U.S. Municipal Bond Market

What the Inflation Reduction Act of 2022 Means for U.S. Public Finance

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- The general public finance reaction to the Inflation Reduction Act (IRA) of 2022 will be mixed over time. The overall impact will be minimal to the U.S. municipal bond market on the spending and revenue side.
- Concern the IRA's new 15% corporate minimum tax will decrease municipal demand and liquidity is unfounded. We expect the new tax law to only impact a very small number of large companies. Decreased demand from a half-dozen to a dozen buyers will not meaningfully impact the market's ability to function.
- What we are concerned about is what the pool of companies who may see less value in tax-exempt bonds could look like in five, 10 or 20 years as a result of this change, if it is not repealed. If a larger portion of the insurance and financial industry loses incentive to buy tax-exempts then demand will need to be found elsewhere on a much larger scale than what will need to be replaced in the near-term.
- This haphazard policymaking process highlights the importance of educational efforts about the municipal bond tax-exemption. Public finance, government, and industry groups should be re-energized to teach D.C. lawmakers about the effectiveness of municipal bonds. They are an efficient and useful infrastructure financing tool.

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Senate Passed IRA of 2022, House Likely to Pass, President Will Sign

The U.S. Senate passed the Inflation Reduction Act of 2022 last weekend by a vote of 51-50, the Vice-President broke the tie. The House is likely to vote in favor of it Friday, August 12th or over the weekend of August 13-14, if needed. The Democrats in Congress are again using the budget reconciliation tactic to move this legislation through the lawmaking process. Like we saw with the American Rescue Plan of 2021, there is no bi-

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Policy	Cost (-) Savings (2022 - 2031) $ in billions
Energy and Climate	-$386 billion
Health Care	-$98 billion
Total, Spending and Tax Breaks	-$485 billion
Health Savings	$322 billion
Revenue	$468 billion
Total, Savings and Revenue	$790 billion
Net Deficit Reduction	$305 billion

Source: CBO, Committee for a Responsible Federal Budget & HilltopSecurities.

partisan support for this law. President Biden is not only in favor of the IRA, this or parts of this legislation were included in the $6 trillion of fiscal policy he proposed back in his first 100 days after taking office in the beginning of 2021. Therefore, the President will sign this into law when it reaches his desk.

What is in the Inflation Reduction Act of 2022? There is not much policy included in the IRA that is likely to reduce inflation in the near term, unfortunately. This is mostly spending that was, in some form or another, proposed in previous iterations of the President's three-part Build Back Better agenda. It seems lawmakers simply re-branded this for a more positive voter reaction.

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- The American Rescue Plan, which was already signed into law, and passed through Congress via the budget reconciliation process;
- The American Jobs Plan, and
- The American Families Plan

President Biden's Three-Part, Build Back Better Agenda

Plan	Name	Date / Status	Amount ($ in billions)
One	The American Rescue Plan	March 11, 2021 / Enacted into law	$1,900
Two	The American Jobs Plan	March 31, 2021 / Introduced	2,650
Three	The American Familes Plan	April 28, 2021 / Introduced	1,800
		Total	**$6,350**

Source: HilltopSecurities.

After the Rescue Plan was signed into law Democrats chaotically tried to get the remaining portions of the Build Back Better agenda across the legislative finish line. But, they failed until recently. The American Rescue Plan provided general economic support and a massive boost to public finance with about $650 billion of direct relief for state and local governments and other public entities. The Rescue Plan legislation is the key reason we indicated (and still believe) there is a Golden Age for U.S. Public Finance.

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Progressives in the House and moderates in the Senate however, blocked passage of anything infrastructure, climate, or Build Back Better related for the most of 2021 and until the end of July 2022. The $550 billion Infrastructure Investment and Jobs Act (IIJA) of 2021 was passed with bi-partisan support. While IIJA was better than nothing, it did not include significant public finance friendly elements, and the IIJA is going to do little in creating a real dent in the U.S. infrastructure gap. The IIJA is also not going to support any meaningful increase in municipal bond issuance.

