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# The political economy of local government financialization and the role of policy diffusion

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## Abstract

By analyzing why English local governments have made extensive use of long-term market loans with embedded derivatives, this paper seeks to contribute to the growing literature on local government financialization. Using an original, large-N panel dataset for the period from 1998 to 2014, we show that the configuration of the local political economy is an important driver of financialization processes: a Labour Party majority as well as fiscal and economic stress make it more likely that councils adopt risky financial instruments. As the use of financial innovations has also diffused geographically, policy diffusion impacts local governments as well. Highlighting the conditional effect of finance sector power, which only increases the use of financial innovations in very large councils, as well as the temporal dimension of fiscal and economic stress, we create ample avenues for further research.

**Keywords:** diffusion, finance power, financialization, local governments, partisan politics.

## 1. Introduction

Since 1998, almost 50 percent of English local governments borrowed through so-called “lender option borrower option” (Lobo) loans with embedded derivatives, essentially betting on rising long-term interest rates. When interest rates were unexpectedly falling to a historic low, however, councils were confronted with massive losses of tax payer money and subsequently faced public outrage, central government inquiries, and lawsuits that are currently being filed (Financial Times 2016; Guardian 2016, 2019). Consequently, the puzzle is why public officials used risk-prone market loans and not the more conservative option of Public Works Loan Board (PWLB) loans with fixed rates and higher planning security.<sup>1</sup> Hence, this paper investigates which factors increased the likelihood of local governments taking out Lobo loans. More generally, as the use of derivatives indicates local government financialization, we ask: what drives the financialization of the state at the subnational level?

In political science, the phenomenon of financialization has received ever-growing attention during the last decade (e.g. van der Zwan 2014; Rommerskirchen 2015; Mandelkern 2016; Witko 2016; Maxfield *et al.* 2017). Broadly defined as the “increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies” (Epstein 2005, p. 3), scholars have focused mainly on the economy as a whole, corporations, and households. The financialization of states, in comparison, is less researched (van der Zwan 2014; Hendrikse & Lagna 2018; Karwowski & Centurion-Vicencio 2018). Only very recently have scholars started to conceptualize and describe the process on the national (Lagna 2016; Fastenrath *et al.* 2017; Trampusch 2019) and the subnational levels (Pacewicz 2013; Hendrikse & Sidaway 2014; Hendrikse 2015; Lagna 2015; Kirkpatrick 2016; Fastenrath *et al.* 2018). In the studies on (local) state financialization, the adoption of derivatives-based financial innovations by public officials has been identified as a crucial dimension of the process.

Despite the achievements of the previous studies, three major gaps still exist: first, the role of party politics remains largely unclear, as Witko (2016), p. 349 highlights, for the financialization literature in general. Second, due to the dominance of case study research, we still lack a systematic quantitative analysis differentiating and testing crucial local political economic factors that may drive financialization, such as financial industry power

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and fiscal or economic stress. In fact, previous descriptive case studies on single municipalities in the United States or Germany have demonstrated the major importance of financial industry interests and economic and fiscal stress in driving the process (Weber 2010; Pacewicz 2013; Hendrikse & Sidaway 2014; Kirkpatrick 2016; Fastenrath *et al.* 2018) but have not systematically quantified the effects of these different aspects of the local political economy across cases. Third, considering the literature on the diffusion of financial innovations (e.g. Molyneux & Shamroukh 1996; Tufano 2003; Akhavein *et al.* 2005) and policies (Berry & Berry 1990; Volden 2006; Shipan & Volden 2008; Gilardi 2016), we know that new financial products or policies are not adopted in a vacuum. Public officials are influenced by policy decisions in other governments, which previous case studies on the use of derivatives by local governments in Germany have also indicated (Hendrikse & Sidaway 2014; Hendrikse 2015; Fastenrath *et al.* 2018).

In order to fill these gaps, based on a newly constructed comprehensive panel dataset including all 353 local governments in England for the period 1998–2014, we test both internal (i.e. the effect of the local political economy) and external (policy diffusion) influences on local government financialization across cases and time. To this end, we collected data for 5,648 unit-year observations with a wide range of variables and ran event history models to understand the dynamic evolution of financialization. Furthermore, to improve our understanding of the dynamics of local authorities' debt policies and interpret our statistical findings, we conducted expert interviews with representatives of investment banks, treasury management advisers, and local authorities.<sup>2</sup>

Our results indicate that partisan politics did play an important role in facilitating the use of financialized borrowing instruments in English councils, highlighting the importance of Labour-dominated councils in driving local government financialization. Next, our results illustrate that both fiscal and economic stress are crucial for understanding financialization processes; however, we find that both interact differently with time. Against our expectations, finance power is actually negatively associated with the use of derivatives in smaller councils and only becomes significantly positive for very large local governments. These complex conditional effects imply that further case study research is indispensable to investigate the causal processes of these local political economic impacts. Finally, our analysis shows that financial innovations diffuse geographically across English local governments.

There are several reasons why the recent spread of Lobo loans among English local authorities is a useful case for generating theoretical contributions: On the one hand, together with the United States, the United Kingdom counts as a benchmark for other countries not only with regard to the power of its financial industry (Culpepper & Reinke 2014; Bell & Hindmoor 2017) but also regarding its degree of economic financialization (Maxfield *et al.* 2017). It remains unclear whether the United Kingdom also constitutes a reference category with respect to state financialization; in addition, English local governments have a tradition of capital market funding because of local authorities' strategy to circumvent central controls through private funding in the money and capital market (Sbragia 1986). This historical trajectory leads us to expect that internal political-economic factors, such as the power and interests of finance, are important drivers of Lobo borrowing. On the other hand, Lobo loans are complex financial instruments whose outcomes are highly sensitive to shifts in market rates and cannot be calculated in advance. According to Makse & Volden (2011, p. 109) and Karch *et al.* (2016, p. 89), complex policies are less likely to be adopted or diffuse across geographical units due to uncertainty about their potential costs and benefits. Thus, any finding of significant effects of policy diffusion on the use of Lobos would indicate that understanding the process of state financialization requires the study of external factors.

The paper is structured as follows: after we describe the structure of Lobo loans and their use by English authorities, we explain our theoretical framework in the third section. The fourth section presents the data and method, followed by our results. In section six, we conclude and present the implications for further research.

## 2. The structure and use of Lobo loans

Until the end of the 1990s, English municipalities possessed little autonomy in their financial policies as local government investments required central government approval, and borrowing limits were set. This changed in the early 2000s, with the push by New Labour to modernize local government finance. Most prominently, the Local Growth Agenda (2003) initiated a great devolutionary reform aimed at giving local officials more freedom in their financing decisions. Equipped with newly gained financial powers and pressured by the central government's austerity policy, municipalities increasingly financed their borrowing through the use of Lobo loans (INT 1, 2, 4).

