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R.J. Lehmann: Could ‘Advance Refunding’ Solve the Phase 4 Impasse?

With Treasury Secretary Steven Mnuchin setting a Friday deadline for negotiations between the White House and House Democrats over the fourth iteration of legislation to deal with the COVID-19 crisis, perhaps no disagreement between the sides is more intractable than aid to state and local governments.

While Democrats prescribed $1 trillion of aid in the Phase 4 package they approved in May, Republicans initially insisted the only aid they would consider is to allow local governments discretion to use an existing $150 billion coronavirus relief fund to cover operating expenses, which initially was prohibited. GOP negotiators reportedly have since upped the offer to $200 billion of new aid.

Democrats point to the extraordinary financial strain the pandemic has placed on local governments, both on the revenue and outlay sides of the ledger. Republicans insist that taxpayers ought not be asked to bail out irresponsible state and local governments that had spent themselves to the brink of insolvency—particularly with ever-more-generous pension fund obligations—long before the virus arrived on these shores.

There is, however, a compromise approach that could begin to address the concerns both parties bring to the table, so long as negotiators are willing to be creative. If Congress were to revisit a change made in the 2017 tax reform bill, which removed the option to “advance refund” municipal bonds, they could make it easier for local governments to borrow without any bailouts.

The Tax Cuts and Jobs Act (TCJA) of 2017 eliminated an option state and local governments previously had to conduct a single advance refund of bond issues. Under an advance refund, a new bond is issued and its proceeds, which are withheld for more than 90 days, are used to pay off the obligations from an outstanding bond issue. It allows the governmental issuer to take advantage of lower interest rates.

While TCJA maintained muni bonds’ tax-free status, it declared the interest income from any advance refunding bonds issued since 2017 is taxable. There were $91 billion of advance refunding bonds issued in that final year before tax reform took effect, representing nearly a quarter of the muni bond market. According to the National Governors Association, which strongly supports reinstating advance refunding, volume of the issues fell 30 percent from Q1 2017 to Q1 2018.

Losing the option to advance refund has combined with broader effects from TCJA, notably cutting corporate rates from 35 percent to 21 percent. On a relative basis, that makes munis’ tax-exempt status less attractive, particularly to institutional buyers like banks and insurance companies. The natural effect, over time, is that muni bonds’ yields would need to rise to remain competitive, thus contributing to the cost for state and local governments to borrow.

Reinstating advance refunding—as proposed by the Investing in Our Communities Act, bipartisan legislation introduced by U.S. Reps. Dutch Ruppersberger, D-Mary, and Steve Stivers, R-

Ohio—would lessen the crush on state and local governments by making it easier and less costly to borrow. The Government Finance Officers Association reports that, between 2013 and 2017, advance refunding saved taxpayers a combined $12 billion.

At the same time, reinstating the option would not change the fact that local governments need to demonstrate they have a path to repayment, which in many cases will mean cutting spending to present to the market that they are on a sustainable fiscal path. It is a potential win-win that ought to be on the table.

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08.06.20