COURT STREET GROUP PERSPECTIVE: TAX REFORM

Elimination of Advanced Refundings Under Tax Reform Impairs Fiscal Federalism

,by Managing Partner, George Friedlander

Both the House and Senate have shocked state and local governments via provisions that either increase their costs of functioning, reduce financial flexibility, increase the cost of their borrowings done to finance important projects, or completely eliminate the ability for state and local governments to issue tax-exempt debt to advance refund governmental, healthcare and higher education projects, as permitted under current law. Our purpose in this piece is to focus on the case for maintaining access to advanced refundings. We begin with one brief statement that applies to all of the provisions that target state and local governments.

Specifically, the provisions that reduce access to or increase the cost of state and local projects are a direct impairment of the concept of Fiscal Federalism. Under fiscal federalism, a large number of activities related to the funding of needed governmental projects are relegated to state and local governments, often assisted by a certain amount of Federal money. It is, in our view, right and proper that the Federal government support such projects, because:

a) costs of certain physical projects are often too great for state and local governments to fund them fully;

b) in many cases, state and local funding relates to Federal mandates that are pushed down to lower levels without the needed money to pay for them; and,

3) in a great number of cases, if the projects are not built and maintained in good order, the national economy will suffer.

In our view, all of the major changes proposed in the tax bills impair fiscal federalism in one fashion or another: Elimination of advance refundings, elimination of PABs, and elimination of deductibility of state and local taxes.

What is an advanced refunding?

Under current law, issuers of debt for state and local projects and nonprofit healthcare/higher education facilities can advance refund their debt one time over the life of the bonds. In an advance refunding, an issuer undertakes a new financing before the old bonds can be called, invests the proceeds in Federal Government Securities, and uses the interest and principal on the Federal Government Securities to call the old bonds on the first call date. Advanced refunding are most commonly used for long-term projects where

savings from lower borrowing costs related to the refunding will be substantial, such as water, power, healthcare, higher education and transportation bonds.

We can identify three major purposes to undertake an advance refunding:

a) take advantage of sharply lower borrowing costs than those that prevailed when the bonds were originally issued (when such an opportunity arises),

b) refinance certain types of projects to effectuate a merger, and,

c) in the case of governments facing severe financial pressure, lengthening the average maturity of existing debt to reduce the amount of debt service due annually.

For at least the last 8 years advanced refundings done to take advantage of lower interest costs have rarely been done more than roughly two years before the bonds can be called, thereby limiting the cost of this process to the Federal government.

The case for maintaining access to advance refundings as under current law.

In our view, there are a large number of public policy reasons to maintain access to advance refundings under rules contained in the existing tax code including fiscal federalism. These include:

--Allowing state and local issuers the flexibility they anticipated when bonds were originally issued. A vast number of state and local issuers are structured to be outstanding for 10 years before they can be called, specifically because a 10-year call date has historically provided an effective balance between the time to first call at issuance, and the time at which an advance refunding is fiscally feasible. If advance refundings were to be eliminated, issuers would have to consider issuing bonds with shorter call protection to maintain financial flexibility resulting in higher initial borrowing costs.

--Retroactive change in flexibility. Bonds that were issued under current law would lose flexibility relative to current law that was not anticipated when bonds were issued and structured.

--Compelling needs to advance refund that are not related to cost savings. As noted above, there are two circumstances where advance refundings are compelling for reasons not related to trends in borrowing costs. a) These occur in the healthcare sector specifically, when a weakened hospital is “ripe” to be acquired by a stronger system, but must refund outstanding debt to meet contracts with existing bondholders. This process can save a failing hospital, and all of the services it currently provides. b) They occur when a local government is facing a financial crisis that can be ameliorated by advanced refunding some existing bonds, and replacing them with longer-maturity bonds that cost the issuer less on an annual basis.

--Massive overestimate of cost. We also believe that it is unlikely that the $17 billion estimate takes into account the fact that in recent years most advanced refundings have only been done less that two years before the old bonds will be called.

Bottom line: We also believe that elimination of financial flexibility for state and local governments is a form of new “hidden tax,” relative to the current code.

Disclaimer: The opinions and statements expressed in this report are solely those of the author(s), who is solely responsible for the accuracy and completeness of this report. The opinions and statements expressed on this report are for informational purposes only, and are not intended to provide investment advice or guidance in any way and do not represent a solicitation to buy, sell or hold any of the securities mentioned. Opinions and statements expressed reflect only the view or judgment of the author(s) at the time of publication, and are subject to change without notice. Information has been derived from sources deemed to be reliable, but the reliability of which is not guaranteed. Readers are encouraged to obtain official statements and other disclosure documents on their own and/or to consult with their own investment professional and advisors prior to making any investment decisions.