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A NEW PERSPECTIVE

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FOLLOWING THE MONEY: THE IMPACT OF THE INVESTMENT AND JOBS ACT ON MUNICIPAL BONDS

The rollout of the Infrastructure Investments and Jobs Act will substantially impact state and local municipalities. Bond investors should pay close attention, especially to revenue system opportunities.

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THE NEW STANDARD IN WEALTH MANAGEMENT

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Evercore Wealth Management is the wealth management division of Evercore (NYSE: EVR) and is an investment adviser registered with the U.S. Securities and Exchange Commission. Founded in 2008, the firm has been named a leading registered investment advisor (RIA)[1] and now manages $10.5 billion (as of June 30, 2022) in assets for families, foundations, and endowments across the United States. Partners at the firm work directly with clients, providing a more personal and modern alternative to big banks and traditional trust companies. Please visit www.evercorewealthandtrust.com for further information or contact the Evercore Wealth Management office near you.

Overview

The slow but now accelerating rollout of the Infrastructure Investment and Jobs Act, or IIJA, will soon impact the municipal bond market. The $1.2 trillion bill effectively subsidizes many essential purpose revenue systems, making some holdings potentially more attractive to investors. Revenue systems such as transportation and utilities present investment opportunities.

Introduction

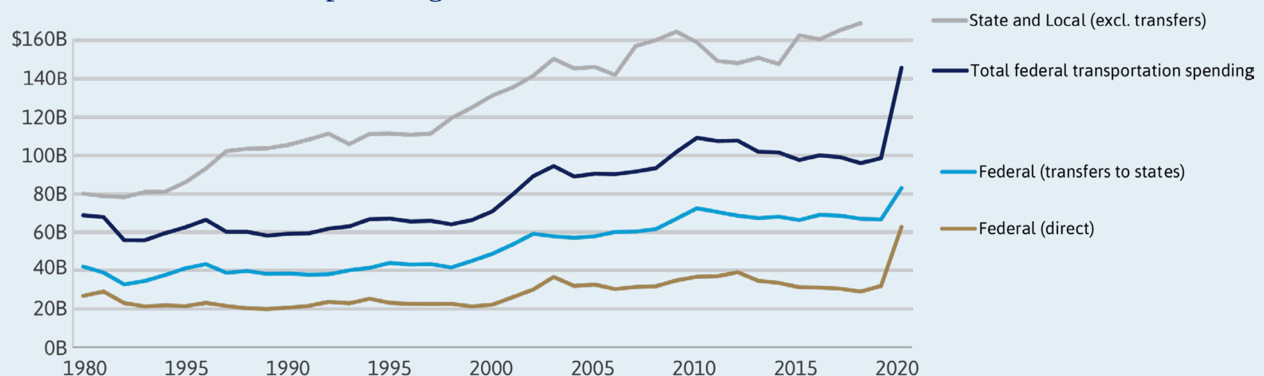
The passage of the remarkably bipartisan IIJA on November 15, 2021, the most comprehensive infrastructure bill in decades, set in motion a chain of events that will likely have impacts on internal government operations, demand for labor, and related supply chains.

The action now shifts from Congress to federal agencies like the Department of Transportation and the Department of Energy, which are responsible for implementing the law, setting up new programs, and finding ways to quickly get the money out the door. Next up will be state and local officials who will assume an even greater burden. As the owners and operators of most infrastructure in this country, they must design and build new assets, hire workers, and mobilize their own financial resources. For municipal bond investors, issues that stand up to rigorous credit analysis, focusing on the demand for the service, demographics of the customer base, capital demands and the financial resources to maintain the system, are now further enhanced by these additional federal monies.

