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 a 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 ot 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?

Comments (3)

- 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