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## Sovereign bond market reactions to fiscal rules and no-bailout clauses: The Swiss experience

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Fiscal Rules and No-Bailout Clauses –  
The Swiss Experience**

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## Non-technical Summary

The budgetary problems of many governments which emerged as a consequence of the economic and financial crisis are on top of the political agenda. Simultaneously to the increasing debt levels, investors demanded much higher compensations for the growing default risk, thus boosting the sovereign bond yields of several nations. The exploding refinancing costs put further pressure on the public budgets and call for measures which are capable of restoring the market participants' confidence in the sustainability of public finances in the short run. This paper focuses on two different institutional factors which can be hypothesised to work in this direction: strong numerical fiscal rules and a credible no-bailout policy.

Concerning fiscal rules, there is large evidence suggesting that numerical constraints limit debt, deficit, expenditure, and revenue levels of governments. In case of fiscal rules being perceived as binding promises for future responsible fiscal behaviour, their adoption should thus immediately restore market confidence in financial sanity and result in lower risk premia. However, the prerequisites for this effect are both strong and reliable numerical fiscal rules. We empirically test the impact of this institutional measure for bond emissions at the subnational level of Switzerland. The Swiss system serves as a perfect laboratory, since it is characterised by an extensive fiscal federalism with high fiscal autonomy at the cantonal level – especially with regard to constitutional and statutory fiscal restraints. Most Swiss cantons have introduced numerical fiscal rules which seem to be much stronger in comparison to other national fiscal rules.

With respect to a credible no-bailout policy, the literature so far has focused almost exclusively on the benefits of such an implicit guarantee for those issuers who are potentially bailed out, and ignored the costs for those who potentially provide a bailout. In the Swiss context, however, we can exploit a quasi-natural experiment generated by a Swiss court decision in 2003 to investigate the opposite effect. On 3 July 2003, the Swiss Supreme Court decided – against general expectation – that the canton Valais is not obliged to bail out its highly indebted municipality Leukerbad. This decision was a break since it relieved the cantons from backing municipalities in financial distress, thus leading to a fully credible no-bailout regime at the cantonal level. Since most Swiss cantons issue tradable bonds, we make use of unique financial market data on 288 cantonal bonds in the period from 1981 to 2007 to measure the impact of both institutional features on the investors' confidence in the cantons' refinancing capacity.

In a nutshell, the results reveal that both the presence and the strength of fiscal rules and a credible no-bailout regime significantly contribute to lower risk premia at the cantonal level. The effects are relevant in qualitative and quantitative terms: The introduction of a strong fiscal rule reduces cantonal risk premia in relation to Swiss federal bonds by 10 basis points on average – even under stable market conditions before the beginning of the financial crisis. Furthermore, we show that risk premia of cantonal bonds were on average 25 basis points higher before the Swiss Supreme Court decided that the cantons are not liable for the obligations of their municipalities. This finding suggests that the implicit liabilities in a non-credible no-bailout regime impose severe sanctions on the possible guarantors. Consequently, both institutional measures, strong numerical fiscal rules and a credible no-bailout policy, can actually contribute to lower refinancing costs and help to restore financial market confidence.

## Das Wichtigste in Kürze

Die im Zusammenhang mit der Wirtschafts- und Finanzkrise zutage getretenen Probleme öffentlicher Haushalte haben im politischen Bereich nach wie vor höchste Priorität. In Verbindung mit den krisenbedingt angestiegenen Schuldenständen verlangten Investoren höhere Risikoprämien für Investitionen in Staatsanleihen, die ihrerseits das Schuldenproblem der Krisenstaaten weiter verschärften. Die Frage ist, welche institutionellen Maßnahmen geeignet sind, diesen sich gegenseitig verstärkenden Effekt aufzulösen und kurzfristig das Vertrauen in die Refinanzierungsfähigkeiten öffentlicher Emittenten (wieder)herzustellen. Die vorliegende Arbeit stellt hierzu auf zwei unterschiedliche Faktoren ab: starke numerische Fiskalregeln sowie eine glaubwürdige No-Bailout-Regel.

Insbesondere Fiskalregeln haben sich in früheren empirischen Arbeiten als wirksam erwiesen. Sie tragen dazu bei, Schuldenstände und Haushaltsdefizite zu verringern, ein übermäßiges Ausgabenwachstum einzudämmen sowie unverhältnismäßige Einnahmeerhöhungen zu vermeiden. Sofern Investoren Fiskalregeln als ein glaubwürdiges Bekenntnis hin zu einer nachhaltigeren Haushaltsführung anerkennen, können Fiskalregeln somit dazu beitragen, verlorenes Vertrauen wiederherzustellen und Risikoprämien zu verringern. Grundvoraussetzungen hierfür sind jedoch das Vorliegen einer starken und vor allem glaubwürdigen Regel. Der Schweizer Fiskalföderalismus eröffnet für diese Untersuchung beste Möglichkeiten: Die verschiedenen föderalen Ebenen und insbesondere die Schweizer Kantone verfügen über ein hohes Maß an Autonomie, was sich besonders im Bereich fiskalischer Regelungen offenbart. So haben die meisten Kantone eigene Fiskalregeln implementiert, die sich zudem aufgrund ihrer spezifischen Ausgestaltungen positiv von übrigen nationalen Regelungen unterscheiden.

Hinsichtlich einer glaubwürdigen No-Bailout-Regel untersucht die Literatur bisher vor allem die positiven Effekte für diejenigen, die von einer impliziten Beistandsgarantie profitieren. Hingegen werden die potentiellen Kosten für die im Beistandsfall haftende Ebene größtenteils vernachlässigt. Der Schweizer Kontext ermöglicht eine Untersuchung des gegenteiligen Effektes. Entgegen der Erwartungen der Investoren entschied das Verfassungsgericht der Schweiz am 3. Juli 2003, dass es keine Einstandspflicht des Kantons Wallis für dessen hochverschuldete Gemeinde Leukerbad gibt. Diese höchstrichterliche Entscheidung markiert einen entscheidenden Wendepunkt in den föderalen Haftungsbeziehungen der Schweiz und kennzeichnet den Beginn einer vollkommen glaubwürdigen No-Bailout-Regel hinsichtlich des Nichteintretens der kantonalen für die lokale Ebene. Die Tatsache, dass verschiedene Schweizer Kantone gehandelte Bonds an internationalen Kapitalmärkten platzieren, ermöglicht somit die Untersuchung des Einflusses beider institutioneller Merkmale auf die Risikoeinschätzung der Investoren. Hierzu wird ein einzigartiger Datensatz bestehend aus Daten zu 288 kantonalen Anleihen für den Zeitraum 1981 bis 2007 verwendet.

Die ökonometrischen Ergebnisse zeigen, dass sowohl die Präsenz und die Stärke kantonalen Fiskalregeln als auch eine glaubwürdige No-Bailout-Regel einen verminderten Einfluss auf die Risikoprämien kantonalen Anleihen haben. Die Ergebnisse sind qualitativ wie auch quantitativ bedeutend: Das Vorhandensein einer starken Fiskalregel reduziert die Risikoprämien der Anleihen Schweizer Kantone im Durchschnitt um 10 Basispunkte. Hierbei ist vor allem bemerkenswert, dass der Effekt ausschließlich auf Werten für den Vorkrisenzeitraum beruht. Darüber hinaus offenbaren die Schätzungen die Zusatzkosten derjenigen föderalen Ebene, die im Beistandsfall haften würde. Risikoprämien kantonalen Anleihen sind im Zeitraum vor der höchstrichterlichen Entscheidung zu einer Nicht-Einstandspflicht der Kantone um 25 Basispunkte höher als im Zeitraum nach der Urteils-

verkündung. Zusammengefasst lässt sich somit festhalten, dass beide institutionellen Faktoren, starke numerische Fiskalregeln und eine glaubwürdige No-Bailout-Regel, dazu beitragen können, das Vertrauen der Kapitalmärkte zu stärken.

