance 22, 4056 and McCaskill, Claire, 2005, General Obligation Bond Sales Practices Follow-Up, Office of the State Auditor of Missouri Report No. 2005-101.

Coordinate Market Participants to Enhance Liquidity

CommonMuni would work with market participants to enhance liquidity.

- **Create standardized issue characteristics.** Municipal bonds are often unnecessarily complex and hard to compare because they are issued in series (divided into many separate bonds) and because they include complex derivatives. CommonMuni would encourage standardization and the creation of plain vanilla municipal bonds that would improve liquidity.

- **Pool small issues to create standard, big issues.** Pooling diverse bonds into a bigger pool would help create larger municipal bond issues with standardized features. CommonMuni could encourage cooperatives of municipalities to engage in this pooling or could pool municipal bonds itself.

- **Reduce or remove the segmentation of markets by state.** Most states exempt interest income from municipal bonds only for bonds issued in that state. Consequently, individuals who hold municipal bonds must bear the risk that the value of their municipal bond holdings will decline if they have to move across state lines. Evidence suggests that this segmentation raises borrowing costs for municipalities since investors demand a premium for this risk, which implies that states could collectively benefit from reducing these barriers.

- **Help create clearinghouses for municipal bonds.** Currently, almost all municipal bonds are sold "over the counter," i.e., directly from investment banks rather than through a centralized exchange. Creating a centralized exchange either at the state or national level would improve the liquidity of municipal bonds and make it easier for ordinary investors to buy and sell the bonds.

- **Help expand the market clientele for municipal bonds.** Currently, municipal bonds are unattractive to tax-deferred and tax-exempt investors such as foreign investors and pension funds because they do not benefit from municipal bonds' tax-exempt status. Experiments such as the Build America Bonds program that make municipal bonds attractive to these investors by directly subsidizing municipal bond interest rather than making the interest tax exempt could expand the market for municipal bonds, increasing liquidity and lowering borrowing costs.

Greater availability and dissemination of information about municipal bonds and the financial condition of issuing states and municipalities could lower borrowing costs ....

Gather and Disseminate Information

Greater availability and dissemination of information about municipal bonds and the financial condition of issuing states and municipalities could lower borrowing costs for many states and municipalities. CommonMuni would help participating municipalities to submit timely, standardized financial reports. These reports then would be compiled into a database that would be freely available to any municipality, investor, or public official. CommonMuni's database also would include all public information about the municipal bond market in one central location in an easy-to-understand format. This information would be released on CommonMuni's website, in regular communication with municipalities and as a part of broader outreach efforts through organizations of government financial officers, city and county treasurers, school district officials, and other relevant government officials.

In addition to its own efforts to gather and disseminate information about participating municipalities, CommonMuni would also advocate for broader steps that would improve access to information in the municipal bond market:

- **Disseminate financial reports in a timely manner.** Currently, states and municipalities do not release standardized information about their financial health or bond issues that is easily comparable across borrowers. States and municipalities should be encouraged to release information that is more user-friendly and timely, in a standardized format.

- **Standardize and improve accounting rules.** Accounting standards for states and municipalities are inconsistent and not as stringent as the corresponding standards for corporations, particularly regarding topics such as employee pensions. The establishment of more-standardized and stringent accounting rules would improve access to information and the ability to compare different municipalities.

- **Improve transparency of issuing costs.** Many municipalities currently report only the gross issuing costs of their municipal bonds, meaning they only report the cost of the interest rate paid on the bond. Reporting net costs, including both the interest rate and the cost of fees or transaction costs involved in the bond issuance would provide a more-accurate measure of the true costs of a bond issue.

- **Promote more-uniform creditor rights.** Municipalities can file bankruptcy through voluntary Chapter 9 filings. However, Chapter 9 treatment is not uniform across states. Currently, twenty-six states do not permit Chapter 9 filings. In California, all municipalities have Chapter 9 blanket filing authority, while in Connecticut, the governor must personally approve a Chapter 9 filing. Making Chapter 9 treatment more consistent and uniform would make municipal bonds more attractive, reducing borrowing costs.

- **Advocate for enhanced investor protections.** The SEC does not have jurisdiction over the municipal market due to the 1975 Tower Amendment to the 1934 Securities Exchange Act. The SEC can intervene only for fraud or criminal malfeasance cases. CommonMuni would lobby for the repeal of the Tower Amendment, which would enhance investor protection.

