Discussion of “Fooling the Market? Municipal Yields and Unfunded State Pension Liabilities”

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The paper...

• Explains state-level muni yields by
  • Federal/Treasury bond yields
  • Explicit debt level (EDR)
  • Implicit debt level (IDR)
  • Funding ratio of state pension funds

• Finds that muni yields are positively related to IDR
  • Yield effect of $1 unfunded pension liability is comparable to that of explicit debt (debt-to-GSP)
The paper...

- Finds that the financial health of the pension system is priced in the muni yields based on:
  - Panel of US states
  - 2001-2014
  - With yearly state pension plan data
  - Bond index data
Comments (1)

• Writing
  • With some polishing of the writing, this will be a great paper!
  • Add more institutional background information
    • US pension system and importance of state funds
    • Further discuss the reasons of unfundedness and make a point whether these are captured by the state fixed effects
    • Are there regulatory changes in the time period?
  • Make the data description and methodology clearer
    • Explain composition of indices and notation – what is index ‘i’ for the Treasury yield? And for states?
    • Do we have a cross-section of muni and treasury yields or are these single indices?
Comments (2)

• Assumptions for the panel analysis
  1. Using market rate for discounting of pension liabilities:
     • By using an identical discount rate, you implicitly assume that the credit quality of states is the same.
     • It is a strong assumption, especially given the sample period. This is not likely not captured by the state FE
     • In muni-pricing the creditworthiness of the states will play an important role... maybe better to use a direct proxy thereof, not EDR, such as the credit rating of each state (S&P or other)
Comments (2)

• Assumptions for the panel analysis
  1. Using market rate for discounting of pension liabilities
  2. Liability duration is the same across all states
     • Average age and life expectancy varies across states
     • E.g. Bureau of Labor Statistics or Measure of America have mortality and data
     • Would this change over time so that the FE does not capture it?
• Other comments
  • Are there muni bonds that are issued for funding pensions? If so, pricing of those would be really interesting to look at.
  • Is there a differences between states with more funds (currently aggregated to an average fund) as opposed to states with a single state plan? This could have an effect on the muni yields.
• Other risks that are ignored in the pricing of muni debt
  • Interest rate risk/default risk/liquidity risk/callability of muni bonds/et.
  • These are most likely time-varying, thus not captured by FE
  • I would love to see if the effect of EDR and IDR survive controls of the risks that could explain the spread on Treasuries
Overall

• This is a nice paper!

• Finding is interesting and the policy implication is non negligible

• Additional analysis, mostly relaxing some of the assumptions, e.g. on default risk of states, would allow to further explore the effect of IDR