# Sovereign Bond Market Reactions to Fiscal Rules and No-Bailout Clauses – The Swiss Experience

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**Abstract** We investigate the political determinants of risk premiums which sub-national governments in Switzerland have to pay for their sovereign bond emissions. For this purpose we analyse financial market data from 288 tradable cantonal bonds in the period from 1981 to 2007. Our main focus is on two different institutional factors. First, many of the Swiss cantons have adopted strong fiscal rules. We find evidence that both the presence and the strength of these fiscal rules contribute significantly to lower cantonal bond spreads. Second, we study the impact of a credible no-bailout regime on the risk premia of potential guarantors. We make use of the Leukerbad court decision in July 2003 which relieved the cantons from backing municipalities in financial distress, thus leading to a fully credible no-bailout regime. Our results show that this break lead to a reduction of cantonal risk premia by about 25 basis points. Moreover, it cut the link between cantonal risk premia and the financial situation of the municipalities in its canton which existed before. This demonstrates that a not fully credible no-bailout commitment can entail high costs for the potential guarantor.

**Classification:** E62, G12, H63, H74

**Keywords:** sub-national government bonds, fiscal rules, no-bailout clause, sovereign risk premium

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# 1 Introduction

The budgetary problems of many governments which emerged as a consequence of the economic and financial crisis are on top of the political agenda. Simultaneously to the increasing debt levels, investors demanded much higher compensations for the growing default risks of several Euro countries (esp. Greece, Ireland, Portugal) as well as of US states (esp. California, Illinois), thus boosting their sovereign bond yields. The exploding refinancing costs put further pressure on the public budgets and call for measures which are capable of restoring the market confidence in the sustainability of public finances in the short run. Our work focuses on two different institutional factors which can be hypothesised to work in this direction: numerical fiscal rules and credible no-bailout policies. Their effects will be tested empirically for sovereign bond emissions at the sub-national level of Switzerland. The Swiss system serves as a perfect laboratory since it is characterised by an extensive fiscal federalism with high fiscal autonomy at the cantonal level – especially with regard to constitutional and/or statutory fiscal restraints. Since most Swiss cantons issue tradable bonds, we can make use of unique financial market data on 288 cantonal bonds in the period from 1981 to 2007 to measure the investors' confidence in the cantons' outstanding debt.

The two political measures we study are also of particular interest from the European perspective. The founders of EMU were fully aware that – as in any federal system with decentralised fiscal authority – the monetary union might run into danger of creating negative incentives for the national governments. According to the literature on 'soft budget constraints' (see, e.g., Kornai et al., 2003), governments in a federal system have incentives to accumulate excessive debt if they can expect to be bailed out by someone else when running into financial trouble. As a remedy against this problem, the framework of the Maastricht Treaty included two main provisions which strongly relate to the policies studied in this paper: (i) fiscal rules in the form of the Stability and Growth Pact (limiting annual budget deficits to 3% and national debt to 60% of GDP), and (ii) a no-bailout clause (Art. 125 TFEU<sup>1</sup>) which prescribed that neither the EU nor the member countries are liable for other countries obligations. However, the experience shows that both provisions were not capable of curbing the problems related to the soft budget constraints. However, this experience does not exclude that such institutional characteristics

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<sup>1</sup>Treaty on the Functioning of the European Union.



could be efficient in restoring financial markets' confidence if they are credibly enforced. Therefore, we refer to Switzerland to study the effects of very strong fiscal rules as well as an exogenous establishment of a credible no-bailout regime at the cantonal level.

Concerning fiscal rules, both the political as well as the academic sphere seem to be very optimistic that numerical restrictions of fiscal policy can have a positive impact on the market participants' confidence. It is already shown in the literature that numerical fiscal rules limit debt, deficit, expenditure and revenue levels of governments (see section 2.3), and therefore make public finances more sustainable. If the financial markets actually believe in such strong effects of fiscal rules, their adoption should immediately restore market confidence in financial sanity and result in lower risk premia. However, as will be shown below, the empirical evidence for those fiscal rules already existing in US states and European countries points to a quantitatively rather low or even non-existent link between fiscal rules and government bond yields.

One explanation for such small effects is straightforward: the existing rules are usually too weak, unreliable and thus not credible in order to have a strong effect on investors' confidence. Here the Swiss cantons come into play. In the past decades, almost all of the 26 cantons of Switzerland have introduced different forms of fiscal constraints that require them to balance their budget over time. On top of that, many of these rules are much more stringent than any form of restrictions existing in the US or at the European level. Just to give an example, some cantons have constitutional requirements which oblige them to increase tax rates if budget deficits exceed a deficit threshold. Such a mandatory enforcement mechanism is to the best of our knowledge unique and generates a much more credible restriction to public finances as compared to rules in other parts of the world. Our empirical results confirm that both the presence and the strength of fiscal rules in the Swiss cantons significantly contribute to lower risk premia, and that this effect is stronger than in comparable studies of US fiscal rules or in cross country studies.

The second institution concerns a credible no-bailout policy with respect to other (usually lower-tier) governments – or to put it differently, the costs of an implicit guarantee in a regime where market participants ascribe a positive possibility to a bailout. The literature has focused almost exclusively on the benefits of such an implicit guarantee for those issuers who are potentially bailed out, and ignored the costs for those who potentially provide a bail out. Furthermore, if the markets assume that a central government would

support a lower-level government in distress, spillover effects should prevail. Risk premia should then not only reflect the government's own budgetary position, but also those of the lower-tier governments which potentially will be bailed out.

Concerning the costs of such an implicit guarantee, we can exploit a quasi-natural experiment generated by a Swiss court decision in July 2003. In this decision the Supreme Court in Lausanne decided – against general expectations – that the canton of Valais is not obliged to bail out its highly indebted municipality Leukerbad. This decision was landmark since it relieved the cantons from backing municipalities in financial distress, thus leading to a fully credible no-bail out regime at the cantonal level. We identify two consequences of this break: firstly, the cantonal yield spreads decreased significantly, and secondly, it cut the link between cantonal risk premia and the budgetary position of the canton's municipalities. These findings hint to the significant costs that a non-credible no-bailout commitment can entail for the potential guarantor.

The remainder of this paper is structured as follows: In Section 2 the theoretical background is presented and the main hypotheses are derived. In section 3 we explain the institutional setting concerning cantonal fiscal rules in Switzerland. The empirical analysis is provided in section 4, and finally, section 5 reiterates the main findings of our study and discusses some implications.

## **2 Literature review and hypotheses**

### **2.1 General determinants of (sub-national) bond spreads**

The methodological standards for the analysis of sovereign bond spreads are mainly set by several studies investigating the yield differentials of European bonds in the aftermath of the monetary union (see, e.g., Codogno et al., 2003; Manganello and Wolswijk, 2009; von Hagen et al., 2011). The following factors are identified as the main drivers of yield spreads by these authors:

1. Exchange rate risk
2. Default risk
3. International risk aversion

#### 4. Liquidity risk

While most studies focus on the yield spreads of central governments, there are so far only few studies analysing the determinants of bond spreads for sub-national governments. Schuknecht et al. (2009), e.g., investigate the main drivers of sub-national bonds in Germany, Spain and Canada. Whereas exchange rate risk obviously plays no role for explaining yield differentials between bonds of different public issuers within the same country, their findings underpin the relevance of the before mentioned determinants. In particular, the bond spreads strongly depend on the fiscal performance of the sub-national governments (measured by the levels of public debt and budget balance), thus reflecting the consideration of default risks.<sup>2</sup>

In the Swiss context, there is so far only one study which analyses the determinants of yield differentials between the cantonal bonds (Küttel and Kugler, 2002). Using a relatively small sample covering 84 bonds from 15 out of the 26 Swiss cantons in the period from 1990 to 1998, the authors do not find significant effects of fiscal indicators such as debt, budget balance, or taxes on the yield spreads. In contrast, institutional factors such as direct democratic elements as well as cultural differences seem to be important. A variable which accounts for the existence or strength of numerical fiscal rules is, however, not incorporated in the econometric model.

## 2.2 (Non-)credible no-bailout clauses

A further aspect which might be relevant regarding the risk assessment of sovereign issuers in a federal setting is the risk taking for other, usually lower-level, governments. This factor has not attracted attention in the literature so far. Although in many instances the liability for other federal levels is regularly disputed ex-ante, many of such no-bailout policies are regarded as not credible by investors. There often is the widespread expectation that the upper-level government would – at least partially – bail out lower-level governments which are in financial distress.<sup>3</sup> Such implicit debt guarantees should have contrary effects on the risk premia for those issuers who *are* potentially *bailed out* as compared to those who potentially *provide a bail out*. The former should have

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<sup>2</sup>Earlier evidence on sub-national bond-markets is provided by Bayoumi et al. (1995) for US states, Booth et al. (2007) for Canadian provinces, and Schulz and Wolff (2009) for German states.