Select Meaningful Legislation Passed (Likely to Pass) Since Biden Became President

Amount ($ in billions)	Title of Legislation	Status
$739	Inflation Reduction Act of 2022	Passed Senate, House to Vote Friday 8/12
$280	Chips and Science Act of 2022	Signed into law Aug 9, 2022
$550	Infrastructure Investment and Jobs Act of 2021	Signed into law Nov. 15, 2021
$1,900	American Rescue Plan Act of 2021	Signed into law March 11, 2021
$3,469	**Total**	

Source: HilltopSecurities.

Manchin and Schumer Surprised Everyone

In July, just a few weeks ago, Senator Joe Manchin and Senator Chuck Schumer startled even Washington insiders with the announcement that they had agreed upon a piece of legislation that is what eventually became the Inflation Reduction Act of 2022. Included in this surprise is $386 billion of spending on energy and climate initiatives, $98 billion for health care, and $305 billion of deficit reduction.

From a big-picture or long-term perspective the energy and climate related line-items are going to be considered a positive to public finance entities concerned with issues related to changing weather patterns and other climate linked themes. It is important to note that not all public finance entities are going to look at these programs and the changes that occur as a result of them as positive developments. These reactions are going to play out over time, they will not be immediate. They will be important to watch as they develop, however. Please see the detailed summary on the last page of this report for more information about specific areas of spending (and revenue creation).

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15% Corporate Minimum Tax is a Consideration for a Handful of Large Companies, but Not an Overwhelming Issue for the U.S. Municipal Bond Market

One of the new and chief revenue provisions included in the IRA is a 15% corporate minimum tax. For the purposes of those interested in the U.S. municipal bond market we mostly care about the fact that this tax applies to U.S. corporations with a 3-year average adjusted book income above $1 billion. The accounting treatment of the new tax is described by the Tax Policy Center in How the Senate-Approved Corporate Minimum Tax Works (Aug. 9, 2022) in more detail. In this analysis the Tax Policy Center notes, and we are strongly highlighting, that there are some investments that are exempt from taxation but reported on book income- and municipal bonds are the major portion of that category.

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So, that leaves us to determine whether or not a meaningful portion of municipal bond buyers will be affected and or will use this accounting method. The Joint Committee on Taxation indicated there would be about 150 companies that would likely be subject to the proposed minimum tax. About 50% of those companies are manufacturing companies, this is one of the reasons we are reading that this tax treatment is going to be impacting manufacturing companies. The other 75 out of 150 companies are in trade, information, holding companies, and other categories.

% Share of Minimum Tax on Adjusted Financial Statement Income by NAICS Code

Sector (NAICS Code)	Share of Additional Tax	Estimated # of Companies
All Manufacturing (31)	49.7%	75
Wholesale Trade (42)	9.3%	14
Retail Trade (44)	4.9%	7
Information (51)	11.5%	17
Management of Companies, Holding Companies (55)	11.2%	17
Other Industries	13.4%	20
Total	100.0%	150

Source: Joint Committee on Taxation and HilltopSecurities.

It is possible, if not likely that there are large-scale banks and/or insurance companies included in the the "other" category. It is also conceivable, if not likely that there are going to be half a dozen to a dozen large banks or insurance companies that are required to treat their current and future municipal bond investments this way, effectively eliminating the value of the municipal bond tax-exemption. We do not think there is going to be a meaningful, if any impact on demand or liquidity in the U.S. municipal bond market, as a result of this new provision. What is most likely is that there will be a small number of large insurance companies and/ or banks that no longer see value in the municipal bond tax-exemption. This change is not likely going to have a consequential impact on the market's ability to match-up buyers and sellers. It is possible that taxable municipals become more valuable to these investors, or they may participate in tax-exempt transactions only when municipal to treasury ratios are in their favor. We also do not expect to see large scale selling by the small number of portfolios affected by this new tax treatment. P&C insurers owned about $2.5 trillion of invested assets according to the National Association of Insurance Commissioners, at the end of 2021. About $1.2 trillion of that amount or 53% was in bond investments. Municipal bond investments make up about 12% of the total amount of P&C insurer's investment portfolios and 23% of all P&C insurer's bond investments.

