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Tax Bill's Fine Print: Making It Tougher for Cities, States to Refinance Debt.

Tax exemption would be erased for type of bond local governments rely on to lower financing costs for schools, roads and other projects

The North Olmsted City school district in suburban Cleveland was planning to wait a few years before refinancing $48 million in outstanding bonds used to build a new middle school and high school. Now Treasurer Robert Matson is hoping to get the deal done before Christmas.

The reason: The Republican tax plan in congress would eliminate a tax exemption on some types of bonds issued by state and local governments to refinance their old debt. "It just made all the sense in the world to do it," Mr. Matson said.

The GOP proposal targets the exemption for so-called advanced refunding bonds, which allow governments to refinance old bonds earlier to take advantage of low interest rates and, occasionally, to postpone upcoming debt payments.

The House approved its version of the tax measure last week, and the GOP has said it aims to get agreement on the bill by year's end. It is one of several municipal-market exemptions that could be phased out under the legislation. The nonpartisan Joint Committee on Taxation estimates that ending advance refundings would mean an additional $17.3 billion in revenue to the federal government over the next decade.

Analysts said the move is likely to reduce the yearly supply of municipal bonds and increase borrowing costs for governments.

The expected change in policy is already prompting cities and states to fast-track their advance refunding offerings before the end of the year. One underway is from the state of Wisconsin, which last week circulated preliminary advanced refunding documents for $375 million of transportation revenue bonds.

"We just want to get ahead of the possible large amount of supply that could hit the muni market in December," said the state's capital finance director David Erdman, who had originally expected to refinance the debt in 2018 or 2019.

New York's Metropolitan Transportation Authority sold $2 billion in transportation revenue bonds Monday and Tuesday partly to get ahead of any potential change in tax policy said spokesman Aaron Donovan.

Advance refundings have been allowed for decades, as long as governments have been issuing tax-exempt bonds. In 1986, as part of the tax overhaul under President Ronald Reagan, Congress limited government borrowers to one advance refunding per bond issue. The yearly volume of advance refundings varies depending on interest rates and the availability of old bonds to be refinanced.

Government borrowers have sold an average of $60 billion in advance refunding bonds per year over the past decade, about 15% of total municipal issuance. Last year, advance refundings swelled to $125 billion, or 30% of total issuance.

With advance refundings, borrowers invest the proceeds in safe, short-term securities, and those funds are used to make payments on older bonds that typically can't be refinanced until a decade has passed.

Advance refundings make the most sense for borrowers when short-term rates are high relative to long-term rates. In that scenario, the income produced by the shorter-term securities bought with the proceeds of the advance refunding bonds will approach the borrowing costs on those bonds.

Both sets of bonds remain outstanding until the first set can be refinanced, and both provide investors with interest exempt from federal taxes.

Participants in the municipal market said they have several concerns about the possible policy change. They worry public-finance officials would no longer be able to take advantage of low interest rates and municipal bond investors and traders would have less debt to buy and sell.

"As a bond manager we could be looking at less attractively priced interest levels for bond investors," said Dan Heckman, senior fixed income strategist at U.S. bank private wealth management.

Ending advance refundings would also take away a crutch some governments have used for short-term budgetary relief. Cash-strapped cities sometimes issue new, longer dated bonds to advance refund bonds that are coming due so they can postpone big debt payments.That move often adds to those cities' interest costs, compounding financial pressures.

If the proposal becomes law, municipalities could start writing earlier refinancing dates into their bond contracts to maintain their flexibility, some analysts said. But because many investors prefer longer dated bonds, that move could drive up borrowing costs as much as a quarter of a percent, said John Mousseau, director of fixed income at Cumberland Advisors, an investment-management firm.

Government-finance officials say the benefits of advance refunding to local taxpayers are significant. Florida bond finance director Ben Watkins estimated the state has saved $3 billion over the past 10 years with advance refundings.

"The vast majority of state and local government refundings are for economic savings rather than as a budgetary gimmick," said Mr. Watkins, a former chair of the Government Finance Officers Association debt committee who serves on the group's executive board.

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