U.S. Municipal Bond Market

Dems Step Closer to Finalizing Infrastructure & Build Back Better After White House Tactics, Public Finance Elements Dropped

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- A new $1.75 trillion framework was released Thursday with updated details about what could be included in the president's and progressive Democrats' Build Back Better Agenda.
- Even though a vote on the bipartisan infrastructure bill did not occur yesterday, two important tasks were accomplished by the Democratic leadership. They probably expected this to be the case all along, or at least since the beginning of this week.
- The municipal bond friendly elements like the subsidized taxable infrastructure bond program and reinstatement of tax-exempts for advance refundings were left out of the new framework.
- Nothing was included in the new $1.75 trillion framework related to the SALT cap.
- On Thursday, Congress voted to extend highway funding to Dec. 3, 2021. This sets up a legislative cliff for that day.

The Leadership Knew They Did Not Have the Votes

Before we get to discussing the implications of Democrats dropping the public finance friendly elements from the latest round of the Build Back Better framework, let's analyze why the White House, even though it likely knew that the House was not going to vote on the package yesterday, released the framework and pressured members to consider a vote.

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Summary of White House's Latest $1.75 Trillion Build Back Better Proposal

Yellow shading meant to highlight items.

Policy	Ten-Year Cost *($ in billions)*
Child Care and Preschool	$400
Home Care	150
Child Care & Earned Income Tax Credits	200
Clean Energy (tax credits) and Climate Investments	555
ACA Credit, Including in Uncovered States	130
Medicare Hearing	35
Housing	150
Higher Ed (acess beyond high school) & Workforce (development)	40
Equity & Other Investments	90
Subtotal	$1,750
Immigration reform (if compliant with the Byrd rule)	100
Total	**$1,850**

Source: The White House and HilltopSecurities.

The first reason is the tactic did help move the ball down the field. A vote did not occur, but language was released, and afterward progressive Democrat leader Pramila Jayapal said she expects the House will be able to pass the Build Back Better Agenda and the bipartisan infrastructure package next week. So now the Democrats are in fact a step closer to a significant legislative accomplishment.

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The second reason is that President Biden likely wanted to have a substantial piece of the package focused on clean energy and climate so he could publicize them while he is in Europe and participating in the G20 Summit in Rome and the United Nations Glasgow Climate Change Conference. The president was successful on both accounts. However, yesterday's events, while they helped to move the legislative "ball" down the field for the Democrats, came at a cost to state and local governments and other public finance entities.

Out: Infrastructure Bonds, Reinstatement of Tax-Exempts for Advance Refundings

The municipal bond friendly elements like the subsidized taxable infrastructure bond program and reinstatement of tax-exempts for advance refundings were left out of a $1.75 trillion framework that was circulated in Washington on Thursday. This framework, released by the White House, is being considered as the latest iteration of the Democrats Build Back Better Agenda.

It should not be considered a surprise that the package evolved this way, as lawmakers had a difficult task in front of them.

Highlights in the newest version of the framework include:

- $555 billion for Clean Energy and Climate Investments;
- $400 billion for Child Care and Preschool; and
- $200 billion for child Tax & Earned Income Tax Credits.

A description of the public finance friendly elements were nowhere to be found. They were dropped completely.

Not a Surprise

It should not be considered a surprise that the package evolved this way, as lawmakers had a difficult task in front of them. They needed to reduce a $3.5 trillion proposal down to something between $1.5 to $2.0 trillion. The framework they proposed Thursday is $1.75 trillion, but that total is also likely to be reduced if they want to have a chance at passing it at some point. Senator Joe Manchin has been staying true to his ceiling of $1.5 trillion, even though there are signals from Senator Joe Manchin on the $1.75 trillion number.

Spending had to be prioritized and some of the progressive goals had to end up on the cutting room floor. On the one hand I thought there was a very slight chance the direct pay infrastructure program could at least be included, even if the other elements fell out. It was not a good sign for the municipal elements when spending line-items like community college began falling out of what lawmakers were aiming for. It was a strong possibility that the $40 billion or so of municipal elements could also get cut when so many priorities like community college and paid leave were being abandoned. These municipal friendly elements were not part of the

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progressives' agenda. Anything that was not part of the core part of the progressives' agenda was at risk of being cut.