<sup>3</sup>This commitment problem in federal systems has been studied extensively in the literature; see, e.g., the models by Wildasin (1997) and Goodspeed (2002) as well as the survey in Oates (2005).

a favourable assessment at financial markets, since their liabilities are backed up by the guarantor, whereas the latter must be expected to pay an additional premium depending on the probability that other governments get into fiscal distress and are bailed out.

In addition to the level effect, a spillover effect can also be expected. For instance, if the market participants expect that a certain government would bail out a lower-level government which is in financial distress, the investor's risk sentiment deteriorates. It thus not only includes an assessment about the higher level government's budgetary position, but also about the probability of additional costs through a potential bailout, which is then reflected by the financial situation of the backed governments.

So far, the existing literature mainly focuses on the positive effect of potential bailouts for the risk assessment of lower-level governments and thereby mainly rests upon indirect evidence. Schuknecht et al. (2009) argue that a non-credible no-bailout policy in the federal context of Germany prior to the European Monetary Union (EMU) led to favourable risk premia of the German states. This finding is based on the widespread expectation that the federal government would help German states in financial trouble. However, the effect disappeared after the start of the EMU, which limited the possibility of the federal government to bail out the states. Heppke-Falk and Wolff (2008) provide further evidence that a higher probability of receiving a bailout by the federal government tended to reduce the German states' risk premia.<sup>4</sup> Contrary, Schulz and Wolff (2009) do not find the expected increase of state risk premia after a court decision that averted the bailout of the state of Berlin. Evidence at the international level comes from Dell'Ariccia et al. (2006) for emerging markets. They show that reduced expectations for a bailout of highly indebted countries by the international community after the decision not to bail out Russia in 1998 increased the cross-country dispersion of spreads. Finally, the relevance of spillovers in a federation, i.e. the responsiveness of creditworthiness to other governments' fiscal positions, has received almost no consideration in the literature. The notable exception is Landon and Smith (2000) who study Canadian provinces. They use credit ratings (due to missing financial market data) and find negative effects of the central government's and other provinces' indebtedness on the creditworthiness of provinces.

It is striking that almost all of the studies mentioned above focus on the benefits

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<sup>4</sup>The bailout probability is indicated by an increasing interest payments-to-revenue ratio; this is the guideline of the German constitutional court which has to declare the fiscal distress of the state to enable the bailout.

for the governments which are protected by conceivable bailouts. However, they do not account for the costs of the liable governments in terms of higher risk premia which are associated with the threat of potential bailouts. The adverse effects of such ‘risk transfers’ on risk premia has only recently found some consideration with respect to the interaction of the private financial and the public sector: Ejsing and Lemke (2011) as well as Attinasi et al. (2010) demonstrate that the announcements of bank rescue packages by European governments in 2008 led to a decline of risk premia for banks at the expense of an increase for country bonds.

With respect to a risk transfer between the different tiers of a government in a federal system, the Swiss experience offers the chance to investigate the consequences for the liable government in greater detail. It is possible to estimate the costs of potential bailout guarantees by means of the Leukerbad court decision in 2003, where the Supreme Court in Lausanne decided – contrary to general expectations – that there is no obligation for the canton Valais to bail out its highly indebted municipality Leukerbad.<sup>5</sup> The small community (less than 2,000 inhabitants) had gone bankrupt in 1998 after having piled up debt amounting to 346 million Swiss francs. Since the cantonal government refused to bail out the municipality, a group of creditors filed lawsuits against the canton to pay for the municipality’s obligations, so the case went to the Swiss Federal Court. Its decision was fundamental with respect to financial markets’ perceptions about implicit cantonal bailout obligations. Prior to the decision, the actual cantons’ liability for the municipalities was rather unclear (Daldoss and Foreita, 2003, p.67f). Indeed, a federal law<sup>6</sup> from 1947 released the cantons from any bailout obligations for their municipalities; however, the cantons were allowed to deviate from this guideline and to set specific rules on their own. Moreover, there is a supervision duty of the cantons regarding the public finances of their municipalities (Feld and Kirchgässner, 2008). That is, if a canton violates its duty of care, the canton also assumes liability for its lower-tier bodies. As a matter of fact, the investors regarded the probability that cantons were obliged to help municipalities in financial distress as relatively high. Blankart and Klaiber (2006, p. 50) state that the creditors “thought that, if the municipality defaults, at least the canton (the state) will

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<sup>5</sup>A more detailed description of the Leukerbad case is given by Blankart and Klaiber (2006) and Blankart (2011).

<sup>6</sup>Federal Debt Collection Act vis-à-vis municipalities and other entities of cantonal public law of December 4, 1947, especially Art. 1 and Art. 3 (Bundesgesetz über die Schuldbetreibung gegen Gemeinden und andere Körperschaften des kantonalen öffentlichen Rechts).

take over its obligation and bailout the municipality as could be expected in a mixed system". However, after the court decision on July 3, 2003, it was legally resolved that cantons were not liable for obvious unsustainable debt accumulation at the local level, so that the no-bailout clause became strongly binding and fully credible. Blankart and Klaiber (2006, p. 50) argue that the court decision thus "contributed to a complete wrap-up of the institutional organisation of the market for municipal and cantonal credits". The decision led to a risk transfer from the cantonal to the municipal level and forced the "creditors to examine the actual creditworthiness of their borrowers" (Blankart 2011, p. 81).

This leads us to the following hypotheses: (1) A punishment of Swiss cantons for serving as a potential bailout guarantor of municipal governments will be reflected in higher cantonal yield spreads before July 3, 2003, the day of the court decision. (2) Moreover, we expect that before the court decision, cantonal risk premia positively depend on the fiscal situation of their respective municipalities; i.e., cantonal risk premia increase with a higher probability of municipal defaults which is reflected by their fiscal situation. This link between municipal budgetary positions and cantonal bond yields is expected to disappear after the court decision.

### **2.3 Fiscal rules and risk premia**

Fiscal rules should have an immediate effect on the risk premia of sovereign bonds if they convince the investors that the lower scope for discretion of fiscal policy reduces the future expansion of public finances, and, consequently, the danger of a default. In several instances, numerical fiscal rules have proven ex-post to fulfil the promised effects of improving fiscal indicators (such as expenditures, revenue, deficits, and debt), although the strength of the effect differs considerably depending on the type and design of the rules and the national context. This has been documented for the US states (see, e.g., Eichengreen and Bayoumi, 1994; Alt and Lowry, 1994; Poterba, 1994; Bohn and Inman, 1996), European countries (see, e.g., Ayuso-i-Casals et al., 2007; Debrun et al., 2008; Foremny, 2011) and Italian municipalities (Grembi et al., 2012), whereas there is particularly strong evidence in the case of the Swiss cantons (see Feld and Kirchgässner, 2001; Schaltegger, 2002; Feld and Kirchgässner, 2008; Krogstrup and Wälti, 2008; Luechinger and Schaltegger, forthcoming). However, for generating an immediate increase of trust

among investors in a more sustainable fiscal policy, rules have to be regarded as strong and credible by the market participants. For instance, rather weak fiscal rules such as the Stability and Growth Pact in the EU, can hardly be expected to restore trust among the investors *ex ante* and to dampen risk premia (see Afonso and Strauch, 2007). Possibly for this reason, the empirical findings on a strong role of fiscal rules regarding the risk assessment of sovereign bonds are generally still scarce.<sup>7</sup>

Conclusive evidence concerning the impact of fiscal rules on the financial markets' risk assessment is mainly based on studies for the US states. Poterba and Rueben (1999) are among of the first who investigate the effect of state fiscal rules on the yields of state general obligation bonds. Using an indicator reflecting the strength of fiscal rules in the states, the authors show that states with tighter deficit rules, and more restrictive provisions on the authority of state legislatures to issue debt, actually paid lower interest rates on their bonds. More specifically, their results suggest that the interest rate differential between states with a very strict anti-deficit constitution and one with a less strict anti-deficit constitution lies between 15 to 20 basis points. In the case of expenditure and revenue rules the authors come to similar conclusions. The quantitative effects on the bond spreads are, however, somewhat lower. In a related study, Poterba and Rueben (2001) also analyse the reaction of risk premia on unexpected deficit shocks. They find that tighter anti-deficit rules almost completely offset the effect of unexpected deficits on the yields of state governments bonds. Lowry and Alt (2001) show that investors are more forgiving of one-time deficits in states with strict fiscal rules (i.e., the bond yields increase significantly less after a deficit), but respond more sharply to consecutive deficits.