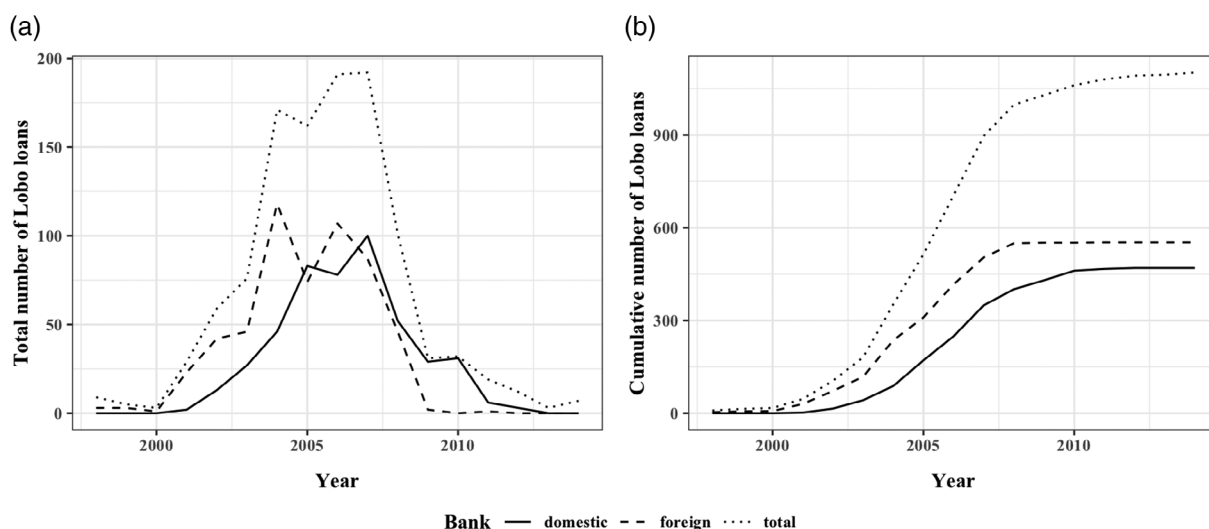
In more detail, Lobo loans can be described as complex financial borrowing instruments containing embedded derivatives, issued with an average lifespan of 40–70 years. Therein, the lending bank has the option to adjust the interest rate charged at predetermined intervals (e.g. 6-month, annually, or on a 5-year basis). If the bank changes the interest rate, the borrower has to accept it or repay the loan in full at current market rates. However, if the borrower chooses to repay the loan early, there is an additional penalty specified in the loan contract (CIPFA 2015). Another crucial aspect of the structure of most Lobo loans is the often very low starting interest rate – a so-called “teaser rate”. These low rates (set for the starting period of 1 or 2 years) are typically well below the standard PWLB interest rates and generate cheaper income on a short-term basis.

Most significantly, Lobo and PWLB loans differ in their degree of embedded risk. In taking out Lobo loans, local authorities were betting on long-term interest rate development. Only if base interest rates rose would local governments have been better off than with standard PWLB loans. However, as interest rates have instead fallen to historic lows, many local authorities now face much higher repayment costs (due to the embedded derivatives) than they would have done with public loans (Financial Times 2016; Guardian 2016; INT 3). Combined with the lender option to increase interest rates periodically and high exit fees, the embedded risk (reinforced by the derivative) in the loan structure is much higher than in standard fixed-rate PWLB loans (INT 4). In sum, Lobo loans represent a highly financialized way of borrowing due to embedded derivatives – that is, the banks’ option to convert fixed into floating interest rates.

Figure 1 illustrates the number of Lobo loans taken out by English local authorities from 1998 to 2014, both in total (1a) and cumulatively (1b). Of 353 local authorities in England, 155 took out Lobo loans at least once, totaling a net worth of £10.6 billion.<sup>3</sup> It is important to note that it were not domestic but foreign banks who started selling Lobo loans in the late 1990s and early 2000s, while domestic banks only started to catch up by 2005. The fact that foreign banks also outperformed domestic banks in the total volume of loans made to local governments indicates the global dimension of local government financialization in England. While Lobo loans were increasingly taken up by local governments prior to 2007, the sharp decrease in new loan contracts after 2007 can best be explained by the turbulence at the beginning of the financial crisis and the corresponding drop in interest rates. As interest rates were expected to continually decrease, Lobo loans were no longer attractive to local governments or to banks. As no new Lobo loans were taken up after 2014, we can observe the entire process of diffusion.

### 3. The financialization of local governments

As we suspect that the financialization of local governments is driven by the configuration of the local political economy, as well as public officials’ orientation toward policymaking in other local governments, we refer to the



**Figure 1** (a) Total number of Lobo loans sold to English local governments by year and bank; (b) cumulative number of Lobo loans taken up. Source: own illustration.

established literature on business power and partisan politics in general, as well as in state financialization, supplemented with the literature on the diffusion of policies and financial innovations.

### 3.1. Partisan politics

In accordance with classical partisan politics models, we argue that the setup of the local political landscape can be of major importance for explaining variation in the use of financial innovations by English local governments. Building on the seminal work by Hibbs (1977), it could be assumed that the partisan composition of local governments influences economic policy as parties cater to the interests of their particular electoral constituencies. As several studies at the central government level have shown, the influence of different party ideologies – along the left–right scale – plays a crucial role on policy decisions in the high-priority field of economic (fiscal and tax) policy (Cusack 1997, 1999; Bräuninger 2005; Cusack & Beramendi 2006). While a consensus emerged in the 1990s that the partisan effects became less pronounced, there exists a growing literature which shows that parties matter for economic and fiscal policymaking on the subnational level (Blom-Hansen *et al.* 2006; Boyne *et al.* 2012; Kleider *et al.* 2017).

Based on these studies, we expect that the left–right composition of English local governments translates into policy decisions on the use of financial innovations. In line with the conventional parties' left–right differentiation, we assume that Labour-dominated councils have greater incentives to increase the local authorities' revenues because, as a left-wing party, they are more willing to follow the "voters' demands for service provision" (Boyne *et al.* 2012, pp. 642–643; see also Blom-Hansen *et al.* 2006), even if this requires the use of complex financial instruments (Tickell 1998). Thus, we argue that Labour councilors prefer revenue increases through financial risk-taking to secure the services level for their core voter clientele. Accordingly, in his study on the use of derivatives (interest rate swaps) by English local authorities in the 1980s, Tickell (1998) points out that it was, above all, Labour-dominated local governments that attempted to circumvent fiscal austerity measures imposed by the central government through the use of speculative financial innovations. In this regard, it is also noteworthy that, in the early 1990, when the Hammersmith-Fulham scandal on the speculative ultra-vires use of interest rate swaps by local authorities blew up, the prominent Labour MP Marjorie (Mo) Mowlam expressed her wish "to see legislation clarifying the legal powers of local authorities to be players in the swaps market" (BoE Archive 1990).