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We are Concerned About What this Pool of Companies May Look Like Over Time, In the Future This Change Could Potentially Really Put a Dent Into Overall Demand

What we are concerned about is what the pool of companies who may see less value in tax-exempt bonds could look like in five, 10 or 20 years as a result of this change, if it is not repealed. Over time an increased number of companies with likely need to comply with the 15% minimum tax because their revenues will likely increase above the tax law's threshold. If a larger portion of the insurance and financial industry loses incentive to buy tax-exempts then demand will need to be found elsewhere on a much larger scale than what will need to be replaced in the near-term. This is a key concern of ours. The unintended consequences from this tax law provision are putting only a wrinkle in municipal demand for now, but that wrinkle could grow to be more impactful over time. This will likely not be the last we hear about this tax provision and its impact on

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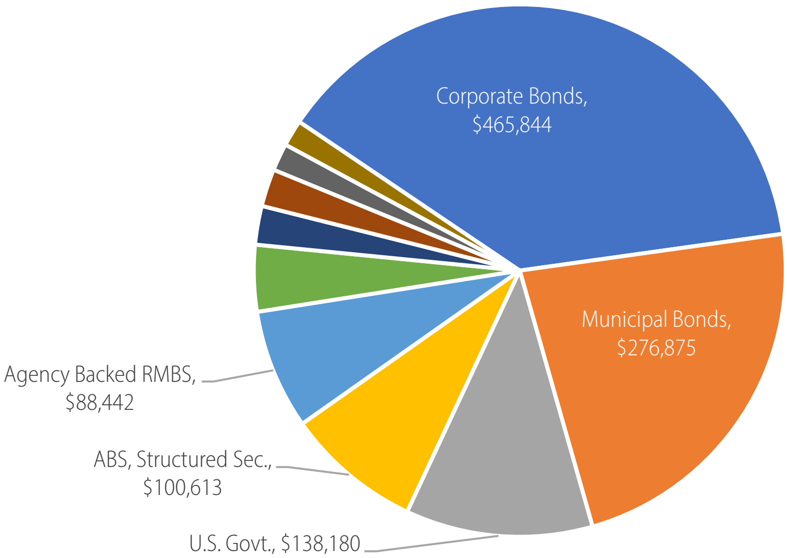
municipal bond demand. Lobbying is not going to be able to change the legislation most likely in the near-term. However, there is time now for state and local government and industry groups to communicate the reality before the impact grows more significant. Lobbying on this topic should not just continue, but it should grow stronger. It is important because the impact from the unintended consequences of this legislation could begin to impact demand and pricing over time.

Breakdown of Bond Investments Held By P&C Insurers, End of 2021



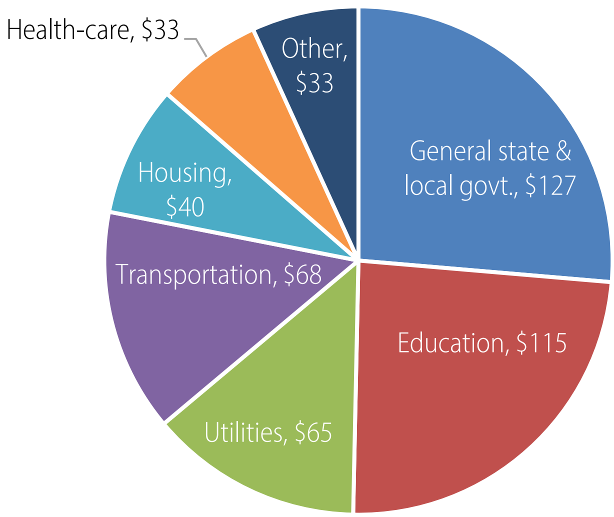
Source: NAIC and HilltopSecurities.

This time around lawmakers barely allowed for any time for feedback, and this lack of time is a key reason why it is that an exception has not been (and probably won't be) carved out of the current version of the IRA for municipal bond investments.