However, contrary to the studies on the determinants of yield differentials (see section 2.1), all of these studies do not utilise financial market data but they base their findings on data from the 'Chubb Relative Value Study'. These are surveys conducted by an insurance company in which 25 traders were asked to evaluate 'hypothetical' general obligation bonds of the US states. This kind of survey-based data has obvious drawbacks as compared to market data: Johnson and Kriz (2005, p. 86) argue that "its surveyed New Jersey-based yield spreads fall far short of yields on actual market transactions" and "are at best indirectly related to the interest costs faced by municipal borrowers in the

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<sup>7</sup>Apart from the studies investigating the effect of fiscal rules on bond spreads, there is a related strand of literature which focuses on the relationship between fiscal institutions and yield differentials. For example, Hallerberg and Wolff (2008) show that better fiscal institutions like the institutional strength of the finance minister are associated with lower risk premia.

primary market". Compared to the survey-based studies, Johnson and Kriz (2005) is the only paper studying the effects of US state fiscal rules using actual financial market data. Their estimated effects are quantitatively much smaller: spending limits reduce interest costs by modest 2.4 basis points while debt limits decrease by 3.3 basis points respectively.

Related studies in the European context are conducted by Iara and Wolff (2011) and Heinemann et al. (2013). They analyse the relationship between numerical fiscal rules and government bond spreads for a panel of Euro area countries. Using the fiscal rule index provided by the European Commission both studies only find a very weak effect of fiscal rules on bond spreads. The effect is generally only sizeable in periods of extremely high risk aversion in the markets (Iara and Wolff, 2011). Similarly, a report by the International Monetary Fund (IMF, 2009) does not find that the presence of fiscal rules affects the spreads of 22 OECD countries. Taken together, these findings suggest that the existing national fiscal rules of European and OECD countries are too weak or not credible enough to generate a strong effect on investors' trust.

This is one of the main distinguishing features of our study. As will be demonstrated in the following section, over the past decades most Swiss cantons have implemented different forms of fiscal rules, and many of these rules can be characterised as very strict and highly credible. We therefore hypothesise a substantial negative effect of both the existence as well as the strength of cantonal fiscal rules on the respective bond yields. Moreover, market penalisation of increasing deficits or debt should be smaller the stronger the cantonal fiscal constraints are.

## **3 Sub-national fiscal rules in Switzerland**

### **3.1 Institutional setting**

Contrary to other OECD countries, the Swiss federal system is denoted by two particular characteristics: (1) Very high participation possibilities for the population, i.e. strong direct democratic elements both at the national and the sub-national levels, and (2) a special kind of fiscal federalism leading to relatively strong autonomy of the different cantons. As a result, fiscal institutions and thus also fiscal rules differ substantially between the 26 cantons (Kirchgässner, 2005). According to an agreement of the cantonal ministers



of finance from 1981, the principle of a balanced budget has to be observed (Konferenz der Kantonalen Finanzdirektoren, 1981). As a consequence, most of the cantons have implemented fiscal rules since then; however, the introduction of these rules happened at different points of time. Moreover, the specific design is up to the cantons. As a result, there are remarkable differences in the stringency of fiscal rules – both over time and between the several cantons.

While some cantons only refer to a mid-term balanced budget (‘over the budget cycle’), other cantons are restricted by annual numerical standards which have to be met by the cantonal politicians. The main difference, however, refers to the implemented mechanisms for a connection of budget planning and budget execution. This comes along with particular sanction mechanisms. The most important sanctions thereby are automatic tax adjustments (e.g. in Basle County, Fribourg, Neuchâtel, Nidwalden, Schwyz, Vaud and Zurich) and specified expenditure cuts (Aargau, Basle city). That is, if the deficit exceeds a certain threshold, there is an automatic adjustment of particular cantonal tax rates, imposing a severe sanction for acting politicians. As can be imagined, sanctions like these are highly effective (Schaltegger and Frey, 2004). This stands in sharp contrast to the sanction mechanisms of national fiscal rules (see, e.g., European Commission, 2006). The latter rules typically do not comprise explicit sanctions comparable to the Swiss cantons (or the sanctions are not very credible, such as in the case of the Stability and Growth Pact of the EMU). Thus, in the end the arrangements mostly rely on implicit sanctions only, such as reputation costs of the politicians.

Additionally, several cantons have defined exception standards which allow the canton for deviating from the specified arrangements. These exceptions take account of narrowly defined events like economic slumps or natural disasters. Such exceptions tend to weaken the stringency of the rules, since they allow for loopholes. Again, the cantons differ both with respect to implemented exceptions per se but also concerning the strength of the exception standards. While some cantons do not have any exceptions in place<sup>8</sup>, cantons like Fribourg or Valais set strict precepts for a deviation from the original budget plan (i.e. extraordinary cyclical strain must be given and an absolute majority of the parliament has to approve the new proposal). On the contrary, Geneva or Lucerne undermine their overall guidelines by implementing weak exception standards (referring to an ‘un-

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<sup>8</sup>For example the cantons of Appenzell Inner Rhodes, Appenzell Outer Rhodes, Basle County, Glarus, Grisons, St Gall, Schaffhausen, Ticino and Uri.

favourable cyclical situation'). Summing up, the exception standards of most cantons are very narrowly defined and furthermore ensure strong compliance of budget planning with actual budget execution and a high credibility of the rules (Konferenz der Kantonalen Finanzdirektoren, 2009).

To sum up, cantonal fiscal rules in Switzerland as they have developed in the past 30 years can be regarded as much stronger as compared to existing national or sub-national fiscal rules in other countries. Especially the strong link between budget planning and budget execution, and the ex-ante defined sanction mechanisms (foremost automatic tax adjustments) in line with the overall fiscal framework in Switzerland, i.e., the strong implementation of direct democracy (e.g. the implementation of fiscal referenda on the expenditure side) impel this result. Moreover, the rules were introduced at different points of time; the significant time variation in the existence of cantonal fiscal rules will be shown in the following.

### **3.2 Fiscal rules index**

Based on the particularities of the fiscal rules described above, it is now possible to group the cantons according to the strength of their implemented fiscal rules and to describe their developments over time. Following Feld and Kirchgässner (2008), we make use of the stated three main components of strong cantonal fiscal rules in order to develop a compound fiscal rules indicator. First, there should be a strong connection of budget planning with actual budget execution; second, the cantonal rule should be characterised by strong numerical constraints, and third, highly effective sanctions in the form of automatic tax adjustments have to be implemented. With respect to the 18 cantons used in the estimation, there are two cantons (Fribourg and St Gall) which are characterised by the most stringent fiscal rules in place. Both cantons fulfil all prerequisites stated above. The second group consists of Aargau, Berne, Lucerne, Neuchâtel, Solothurn and Valais. In each of these cantons at least one of the main items is missing. The third group comprises the cantons Appenzell Outer Rhodes, Grisons, Schwyz, Vaud and Zurich. Finally, the last category covers all cantons without (binding and legally defined) fiscal constraints (Basel-Country, Basel-Town, Geneva, Thurgau and Ticino).

We construct the fiscal rules indicator by using the before elaborated classification of

cantons into four groups. In the following, we use an ordinal scale reaching from 3 (all three requirements fulfilled) up to zero (no requirement fulfilled; i.e. all cantons with no fiscal rules in place). The development of our fiscal rule indicator is depicted in Figure 1. The figure reveals that the fiscal rules in Fribourg and St Gall are highly persistent over time while most other cantons changed their institutional framework within the last twenty years. Most cantons thereby strengthened their fiscal framework in the early 2000s; Solothurn, Grisons and also Appenzell Outer Rhodes already strengthened their rules in the mid-1980s and the mid-1990s, respectively. To sum up, the institutional characteristics – high stringency of the rules and variation between and within cantons – within the same constitutional environment make the Swiss cantons very suitable for studying the impact of fiscal rules on the assessment of financial markets.

In our empirical part, we follow two different approaches to appraise the effects of the cantonal fiscal rules. First, we employ the fiscal rules indicator based on the peculiarities described above. Second, we follow the strategy of Krogstrup and Wälti (2008) and create a dummy variable which is coded one if a fiscal rule is in place, i.e. the fiscal rule index in a particular year is greater than zero.

