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Only a Limited Chance Advance Refundings Come Back

THE THREAT TO THE TAX EXEMPTION MEANS UNCERTAINTY FOR MUNICIPALS

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Summary

Not only is there just a limited chance for advance refundings to make a comeback, we believe the threat to the municipal bond tax exemption has never left despite the lack of attention toward it by municipal market participants and observers since the Tax Cuts and Jobs Act of 2017 repealed advance refundings. Efforts for federal deficit reduction are likely to gain attention in the coming years. The threat to the tax exemption remains and it makes for an uncertain future for municipals.

Are Advance Refundings Coming Back?

On May 15, 2019, Representative Dutch Ruppersberger, D-MD, who served as a county executive for almost 20 years, introduced H.R. 2772 of the 116th Congress, a bill that seeks to reinstate advance-refunding bonds.[1]

The introduction of H.R. 2772 is a step in the right direction. Yet, while the proposed legislation has bi-partisan support from seven Democrats and three Republicans, it faces substantial legislative and financial roadblocks.

The introduction of the bill alone is a success of sorts. Issuer and industry groups alike have been lobbying congressional lawmakers to reinstate advance refundings since they were eliminated by the Tax Cuts and Jobs Act of 2017. Some issuer and industry groups have also been asking for more than just the restoration of advance refundings. Among other policy proposals, they've also asked Congress to expand the definition of private activity bonds (PABs), increase the bank qualification eligibility, and introduce a new type of sequestration-proof, direct-pay bond similar to the Recovery Act's Build America Bonds (BABs).

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1. There's a backlog of priorities D.C. lawmakers need to consider before the end of the year, including disaster aid, an agreement to raise spending levels for defense and nondefense agencies (budget caps), a debt ceiling extension, and a renewed agreement for government funding (most lawmakers want to avoid a second federal government shutdown in 2019).[2]

2. The potential for an infrastructure package seemed bright after lawmakers from both sides agreed on $2 trillion. However, they agreed on this amount in April and didn't negotiate specifics. Neither side compromised on how to spend the $2 trillion or, more importantly, how to pay for it, leading to dim prospects for the infrastructure plan. Democrats are seemingly asking for the moon, and no-tax pledges are holding Republicans hostage. Therefore, it's not likely lawmakers will come to an agreement on infrastructure this year, which also dims prospects for an advance refunding reboot if it was to be attached to a larger legislative vehicle.[3]

3. The threat of near-to-medium term deficit reduction is probably the most substantial barrier lawmakers face in reinstituting advance refundings or earning

the other items on issuer and industry group's wish lists. Several federal agencies maintain that the federal government's current fiscal path is unsustainable:

> "The 2018 Financial Report, the Congressional Budget Office and the Government Accountability Office (GAO) all project that federal debt held by the public will grow unsustainably into the future."[4]

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It seems that many observers have forgotten about the threat that deficit reduction has posed to the municipal bond tax exemption, especially in the wake of the 2008 financial crisis. The below is a reminder.

The Threat to the Municipal Bond Tax Exemption

Recently, the impact of federal government policy on municipal market issuer finances has been mixed. In 2009, President Obama signed into law the American Recovery and Reinvestment Act, a $787 billion stimulus package. Its provisions boosted aid to state and local governments and healthcare and education providers, as well as incentivized infrastructure investment. Some expected Congress to provide a follow up to the act, but it never materialized—partly because of Tea Party opposition. BABs were also a product of the 2009 Recovery Act and considered one of its triumphs. However, they expired at the end of 2010 due, in part, to their success.

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The Great Recession finally ended in June 2009 and in its wake came proposals to control the rising U.S. deficit. In 2010, the Simpson-Bowles-led National Commission on Fiscal Responsibility and Reform, seeking to reduce the deficit by $4 trillion, prepared a menu of revenue enhancements and spending cuts. The Simpson-Bowles plan eliminated several tax deductions and expenditures, including the municipal bond tax-exemption tax expenditure.

At the time, many observers considered these eliminations a shot across the bow toward the tax exemption, even though the Simpson-Bowles plan did not pass. A tax expenditure supports government policy by providing a taxpayer benefit that's supposed to achieve a specific goal. For example, the mortgage interest deduction is a well-known tax-expenditure provision. The accompanying table illustrates the estimates for tax expenditures related to municipal bonds from 2018-2028.

