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The Cost Burden of Negotiated Sales Restrictions: A Natural Experiment Using Heterogeneous State Laws.

Each year, states and municipalities in the U.S. issue approximately $400 billion of municipal bonds (about 40% of the corporate bond issue volume). States and municipalities issue bonds either through negotiated sales or through competitive sales. In a negotiated sale, the issuer sells the bonds directly to the underwriter without previous public bidding by the underwriters. In a competitive sale, the issuer requests the underwriters to submit a firm offer to purchase the bonds, and the issuer awards the new issue to the underwriter providing the lowest interest rate cost. Many states have laws restricting bond issuers to use only competitive sales for new municipal bond issues.

In this paper we use the legal restrictions on issue choice to directly answer several policy questions. Should legislation restrict the negotiated sale of bonds? What are the costs of such restrictions? Such questions avoid the choice problem because municipal issuers must abide by the legal restrictions on the method of sale. If there is no choice involved, there is no estimation bias. The municipal bond market is a valuable empirical setting to study many economic problems because of the many natural experiments from the heterogeneity in bond laws and the laws' frequent changes.

The classification of a bond's statutory security that we developed is parsimonious by construction. It is likely that it is also scalable given that it already includes a number of bond types issued under the several chapters and sections of the statutes of 40 states. We also show evidence that it is informative: Despite including bond ratings covariates, the security parameters are statistically significant and economically meaningful in every regression. Nevertheless, we do not test whether they capture all the relevant information of the statutory security of bond. We recommend that future research use this classification when seeking a sample of comparable bonds, regardless of the policy question being addressed.

Special laws allowing negotiated sales for specific purposes in states where negotiated sales are restricted, are usually accompanied by statutory maximum terms of ten years. We recommend that future legislation include additional purposes in these special laws. It is also optimal to increase the maximum maturity to twenty years. It might be optimal to increase them above twenty years, or even eliminate the negotiated sales restrictions altogether. In designing these extensions, the policy maker must take into account the trade-off between lower yields and higher gross spreads of the restrictions for maturities above 20 years.

Read the full paper here.

The Brooking Institute

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