[Figure 1 about here]

## 4 Empirical Analysis

### 4.1 Model specification and estimation method

In order to investigate the determinants of the cantons' yield spreads use the following econometric specification which is largely motivated by the literature on European bond spreads presented in subsection 2.1 (see, e.g., Schuknecht et al., 2009):

$$\begin{aligned}
 YieldSpread_{i,j,t} = & \beta_0 + \beta_1 Debt_{j,t} + \beta_2 Deficit_{j,t} + \beta_3 Liquidity_{i,j,t} + \beta_4 RiskAversion_t \\
 & + \beta_5 Duration_{i,j,t} + \beta_6 FiscalRules_{j,t} + \beta_7 Interactions_{j,t} + \beta_8 NoBailOut_t \\
 & + \beta_9 TimeTrend_t + \gamma_j + \epsilon_{i,j,t}
 \end{aligned}$$

As dependent variable we use the yield spreads of the cantonal bonds compared to Swiss federal bonds. The latter are chosen as reference values, since federal bonds account for country-specific influences on sovereign yields, such as monetary policy, exchange rate developments or country-wide political developments. Subtracting this common component of the cantonal bonds – expressed as the yield of federal bonds with a duration of 10 years – allows us to isolate the canton-specific effects. Therefore, the cantonal yield spreads are obtained from the difference of the yield of bond  $i$  of a particular canton  $j$  at time  $t$  to the average yield of the federal bonds. The time indicator  $t$  is included on a monthly basis to the estimation equation. To account for diverging maturities of the bonds, we restrict our sample to cantonal bonds with a time to maturity of 8 to 12 years and, furthermore, control for the time to maturity in our regressions.

The choice of the control variables largely follows the standard approaches in the literature on sovereign bonds (see section 2). Firstly, we include public *debt* as well as the budget *deficit* of the cantons in order to control for the effect of the cantons' actual fiscal position and to account for the default risk which is reflected by the fiscal variables. Both variables are defined as a share of GDP.<sup>9</sup> In addition, we include the aggregated *municipal deficit* in the respective canton in order to account for spillover effects from the fiscal situation of the municipalities.<sup>10</sup> Moreover, the *liquidity* of the bonds is accounted for by including the issue volume of the respective bonds. If the market size for a certain security is rather small, investors request a higher liquidity premium. We therefore expect the liquidity premium to be negatively related to the yield spreads. As a further explanatory variable we also include a measure for the general *risk aversion* in international bond markets. This variable is derived from the spread of low-grade US corporate bonds (grade 'BBA') to risk-free US federal bonds. It is expected that the higher this spread is, the greater is the general risk aversion in international bond markets, i.e., the higher is the investors' request for a sufficient compensation of default risks. Finally, we include the *duration* of a particular bond assuming that yield spreads should be higher with an increasing maturity.

Our main variables of interest are the measures of cantonal *fiscal rules*, its *interactions* with the fiscal variables and the dummy variable *NoBailOut*. We study both the effects

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<sup>9</sup>Since information about cantonal GDP growth was not available for the whole sample, we use the federal growth rate in order to adjust the fiscal variables.

<sup>10</sup>Data about municipal debt is only available from 1990 onwards and therefore excluded from the estimation.

of the existence of fiscal rules – represented by a dummy variable which is coded one if a fiscal rule exists in a canton at a given point of time – and the strength of fiscal rules (fiscal rule index, see section 3) on the bond spreads. In order to test the hypothesis whether market penalisation of increasing deficits or debt is smaller the stronger the cantonal fiscal constraints are, we further interact the fiscal variables (deficit and debt) with the dummy variable for the existence of fiscal rules as well as with the fiscal rule index. In addition, the dummy variable *NoBailOut* is included to test the hypothesis whether the cantonal risk premia decreased in the aftermath of the Supreme Court decision excluding the bailout of Swiss municipalities by the cantons, i.e. the variable is equal to 1 for the time from July 3, 2003 onwards. Finally, the *NoBailOut* dummy is also interacted with the deficit level of the cantons’ municipalities in order to test whether the spillover effect from municipal indebtedness changed after the Leukerbad court decision.

We estimate an unbalanced panel, since there are cantons which are tabbed with several bonds  $i$  at time  $t$ , whereas there are also periods for particular cantons without any bonds issued. To cope with the problem of canton-specific unobserved heterogeneity, we include cantonal dummies ( $\gamma_j$ ) to control for time-invariant cantonal effects such as language or culture. In our robustness checks, we will furthermore account for possibly time-varying influences. These can be captured by an indicator about voters’ preferences for the size of the public sector in the Swiss cantons which is provided by Funk and Gathmann (2011). In addition, a time trend variable is included to control for general changes of risk evaluation over time. Since our data structure would result in biased standard errors based on autocorrelation of the error term between bonds issued in the same canton, the error terms are clustered on cantonal-year levels and corrected for heteroscedasticity.

## 4.2 Data and descriptive statistics

Our empirical analysis is based on data for the period 1981 to 2007 and covers 18 out of the 26 Swiss cantons.<sup>11</sup> These are the cantons which issued traded bonds in the period mentioned above. Taken together, the overall sample consists of 288 cantonal bonds. The average yield spreads (on a yearly basis) of the largest emitting cantons compared to the

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<sup>11</sup>These are Aargau, Appenzell Outer Rhodes, Basel County, Basel-Town, Berne, Fribourg, Geneva, Grisons, Lucerne, Neuchâtel, Schwyz, Solothurn, St Gall, Ticino, Thurgau, Vaud, Valais, and Zurich.

federal level are presented in Figure 2.<sup>12</sup> As can be seen from the figure the yield spreads are – with few exceptions – positive, whereas maximum premiums reached up to 60 basis points to the end of the 1990s. At the beginning of the last decade, however, the cantonal yield spreads started to decrease until 2003. This decrease exactly coincides with both the introduction of several cantonal rules but also with the Leukerbad court decision on July 3, 2003. Especially the latter event seems to change the financial markets perceptions about the relative risk structure concerning cantonal vs. federal bonds, thus leading to a period of risk moderation of cantonal bonds.

[Figure 2 about here]

Figure 3 presents the indicator on general risk aversion, which is widely used in studies investigating risk premiums in international bond markets. The indicator is constructed by comparing average US corporate bond yields with a Moody's 'BAA' rating with average yields of ten year US Treasury bonds. Higher spreads thereby indicate a higher general risk aversion. To facilitate the comparison, Figure 3 also contains a simple time series on the development of the annual average cantonal yield spreads of those cantons shown in Figure 2. The development of the average cantonal bond spreads for the period from 1981 until the mid-1990s is in line with the development of the general risk aversion. Subsequently, however, cantonal bond spreads seem to decouple from international trends. While general risk aversion of financial markets started to increase strongly from 1997 on, and further intensified after 2001, yield spreads at the cantonal level did not follow this development. A summary of the descriptive statistics of all variables used in the analysis is provided in Table 1.

[Figure 3 about here]

[Table 1 about here]

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<sup>12</sup>Since several cantons have issued bonds only within specific periods, showing the full set of all average yield spreads is not much demonstrative with respect to a description of a general trend.

### 4.3 Results

The results of the empirical analysis are shown in Table 2. Column (1) presents the results for the baseline specification where only the standard control variables are used. It can be seen that the signs of almost all coefficients in column (1) are in line with the results of previous studies for the US or Europe (see also section 2). The coefficient of the cantonal debt is positive and highly significant in all specifications; this also holds for the coefficients of the deficit variables – on the cantonal as well as the municipal level. Our results suggest that an increase of the cantonal debt by 1% of its GDP induces the yield spread to rise by approximately 0.9 basis points. The effect on the municipal level even turns out at almost the same level. However, this does not imply that the municipal fiscal situation is equally important for investors regarding the evaluation of default risks of cantonal bonds as the cantonal fiscal situation, since the latter is reflected in the conjoint effect of cantonal debt and deficit. Furthermore, the coefficients of the variables for the market liquidity and the international risk aversion show the expected signs and are mostly statistically significant. An increase of the yield spread between low grade US corporate bonds ('BAA') and benchmark US government bonds by one percentage point leads to an increase in the cantonal bond spreads by approximately 8 basis points. Finally, the duration of the bonds does not have a sizeable effect on the spreads which seems reasonable given that our sample is restricted to a very narrow margin of durations around 10 years in which the yield curve is usually very flat.