Our expectation to observe a Labour Party impact on financialized policy outputs is further strengthened by the party's transformation in the 1990s. The elected New Labour government coming into power in 1997 not only radically restructured local government finance but also wanted to establish a business-friendly image, even surpassing the efforts made by the preceding Conservative government (Wilks-Heeg 2009, p. 30). According to Fuller (2016, pp. 85–88), New Labour forcefully tried to incorporate the image of being business-friendly after its crushing defeat in the 1992 elections, leading to a large-scale ideological transformation, including the belief in limited government, financial innovations, and the encouragement of financial risks. Public officials in English local councils have traditionally been prone to a strong degree of intraparty group loyalty (Copus 1999; Kleider *et al.* 2017), and so, we assume that the ideological shift at the national level had a spill-over effect on local officials within the Labour party. Due to the "pro-finance, pro-innovation bent" of New Labour (Fuller 2016, p. 91), hypothesis H1 thus states:

**Hypothesis 1:** *Local authorities with councils dominated by the Labour Party have a higher propensity to use Lobo loans.*

### 3.2. Fiscal and economic stress

In addition to partisan politics, we assume that the degree of problem pressure faced by local officials has an impact on the likelihood of Lobo use – regardless of the party with the council majority. The relationship between fiscal stress (public debt) and the use of speculative financial innovations is well explored in the literature on state financialization (Hendrikse & Sidaway 2014; Lagna 2015; Kirkpatrick 2016; Fastenrath *et al.* 2018). Ever-increasing debt obligations – caused by declining aid from the central government, as well as tax revenues with a simultaneous increase in the municipal tasks delegated – strengthen the incentives for local officials to minimize interest payments through innovative financial instruments (Hendrikse & Sidaway 2014, p. 199; Hendrikse 2015;

Lagna 2015; Strickland 2013) or to shift repayment costs into the future as the “financial constraint is more likely to be currently binding and limit politicians’ actions” in highly indebted local governments (Pérignon & Vallée 2017, p. 1912). For many local governments, high fiscal pressure (high levels of indebtedness) often means that the political room for maneuver is considerably restricted by the following austerity measures and the resulting imperative of fiscal consolidation. Fastenrath *et al.* (2018) show that municipal representatives perceive financial innovations as a less politically costly means (no direct cuts) to regain a certain financial, and eventually political, leeway. In their studies on derivatives use by German and French municipalities, both Trampusch and Spies (2015) and Pérignon and Vallée (2017) demonstrate a significant positive relationship between the level of municipal debt and the use of innovative financial instruments. Hence, our second hypothesis reads:

**Hypothesis 2:** *The higher the level of local public debt, the higher the propensity of local councils to use Lobo loans.*

While public debt and economic deprivation might be entangled in practice, it still makes sense to analytically differentiate between fiscal and economic stress. As drivers of local government financialization, they indicate different actors’ motivations, that is, whether local governments use Lobo loans as an instrument of debt or economic policy. More specifically, while high levels of public debt might motivate politicians to use Lobo loans for restructuring their debt portfolios and decrease their overall interest rates, economic deprivation incentivizes local authorities to borrow money at favorable rates to invest in infrastructure projects. In general, economic deprivation describes the general economic conditions within local governments (Bertelli & John 2010). According to Hendrikse and Sidaway (2014, p. 198), it was not only public debt but also the demise of the local economy and rising levels of unemployment that exerted pressure on local governments to find “novel ways to raise revenue”, eventually leading to the use of derivatives. In addition, Strickland (2013, p. 389) describes the use of derivatives explicitly as a means of paying and investing in infrastructure to generate growth. Thus, it can be assumed that worse economic conditions put pressure on local councilors to use risky financial instruments to raise additional money for investments and public infrastructure projects to stimulate the local economy.

**Hypothesis 3:** *The higher the economic deprivation in a local council, the higher the likelihood of the respective government to adopt Lobo loans.*

### 3.3. Local finance power

Previous research has shown that financial sector institutions are important actors in facilitating local government financialization (Pacewicz 2013; Hendrikse & Sidaway 2014; Kirkpatrick 2016). Hence, we assume that the structural and instrumental power of the local finance industry might be an important driver of the use of Lobo loans by local councils.<sup>4</sup> While *structural power* describes the dependency of governments on private business interests in their policymaking decisions, as business may automatically or strategically threaten to withdraw investments (Lindblom 1982; Hindmoor & McGeehan 2013; Culpepper 2015; Fairfield 2015), *instrumental power* comprises “the non-core functions of the firm on which business relies to attain a political edge, such as campaign donations and the use of lobbying” (Culpepper 2015, p. 396). In our case, both dimensions are relevant. While public officials are generally aware of the growing importance of the financial sector for generating growth and employment, there are also numerous events (e.g. receptions and other social activities) organized and financed by local financial market actors to which local councilors are invited, as well as the regularly observed phenomenon of public–private “revolving doors” in local authorities’ treasury management. Local officials develop the skills that enable them to “work as private money brokers”, and so, the phenomenon of revolving doors, that is, leaving to work in the financial sector, has always existed in English local governments (Sbragia 1986, pp. 318–319). In addition, Schwan (2017) has documented a considerable variation in the strength of the financial sector within different regions in the United Kingdom. Having more financial institutions close to the city hall doors might lead to more and more intense interactions between finance and local authority representatives. Being neighbors to local politicians makes it easier for bankers to advertise and supply new financial instruments. Consequently, the stronger the local financial sector in a municipality, the more likely it is that banks will use their instrumental

power to “persuade” politicians to use Lobo loans. In accordance with recent studies on finance power, we assume that structural and instrumental power can be mutually reinforcing (Hindmoor & McGeechan 2013; Fairfield 2015; James & Quaglia 2019). Hypothesis H4a proposes that the use of Lobo loans is likely to increase where the local financial sector is strong:

**Hypothesis 4a:** *The likelihood of local authorities using Lobo loans increases where the power of the local financial sector is strong.*

Furthermore, we consider that the effect of finance power is conditioned by the size of a local government. As local governments differ broadly on a range of relevant indicators such as the expertise of their officials and their level of public debt (Trampusch & Spies 2015), as well as their investment portfolios, development, and economic growth (Strickland 2013), we believe that the size of a local authority is likely to moderate the effect of financial sector power. Eckersley (2016, p. 5) argues that the “level of internal capacity” directs whether municipalities “look to private businesses to provide them with the ‘power to’ achieve their objectives”. The inability of smaller councils to hire more qualified personnel can especially create an “asymmetry of expertise” between smaller local governments and a financial counterpart (Culpepper 2011, p. 178). This is also argued by Tickell (1998, p. 877), who states – in his study on that the use of derivatives by English local authorities – a case of “major information asymmetries” between the selling financial institution and the buying local authority. As smaller councils often lack the financial expertise to understand more complex financial instruments, financial institutions might exploit situations of even greater information asymmetry and find it easier to sell unsound financial products. Moreover, smaller local authorities may also more likely approach banks because they recognize that “the use of consultants is necessary to access expert knowledge” (Weber & O’Neill-Kohl 2013, p. 12).

**Hypothesis 4b:** *In smaller local governments, the power of the financial sector has a stronger effect on the likelihood of Lobo loans being used.*

### 3.4. The diffusion of policies and financial innovations

We assume that it is not only the local political economy but also the behavior of other local authorities that push local governments to take out Lobo loans by exerting pressure to follow the trend. In line with Graham *et al.* (2013, p. 675), we argue that “policy innovation is influenced by choices made by other governments” and consequently use the literature on the diffusion of policies and financial innovations to explain the phenomenon of state financialization better.

