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Inside the Beltway: Budgets, Infrastructure and Such

Away from the president's budget and infrastructure proposals we summarize actions that already have legislative girth: the budget resolution, dates for an actual budget, and the debt ceiling. OK, we will briefly discuss the president's infrastructure proposal. We also provide a brief analysis of recent market reaction.

- Congress passed and President Trump signed a two-year budget resolution that **sets budget caps for various spending items**. Those caps cover the remainder of federal FY2018 and the full FY2019. The resolution is not yet a spending plan, rather, it is a broad brush of dollar limits mainly for the discretionary budget (defense and domestic spending).
- To keep the government running, Congress also passed a continuing resolution effective **until March 23, 2018.** This gives time for each congressional appropriations committee to write actual spending bills within the resolution's caps.
- The **debt ceiling limitations were suspended through March 1, 2019**. Borrow on!

Numbers Please

- The budget resolution **increases defense caps** by $160 billion over two years. **Non-defense discretionary caps** go up by $136 billion. In addition there is $89.3 billion in new emergency budget authority for **disaster relief**. Emergency disaster relief does not "count" toward the deficit although it adds to it.
- There are $100 billion offsets , one third comes from extending the sequester on mandatory spending for an extra two years; another third comes from Medicare and Medicaid changes and the rest comes from selling oil from the strategic Petroleum Reserve.
- There are a number of changes good for Puerto Rico and the Virgin Islands: $4.9 billion in Medicaid funds for Puerto Rico, the approval of an extension of the "rum cover over" tax through 2022 that allows the two territories to receive payments on beverages brought into the US from Puerto Rico and the U.S.Virgin Islands and tax credits to investors in "opportunity zones" on the islands.
- Children's Health Insurance Program, CHIP, is now authorized for 10 years instead of six.
- Community Health Centers also received funding.
- Former President Obama's Medicare Cost Control Panel was eliminated (Independent Payment Advisory Board [IPAB].)
- In addition, there is $3 billion to combat the opioid crisis, $2 billion for veterans, $10 billion on infrastructure, $2 billion on higher education and $2.9 billion on childcare.

What Else?

- As if the tax cut bill wasn't enough, legislators approved 32 special tax subsidies that had expired at a price tag estimated at $15 billion. As stated by Howard Gleckman of the Tax Policy Center, "If the purpose of a tax preference is to encourage businesses or individuals to change behavior, what possible purpose is served by subsidizing activities that already have occurred?"
- The Committee for a Responsible Federal Budget estimates that the agreement **would push the annual budget deficit in 2019 from $1 trillion to $1.2 trillion**. CBO estimated the overall price tag is

$320 billion over 10 years in addition to the $1.5 trillion cost of the 10-year tax cut just passed.

Market Counterpoints

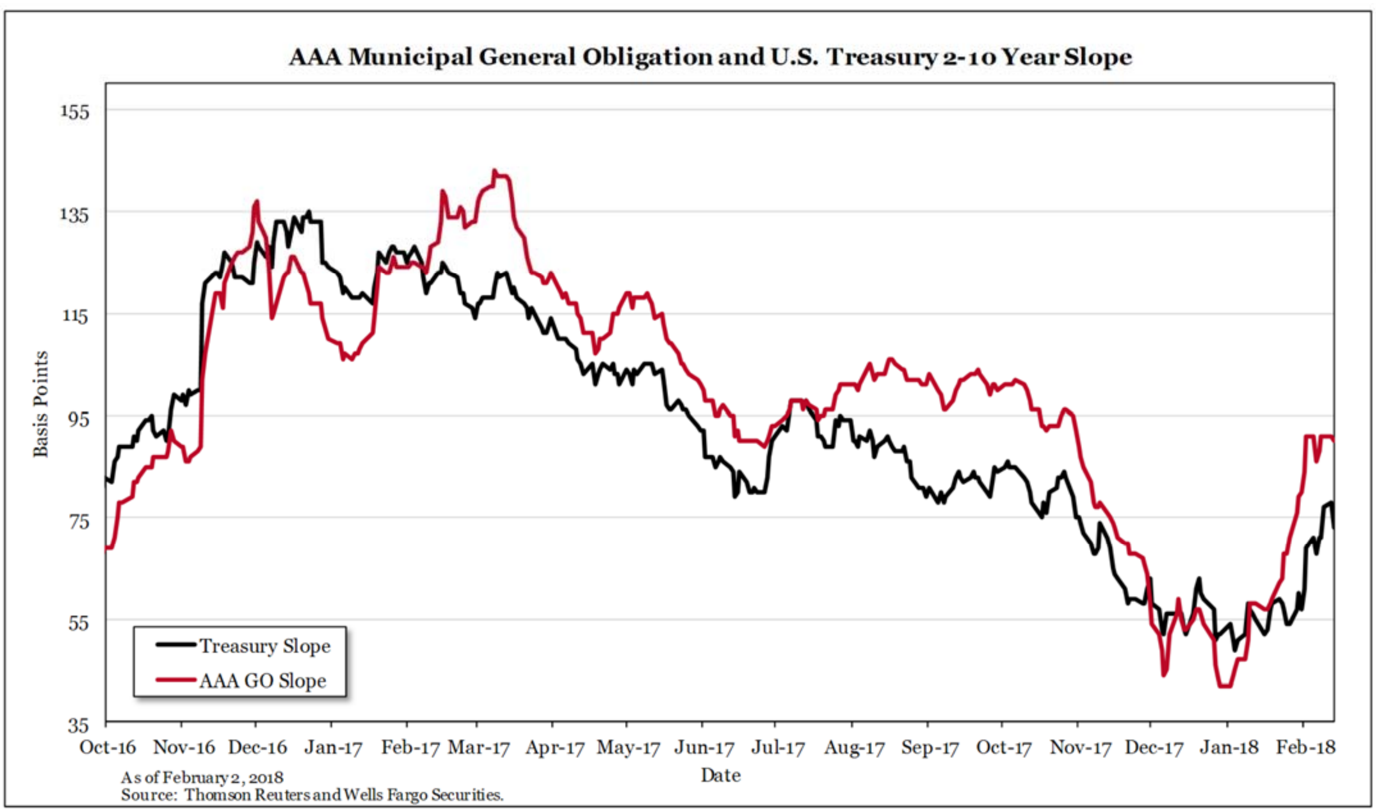
In the not too distant past, bonds typically moved in the opposite direction of equities. However, the weakening in both asset classes seemed to be in sync. We believe two very different factors are at play. First, over the many years investors have searched for yield, some market participants invested in volatility options (including retail investors) that assumed volatility would remain low over the long term — and made good money in the process — until they didn't. Some estimates are that between $3 billion and $7 billion were in these instruments. Perhaps a sequence of strong economic and labor reports, coupled with the conviction that the Federal Reserve would hike rates three, or perhaps four, time over the next year were catalysts for the turn in thinking. Perhaps machine selling contributed.

