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The Feds Outlawed a Key State and Local Refinancing Tool. Now What?

Tax-exempt advance refunding helped state and local governments save billions of dollars in recent years.

Vermont Treasurer Beth Pearce recognizes that the demise of tax-exempt advance refunding bonds, and what it means for state and local public finance, may not be a front-and-center issue for many Americans.

"It's not something that is readily apparent," she told Route Fifty in late April.

But that doesn't mean the change is inconsequential. "It's going to increase borrowing costs for state and local governments, which will ultimately be borne by the taxpayers," Pearce said.

Last year's Republican-led federal tax overhaul put the kibosh on tax-exempt advance refunding bonds. As of Jan. 1 the bonds are banned under federal law. They had served as a tool state and local governments commonly used to refinance and restructure debt.

Figures compiled by the Government Finance Officers Association show that at least 8,353 tax-exempt advance refundings took place across the U.S. between 2012 and 2016. These totaled $391 billion, and resulted in an estimated minimum savings of $11.7 billion.

The change in tax law has left finance officials chafing at the loss of an option to reduce borrowing costs. Meanwhile, the municipal finance world is eyeing possible alternatives to advance refunding, some of which could carry added expenses and new risks.

"I'm very disappointed, obviously," Eric Johansen, debt manager for Portland, Oregon, said recently as he discussed the lost exemption. "We were frequent issuers of advance refunding bonds," he added, "and had the opportunity to save hundreds of millions of dollars."

Much of the government borrowing at the state and local level goes to pay for infrastructure, like roads, waterworks and schools.

President Trump has identified public works investment as one of his priorities. And his administration has indicated a preference for funneling federal aid to states and localities that can bring greater shares of non-federal money to the table for infrastructure projects.

Eliminating advance refunding puts a dent in the ability of states and localities to do that, finance officials say. "Whatever we're not saving because they've taken this tool away means less investment in infrastructure," said Florida's director of bond finance, J. Ben Watkins.

Florida executed roughly $14 billion of advance refundings between fiscal years 2011 and 2017, achieving gross savings of about $2.8 billion, according to Watkins.

Like other forms of municipal debt, investors’ interest earnings on advance refunding bonds were exempt from federal income tax prior to the new tax law taking effect.

By eliminating the advance refunding exemption, the lawmakers who crafted the tax package gained a roughly $17.4 billion offset over a decade to help pay for tax cuts for corporations and individuals, as well as other changes to the tax code, which are expected to erode upwards of $1 trillion of federal revenues in the years ahead.

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