Benefits to State and Local Governments

About two thirds of spending on infrastructure has historically come from the state and local level, as illustrated on the chart below. Consequently, this infusion of federal cash is not expected to replace local capital plans but to incentivize governments to address and supplement their capital needs – and capital needs are abundant. U.S. domestic infrastructure rates just a C- grade overall, according to the last report by the American Society of Civil Engineers, or ASCE. Some components, including the D in stormwater and a D- in mass transit make for worrying reading.[2]

Total Infrastructure Spending



Source: US News & World Report, "A Look at Infrastructure Spending: Old and New", 9/30/21, USAFacts, U.S. Department of the Treasury

From the total bill's $1.2 trillion in infrastructure spending, approximately $550 billion is meant for new spending through 2026. (The remaining $650 billion is meant to maintain funding for already established programs such as federal gas tax receipts for highways.) Of the $550 billion, over half is earmarked for various transportation categories including roads and bridges, rail, public transit, airports and ports/waterways, electric vehicles, buses and ferries and transportation safety and connecting communities. Other significant categories include power and water infrastructure, broadband, system resiliency and environmental remediation. Funds will be allocated based on varying formulas and distribution methods to state and local governments and to government agencies, such as transit authorities, each of which will have a certain amount of autonomy in determining funding for their specific capital needs. While noteworthy, it will not eliminate the backlog of capital needs and deferred maintenance requirements. Indeed, the infrastructure investment gap identified by the ASCE is $2.59 trillion.[3]

Challenges for State and Local Governments

Infrastructure remains the top priority for U.S. mayors, according to the latest *State of the Cities* report published by the National League of Cities.[4] The issue was worsened by the pandemic, with finance officers pausing infrastructure projects to focus on balancing the budget in the face of reduced revenues and elevated costs – prior to federal aid packages and the resumption of projects. Basic public infrastructure, such as clean drinking water and availability of parks and green spaces, is highlighted as a key element of community resilience. However, roads and bridges are the most widely cited areas of infrastructure experiencing declining quality. There is also increased attention on broadband access.

Gains for state and local governments will go beyond funding for core infrastructure. For example, investments in broadband will provide economic and social benefits to rural and underserved urban communities. Investments in power sector resiliency will help mitigate the negative impact of extreme weather on local economies. The legislation also makes money available for state, local, tribal, and territorial governments to ward off cyberattacks, which will help reduce the impact of related financial harm and interruption of essential services.

There's going to be tension as governments decide between shovel-ready and shovel-worthy projects and face pressure to get money out the door quickly. If the past is any guide, that should result in hasty backing of shovel-ready projects without full consideration of solutions that leverage better technology and have a greater economic and environmental impact. States and local regulators have an important role to play here in guiding the investment in directions that lead to longer-term sustainability, keeping in mind that while the funds today will finance capital

expenses, communities will be on the hook for longer-term operations and maintenance. As funds begin to flow, there is a need to manage issues such as permitting, community opposition and litigation, which have long driven up the costs and timeline of U.S. infrastructure projects. Those challenges are on top of the current economic hurdles of inflation and a tight labor force. The Act has already launched 129 brand-new federal infrastructure programs or set-asides.[5] These range from the Department of Transportation's Bridge Investment Program to the Department of Energy's program to improve battery processing and manufacturing. These new programs come with regulations and reporting requirements and presents unique challenges.

Other federal programs that could assist in funding infrastructure needs are the American Rescue Plan Act, or ARPA, of 2021 and the proposed Inflation Reduction Act. ARPA's $1.9 trillion in additional COVID-related relief includes $350 billion in direct state and local government aid that more than doubles the $150 billion in aid received from the Coronavirus Aid, Relief and Economic Security Act, or CARES Act. Under ARPA, there is significant flexibility in the use of this money including to help supplement capital costs. While the bulk of the monies so far have gone for revenue replacement and replenishing unemployment insurance trust funds[6], monies can be used to address social factors that caused the pandemic to hit some citizens much harder than others. However, ARPA funds are not fully discretionary and come with reporting requirements that makes it potentially administratively more burdensome than simply replacing state and local revenues or replenishing funds.