Considering the characterization of financialization as a process that unfolds over time (Lee *et al.* 2009) and its coevolution with innovations in financial engineering (Buenza & Stark 2004; Pacewicz 2013, pp. 415–416), it makes sense to analyze state financialization as a process of diffusion. Innovation, in general, includes the element of invention and the diffusion or adoption of new products, services, or ideas (Rogers 2003; Tufano 2003, p. 311). While there is a large body of literature investigating the diffusion of financial innovations (see Molyneux & Shamroukh 1996; Tufano 2003; Akhavein *et al.* 2005), the analysis is restricted exclusively to financial institutions (e.g. banks or exchanges). In the present case, however, local government officials are pivotal in deciding which new type of loan is used by their respective municipal government. Therefore, we resort to another sub-branch of the literature on the diffusion of innovation – the literature on policy diffusion (see Berry & Berry 1990; Shipan & Volden 2008; Graham *et al.* 2013; Gilardi 2016; Karch *et al.* 2016; Maggetti & Gilardi 2016).

Because a meta-analysis by Maggetti and Gilardi (2016) demonstrated a considerable lack of coherence in the respective literature in measuring the different mechanisms (the same indicators are used for different mechanisms, and different indicators are used for the same mechanism), we refrain from claiming to test for a specific mechanism of diffusion but rather use geographical proximity as a general indicator thereof (Mooney 2001; Shipan & Volden 2008). It was popularized by Berry and Berry (1990), who argued that lottery adoptions have a higher probability in states where an immediate neighbor (i.e. a state with a common border) has already implemented a lottery. Some scholars argue that geographical proximity “can facilitate the development of communication networks through which policy-relevant information spreads” (Karch *et al.* 2016, p. 94; Mooney

2001). We assume that the same logic can be applied to the diffusion of financial innovations. In fact, there are various local authority associations in England where the officials can network and exchange ideas (Rhodes 2003, pp. 216–217). Not only do councilors and treasurers from different municipalities exchange ideas about the use of distinct financial instruments, but association meetings and conferences are also frequented and financed by bankers and others in the financial market to advertise the newest product (see Hendrikse & Sidaway 2014; Fastenrath *et al.* 2018). Hence, we expect that information regarding the use of Lobo loans is likely to diffuse across regional communication networks. Accordingly, we expect local governments to use experiences from their closest neighbors to decide on their own policies.

**Hypothesis 5:** *The likelihood that a local government will take out Lobo loans is positively related to the percentage of bordering municipalities that have used the same kind of loan.*

## 4. Data and method

### 4.1. Dependent variable

For our dependent variable – the use of Lobo loans by local governments – we resorted to the Freedom of Information Act (2000), which enables private persons to request any information held by public authorities in the United Kingdom. Using Freedom of Information requests, data were collected for the total number of Lobo loans taken up by each local authority, the date the loans were signed, the loan principal, the initial interest rate, and (if applicable) the step-up rate of the loans, as well as the name of the bank that sold the loan.<sup>5</sup> We gathered reliable information on the use of Lobo loans for all the 353 local authorities. As we run an event history analysis (EHA) with repeated events and time-varying covariates, which require each time period for an individual to appear as a separate observation, we collected the start and end times, as well as event occurrence (binary), for each interval (see Allison 2014, pp. 38–41).

### 4.2. Independent variables

Concerning the effects of partisan politics, we collected data for the categorical variable *party in office*, denoting the party with a majority in the respective local council. It differentiates between “Labour Party”, “Conservatives”, and “Other”, which includes Liberal Democrats, the Independent Party, or no overall control in a local council. Data were collected using the British Local Election Database (2015).

The variable *public debt* was measured as the ratio of total debt to population size. To collect local-level data on the levels of public debt, we purchased a dataset on capital expenditure and treasury management for all local governments in the United Kingdom (CIPFA). For the years 2008–2014, we cross-checked the data with those provided by the Department for Communities and Local Government in the United Kingdom (DCLG) to enhance the general quality of the dataset.<sup>6</sup>

Data for *economic deprivation* were collected from the Economic Deprivation Index (EDI) made available by the DCLG, comprising the two elements of income and employment deprivation. We use the population-weighted average ranks of the EDI to improve comparability across units and time.<sup>7</sup>

To test our fourth hypothesis about the effect of financial sector, we calculated the variable *finance power* as the share of the gross value added (GVA) of the financial sector of the total GVA of the local economy using data from the Office for National Statistics (ONS), which are provided on a yearly basis for the period 1998–2014. The variable is a proxy for the relative importance of the financial sector for the individual local economy. The greater the proportion of financial sector GVA, the more important it is for the local economy relative to other sectors and the more valuable is the sector for incumbent politicians (through employment, taxes, etc.). For the interaction effect, a local government's *population size* was measured as the logarithm of its total population in thousands of persons. Data were acquired from the ONS yearly population estimates.

To test hypothesis H5, we constructed a variable by counting the *number of bordering local governments* that had previously (*t-1*) used Lobo loans in relation to the total number of neighboring governments. Theoretically, row standardization makes sense as decisionmakers on the local level have only limited resources and hence less capacities to monitor a larger number of other local governments (Weyland 2006). Given their bounded



rationality, we use row standardization to decrease the relative influence of each unit with an increasing number of neighboring local governments (see Plümper & Neumayer 2010). The neighboring units were identified using polygon contiguities, that is, by identifying polygons sharing boundary points as neighbors. The necessary shape files were collected from the UK Data Service Census Data Set (2011). As additional robustness checks, we also identified second-order contiguity neighbors and used inverse distance matrices with a cut-off at 80 km.

#### 4.3. Control variables

We controlled for a number of variables that have been established in the literature of state financialization and policy diffusion.

First, we introduced the *number of previous adoptions* as a control variable in every model. According to Beck *et al.* (1998, p. 1272), it makes sense to account for the number of previous adoptions when using repeated event models (see next section) as the events following the first adoption cannot be considered to be independent of the former. This variable simply counts the number of previous event occurrences – that is, the number of Lobo loans each local government used up to the current year – in local governments.

Next, we controlled for the *type of local government*. The categorical variable differentiates between single-tier (unitary authorities, London boroughs, and metropolitan boroughs) and two-tier authorities (shire districts). As the different types share most responsibilities but differ in certain areas of providing public services, we include the distinction in the analysis to account for possible repercussions of type-specific effects.<sup>8</sup>

To control for the effect of election years, we incorporated *year of election* in our analysis. The literature generally assumes that politicians try to appeal to their electorate by smoothing their portfolios before elections to give the illusion of economic gains (Tufté 1978; Franzese 2002; Benton & Smith 2017). As the Lobo loans' teaser rates indicate a short-term reduction of interest payments in the very beginning, their use would be attractive to incumbent politicians, especially in election years. Hence, we controlled for *election year*, coded "1" if a local election was held in the given year and "0" if there was no election. Data were collected from the British Local Election Database (2015) and the Ministry of Housing, Communities & Local Government (2018).

