U.S. Municipal Bond Market

Mostly Constructive News for Public Finance in Ways and Means Committee's Build Back Better Markup, However the Path for Passage Remains Challenging

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- The Ways and Means Committee's $3.5 trillion Build Back Better markup includes several public finance friendly elements such as the reinstatement of advance refundings with tax-exempt bonds, a direct pay taxable bond program (similar to, but not exactly the same as BABs), an increase in the bank-qualified limit, and several other elements.
- Issuers are still not likely to see this direct-pay bond program as entirely advantageous despite the sequestration-proof language included in the proposal, because many of them were burned by BABs the first time around. We are also concerned the Davis Bacon Act requirement may add a level of complication and expense as well.
- Frankly, what really matters is that the passage for either the $3.5 trillion of $1 trillion infrastructure packages, at least currently, remains unlikely unless the political landscape significantly shifts. Just this weekend Senator Manchin said he is a "hard-no," on the $3.5 trillion plan. Last week he described in the Wall Street Journal Why I Won't Support Spending Another $3.5 Trillion.

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Ways and Means Committee's Build Back Better Markup Released

There is mostly constructive news for U.S. public finance in the Ways and Means Committee markup that was just released as part of preparation for the legislative details that could be included in the $3.5 trillion Build Back Better plan. A full text of the Committee Print Consisting of Subtitles F, G, H, and J Budget Reconciliation Legislative Recommendations Relating to Infrastructure Financing, Green Energy, Social Safety Net, and Prescription Drugs can be found here at the Ways and Means website. A section-by-section summary of the Committee Print for Subtitles F, G, H, and J from Ways and Means can also be found here.

We were disappointed in the lack of municipal bond-friendly elements that were included in the $1+ trillion bipartisan infrastructure agreement passed by the Senate at the beginning of August. However, we were expecting there could be more substance included in a draft of the $3.5 trillion text, and what was included should be considered positive for public finance going forward if it in fact is able to pass into law. We write about the chances of it becoming law in more detail below. For now, we want to outline the major public finance related details included.

Advance Refunding Bonds

This legislation would reinstate tax-exempt bonds for advance refundings. Advance refundings with tax-exempts were lost as a result of the 2017 Tax Cut. Many entities have issued taxable bonds as a replacement strategy, but we expect public finance issuers overall would like to have this option returned and that it would be heavily used if it was returned.

New Direct Pay Qualified Infrastructure Bonds

Public finance issuers sold about $187 billion of taxable Build America Bonds (BAB) back in 2009 and 2010. The federal government's BAB program initially offered a 35% subsidy directly to issuers, making it an attractive option compared to tax-exempt bonds considering market conditions at the time.

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This iteration of a Qualified Infrastructure Bond would be a direct pay and would include a subsidy that begins at 35%, but declines to 28% on and after 2027.

Subsidy Rate

35%.....2022 through 2024
32%.....2025
30%.....2026
28%.....2027 and after

We should note the tax credit versus direct pay question has been answered despite initial confusion. It has been confirmed to us that the program will offer a direct payment, as noted above, to the issuer of the subsidy amount. The program would not be a tax credit or credit.

There is also a gross-up provision included in the text that basically says that a gross-up of the subsidy will occur in case of sequestration. For some, this will be considered an absolute plus because this is one of the key concerns many had with the BAB subsidy. This concern existed because the BAB subsidy that the federal government has been paying has been cut every year since the budget sequestration in 2013, when issuers started receiving about 6% to 8% less of a subsidy payment than what they originally promised.

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We expect that issuers will continue to be skeptical toward accepting the federal government's terms even though this gross-up provision exists. We have heard too much negative reaction from issuers to think they will have faith that this program could be sequestration-proof according to the terms. Issuers are also going to be skeptical and anticipate that something sequestration-like may occur, and that the federal government for some other reason may end up cutting their subsidy. We believe many will choose to go the more certain route, unless there is so much of an advantage that the option could not be passed up. But, even then, we think they will be still be very skeptical.

Another provision included in the draft text is that the proceeds must meet the requirements of the Davis Bacon Act. Depending on how stringent the requirements, this could offer another barrier to issuer interest. We currently need more information to determine how this will impact labor or wage costs going forward to gauge the severity.

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Small Issuer or Bank Qualified Limit Would Increase to $30 million

Banks have not been as interested in tax-exempt municipals since the 2017 Tax Cut, and it is unclear if such a change would boost bank appetite.

The legislation would permanently increase the small issuer definition to $30 million from $10 million. A similar change occurred temporarily in the wake of the 2008 Financial Crisis and as a result helped increase the amount of municipal bonds purchased by financial institutions. Banks have not been as interested in tax-exempt municipals since the 2017 Tax Cut, and it is unclear if such a change would boost bank appetite.

Other Municipal Bond Related Provisions

There are also several other smaller but still important provisions that were included in the legislative text including, among several others:

- Expansion of private activity bond rules for first-time farmers;
- Certain water and sewage facility bonds exempt from private activity volume cap;
- Exempt facility bonds for zero-emission vehicle infrastructure;
- Credit for operations and maintenance costs of government owned broadband;
- Permanent extension of New Markets tax credit;
- Rehabilitation tax credit;
- Qualification of rehabilitation expenditures for public school buildings for rehabilitation credit;
- Increases in state allocation for the Low-Income Housing Tax Credit;
- Treatment of Indian Tribes as states with respect to bond issuance;
- New Market tax credits for tribal statistical areas; and
- Possessions economic activity credit, New market tax credit for Territories

The larger question is whether the $3.5 trillion Build Back Better agenda actually has a chance to become law.

Will the $3.5 Trillion Build Back Better Agenda Become Law?

The larger question is whether the $3.5 trillion Build Back Better agenda actually has a chance to become law. We indicated at the beginning of the month that although Lawmakers Moved Closer on Infrastructure in August, [there is] Still No Clear Path for either of the proposals to become law.

On Sunday's episode of Meet the Press with Chuck Todd, Senator Joe Manchin (D-WV) said he is a "hard no" on the $3.5 trillion plan. Last week, he described in the Wall Street Journal, Why I Won't Support Spending Another $3.5 Trillion. The Democrats need his vote to not only get the $3.5 trillion done, but also for the House to approve the $1 trillion bipartisan plan in the aforementioned Sept. 1 report.

Remember, infrastructure is currently not the only topic being considered by lawmakers. Now that there are only 17 days until Congress faces a budget deadline, that could result in a government shutdown, and a debt ceiling deadline is coming as early as Oct. 1, infrastructure negotiations may be pushed aside.

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