In addition, the proposed Inflation Reduction Act, with passage dependent upon the congressional reconciliation process as opposed to bipartisan support, has monies dedicated to home electrification and efficiency, electric vehicles, environmental justice, and conservation. All these categories could have an impact upon public power entities, transportation systems, combating wildfires and air pollution.

Impact on Future State and Local Debt Issuance and Budgets

It seems likely that the additional funding provided in the IIJA, as well as monies in the ARPA, will lead state/local governments and government agencies to resume, and even expand, their infrastructure plans. In conjunction with infrastructure costs only partially covered by grant funding from the bill it seems likely that many issuers will rely on debt financing to cover remaining capital costs.

While much of the bill is in the form of grant money, several sections of legislation specify the use of grant capital to include interest and other financing costs. Further, some sections of the bill specify maximum Federal funding levels of as low as 10% but rising to 100% in certain instances. As such, it is likely that some

level of tax-exempt funding will pay for the proportions of the project that are not provided for under the legislation as well as grant anticipation funding for some portion of the project finance.

Other provisions of the IIJA that could lead to more debt issuance include a requirement for assessments of large projects to see if Public-Private-Partnerships are more advantageous than traditional design-build contracts. Depending on the financing structure and legal documents, there could be an element of construction, project completion and operation risk that needs to be scrutinized before the purchase of any bonds. There is also an increase in the cap of Private Activity Bonds[7] to $30 billion from $15 billion so we can expect more tax-exempt bond issuance.

Conclusion

Investors, as well as all levels of government, know that the need for improving the infrastructure in the United States is clear and critical. Washington has recognized this need with money. The IIJA and potentially the ARPA present the opportunity to leverage these monies into new investment opportunities.

Our analysis of bonds secured by these various financing options is based on several factors: the volatility of the revenue stream, the construction and operating risk of specific projects and the underlying economics. It is important that issuers provide and document safeguards against over-leverage through various legal protections.

Our portfolios are currently heavily weighted toward essential purpose revenue systems and they should benefit from the additional federal aid. Changes to enterprise systems will continue as the infrastructure needs only grow and there remain questions on financial resources. Continuing conversations with our clients about risks and opportunities in this and other rapidly evolving sectors help us construct and manage truly customized portfolios.

Notes

[1] *Financial Advisor* 2022 RIA Ranking; *Barron's* 2021 Top Independent Advisors; *Financial Planning* 2021 RIA Leaders
[2] 2021 Report Card for America's Infrastructure from the American Society of Civil Engineers
[3] 2021 Report Card for America's Infrastructure from the American Society of Civil Engineers
[4] *State of the Cities 2022*, National League of Cities
[5] The Brookings Institution: Introducing the Brookings Federal Infrastructure Hub: A comprehensive guide to the infrastructure law. 2/10/22
[6] "What the First Batch of Treasury Department Reports Tells Us About How Governments are Using Their ARPA Money", University of Illinois Chicago Government Finance Research Center, June 15, 2022
[7] "Introduction to Private Activity Bonds", US Treasury, Internal Revenue Service. Private Activity Bonds (PABs) are obligations that benefit non-governmental persons, such as private businesses, charitable organizations or individuals and are tax-exempt if they meet certain requirements. Generally, each state is limited to a maximum amount of qualified PABs that can be issued on an annual basis. Common qualified recipients include airports, private schools & universities, hospitals & health centers, and student loans.

About the Author

Howard Cure is a Partner and the Director of Municipal Bond Research for Evercore Wealth Management. He has over 30 years of experience in analyzing municipal securities.

Prior to joining Evercore in 2009, he was for 11 years a director at the Public Finance Department of Financial Guaranty Insurance Company. He previously was a vice president with the investment banking firm of Prager, Sealy & Co. and, earlier, a vice president at Moody's Investors Service. He began his career as an economist with the New York State Senate Finance Committee in Albany, New York.

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