Although CommonMuni could implement or facilitate the adoption of the reforms discussed above, many of these reforms are not dependent on CommonMuni itself. States and municipalities could implement many of these changes independently to improve transparency and liquidity, thereby lowering municipal borrowing costs.

The Model for CommonMuni

CommonMuni was inspired by Commonfund. To address low returns on small college endowments, the Ford Foundation set up the Common Fund for Nonprofit Organizations (since renamed Commonfund) in 1971 with a $2.8 million grant (approximately $15.5 million in today's dollars, adjusted for inflation). The Commonfund allowed small colleges access to high-quality investment management, independent advice, and financial sophistication that they otherwise would have had difficulty accessing. There were sixty-two members of the Common Fund when it was started in 1971. Today, Commonfund serves approximately 1,500 universities, colleges, foundations, and other nonprofit organizations and manages more than $25 billion. Membership across college endowments includes the very largest institutions down to the very smallest. Commonfund demonstrates the potential of a number of institutions banding together to take advantage of investment opportunities and advice not affordable for a single institution. Although Commonfund was designed to fix a different problem, there are similarities between the problems that small- and medium-size universities faced in the 1960s and the problems many municipalities face now. The striking success of Commonfund suggests that CommonMuni can have a similarly large impact if organized, funded, and staffed properly.

Putting CommonMuni Into Action

The basic idea behind CommonMuni is relatively simple: create an independent organization that can provide high-quality, unbiased advice to municipalities when they borrow money while publicly disseminating information about the municipal bond market. In practice, however, setting up the organization, attracting staff, and gaining buy-in from municipalities across the country will involve many challenges.

CommonMuni's design would closely follow the successful model of Commonfund. CommonMuni would be established as a 501(c)(3) nonprofit and would be managed by a board of directors comprising leaders in government, academia, and the private sector who have expertise in municipal finance.

The striking success of Commonfund suggests that CommonMuni can have a similarly large impact if organized, funded and staffed properly.

Key Highlights

Ang and Green propose the creation of CommonMuni, an independent nonprofit organization initially funded by private grants that would improve the efficiency of the municipal bond market.

The Proposal

Provide individualized advice and establish best practices. CommonMuni would provide individualized advice to municipalities on the selection and structure of financial products, appropriate use of derivatives, and other high-fee or costly practices to help minimize issue costs.

Gather and disseminate information. CommonMuni would compile and release user-friendly information on all participating municipalities that is easily comparable. Additionally, CommonMuni would work with market participants to (1) increase access to information by encouraging timely dissemination of financial information, (2) improve accounting rules, (3) improve the transparency of issuing costs, (4) promote more-uniform creditor rights, and (5) advocate for more robust investor protection.

Coordinate market participants to enhance liquidity. CommonMuni would work with market participants to enhance liquidity by (1) recommending the issue of standardized, plain vanilla bonds, (2) pooling, (3) helping create clearinghouses for municipal bonds, and (4) helping to expand the market for municipal bonds.

Benefits

CommonMuni has the potential to lower borrowing costs for states and municipalities by promoting best practices through individualized advice, enhancing liquidity, and improving the access and dissemination of information. Individual investors also would benefit through improved information on their bond holdings and reduced risk of illiquidity.

Initially, this board of directors would be appointed by the funding organizations, but eventually directors would be appointed by CommonMuni member municipalities. Funding would come exclusively from private grants or private donations from parties that do not participate in this market, because government or corporate funding could create conflicts of interest and complicate CommonMuni's mission. To begin operations, CommonMuni would need $25 million in seed money; this would be used to hire and maintain a highly qualified and well-compensated staff that could advise municipalities and gather and disseminate information on the municipal bond market. Over time, CommonMuni would become financially independent by charging municipalities market rates for advisory services.

After incorporation and hiring a staff, CommonMuni would begin attracting an initial set of client municipalities. As discussed above, it is very difficult for any one municipality to break away from the status quo; consequently, many municipalities would initially be hesitant to join CommonMuni. To alleviate this problem, CommonMuni could partner with state treasurers' associations around the United States to solicit volunteers for the initial launch of CommonMuni. Working with these large organizations would help CommonMuni get buy-in from municipalities and also promote reforms and best practices that would improve transparency and liquidity, thereby lowering borrowing costs.

