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Who Labels and What's Priced? Evidence from Third-Party ESG Assessments in the Municipal Bond Market - Brookings

Abstract

We study the supply and pricing dynamics for ESG labels using a novel and unexpected third-party assessment of environmental, social, and governance (ESG) characteristics for over \$1 trillion in municipal bonds. We show that most eligible bonds are issued without ESG labels and that local beliefs and issuance terms discourage labeling. Using a difference-in-differences design in combination with these assessments, we provide within-bond evidence that reducing ESG-related uncertainty increases investors' willingness to pay. We find a 3-4 basis point premium for assessed bonds, even those with average ESG scores (i.e., ineligible for ESG labels) - which we call an assessment effect. The premium for higher environmental or transparency scores is smaller but significant. These pricing effects are consistent across local characteristics, but are much larger for revenue bonds with material credit risk. Our evidence highlights the general relevance of ESG information in assessing credit risk and a mismatch between its supply and investor demand.

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Authors: Daniel Garrett (University of Pennsylvania Wharton School), Brian Gibbons (Oregon State University), and Mahdi Shahrabi (University of Pennsylvania)

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