[Table 2 about here]

Turning now to the central fiscal rules variables, Table 2 shows that both the existence and the strength of numerical fiscal rules add significantly to the explanatory power of the model. A first cautious conclusion is that numerical fiscal rules matter regarding the confidence of market participants; the pure existence of a numerical fiscal rule in a Swiss canton is accompanied by a yield spread which is on average 17 basis points lower than in cantons without fiscal rules. Moreover, the stricter the existing rule in a canton, the lower is the yield spread: the results in column (3) suggest that cantons with stricter fiscal rules are associated with lower yield spreads than cantons without or with weaker fiscal rules.

In columns (4) to (7) we additionally test the effect of the interactions of the fiscal rule variables with the fiscal variables, i.e. debt and deficit. As can be seen from the table, the interactions with the fiscal rules dummy are negative indicating that increases in the deficit or debt levels of cantons with numerical fiscal rules induce cantonal yield spreads to increase not as strong as for cantons without fiscal rules. However, the coefficients of these interactions miss statistical significance.

In column (8) we test for the effect of the risk transfer on the cantonal yield spreads after the Leukerbad court decision ('no-bailout regime') in July 2003. The coefficient indicating the no-bailout regime after the court decision shows a statistically significant negative effect: after the decision the spread between the yields of cantonal and federal bonds was on average up to 25 basis points lower as compared to the time before the decision. This result confirms the hypothesis that prior to the court decision the cantons had to pay higher risk premia due to their (potential) liability for the municipalities located in their cantons. The interaction of the *NoBailOut* dummy with the deficit of the municipalities further shows that – after the court decision – cantonal yield spreads decreased as a direct response to increases in municipal deficit levels. This reflects the severing of the link between cantonal yield spreads and the budgetary situation of the respective municipalities after the court decision. The consideration of the no-bailout regime after the court decision also has a non-negligible effect on the quantitative impact of the fiscal rules index: the coefficient drops from about -0.10 to -0.05, but stays statistically highly significant. This implies that the introduction of a reasonably strong fiscal rule (index change from 0 to 2) reduces the bond spread by about 10 basis points, which is still a strong impact, but apparently falls short of the quantitative effect of the credible no-bailout regime.

#### **4.4 Further discussion**

In the following, we first address concerns which may arise due to potential endogeneity of fiscal rules. In any analysis of fiscal institutions, an omitted variable bias cannot be fully excluded, since fiscal institutions are not fully exogenous and also depend on voters' or legislatures' preferences. However, in the Swiss context, this problem seems to be of minor importance. As compared to cross-country studies, preferences within a country can be assumed to be more homogenous than between countries. Since we add cantonal dummies



in our regression model, we further explicitly control for time-invariant influences (such as cultural factors or long-term preferences of the citizens in the cantons).

Due to the relevance of direct democracy in Switzerland, the introduction of cantonal fiscal rules has to be adopted by the canton's electorate in form of a referendum. Therefore, we account for possibly time-varying preferences of the citizens by making use of the fiscal preferences measure provided by Funk and Gathmann (2011). This indicator measures the preferences for government spending of each canton's electorate.<sup>13</sup> Column (1) of Table 3 shows the results of the re-estimation using the fiscal rules index. The *fiscal preferences* indicator has no significant effect on bond spreads, whereas the coefficients of the fiscal rules variable as well as the no-bailout variable remain negative and highly statistically significant. This suggests that taking into account time-varying voter preferences does not substantially affect the impact of our main variables on the cantonal yield spreads. Moreover, both coefficients change only by a relatively small amount of less than one basis point. We therefore find no evidence that changes of the voters's preferences interfere with the qualitative or quantitative impact of fiscal rules or of a reliable no-bailout regime on bond spreads.

[Table 3 about here]

Since direct voter participation is quite strong in Switzerland and also increases fiscal soundness (Feld and Matsusaka, 2003; Funk and Gathmann, 2011), a link between direct democracy and market confidence seems to be reasonable. And indeed Küttel and Kugler (2002) find such an effect. Therefore, we include variables reflecting differences in levels of direct democracy between the cantons to the estimation specification. We add three variables which have become standard in the analysis of direct democracy in Switzerland (see, e.g., Feld and Matsusaka, 2003): (1) A dummy variable which indicates whether there are *mandatory referendums* on spending projects in the canton (in which a majority of all voters has to approve a proposal), (2) a variable indicating the *spending threshold*, i.e., the lower limit of project costs which enforces a mandatory referendum, and (3) a variable representing the *signature requirement*, i.e., the number of signatures required

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<sup>13</sup>The indicator is based on voting data of 331 federal ballot propositions. It measures the preferences for government spending of each canton's inhabitants, and it is demonstrated to have a sizable effect on government spending even conditional on observable characteristics.

for an initiative process, which allows citizens to propose entirely new laws which will then be subject to a referendum. A positive value of (1) represents stronger participation rights of the citizens, whereas positive values of (2) and (3) have the opposite meaning since they hamper the participation of the citizens in political decisions in their canton.

The results are shown in columns (2) and (3) of Table 3 – with and without the fiscal preferences indicator, respectively. It can be seen that none of the proxy variables for the strength of direct democracy at the cantonal level has a significant effect on the risk premia. Moreover, the table reveals that the coefficients of the fiscal rules indicator as well as the no-bailout regime are not affected considerably. The coefficients still remain negative and statistically highly significant. Therefore, taking into account direct democratic elements of the cantons also does not change our main results, namely, that governments with (stricter) fiscal rules enjoy higher confidence among the market participants which is represented by lower yield spreads.<sup>14</sup>

Finally, we show that the negative effect of the no-bailout dummy on the yield spread between cantonal and federal bonds can actually be ascribed to a changed risk assessment of the cantonal level, and is not caused by contemporaneous developments at the federal level. In columns (4) and (5) we replace the values of the debt and deficit variables with their spreads relative to the debt and deficit values for the federal level. The effects of our main variables are largely unaffected by this modification, so that we can conclude that the slump of cantonal bond spreads relative to federal bonds after the Leukerbad decision was not due to a deterioration of the federal fiscal situation at that time.

## 5 Conclusions

The Swiss experience teaches us some important lessons on the potential effects of institutional factors on sovereign risk premia. First, we show that both the presence and the strength of fiscal rules in Swiss cantons significantly contribute to lower risk premia. These effects are relevant in qualitative and quantitative terms: the introduction of a strong fiscal rule contributes to a decline of risk premia of more than 10 basis points, even

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<sup>14</sup>Note that we conducted further robustness tests in which we included nominal values of the fiscal variables. Using nominal instead of GDP adjusted fiscal variables changes the results only marginally. Moreover, the results still hold, if we include lagged instead of real fiscal variables (deficit and debt levels) to the estimation equation (Results are available upon request).

under stable market conditions before the beginning of the financial crisis.

This result is also important beyond the Swiss context. The implementation of strong and binding fiscal rules can contribute to significantly lower refinancing costs. The comparison with the much weaker effects found in earlier studies underlines that only strong rules can be expected to have a credible effect on the financial markets' assessment. Due to their design, several of the Swiss cantonal rules serve as a benchmark in order to foster a sustainable budget policy. In turn, the capital markets treat the rules as credible and thus respond in a positive manner. In many respects the Swiss cantonal rules have already served as a benchmark model for the creation of the Swiss and the German federal debt brakes. Both rules in turn have set a standard which ambitious national reforms can aspire to.

