Bond Case Briefs

Municipal Finance Law Since 1971

Cato: Bonds Are Taxes.

On Nov. 8, voters where I live in Fairfax, Va., will be asked to approve general obligation bonds to finance subway maintenance, park renovations, and other run-of-the-mill local spending. There will be hundreds of similar questions on ballots across the country to issue billions of dollars in new debt.

Voters typically approve state and local bonds by large margins. Bond Buyer data show that bond approval rates in presidential election years have been more than 80 percent. Apparently, voters think that there are prudent and practical reasons for governments to issue general obligation bonds. But there usually aren't.

Using debt allows politicians to claim credit for spending while evading responsibility for the resulting higher taxes, which hit citizens down the road. By putting bonds on the ballot, politicians are really asking voters to hike taxes, to enrich finance industry middlemen, and to make government budgets more complex and opaque.

State and local governments issue bonds to finance infrastructure, such as schools. The interest and principal on bonds is paid back over time from taxes. The states have been issuing debt for infrastructure since at least 1818, when New York floated bonds to finance the Erie Canal.

However, debt is not the only way to pay for investments. Indeed, much of state and local infrastructure is financed on a pay-as-you-go basis. Under that approach, governments construct needed facilities in sequence over time with a portion of annual revenues.

Pay-as-you-go financing is more transparent and less risky than debt financing. The Erie Canal was a success, but it spurred many other states to borrow heavily and spend lavishly on their own, more dubious, canal schemes. Politicians at the time overestimated the demand for canals and underestimated the costs. As a result, most state-sponsored canals turned out to be money-losing failures that damaged state finances.

Those debt-financed failures led to sweeping budget reforms. Nineteen states imposed constitutional limits on government debt issuance between 1840 and 1855, and other states followed in later years. Reformers recognized that political incentives to spend combined with easy access to money is a combustible combination. In recent years, we've seen places such as Greece, Puerto Rico, and Detroit burn their fiscal houses down from their debt-fueled spending.

Today, all state governments operate within statutory and/or state constitutional limits on debt. But voters should be asking their governments why they need to borrow at all. Why can't they plan ahead for the schools and parks that are needed, and allocate a portion of ongoing tax revenues for construction and renovation?

Debt financing costs more than pay-as-you-go financing because of the interest payments, but also because governments pay fees to the municipal bond industry. Thousands of high-paid underwriters, traders, advisors, bond insurers, and other finance experts are the overhead costs of bond financing. That means billions of dollars a year of taxpayer money going to Wall Street, not to schools and parks.

A further cost of state and local debt is corruption. The municipal bond industry has been plagued by scandals related to political influence. If you Google “muni bonds” and “pay-to-play,” you find story after story about finance firms using campaign contributions and other payments to win bond business from government officials.

Debt financing also makes budgeting less transparent to citizens, especially given the complex ways that governments borrow these days. Also, citizens have less appreciation for the costs of government projects if they do not feel the bite of current taxes to pay for them.

Total state and local government debt now totals more than $3 trillion. While some states such as New York are heavily indebted, other states such as Idaho issue very little debt and finance their capital expenditures primarily on a pay-as-you-go basis.

It is true that for particularly large capital projects, general obligation debt may be appropriate in some cases. But if you have bonds on the Nov. 8 ballot where you live, they are probably for routine spending that should be funded by ongoing tax revenues. Next door to Fairfax is Arlington, Va. It has bonds on the ballot next week to fund street paving, park maintenance, playground improvements, school renovations, and similar sorts of projects.

Bonds don’t magically make these spending projects free. Instead, the projects will end up costing taxpayers more than they should have because of the debt servicing costs.

I benefit from local parks and schools, but I always vote “no” on bond questions.

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