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Infrastructure and Tax Proposals Lift Muni Market's Profile

We believe the American Jobs Plan and Made in America Tax Plan, which propose infrastructure spending and corporate tax hikes, will likely boost the outlook for municipal bonds (munis) and the broad economy.

GLOBAL FIXED INCOME

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KEY TAKEAWAYS

- We believe the traditional infrastructure projects highlighted in the proposed American Jobs Plan support the muni market.
- The proposal to raise corporate taxes to pay for the projects could fuel demand for tax-exempt munis, which would benefit the muni market overall.
- We believe the American Jobs Plan promotes job gains and productivity, which ultimately should support economic growth.
- Despite the Democrats' control of Congress, there's some room for negotiation on the tax rate and size of the infrastructure plan.
- We expect most spending provisions of the legislation to pass, largely because Senate Democrats might use the budget reconciliation process to avoid a Republican filibuster.

President Joe Biden recently revealed his American Jobs Plan (AJP), a massive eight-year spending proposal for infrastructure and other projects. The plan's original $2.3 trillion price tag would equal approximately 1% of annual U.S. gross domestic product (total economic output in goods and services) in each year of the legislation's lifespan. The Biden Administration has subsequently proposed reducing the size of the plan. The administration is seeking higher corporate taxes to pay for the legislation.

We believe higher tax rates, along with the AJP's infrastructure mandates, should benefit the muni market and muni investors. We also expect the proposal to promote job growth and broad U.S. economic gains.

SELECT SECTORS SET TO ADVANCE

The plan directs a portion of spending to traditional infrastructure projects, such as road construction, water system upgrades and electrical power grid enhancements. For muni investors, this focus could directly benefit select securities, including transportation, water/sewer and public power credits. The proposed federal spending for these projects could offset the need for locally debt-financed projects.

However, despite the plan's substantial size, it only meets a fraction of the nation's infrastructure needs. Moody's reports the plan's proposed annual expenditures for roads and bridges ($115 billion) represents only 10% of the amount the U.S. currently spends on infrastructure.

Much of the plan includes spending on items not considered traditional infrastructure, such as health care access, domestic manufacturing and workforce development. Climate change and social inequity initiatives also are among the non-infrastructure issues the bill would finance. See **Figure 1**.

BILL SHOULD GO FURTHER TO SUPPORT THE MUNI MARKET

The AJP still faces congressional scrutiny and debate, so final provisions of the legislation aren't yet clear. But we're hoping the final bill addresses two key issues important to muni investors—advance refunding bonds and Build America Bonds.

Return of advance refunding bonds would likely aid market

The 2017 Tax Cuts & Jobs Act prevented certain municipalities from refinancing existing debt by issuing new tax-exempt debt—a process known as advance refunding. Some issuers worked around this restriction by refinancing with taxable munis, which proved advantageous when Treasury yields were ultra-low. But with Treasuries now on the rise, this tactic is no longer as appealing.

The current AJP doesn't address the reinstatement of tax-exempt advance refunding bonds. However, we believe reinstating the bonds would provide these benefits to the muni market:

- It would increase the supply of tax-exempt (versus taxable) munis.
- It would give municipal issuers more flexibility in lowering their interest costs—a positive factor for credit ratings.
- It may benefit muni total returns, given the price appreciation potential and economic advantages often associated with tax-exempt advance refundings versus taxable.

FIGURE 1

White House Infrastructure Initial Proposed Spending ($ billions)

Transportation	
Electric Vehicles	$174
Roads, Bridges	$115
Public Transit	$85
Railroads	$80
Transportation Climate Defense	$50
Airports	$25
Ports, Ferries, Waterways	$17
Other Transportation	$75
Transportation Total	**$621B**
Housing and Construction	
School Construction	$100
Housing Upgrades	$213
Public Housing Construction	$40
Child Care Facilities	$25
Other Buildings	$40
Housing and Construction Total	**$418B**
Essential Services	
High-Speed Broadband	$100
Water Infrastructure	$111
Electric Grid	$100
Essential Services Total	**$311B**
Other Items	
Manufacturing	$150
Research & Development	$244
Worker Development and Protection	$98
Medicaid Home & Community-Based Care	$400
Other	$46
Other Items Total	**$938B**
Grand Total	**$2.3T**

Sources: Citi Research, The White House, Spring 2021.

Build America Bonds program could lower borrower costs

An Obama administration relic, the taxable Build America Bonds (BAB) program provided financing for muni issuers during the financial crisis. The federal government subsidized the interest rates on BABs, which lowered the cost of borrowing for infrastructure projects. The program expired in 2010.

We believe enacting a BAB-like program would benefit the muni market.