#### 4.4. Method

To analyze the use of Lobo loans over time, we ran several models using EHA techniques. EHA focuses on the distribution of events over time and is widely used in the literature on the diffusion of innovation (Berry & Berry 1990; Shipan & Volden 2008; Karch *et al.* 2016), essentially estimating the "hazard rate" of event occurrence (i.e. the probability that a local government is at risk of taking out a Lobo loan at time  $t$ ). As we do not have strong assumptions about the effects of time on the baseline hazard, we used Cox proportional hazard models with time-varying covariates instead of its parametric alternatives (Box-Steffensmeier & Jones 2004; Allison 2014).

Many local authorities repeatedly took up Lobo loans, while others used the loans only once or twice. As each loan adoption can be considered to be a deliberate decision (each loan adoption has to be discussed and agreed upon by the Council), rather than an automatic extension of existing contracts, subjects were not dropped from the risk set after the first event had occurred. Because the observations become clustered and hence statistically dependent when multiple events occur for the same subject, we calculated robust standard errors within the Andersen-Gill modeling framework (Andersen & Gill 1982; Allison 2014, p. 70). The Andersen-Gill model assumes events to be independent given variance-corrected errors and the correct specification of time-dependent covariates. Hence, all models use robust standard errors, clustered by local authority. We corrected for non-proportional hazards with the inclusion of time interactions for variables in violation of the proportional hazard assumption (Box-Steffensmeier & Jones 2004; Licht 2011). In addition to the inclusion of the number of previous adoptions as the control variable (Beck *et al.* 1998), the calculation of robust standard errors, and the inclusion of time interactions, we also calculated conditional gap-time (PWP) models as suggested by Box-Steffensmeier and Zorn (2002). Finally, we estimated different parametric models (Weibull, Gompertz, lognormal, log-logistic, and exponential) and models with different variable operationalization and specifications as robustness checks.<sup>9</sup>

Given the complex structure of English local governments, we excluded all county councils from our main analysis because some of the covariates would not have been independent from each other (e.g. a county's

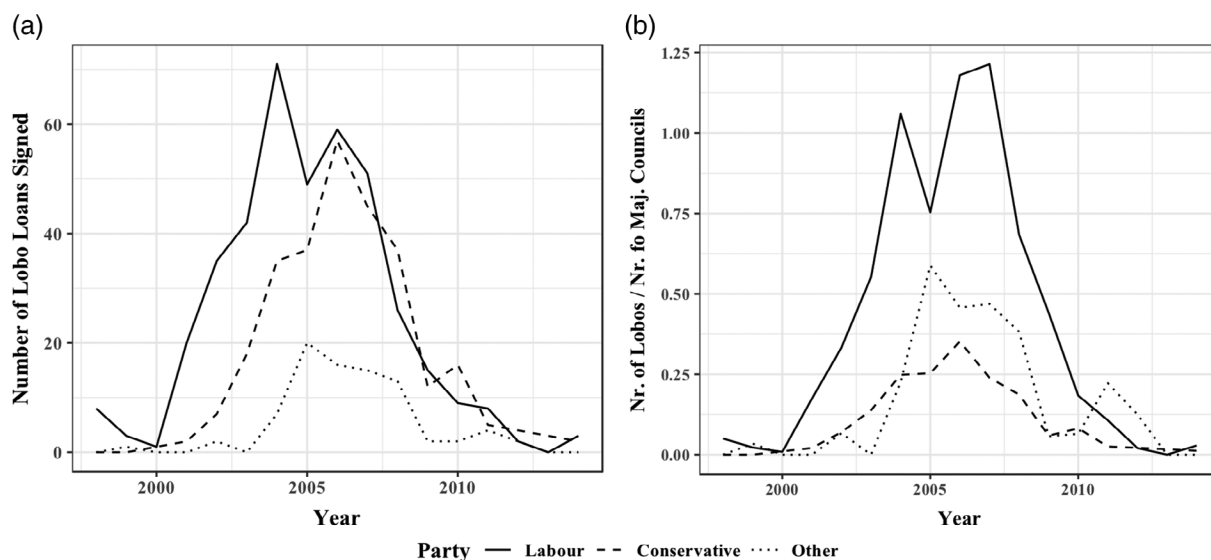
population size comprises the population size of the shire districts within its boundaries). To account for the remaining differences between single- and two-tier local authorities, we included the *type* variable in each model to control for the variation, explained simply by differences in the local governments' structural setup.

## 5. Findings

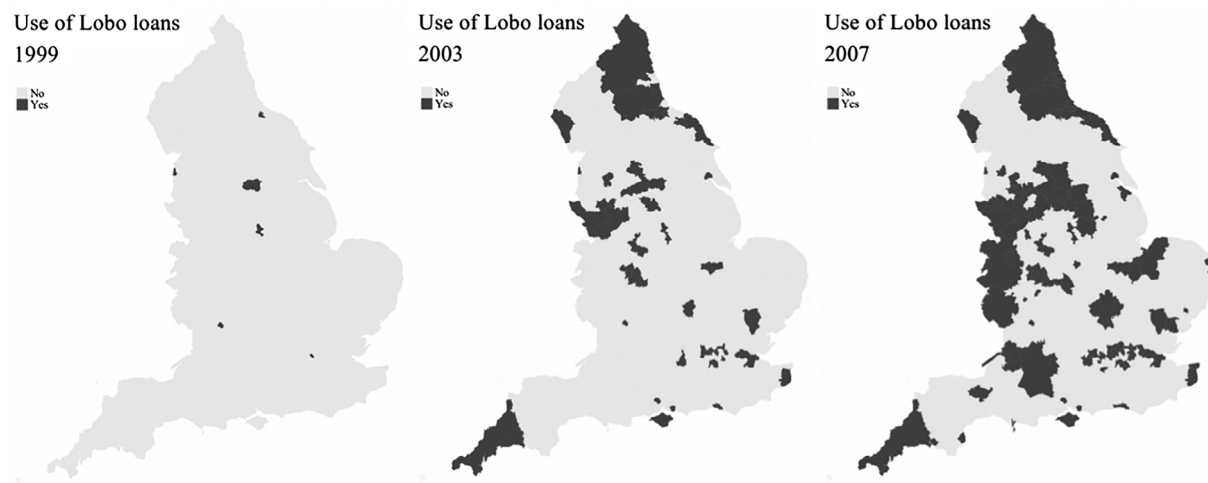
### 5.1. Descriptive statistics

We begin with a descriptive evaluation of our hypotheses. First, Figure 2a indicates that, as expected, Labour did indeed take out more Lobo loans compared to all other political parties. The biggest difference between Labour and Conservative can be observed in the early years of the diffusion process (2000–2002). Hence, Labour not only issued more loans in total but also started earlier, setting the trend for the local political parties that others followed. After 2007, the numbers are essentially indistinguishable for Labour and Conservative as adoption rates decreased at the same pace for both parties. Furthermore, Figure 2b shows that, in relation to the total number of local governments where the respective party had a council majority (hence, where the party actually had the ability to take out loans), Labour issued significantly more than the Conservative Party.<sup>10</sup>

With respect to the process of the geographical diffusion of Lobo loans taken by English local governments, Figure 3 shows the diffusion dynamics across space and time. It depicts the cumulative use of Lobo loans for all 335 local governments included in the analysis. In 1999, only six local governments signed Lobo loans, accounting for less than 2 percent of all English local authorities. However, the use of Lobo loans spread rapidly: 67 (20 percent) local authorities in 2003 and 141 local authorities (42 percent) in 2007 used them. By 2011, almost 50 percent of all local councils in England used the new financial product at least once. Next to the total proportion of adoptions, Figure 3 gives first insights relating to our hypothesis on the geographical diffusion of Lobo use. At first glance, several clusters of bordering local governments that used Lobo loans can be observed. They include the most northerly region around Northumberland and Newcastle upon Tyne, the western region around Liverpool and Manchester, and the area around London, as well as several smaller clusters across the whole country. Spatial regression techniques in the subsequent chapter will show whether the observed establishment of clusters can legitimately be described by a process of diffusion.