Implications for Public Finance

Losing the taxable, subsidized, infrastructure bond option was probably not as impactful as it may seem. This version paled in comparison to the 2009 Recovery Act's Build America Bonds (BAB) mostly because the subsidy was not even close this time around. But also, we questioned the attractiveness of the taxable, subsidized, infrastructure bond to issuers today. Our doubt exists because we think that issuers across the board still feel burned by the subsidy cuts that occurred to the BAB payments from the federal government as a result of the 2013 budget sequestration. Even though the new taxable, subsidized, infrastructure bond included sequestration-proof language, we do not think there was much faith in the federal government where this was concerned. Even if the infrastrucutre bonds were implemented, we were not planning on making a significant allocation for them in our 2022 issuance forecast.

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We do think that state and local governments and other public finance entities missed out on something in the form of debt service savings when they lost the potential ability to execute advance refundings with tax-exempt bonds. This ability was lost as a result of the 2017 Tax Cuts and Jobs Act, but many were hoping and maybe even expecting a return. This will likely cost billions of dollars in debt service savings for state and local governments and other public finance entities. We most likely would have allocated a healthy amount of refunding issuance if this would have been included in the Build Back Better agenda.

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The Value of Tax-Exempt Municipal Bonds Will Remain

Even though these important elements are likely lost, we still think there is constructive news at least for investors. That is because the value of tax-exempt municipal bonds is still likely to get an imperceptible boost from the higher tax rates that are being proposed and that will likely be implemented in one form or another. This is not going to be meaningfully enough to show up in pricing or trading activity, however. Lawmakers likely must find something between $1.5 trillion and $1.75 trillion of offsets to help pay for the Democrats' historic investments. There were even $1.9 trillion of offsets included in the recent framework. At least two of these should offer incentive to investors to increasingly consider tax-exempt municipal bonds.

However, there is currently already a healthy amount of demand for tax-exempt and taxable municipal bonds. This can be illustrated in fund flow data and the level of investor participation in primary market transactions. We also not expect the components of this framework to meaningfully reduce investor behavior. This opinion could change if the components or details of the offsets are adjusted. But the changes would have to be drastic for us to think investor behavior could meaningfully decline. After the 2017 Tax Cuts and Jobs Act there were significant changes in the corporate tax rate and the individual tax rates that some thought would have a meaningful impact on investor action, but we did not think investor behavior was likely to change then and it did not for the most part. Some investors

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sold municipal holdings at times since, and the relative value of tax-exempt municipals did take a slight hit where some investor analysis was likely concerned. But, there was nothing that led to believe that the changes from the TCJA increased or would increase municipal yields. Again, we are not expecting investor behavior to change in any way as a result of this framework that could meaningfully impact day to day pricings.

It is important to note that there was also nothing included in the $1.75 trillion framework related to getting rid of the $10,000 state and local government tax deduction cap, or SALT cap.

Summary of Offsets for White House's Latest Build Back Better Proposal

Yellow shading meant to highlight items.

Offsets - Estimates, Subject to Confirmation	Amount *($ in billions)*
15% Corporate Minimum Tax on Large Corporations	$325
Stock Buybacks Tax	125
Corporate International Reform to Stop Rewarding Companies that Ship Jobs Overseas	350
AGI Surcharge on the Top 0.02%	230
Close Medicare Loophole for the Wealthy	250
Limit Business Loses for the Wealthy	170
IRS Investment to Close the Tax Gap	400
Perscription Drugs: Repeal Rebate Rule	145
Total	**$1,995**

Source: The White House and HilltopSecurities.

Nothing on SALT Included

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Next up where the municipal market and federal government is concerned very well could be a theme that is important but could also be years in the making. We should be on the lookout for the threat to the municipal bond tax-exemption.

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Surface Transportation Extended to Dec. 3

Even though the House did not vote on the bipartisan infrastructure bill yesterday, they did not waste their entire day on Capitol Hill. The House extended highway funding to December 3, setting up what could be a bit of a legislative cliff of items expiring that day, which also include federal government funding and the debt limit extension (although this will likely change based on more updates from the Treasury Dept.). The Senate also indicated the measure would pass by unanimous consent, so it will await the president's signature.

Recent HilltopSecurities Municipal Commentary

- Municipal Friendly Elements are Out, Oct. 28, 2021
- A New Decade & The Threat to the Municipal Bond Tax-Exemption, Oct. 22, 2021
- Lawmakers Shift to Compromise, Some Spending Jettisoned, Municipal Elements Remain if Only For Now, Oct. 20, 2021
- White House Scrambles to Revive its Approval Rating & Legislative Agenda, Municipal Friendly Elements Hang in the Balance, Oct. 15, 2021
- Municipal Bond Friendly Elements Could Be Lost if Build Back Better Agenda is Pared Back, Sept. 30, 2021
- The Road to Getting Infrastructure Done in 2021, Sept. 20, 2021

Readers may view all of the HilltopSecurities Municipal Commentary here.