Questions and Concerns

1. Who benefits from CommonMuni?

Municipal borrowers, investors, and taxpayers would all benefit. Reducing information and illiquidity risk premiums can be a net benefit to taxpayers, local and state governments, and investors. These benefits will show up in lower borrowing costs for states and municipalities as well as reduced prices paid for municipal bonds by investors. Taxpayers will benefit from the increased investment and decreased budget pressures resulting from lower state and local borrowing costs.

2. How would CommonMuni get states and municipal governments to initially join?

CommonMuni would work with organizations of county treasurers to establish relationships with different municipalities and develop leads for municipalities interested in participating. CommonMuni would recruit a high-quality staff with signficant experience and expertise in the municipal bond market. Importantly, the staff would follow the highest ethical standards in an effort to provide independent, objective advice. This high-quality staff, combined with CommonMuni's outreach efforts, would allow CommonMuni to quickly attract municpalities and build its clientele and reach. As CommonMuni's reputation grows and municipalities see the benefits of coordination, an increasing number of municpalities would join to access CommonMuni's pooled resources and information.

Conclusion

State and municipal governments raise funds for large up-front investments with long-term benefits through the municipal bond market. However, many state and municipal governments incur high borrowing costs because of illiquidity, insufficient transparency, and lack of knowledge on best practices in the municipal bond market. The authors propose the establishment of CommonMuni, a nonprofit, independent organization that would provide individualized advice to municipalities, gather and disseminate information, and coordinate market participants to enhance liquidity. CommonMuni has the potential to enhance the liquidity and transparency of the municipal bond market while providing municipal borrowers with access to high-quality, independent advice. These changes have the potential to transform the municipal bond market, lowering borrowing costs for municipalities, improving returns, and reducing risks for investors. Importantly, CommonMuni could be started for roughly $25 million, or just a tiny fraction of the potential benefits.

Learn More About This Proposal

This policy brief is based on The Hamilton Project discussion paper, Lowering Borrowing Costs for States and Municipalities Through CommonMuni, which was authored by:

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Additional Hamilton Project Proposals

Public-Private Partnerships to Revamp U.S. Infrastructure

Public-private partnerships are often touted as a "best-of-both-worlds" alternative to public provision and privatization. But in practice, they have been dogged by contract design problems, waste, and unrealistic expectations. This paper proposes a series of best practices that communities can undertake to ensure that public-private partnerships provide public value. These include choosing partnerships for the right reasons; relying on flexible-term Present-Value-of-Revenue (PVR) contracts; including partnerships on government balance sheets; and implementing good governance practices. Enacting these reforms will help maximize taxpayer value and reduce risks for each party involved in a public-private partnership.

Fix It First, Expand It Second, Reward It Third: A New Strategy for America's Highways

The roads and bridges that make up our nation's highway infrastructure are in disrepair as a result of insufficient maintenance that increases travel times, damages vehicles, and can lead to accidents that cause injuries or even fatalities. This paper proposes a reorganization of our national highway infrastructure priorities to "Fix It First, Expand It Second, and Reward It Third." Revenues from the existing federal gasoline tax would be devoted to preserve, maintain and enhance existing infrastructure; funding to build new and expand existing roads would come from a newly created Federal Highway Bank; and projects that meet or exceed projected benefits would receive an interest rate subsidy from a Highway Performance Fund.

The Hamilton Project seeks to advance America's promise of opportunity, prosperity, and growth. The Project's economic strategy reflects a judgment that long-term prosperity is best achieved by making economic growth broad-based, by enhancing individual economic security, and by embracing a role for effective government in making needed public investments. Our strategy—strikingly different from the theories driving economic policy in recent years—calls for fiscal discipline and for increased public investment in key growth-enhancing areas. The Project will put forward innovative policy ideas from leading economic thinkers throughout the United States—ideas based on experience and evidence, not ideology and doctrine—to introduce new, sometimes controversial, policy options into the national debate with the goal of improving our country's economic policy.

The Project is named after Alexander Hamilton, the nation's first treasury secretary, who laid the foundation for the modern American economy. Consistent with the guiding principles of the Project, Hamilton stood for sound fiscal policy, believed that broad-based opportunity for advancement would drive American economic growth, and recognized that "prudent aids and encouragements on the part of government" are necessary to enhance and guide market forces.

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