Second, we show that risk premia of cantonal bonds are on average 25 basis points higher before the Swiss Supreme Court decided that the cantons are not liable for the obligations of their municipalities. Our finding suggests that the implicit liabilities in a non-credible no-bailout regime impose severe sanctions on the possible guarantors. While the focus of our analysis is on the positive effect of hardening the no-bailout clause on the financial market confidence in the higher federal level, it also provokes the question of the costs for the lower level, in our case the Swiss municipalities. Anecdotal evidence suggests that the court decision impaired significantly the access of municipalities to financial markets, which particularly affected smaller municipalities. Prior to the court decision, the 'emission centre of the Swiss municipalities' (Emissionszentrale der Schweizer Gemeinden, ESG) acted as loan broker for the municipalities by bundling their loans and issuing bonds. These pooled bonds with joint guarantees then could be placed at financial markets at favourable interest rates. The service was mostly used by smaller jurisdictions whose refinancing capacities were rather limited (Blankart, 2011; Fasten, 2006). Even though the ESG got into financial trouble as a direct consequence of the announcement of the Leukerbad insolvency in 1998, after a take over by Credit Suisse in 2001 it was still able to issue bonds at good conditions until shortly before the court decision. For instance, in May 2002, i.e. a long time after the announcement of Leukerbad's insolvency but about less than a year before the federal court decision on the canton's bailout obligation, it successfully placed a bond with a Standard&Poor's AA-rating (Glatthard, 2002). However, after the court decision the troubles of the ESG intensified. Since it

was clarified that creditors had to bear the costs of potentially defaulted investments, the financial markets doubted the viability of Swiss municipal bonds. Additionally, to protect itself against municipal defaults, the ESG partly insured against municipal insolvencies which in turn increased the municipal refinancing costs. Furthermore, the maximum stake of a municipality per pooled bond was limited and municipalities with an unfavourable fiscal situation had to pay an additional risk premium of 0.125% to 0.25% (Rehm and Tholen, 2008, p. 130f). Taken together, both the ESG's internal and external reputation deteriorated until in 2011 the ESG decided to phase out the program of joint municipal bond issuing.<sup>15</sup>

Several larger cities continued to refinance on financial markets after 2003, but it seems that the Supreme Court decision also affected the financial market access of several cities. In the 5 years before the court decision, for instance, 14 cities issued new tradable bonds (with a time to maturity of more than 8 years) as recorded by Datastream, whereas this number shrank to 6 cities<sup>16</sup> in the 5 years after July 3, 2003. Unfortunately, the number of observations which fit our estimation strategy is thus too small to draw definite conclusions.<sup>17</sup> However, it seems that bigger cities were less affected by the risk transfer than smaller municipalities. This might imply that – since larger cities are important for the Swiss federal system as a whole – ‘too big to fail’ considerations might still undermine the credibility of the no-bailout commitment with respect to bigger cities.

Consequently, the results presented in this paper suggest that both strong and reliable fiscal rules as well as a credible no-bailout regime can actually contribute to restore financial market confidence and lead to lower refinancing costs. However, the experience with both kinds of political measures in the Euro area suggests that simple ‘lip services’ are not sufficient to reach such targets. In fact strong commitments, such as fiscal rules with enforceable sanction mechanisms, are needed, and in the end will be rewarded by financial markets.

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<sup>15</sup>[http://www.chgemeinden.ch/de/4-kommunikation/Newsletter/Newsletter-2011/11\\_06-Newsletter.dt.pdf](http://www.chgemeinden.ch/de/4-kommunikation/Newsletter/Newsletter-2011/11_06-Newsletter.dt.pdf)

<sup>16</sup>These are Bern, Biel, Lausanne, Lugano, Winterthur, Zurich.

<sup>17</sup>Fasten (2006) applies an event study framework with an event window of three months prior and after the court decision. Using 8 municipal and 31 city bonds, he does not find an immediate reaction of the markets to the court decision.

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Table 1: Descriptive statistics

Variable	Unit	Frequency	Obs.	Mean	Std. Dev.	Min	Max
Yield Spread	Percentage points (reference: Swiss federal bonds)	Month	7,919	0.232	0.267	-2.292	1.690
Debt	Canton Share in GDP	Year	697	0.123	0.106	0.023	0.813
Deficit Canton	Share in GDP	Year	698	0.001	0.009	-0.051	0.054
Deficit Municipalities	Share in GDP	Year	698	0.000	0.004	-0.015	0.018
Liquidity	Issue volume (bond denomination: 1,000,000 units)	Month	7,919	0.124	0.103	0.018	0.750
Risk Aversion	Percentage points (yield US corporate bond minus yield US Treasury bonds)	Month	324	2.111	0.534	1.290	3.820
Duration	Years	Month	7,919	9.453	0.989	8	12
Dummy Fiscal Rule	Dummy variable	Year	513	0.292	0.455	0	1
Fiscal Rule Index	Ordinal scale (3: strongest fiscal rules; 0: no fiscal rule)	Year	513	0.589	1.023	0	3
No-bailout	Dummy variable	Month	324	0.167	0.270	0	1
Fiscal Preferences	Index	Year	324	0.749	7.506	-19.156	35.889
Mandatory Referendum	Dummy variable	Year	475	0.587	0.493	0	1
Spending Threshold	million Swiss Francs	Year	475	3.818	6.838	0	25.000
Signature Requirement	Number of signatures in thousand	Year	0.475	4.934	3.410	1	15.000

Table 2: Cantonal fiscal institutions and bond yield spreads: baseline regressions

Dep. Var.: Yield Spread	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Debt Canton	0.866*** (3.891)	0.729*** (3.363)	0.793*** (3.657)	0.760*** (3.426)	0.798*** (3.607)	0.706*** (3.217)	0.798*** (3.645)	0.449** (2.179)	0.410** (2.003)
Deficit Canton	6.128*** (5.598)	5.527*** (4.955)	5.598*** (5.047)	5.515*** (4.950)	5.596*** (5.041)	5.761*** (5.072)	5.542*** (4.863)	4.929*** (4.705)	4.944*** (4.737)
Deficit Municipalities	5.728** (2.155)	5.286** (2.104)	5.296** (2.075)	5.379** (2.135)	5.308** (2.079)	5.361** (2.142)	5.274** (2.069)	4.970** (2.074)	5.660** (2.295)
Liquidity	-0.303** (-2.040)	-0.194 (-1.491)	-0.252* (-1.876)	-0.186 (-1.439)	-0.250* (-1.867)	-0.173 (-1.337)	-0.256* (-1.913)	-0.010 (-0.079)	0.041 (0.313)
Risk Aversion	0.083*** (4.897)	0.089*** (5.086)	0.089*** (5.122)	0.091*** (5.147)	0.089*** (5.127)	0.089*** (5.106)	0.089*** (5.123)	0.084*** (4.746)	0.085*** (4.796)
Duration	-0.008 (-1.091)	-0.007 (-0.993)	-0.007 (-1.018)	-0.007 (-1.019)	-0.007 (-1.020)	-0.007 (-0.967)	-0.007 (-1.029)	-0.003 (-0.387)	-0.003 (-0.421)
Dummy Fiscal Rule		-0.170*** (-3.997)		-0.0505 (-0.508)		-0.176*** (-4.219)			
Fiscal Rule Index			-0.101*** (-3.936)		-0.091 (-1.646)		-0.010*** (-3.804)	-0.052** (-2.030)	-0.053** (-2.130)
Dummy Fiscal Rule × Debt Canton				-1.033 (-1.256)					
Fiscal Rule Index × Debt Canton					-0.082 (-0.198)				
Dummy Fiscal Rule × Deficit Canton						-3.034 (-0.832)			
Fiscal Rule Index × Deficit Canton							0.474 (0.241)		
No-bailout								-0.255*** (-6.807)	-0.277*** (-7.008)
No-bailout × Deficit Municipalities									-15.85* (-1.739)
Time Trend	0.002 (1.090)	0.004* (1.874)	0.004* (1.943)	0.004* (1.774)	0.004* (1.915)	0.004* (1.794)	0.004** (1.976)	0.006*** (3.339)	0.006*** (3.136)
Number of Observations	7,919	7,919	7,919	7,919	7,919	7,919	7,919	7,919	7,919
R <sup>2</sup>	0.133	0.145	0.144	0.146	0.144	0.146	0.144	0.170	0.172

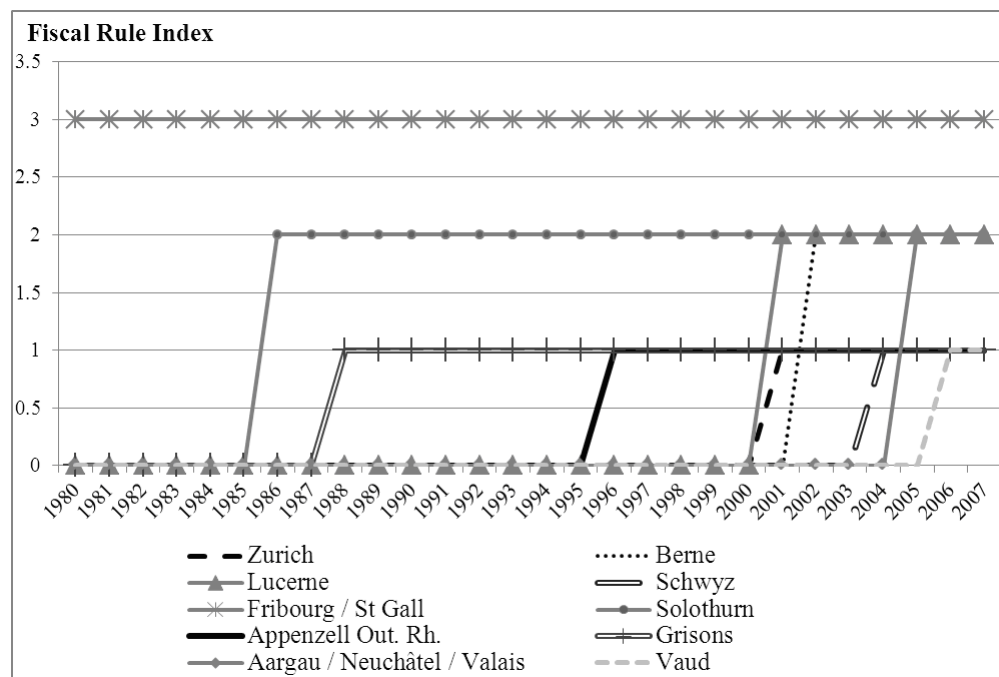
Note: All specifications include canton-specific fixed effects (canton dummies). Robust t-values in parentheses. \*\*\*, (\*\*), (\*) denotes significance at the 1-, (5-), (10-)%-level. Clustered error terms on canton-level per year.