The Larger Potential Threat to the Municipal Bond Tax-Exemption

It is not likely that this new treatment of municipal bond investments was targeted by policymakers. But, this instance does highlight the potential impact that can occur when adjusting tax policy without time for policymakers to weigh-in on the potential consequences of a change. The 2017 Tax Act did target the tax-exemption, and there was not enough time for public finance entities to describe the cost-savings they would lose out on by not being able to utilize tax-exempt bonds for advance refundings. This time around lawmakers barely allowed for any time for feedback, and this lack of time is a key reason why it is that an exception has not been (and probably won't be) carved out of the current version of the IRA for municipal bond investments.

Public Finance Entities Sold $482 billion of Municipal Bonds in 2021, Issuance by Sector



Source: Refinitiv, The Bond Buyer and HilltopSecurities; $ in billions.

We think that tax-exempt municipal bonds are a very important, and effective financing tool that is available to not just large public finance entities but also small cities, towns and school districts. We do not see this tax policy shift as a direct threat to the municipal bond tax exemption, but we do foresee a political landscape that would facilitate a strong threat as we wrote last year in A New Decade & The Threat to the Municipal Bond Tax-Exemption (Oct. 22, 2021).

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This recent policy, and the potential threat on the horizon reinforces the need to educate lawmakers in Washington D.C. about the types of projects that municipal bonds finance. In the accompanying pie chart we note that last year public finance entities sold $482 billion of municipal bonds across different sectors. Issuance has been curtailed this year because of adjustments made in the 2017 Tax Cut. We think the lobbying efforts led by issuer groups like the Government Finance Officers Association deserve credit for making sure that public finance related elements were strongly considered during multiple iterations of 2021 legislation. The fact that municipal bond elements were even considered should be considered a strong win and attributed to these lobbying efforts. These efforts should be positively recognized, and future resources targeted to an increased educational attempt in D.C. Even more work needs to be done to make sure this ground is not lost in coming years.

Inflation Reduction Act of 2022 Detailed Summary

Policy	Cost (-) Savings (2022 - 2031)
Energy and Climate	**-$386 billion**
Clean Electricity Tax Credits	-$161 billion
Air Pollution, Hazardous Materials, Transportation & Infrastructure	-$40 billion
Individual Clean Energy Incentives	-$37 billion
Clean Manufacturing Tax Credits	-$37 billion
Clean Fuel and Vehicle Tax Credits	-$36 billion
Conservation, Rural Development, Forestry	-$35 billion
Building Efficiency, Electrification, Transmission, Industrial, DOE Grants and Loans	-$27 billion
Other Energy and Climate Spending	-$14 billion
Health Care	**-$98 billion**
Extension of Expanded ACA Subsidies (three years)	-$64 billion
Part D Re-Design, LIS Subsidies, Vaccine Coverage	-$34 billion
Total, Spending and Tax Breaks	**-$485 billion**
Health Savings	**$322 billion**
Repeal Trump-Era Drug Rebate Rule	$122 billion
Drug Price Inflation Cap	$101 billion
Negotiation of Certain Drug Prices	$99 billion
Revenue	**$468 billion**
15 Percent Corporate Minimum Tax	$313 billion
IRS Tax Enforcement Funding	$124 billion
Closure of Carried Interest Loophole	$13 billion
Methane Fee, Superfund Fee, Other Revenue	$18 billion
Total, Savings and Revenue	**$790 billion**
Net Deficit Reduction	**$305 billion**

Source: Congressional Budget Office, Committee for a Responsible Federal Budget and HilltopSecurities.

Recent HilltopSecurities Municipal Commentary

- The Municipal Sector is Where Investors Can Wait Out the Uncertainty, Next Recession, July 29, 2022
- A Playbook to Navigate Municipals in the 2nd Half of 2022, July 15, 2022
- Municipals Still Investable in Front of Fed's June 2022 Announcement, June 14, 2022
- REVISED: Our 2022 Municipal Bond Issuance Forecast, June 13, 2022
- School District Credit Quality is Strong, Former Mayor Bloomberg is Overreaching, June 2, 2022

Readers may view all of the HilltopSecurities Municipal Commentary here.