Summary of Estimates for Municipal Bond Related Tax Expenditures 2018-2019 ($ in millions)

Exclusion of interest on State & Local bonds for:	2018	2019	2020	2021	2022	2023	2024	2025
Public purposes	$19,550	$21,390	$22,730	$24,690	$27,090	$29,330	$30,840	$31,920
Energy facilities	10	10	10	10	10	10	10	10
Water, sewage, and hazardous waste disposal facilities	270	300	320	340	380	410	430	440
Small-issues	100	110	110	120	130	140	150	160
Owner-occupied mortgage subsidies	750	820	870	940	1,030	1,120	1,180	1,220
Rental housing	770	850	900	980	1,070	1,160	1,220	1,260
Airports, docks, and similar facilities	470	510	550	590	650	710	740	770
Student loans	200	220	240	260	280	310	320	330
Private nonprofit educational facilities	1,550	1,690	1,800	1,950	2,140	2,320	2,440	2,530
Hospital construction	2,280	2,500	2,650	2,880	3,160	3,420	3,600	3,720
Veterans' housing	30	30	30	40	40	40	40	50
Total bond tax-expenditure	$25,980	$28,430	$30,210	$32,800	$35,980	$38,970	$40,970	$42,410

Source: Analytical Perspective, Budget of the U.S. Govt. FY20; Table 16-2B; page 193, 194; Addendum: Aid to State and local governments

Prior to 2011, the process to approve increases in the federal debt ceiling was practically automatic, mostly because of the systemic financial consequences posed by not doing so. However, D.C. lawmakers politicized the process, leading to the summer 2011 debt-ceiling showdown. Finally, in the 11th hour at the end of July, lawmakers agreed upon the Budget Control Act (BCA) of 2011. Days later, S&P downgraded the U.S. Sovereign rating to AA+ and kept the "Negative" outlook despite the BCA. S&P identified both financial and political reasons for their souring take on the U.S. credit. The rating agency wrote:

Leading up to the Fiscal Cliff, the municipal bond tax expenditure was almost included in a budget agreement that would have eliminated several related tax deductions and expenditures.

> "The political brinkmanship of recent months highlights what we see as America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed."[5]

Now, years after S&P downgraded the U.S., the rating agencies have assigned Aaa/AA+/AAA ratings to the country's sovereign credit.

It's incredible to think the issues, political maneuvering, and results could get any messier—but they did. On January 1, 2013, previously enacted laws effectively increased taxes and decreased government spending, creating what experts identified as a "Fiscal Cliff." Leading up to the Fiscal Cliff, the municipal bond tax expenditure was almost included in a budget agreement that would have eliminated several related tax deductions and expenditures.

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A sequester is a spending procedure created by the Balanced Budget and Emergency Deficit Control Act of 1985. Under a sequester, the Federal Office of Management and Budget issues an order using a formula set forth in a statute to cap spending of federal programs. This sequester mechanism caused BABs and other Recovery Act program bonds to lose a small amount of their subsidy. In 2018, the sequester cut the subsidy by 6.2%, down from the 8.7% reduction in 2013.

The Repeal of Advance Refundings - Tax Cuts and Jobs Act of 2017

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A tax cut put municipals in federal lawmaker's crosshairs at the end of 2017. Starting in November 2017, federal lawmakers offered up a tax plan that would curtail some municipal market issuers' ability to sell tax-exempt bonds. Most notably, the proposed scheme sought to repeal both the issuance of private activity bonds (which includes 501(c)3 organizations such as hospitals and universities) and advance refundings.

Because of the potential threat, issuers flocked to the market in the last two months of 2017 with $115 billion of issuance. In the end, PABs were saved. However, issuers lost the ability to sell advance-refunding bonds for $17.4 billion in estimated savings between 2018 and 2027.

Municipal Bond Related Tax Cuts and Jobs Act of 2017 Estimated Budget Effects ($ in millions)

Provision	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-2027
Repeal of Advance Refunding Bonds	$400	$1,100	$1,400	$1,700	$2,000	$2,100	$2,100	$2,200	$2,200	$2,200	$17,400

Source: Joint Committee on Taxation December 2017 estimate.

The 2017 attacks on the municipal bond tax exemption had one positive result: they jump-started issuer and industry group support for the municipal bond tax exemption and its components.

A product of that support is the previously mentioned H.R. 2772.[1] At a time when all governmental and other municipal issuers need access to any and every tool available, it's important that Washington lawmakers find a way to support them. It's also important that issuer and industry groups, as well as other proponents, share the facts about the day-to-day positive impact of advance refundings and the municipal bond tax expenditure.

Time could be running out on the municipal bond tax exemption, and it's possible that the advance refunding repeal is just the beginning. Remember, at some point lawmakers will need to revisit deficit reduction and again become serious about it. When that time comes, the municipal bond tax exemption and what is left of its components could be on the chopping block once again.

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1. Please see Congress.gov for an update on the legislative progress of H.R. 2772 – 116th Congress: To Amend the Internal Revenue Code of 1986 to reinstate advance refunding bonds. As of May 15, 2019, the bill was referred to the House Committee on Ways and Means.
2. See more in To-do list piles up for Congress, Jordain Carney, The Hill, May 28, 2019.
3. See more in Trump falls short on infrastructure after promising to build roads, bridges and consensus, Toluse Olorunnipa and Mike DeBonis, the Washington Post, May 26, 2019.
4. The Nation's Fiscal Health: Action is Needed to Address the Federal Government's Fiscal Future, GAO-19-314SP, April 10, 2019.
5. United States of America Long-Term Rating Lowered to AA+ On Political Risks and Rising Debt Burden; Outlook Negative; Standard and Poor's; August 5, 2011.