**Figure 2** (a) Total number of Lobo loans signed by party in office (1998–2014); (b) total number of Lobo loans signed by party in office divided by the total number of local governments where the party had the council majority. “Other” includes Liberal Democrats and Independent candidates. Source: own illustration.



**Figure 3** The geographical diffusion of Lobo loans across English municipalities (1999–2011). Source: own illustration.

## 6. Results and discussion

Our statistical results are shown in Table 1. Considering hypothesis H1, assuming a positive relationship between the Labour party being in office in a local government and the use of Lobo loans, we can observe a positive and statistically significant association of the respective coefficient. Substantively, compared to local council with a Conservative majority (the reference group), a Labour majority increases the likelihood of the use of Lobo loans by 66% (Model 3).<sup>11</sup> Supporting the descriptive evidence of the previous chapter, we find strong support for H1 on partisan politics and increasing levels of local government financialization. Hence, partisanship *does* (still) matter for local governments' debt policies. Given the core expectation of partisan theory – that different incumbent parties pursue different policies to cater to the interests of their constituencies (see Hibbs 1977; Schmidt 1996), we find that party differences do help to explain the use of financial innovations in English local governments. This notion is also supported by our interview evidence as a Labour councillor describes the notion that Lobo loans were predominantly taken up by the Labour party as “quite logical” given their need to finance infrastructure projects and the fact the Labour “is strong in industrial areas [like] Manchester [or] Birmingham” (INT 4).

Next, it has to be noted that, with regard to the fiscal and economic stress hypotheses, both variables (public debt per capita and economic deprivation) violated proportional hazard assumptions and had to be specified with log-time interactions (see Licht 2011). Accordingly, the coefficients of the main effects reported in Table 1 show an incomplete picture, and both effects were plotted in Figure 4 for post-estimation.

We can observe a highly significant association between public debt and the use of derivatives in both Models 2 and 3. While the negative direction of the coefficient in Table 1 seems to contradict our hypothesis, caused by the log-time interaction, it only shows the effect for the year 1998. Looking at Figure 4, it can be seen that the association between public debt and local government financialization is only negative for the very early years of the diffusion process (1998–2000). Interestingly, the direction of the relationship changes over time and becomes significantly positive after 2007. One possible explanation could be differences in risk-seeking behavior. While leaders of diffusion processes can be associated with more risk-prone behavior, laggards may be more risk-averse (see Graham *et al.* 2013, pp. 698–699; Walker 1969). In this context, local governments were potentially less focused on reducing high levels of public debt with more lucrative borrowing instruments but rather sought to decrease their level of economic deprivation by making a risky move on the financial markets in order to obtain money to invest in public infrastructure projects.

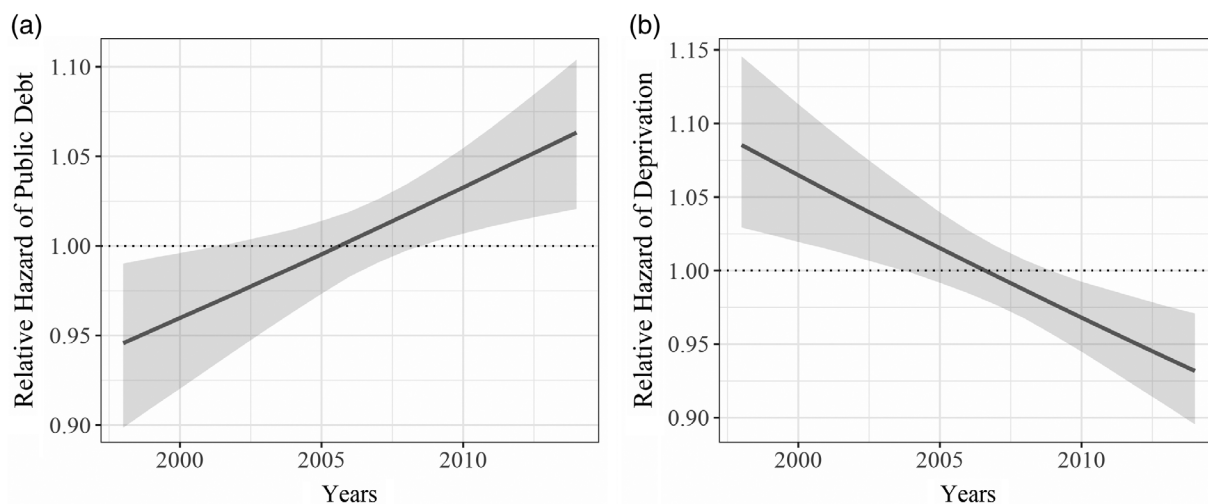
In view of this interpretation, the coefficient of economic deprivation as reported in Table 1 and Figure 4b also makes sense. In contrast to public debt per capita, the association between economic deprivation and the use of derivatives is actually significantly positive in the early diffusion process (until 2004) and turns significantly

**Table 1** Repeated event survival analysis (1998–2014)

	Model 1	Model 2	Model 3
Independent variables			
Party: Labour	–	0.535** (0.212)	0.508** (0.212)
Party: Other	–	0.336* (0.194)	0.301 (0.194)
Public debt <sub>t-1</sub>	–	–0.114*** (0.040)	–0.111*** (0.040)
Public debt <sub>t-1</sub> * ln( <i>t</i> )	–	0.015*** (0.005)	0.015*** (0.005)
Deprivation <sub>t-1</sub>	–	0.146*** (0.043)	0.146*** (0.042)
Deprivation <sub>t-1</sub> * ln( <i>t</i> )	–	–0.019*** (0.006)	–0.019*** (0.005)
Finance power	–	–0.172 (0.156)	–4.543*** (1.541)
Finance power * ln population	–	–	0.796*** (0.279)
Neighbor	–	1.052*** (0.402)	1.142*** (0.401)
Controls			
Number of previous adoptions	0.286*** (0.034)	0.216*** (0.038)	0.208*** (0.039)
ln population	0.452*** (0.139)	0.495*** (0.154)	–0.044 (0.243)
Election year	–0.024 (0.147)	–0.070 (0.150)	–0.067 (0.149)
Type of local government	–2.196*** (0.257)	–1.932*** (0.282)	–2.146*** (0.289)
AIC	2,646.819	2,631.079	2,627.145
Number of events	286	286	286
Number of observations	4,211	4,211	4,211
PH test	0.227	0.716	0.605

Standard errors clustered by local authority in parentheses. Reference group for Party: Conservative. Levels of significance: \*\*\* $p < 0.01$ , \*\* $p < 0.05$ , \* $p < 0.1$ .

negative after 2007. Hence, we find some supportive evidence for hypothesis H3, assuming a positive relationship between economic deprivation and the use of Lobo loans by local governments. However, the association is conditioned by time. As a consequence, it is important to account for the dynamic nature of the relationship between both fiscal and economic stress with increasing levels of local government financialization. While early adopter local authorities are more risk-prone and driven by economic motivations when they use Lobos, late adopters are more risk-averse and fiscally motivated.

