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## Insights: Threat to State Tax Revenues, What's Next for Advanced Refundings?

The potential threats posed to state revenues by the tax reform law have already been discussed. The other shoe to drop has been the steady stream of budget proposals that have been articulated since tax reform was enacted. Many of these cuts are in areas broadly defined as social service based. They include health, housing, income maintenance as well as the administration's love affair with block granting.

In each case, the proposed changes would either reduce revenues available for services to satisfy demographically driven demand or would replace cash income available to generate retail sales. No matter how you slice it, the budget ideas from the Trump Administration are bad for state finances.

Take the proposal to replace half of the cash portion of the food stamp program with the distribution of food boxes. While presented as a source of both cost savings and better health, the plan would make a serious dent in the income generated from the sale of the products to be distributed. The federal government would buy food products at wholesale and compete against entities whose purchases currently generate sales tax revenues on their own. The government could also use its scale of purchasing power to drive down prices and therefore, agriculture-related incomes. By reducing the amount of food purchased by SNAP recipients from retailers, those retail food distributors would see their sales go down, thereby reducing their taxable incomes. The likely result would be employment reductions at those stores resulting in further declines in the taxable income base.

Then there are the stealth proposals to reduce benefits to the fast-growing elderly population. The Centers for Medicare and Medicaid Services (CMS) actuary said this week that American healthcare spending will grow from 4.3% in 2016 to 5.3% this year and 5.7% by 2021. Much of that increase will be driven by aging baby boomers in need of more medical care. With the retirement assets of most Americans way below their needs, much of that cost will be borne by Medicaid—the health insurance program for low-income and disabled Americans —not by Medicare. Some states are taking a proactive approach.

At least five states — Maine, Arizona, Utah, Wisconsin and Kansas — have asked the Department of Health and Human Services (HHS) to approve proposals that would put a cap on how long Medicaid beneficiaries can receive coverage. Republicans on the House Budget Committee are pushing forward with a new budget resolution this year designed largely to rein in spending on entitlement programs like Medicare and Social Security.

The Administration has proposed a freeze on most funding under the Older Americans Act, which provides money for social and nutrition services for seniors, including Meals on Wheels. While the proposal contains a small increase for food programs, it would cut funding for disability programs by about 30%. It would also eliminate federal block grants that states use to fund programs for seniors.

Since Congress just passed a two-year spending plan, it's highly unlikely Trump's budget will be

enacted but it signals where, at least the Republican party, would like to go on entitlements. All of this would be credit negative for the states.

**Response to the Loss of Advanced Refundings and Alternatives For the Market**

Much has been written about how issuers of new deals, issuers with bonds that are not yet callable, and investors are likely to respond to the loss of advanced refundings. That loss was a substantial blow to financial flexibility for issuers—certainly an ironic result, given the purported desire to generate more capacity to finance and fund infrastructure.

Here are the key considerations for all three parts of a muni transaction:

- First, issuers seeking to maximize flexibility on new long-term financings need to be cautious about expectations that shorter-call paper will be absorbed readily by the market at a yield commensurate with how short-call paper has traded recently. We believe that if short-call paper becomes more common, the yield spread between this paper and bonds with 10-year calls will increase dramatically.
- Second, we support the use of variable-rate debt for a portion of a strong issuer's financings as a way to enhance flexibility without increasing all-in borrowing costs. The challenge will often be in getting credit backstop for such an issue, or in keeping current credit ratings. Stronger issuers such as double-A-rated states will have more flexibility in this context.
- Third, some issuers have discussed the use of much larger amounts of lower-coupon bonds as a way to reduce the yield-to-call on paper with a 10-year call, and thus the urgency to find an alternative to advance refundings. As with short-call paper, issues with coupons well below 5% may find that the market is not willing to buy such deals except at substantial yield premium over more traditional 5s. This pattern may also reduce the proportion of competitively sold paper. Competitive issues tend to use bidding requirements that lead to a large proportion of lower-coupon bonds—the type that the market may increasingly require to have higher yields to the call date than 5s.
- Fourth, institutional investors with old, short-call paper that they would like to unload also need to be cautious. We expect that either new or aged short-call paper will run into situations of diminishing returns as more of it reaches the market.
- Fifth, issuers seeking to refund bonds significantly before the first call date need to be cautious about paying up too much in yield for alternatives such as forwards or taxable crossover bonds, rather than simply waiting until the bonds are currently refundable. Most potential techniques for refunding such bonds before the first current refunding date will lead to a relatively sharp increase in the borrowing cost, which only makes sense under the assumption that muni yields will be moving significantly higher between now and the first current refunding date.
- Sixth, we are less worried than some observers about the use of floating-to fixed swaps or other derivatives as a way to do an early refunding—but only if the issuer is equipped to recognize the risks and extra costs involved in such a transaction. Many issuers will need outside expertise to handle such potential risks and costs. We note that some of the well-described disasters in swaps stemmed from a reliance on auction rate securities or other warning signs that no longer apply. We do agree strongly with the need for strong hands-on expertise when considering such a choice, however.

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**Neighborly Insights**

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