Table 3: Cantonal fiscal institutions and bond yield spreads: robustness checks

Dep. Var.: Yield Spread	(1)	(2)	(3)	(4)	(5)
Debt Canton	0.445** (2.156)	0.496** (2.314)	0.491** (2.281)	0.618*** (2.939)	0.631*** (2.997)
Deficit Canton	4.906*** (4.763)	5.039*** (4.699)	5.004*** (4.750)	1.386 (1.353)	1.049 (0.999)
Deficit Municipalities	5.129** (2.112)	4.978** (2.010)	5.120** (2.039)	-7.102*** (-5.329)	-7.587*** (-5.564)
Liquidity	0.011 (0.080)	-0.038 (-0.280)	-0.014 (-0.103)	-0.055 (-0.385)	-0.050 (-0.327)
Risk Aversion	0.086*** (4.682)	0.087*** (4.854)	0.089*** (4.774)	0.091*** (5.069)	0.098*** (5.308)
Duration	-0.003 (-0.424)	-0.004 (-0.612)	-0.004 (-0.648)	-0.002 (-0.275)	-0.004 (-0.561)
Fiscal-Rule-Index	-0.056** (-2.133)	-0.066** (-2.005)	-0.069** (-2.080)	-0.065** (-2.418)	-0.073** (-2.207)
No-bailout	-0.255*** (-6.817)	-0.271*** (-7.082)	-0.271*** (-7.112)	-0.202*** (-4.519)	-0.216*** (-4.939)
Fiscal Preferences	-0.001 (-0.634)		-0.001 (-0.607)		-0.000 (-0.248)
Mandatory Referendum		-0.225 (-0.840)	-0.211 (-0.781)		-0.164 (-0.566)
Spending Threshold		0.012 (0.917)	0.011 (0.868)		0.011 (0.801)
Signature Requirement		-0.011 (-0.761)	-0.010 (-0.719)		-0.009 (-0.584)
Time Trend	0.006*** (3.323)	0.006*** (3.017)	0.006*** (3.004)	0.008*** (3.774)	0.008*** (3.319)
Number of Observations	7,919	7,746	7,746	7,919	7,746
$R^2$	0.171	0.166	0.166	0.172	0.171

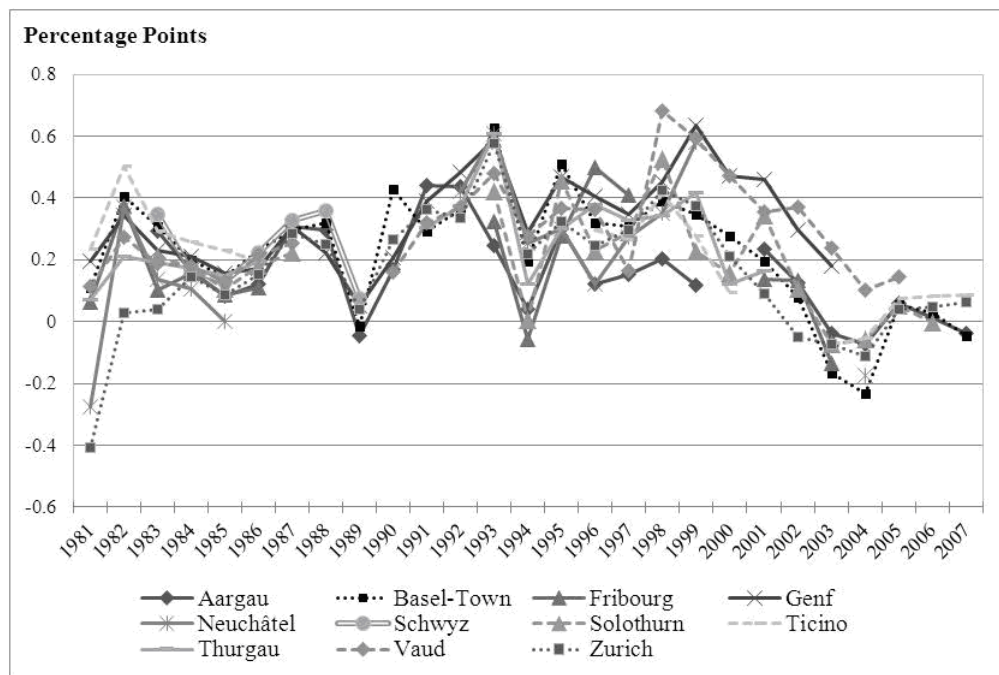
Note: All specifications include canton-specific fixed effects (canton dummies). Robust t-values in parentheses. \*\*\*, (\*\*), (\*) denotes significance at the 1-, (5-), (10-)%-level. Clustered error terms on canton-level per year.

Figure 1: Development of the Fiscal Rule Index



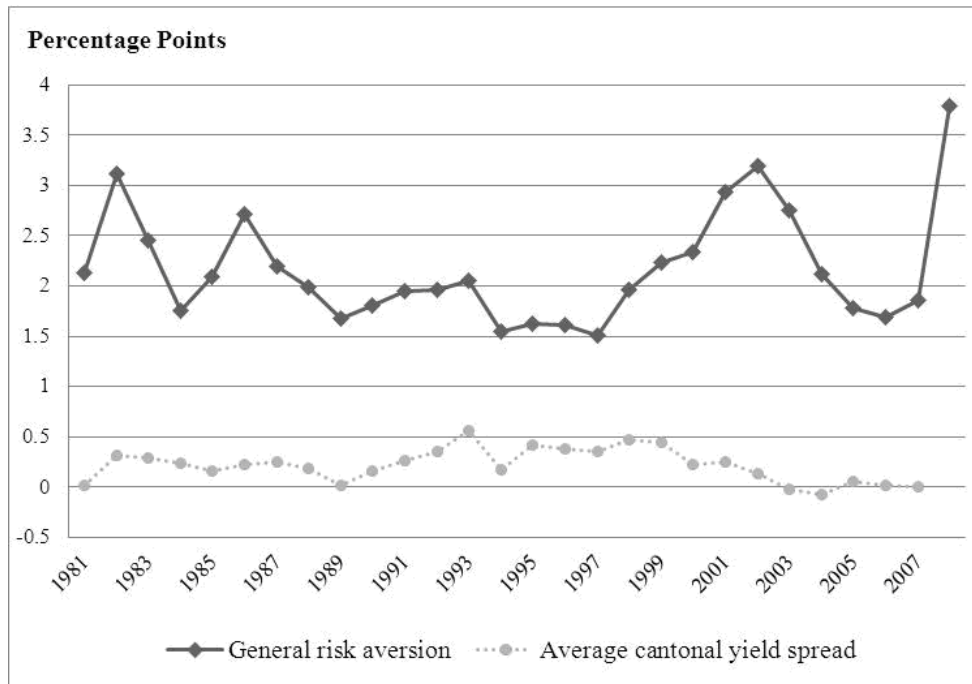
Source: Feld and Kirchgässner (2008). The cantons Basel County, Basel-Town, Geneva, Ticino and Thurgau are excluded from the figure since they had no fiscal rules in place over the regarded period.

Figure 2: Cantonal yield spreads compared to Swiss federal bonds



Source: Datastream (own calculations)

Figure 3: Development of general risk aversion



Source: Datastream (own calculations)