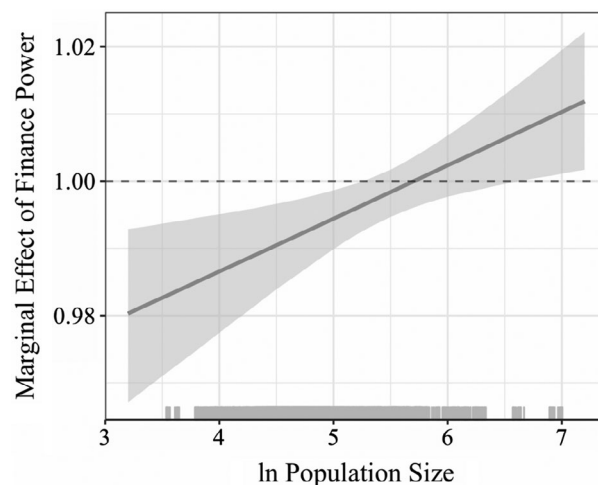


**Figure 4** (a) Simulated relative hazards for the effect of public debt on the time it takes to use Lobo loans; (b) simulated relative hazards for the effect of economic deprivation on Lobo use over time; 95% confidence intervals in shaded grey.

Next, Table 1 shows the coefficients for the association between financial sector strength and the use of innovative borrowing instruments by local governments. In contrast to the positive relationship assumed in hypothesis H4a, the effect is actually negative and not statistically significant. However, given the fact that the interaction effect between financial sector power and the size of a local government (postulated in hypotheses H4b) is significant (see Model 3 in Table 1), the main effect cannot be meaningfully interpreted in isolation (Braumoeller 2004; Brambor *et al.* 2006). Hence, we plot the marginal effect of finance power conditioned by population size in Figure 5. Given our assumptions expressed in hypothesis H4a (i.e. that a strong local financial sector increases the likelihood of using Lobo loans), the results are very surprising: the effect of local financial sector power is significantly negative for local governments with a population size <190,000 and turns positive for very large councils with more than ~570,000 inhabitants. Hence, the effect is the opposite of the expected direction.

This conditional effect could be driven by different causal processes: first, contrasting our initial expectation, there could also be incentives for finance to lobby larger local governments more frequently as “[p]olicy making in the larger municipalities is less transparent” (Sørensen 1998, p. 309) or because employment opportunities are more prestigious and reinforce the revolving-door phenomenon (Sbragia 1986, pp. 318–319). Consequently, the effect of financial sector on smaller councils could actually be less pronounced compared to larger ones. Second, the global dimension of financialization that was previously discussed (see pp. 5–6) might play a decisive role. Foreign banks might have intentionally targeted those local governments where the domestic financial industry was less present. Given the fact that it was foreign banks that started selling Lobo loans to English municipalities in the late 1990s, the demand for new Lobo loans might actually have been substantially decreased in those smaller councils when domestic banks started to participate in the market. Third and finally, recent research by Trampusch (2019) suggests that finance uses different channels to drive the process of financialization: next to the means of structural and instrumental power, state financialization can also be increased by financial industry experts who are already part of the state apparatus. If this interpretation was correct, the interaction term (power\*size) would actually be less a proxy for the interaction between finance power and government size but rather a proxy for local governments’ capacity to poach financial experts from local financial services firms – it is more difficult to attract professional financial experts from a well-developed local financial sector in small- and medium-sized local governments compared to larger ones, which can offer higher salaries and better career opportunities in their treasury departments.

The neighbor variable (i.e. the ratio of contiguity neighbors who previously adopted Lobos to the total number of neighbors) was introduced in Models 2 and 3 to test our assumption of the relationship between external pressure and the use of Lobo loans. In line with our expectations, the effect is significantly positive. The coefficient of ~1.14 in Model 3 results in the interpretation that a 1-unit increase in the neighbor variable would



**Figure 5** Simulated marginal effects of financial sector power on Lobo use by population size (log); 95% confidence intervals in shaded grey.

increase the likelihood of using Lobo loans by 213 percent. While the effect seems to be rather large, it describes that *all* of the subject's neighboring local governments previously used Lobo loans. In most cases (where only a small share of neighbors used Lobo loans), the effect is much smaller. Considering the differently specified spatial weights (see Models 1 and 2 in Table B3 in the online Appendix S1), the associations are still substantively positive but are only significant at  $P < 0.1$  (second-order contiguity) or  $P < 0.13$  (inverse distance). Hence, in line with our assumptions, local governments might actually only look to their closest (direct) neighbors and lack the capacities to monitor the borrowing behavior of councils that are farther away. In addition, the results of the PWP model (Model 3 in Table B3) indicate that the pressure exerted on local governments by its closest neighbors might only be relevant for the first adoption of Lobo loans but loses its significance for later adoptions. Nevertheless, we find some supportive evidence that geographic proximity, and hence external pressure, might play an important role in facilitating the spread of local government financialization. This finding is also backed by our interviews. Smaller local authorities in particular compare each other with other local councils in their area (INT 6), and once a new financial instrument is used by these authorities and has been established, they tend to follow the trend (INT 1, 4, 6).

The coefficients of our control variables for all models are reported in the bottom half of Table 1. Several aspects are noteworthy. First, the coefficient for the number of previous adoptions is positive and statistically significant across all models. Next to the necessity of including the variable due to our choice of a statistical model (see Beck *et al.* 1998), it can also be interpreted with substantive meaning: each loan contract that was previously signed by a local government increases the likelihood of taking up a new loan by 23 percent. This might be caused by the fact that having used this complicated borrowing instrument in the past might reduce the inhibition threshold to use it again. Next, population size is also significantly positively associated with Lobo use in Models 1 and 2. The change in direction of the coefficient in Model 3 is caused by the introduction of the interaction effect. In addition, a substantive difference can be observed between different types of local governments across all specified models. Shire districts are far less likely to use Lobo loans than are metropolitan districts, London boroughs, and unitary authorities. Contrary to expectations, the coefficient for election years is actually negative and not statistically significant. This might be caused by the fact that local governments in England adhere to different electoral cycles. As the shire districts hold council elections in 3 of 4 years, the differences in electoral systems might be captured by the *type* variable. The negative direction of the effect could also be caused by the relative frequency of elections compared to other countries.

