Political Conditions Cited as Key Factors
Affecting State Default Risk, New Study Finds
*Report links public sector unions and legislatures’ political makeup to debt crisis*

**CAMBRIDGE, MA** – A new study released today by researchers at Harvard’s Program on Education Policy and Governance (PEPG) at the Harvard Kennedy School reveals that a state’s perceived risk of default on its bonds is associated not only with economic conditions within the state but also two key political factors: 1) the degree of public-sector unionization in that state, and 2) the percentage of the membership of the state’s legislature that is Democratic.

The study, co-authored by PEPG researchers Daniel Nadler and Sounman Hong, finds that these political factors remain significant after taking into account a state’s unemployment rate, growth in a state’s Gross Domestic Product (GDP), and the state deficit to the state GDP ratio. “Separate and apart from economic considerations, bondholders see additional risks when they view the political situation within a state as unfavorable toward budget reform,” Nadler said.

The study examined the change in the default risk of the 20 economically largest states in the U.S. between June of 2008—several months prior to the major seizure of global credit markets—and June of 2009, immediately after the National Bureau of Economic Research announced the end of the recession. The study used Bloomberg’s *State General Obligation Municipal Yield Curve Data*¹—a market-based measure of state bond yields widely used by market participants; it examined the daily closing price in basis points of the one, five, and ten year bonds for every trading day since June of 2008.

The study found that variation in state expenditures on Medicaid were not significantly associated with an increase in perceived default risk.

According to the study, a 20 percentage point difference in the share of the public-sector workforce that is unionized is associated with an additional increase in state borrowing costs of 40.4 basis points, for every billion dollars of unexpected deficit shock that the state experienced in the wake of the 2008 financial crisis. Similarly, for every billion dollar change in unexpected deficit shock that a state experienced after the crisis, a 20 percentage point increase in the Democratic share of the state legislature was associated with an additional 60 basis point increase in state borrowing costs.

“The cost to the state taxpayer of that difference in either unionization or political composition is, roughly speaking, about one half of one percent on a five-year security note,” Nadler said. “That amount is non-trivial. In Illinois, a one-half percent increase in the yield spread on its state and municipal debt of $145.5 billion amounts to $727 million dollars in additional interest costs annually.”

¹ Bloomberg’s state municipal curves are constructed with G.O. bonds that are issued by the state, as well as municipalities that are within the state, so long as they have the same average rating as the state General Obligation Bonds.
Unexpected fiscal shocks, the authors observe, “tend to widen interstate differentials in the state and municipal bond market and increase the yield spreads of state bonds over safer U.S. Treasury counterparts. In this context, bondholders become highly sensitive to a state’s perceived political capacity to take actions needed to bring budget deficits under control.”

Nadler observes that S&P and the other credit rating agencies have already indicated that after the U.S. credit downgrade, dozens of states and thousands of municipalities will now see their own ratings cut, raising municipal borrowing costs. As of today, S&P had already begun downgrading multiple U.S. municipalities. In commenting on recent developments, Nadler noted that new state laws that place bondholders ahead of pensioners and other creditors, such as the ones recently proposed in Central Falls, Rhode Island—the second U.S. municipality to seek Chapter 9 protection this year—are likely a harbinger of the kinds of measures states and municipalities may need to take in order to keep bond rates from rising. “But political factors may prevent governments from taking the tough decisions necessary to guarantee bondholder investments,” he points out.


About the Authors
Daniel J. Nadler and Sounman Hong are research fellows at the Program on Education Policy and Governance at Harvard University. The authors are available for interviews.

About PEPG
The Program on Education Policy and Governance (PEPG) was established in 1996 with the a mission to provide high-level scientific training for young scholars who can make independent contributions to scholarly research, foster a national community of reform-minded scientific researchers, and produce path-breaking studies that provide a scientific basis for reform policy. PEPG is co-sponsored by the Taubman Center for State and Local Government at the Kennedy School of Government and the Department of Government in Harvard University's Faculty of Arts and Sciences

For more information please visit: www.hks.harvard.edu/pepg/  

###