- It would allow issuers to offer low-cost taxable debt to a broader market, including life insurance companies, pension funds and sovereign buyers.
- BABs could serve as a low-cost alternative to funding a portion of the AJP.
- Of course, issuer use of BABs would depend on the level of federal subsidies issuers receive. They would be more likely to use this funding mechanism if the program guaranteed subsidy payments. The government eventually reduced subsidies for the original BAB plan.

DEMAND FOR MUNIS LIKELY TO SOAR AS TAX RATES RISE

Paying for the AJP would require higher taxes—specifically, corporate tax increases and changes spread over 15 years. And higher taxes may make the tax-exempt muni market more attractive to some investors.

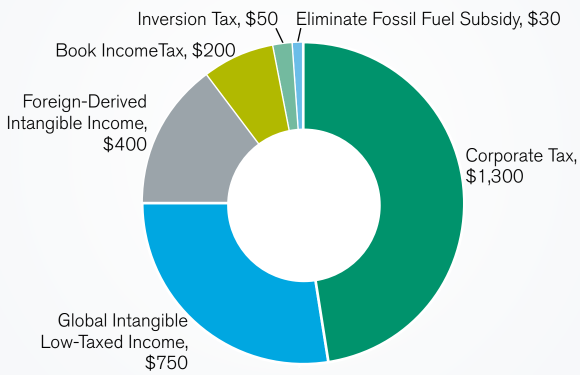
President Biden is currently proposing to lift the corporate income tax rate from 21% to 28%. He's also pushing for companies with net incomes in excess of $2 billion to pay a 15% minimum tax on book income (the amount of income reported to shareholders on financial statements).

The Biden administration asserts these hikes, along with other new corporate tax provisions, would raise $2.75 trillion in revenue over 15 years. See **Figure 2**.

FIGURE 2

Funding the American Jobs Plan

(TAX REVENUE COLLECTED OVER 15 YEARS)



Data in billions. Source: Committee for a Responsible Federal Budget, April 2021.

With corporations funding most of the AJP, we expect increased demand for munis, particularly from banks and property and casualty insurers. These companies are among the largest buyers of munis, after mutual funds and individuals.

RESISTANCE PERSISTS

The AJP will likely face changes, given resistance from Republicans and some Democrats.

Republicans balk at higher taxes, plan's broad scope

Republicans generally oppose the bill's higher corporate tax rates and its focus on significant non-infrastructure spending. Recently, congressional Republicans offered their own version of a traditional infrastructure bill with a much more modest price tag of $568 billion. Senate Majority Leader Mitch McConnell also said the AJP in its current format would receive no Republican support.

Democrats seek SALT deductions

Some Democrats from high-tax states oppose the current AJP because it doesn't repeal restrictions on state and local tax (SALT) deductions. The 2017 Tax Cuts & Jobs Act capped the SALT deduction at $10,000 per year. Since then, higher-income taxpayers from high-tax states have been clamoring for a repeal.

Reconciliation may ensure bill's passage

Both parties claim they want a bipartisan bill. But because the Democrats have the majority in Congress, they also have a path to passing the bill they want.

To avoid a Republican filibuster in the Senate, it's likely Democrats will use the budget reconciliation process to secure most or all AJP spending provisions. However, given the reluctance of some Democrats to raise corporate taxes and maintain SALT deduction limits, some compromise is likely. In our view, the final bill may feature a smaller hike in the corporate tax rate and an increase in the current SALT cap.

OUTLOOK IS UPBEAT FOR MUNIS

While the final AJP likely will differ from the proposed version, we believe the muni market will remain a key beneficiary. The bill's infrastructure spending should directly benefit municipalities across the country. Additionally, we believe the higher corporate tax rates to pay for those projects likely would boost demand for munis from corporations looking to ease their tax burdens.

Meanwhile, we believe reopening of the U.S. economy and ongoing recovery bode well for the muni market. The massive fiscal spending already working its way through the economy, including direct federal aid to state and local governments, is providing support. Furthermore, the market continues to benefit from robust investor demand for tax-exempt munis amid the modest amount of new muni bond issuance.

GLOSSARY

Municipal securities. Debt securities typically issued by or on behalf of U.S. state and local governments, their agencies or authorities to raise money for a variety of public purposes, including financing for state and local governments as well as financing for specific projects and public facilities. The interest income earned on most munis is exempt from federal income taxes. Interest payments are also generally exempt from state and local taxes if the bond owner resides within the state or municipality that issued the security.

U.S. Treasury securities. Debt securities issued by the U.S. Treasury and backed by the direct "full faith and credit" pledge of the U.S. government. Treasury securities include bills (maturing in one year or less), notes (maturing in two to 10 years) and bonds (maturing in more than 10 years). They are generally considered among the highest quality and most liquid securities in the world.

Yield. Yield is a rate of rate of return on bonds and other fixed-income securities.

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