## 7. Conclusion

This article makes an original contribution to the growing literature on local government financialization by analyzing the use of long-term market loans with embedded derivatives for all local authorities of a country in its entirety over time. By transcending and expanding extant literature, which so far has mainly produced results from within-case analyses, our approach increases the external validity of previously found relationships in single municipalities. Based on an extensively compiled panel dataset of all 353 local authorities in England, our event history analysis across cases identified the configuration of the local political economy and policy diffusion as important drivers of the spread of financialization among English local authorities. Our study deepens the understanding of the effects of internal and external influences of local state financialization (effects of causes), and future studies should further investigate the causes of these effects and thus the underlying causal processes.

With respect to local political economy factors, we find supportive evidence for the impact of a Labour majority in local councils on the propensity to adopt financial innovations. Given the core expectation of partisan theory that different incumbent parties pursue different policies to cater to the interests of their constituencies, we find that party differences do help to explain the use of financial innovations in English local governments. This result provides new insights to the existing literature on party ideology and economic and fiscal policymaking, as well as the literature on local government financialization in general.

Moreover, our analysis demonstrates that the other internal factors discussed in the previous literature, such as the degree of fiscal stress, of economic deprivation, or the strength of the local financial industry, are associated with increasing financialization in a more complex way than previously assumed as these are moderated by other factors. In this sense, we were able to show that different temporal stages of the financialization process affect the

effects of local indebtedness and economic deprivation on this very process. While in the early phase (1998–2003), the probability of Lobo use correlates with a high degree of economic deprivation and a low degree of debt, the directions of both factors are reversed in the late phase of Lobo use (2007–2014). In addition, we find that financial sector power is moderated by the size of a local authority's population. While finance power decreases the likelihood of Lobo use for small to medium-sized governments, the effect is positive for very large authorities. We propose that this unexpected conditional impact of local finance power can be driven by different processes: larger authorities being targeted more frequently by the financial industry, foreign banks mainly targeting local authorities with smaller domestic financial sector or local authorities' ability to hire financial experts from the local financial market. To investigate these different processes, further research should systematically compare governments of different sizes and, more specifically, with different institutional capacities of their local treasuries with regard to salary structures and human resource development. This avenue of research also indicates that financialization studies need to consider the literature on public administration, administrative recruitment patterns, and the role of professional training in public policymaking (e.g. Fourcarde 2009; Campbell & Pedersen 2014). In addition, an analysis explicitly differentiating between the role of domestic and foreign banks might provide interesting results.

While we illustrate the importance of the local political economy, we also want to highlight the relevance of external factors, that is, the role of diffusion (Gilardi 2016) for understanding financialization of local governments as was suggested by previous case study research (Hendrikse & Sidaway 2014; Fastenrath *et al.* 2018). Our results show that geographic proximity is highly relevant for the analysis of local borrowing through Lobo loans, which is supported by our interview material. The substantive and significant effect of geographic proximity as a “catch-all” indicator for diffusion clearly demonstrates that diffusion does take place; however, further research is necessary to analyze which specific mechanism operates and how exactly it translates into the use of financial innovations by local governments.

While our quantitative analysis identified several factors that contributed to the spread of financialized borrowing among English local governments (effects of causes), additional process-tracing case study research is necessary to improve our understanding of the concrete causal mechanisms that help to comprehend exactly how these factors produce state financialization in single cases (causes of effects). The conditional effects clearly point to variegated paths of state financialization and varying motivations of local policymakers to financialize their borrowing depending on the timing of local politicians' motivations. Further advances could be made by more theoretical and empirical work on the (conditional) impact of the local financial sector on public debt policies by extending the scope of analysis to a larger sample of local governments from different countries.

We conclude with four remarks on the generalizability of our findings. First, with regard to partisan politics, it seems reasonable to assume that our results also apply in other countries. Although this should be considered with caution as the English case of New Labour is certainly regarded as special and not as the case of a classic social democratic party (as seen in the partisan politics literature), individual studies have already pointed to the crucial role of left political parties as being receptive to voters' demands for increasing revenues to expand public services (e.g. Boyne *et al.* 2012). Moreover, as the literature on European social democratic parties' rightward shift during the 1990s indicates, the ideological change of the Labour Party in England should by no means be treated as a singular phenomenon (see Allen 2009). Second, we suppose that the dynamic effects of fiscal and economic stress on local public finance are transferable to countries with more fiscally autonomous local governments as such autonomy means that local governments are free to harness any form of financial innovation to reduce local problem pressures. While in unitary states such as England, the central government can have a significant influence on the fiscal position, as well as on the financialization of its local governments, in federal states, there is less involvement in local economic and fiscal affairs. Hence, we can expect that an increasing fiscal and economic pressure will lead those more autonomous local governments to use all available creative ways to produce leeway. Third, the conditional impact of finance power is certainly transferable to other countries, not only in England. Fourth, given that studies on policy diffusion focus almost exclusively on international diffusion (Levi-Faur 2005; Jordana *et al.* 2011) or federal political systems, such as the United States (Berry & Berry 1990; Shipan & Volden 2008), Germany (Abel 2019), or Switzerland (Gilardi & Fuglister 2008; Fuglister 2012), we provide additional insights in illustrating how policies diffuse in a nonfederal (unitary) political system.

## Disclosure statement

There is no potential conflict of interest with respect to the research, authorship, and/or publication of this article.

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## Endnotes

- 1 The PWLB is a government institution issuing loans to local authorities with an interest rate linked to the UK gilt yield. Traditionally, these constituted the main borrowing source for local governments.
- 2 See Section Table E1 in the online Appendix S1 for an overview of the interviews we conducted and the abbreviations used in this article.
- 3 Calculation by the authors using our dataset including all 353 local authorities in England.
- 4 Regardless of the previous differentiation between domestic and foreign banks operating in a local economy, we assume this effect to be driven by the local financial sector comprising both domestic and foreign actors as both can contribute to economic growth and employment in a local authority.
- 5 Part of the data on the use of Lobo loans were collected by the UK public initiative „Debt Resistance“ and was graciously given to us. The rest of the data were obtained using Freedom of Information requests.
- 6 Concise variable descriptions and descriptive statistics are shown in Table A1 in the online Appendix S1.
- 7 While previously discussed entanglement between public debt and economic deprivation is also considered in the moderate correlation coefficient of 0.546 (see Table C1 in the online Appendix S1), both variables still explain different parts of the variation in using Lobo loans (see the results of our event history analysis in Table 1).
- 8 For a more in-depth description of local government organization in England, see section D and Table D1 in the online Appendix S1. In addition, the variable type might capture important dynamics of central government budget cuts. While all local governments are frequently hit by budget cuts, which could increase the use of innovative financial instruments, the budgets of shire districts are mostly reduced at higher proportions.
- 9 See Tables B1 and B2 in the online Appendix S1. Our results remain largely the same.
- 10 Values >1 appear as multiple loans could be taken up by a single local government in the course of 1 year. Councils with no overall majority are not included.
- 11 The increase in percentage points can be calculated with the formula:  $100 * (\exp(\text{coef}) - 1)$ .

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### Appendix S1 Supporting information