On the other hand, a strong fiscal cocktail of higher spending and higher federal deficits on top of a recovering economy woke investor fears of inflation. Heavy borrowing needed to pay for both the tax cut program and increased budget spending caps also serve to weaken the Treasury and municipal markets. With higher rates, federal debt service would occupy a growing share of the budget, limiting the flexibility to handle future crises, whether natural or manmade. We show in the exhibit below, the recent dramatic turn in the slope of the yield curve.

Enter an Infrastructure Plan

Although promised at the beginning of his administration, the president's infrastructure comes amid congressional exhaustion, after efforts to repeal and replace healthcare, pass a tax cut package, and come to agreement on a budget resolution and, now, the pressure to come up with an immigration policy ahead of a March 5 deadline. Some in Congress have expressed unwillingness to "deal" with infrastructure now.

While there is much to criticize and much that is inconsistent and confusing in the proposal, there are a number of interesting and useful ideas that can be extracted. **Keep in mind, however, a major factor is missing; away from a federal contribution of $200 billion over 10 years, there is no additional way to pay for the projects, other than the usual state and local taxes and fees.** The proposal is an



attempt to invite in more private sector financing for projects, but private corporations want to be paid back a decent ROI as well.

The original Ross/Navarro proposal, as some may remember, included a conspicuously similar $200 billion in federal cash. However, that derived from a repatriation of cash earned abroad. As enticement to the private sector to invest in infrastructure, a temptingly low tax was proposed (hence the $200 billion available on an estimated $2 trillion abroad) and juicy tax credits were offered. That proposal was expected to facilitate $1 trillion in investment (also conspicuously still part of the "pitch" on the current proposal.) Well, the low tax on "deemed" repatriation (i.e., the cash doesn't have to come back to the US) has already been spent many times over and a variety of credits have been embedded in tax reform and the budget resolution.

So What's Left?

We list the programs included on the next page. In addition to direct spending by the federal government, there are numerous proposals that would reduce the cost of projects, smooth the construction process and simplify federal involvement. We focus on the $20 billion (again, over 10 years) that comprise $14 billion tax credits and $6 billion for private activity expansion. These are ideas that help reduce the cost of projects for state and local government — a good thing, right? The $14 billion is for transportation, water, railroads, using the TIFIA structure (WIFIA, RRIF, RUS for the acronym inclined).

Development of non-federal waterways and ports, simplifying permitting and approval processes and allowing the EPA to waive the federal government's "springing lien" are all good ideas that could expand use of these financing structures. Expanding the use of the Rural Utilities Service loan subsidy program could also help move along additional projects that may not have previously been affordable for those communities.

The proposal to expand Private Activity Bonds (PAB) is also a good idea. (We include a list of existing PAB categories on the following page.) The proposal eliminates the AMT on these bonds, although advanced refunding is still excluded despite the fact this was included in the earlier "leaked" statement of principles. Restrictions on change of use to the private sector would still preserve tax exemption — another idea that could make PABs more flexible.

New categories of borrowing could use PABs and this would make additional projects more cost effective. These include: flood control and stormwater management, rural broadband, environmental mediation of Brownfield and Super Fund sites as well as expansion of the surface transportation and hydro-electric categories. The proposal also suggests lifting state and national caps on the program. The budget shows $6 billion over 10 years which we assume to be the "tax expenditure" tied to interest on these new tax free bonds. This is not a direct outlay by the federal government, unlike the Incentive Grants or Transformative Projects, but an estimate of **federal taxes *not* paid on exempt bonds.** (One would think anti-tax lawmakers would applaud such a proposal.)

Tucked into the infrastructure proposal is also a section on workforce development. Much of this section allows for existing federal aid programs in higher education to be broadened to promote workforce development. Ironically, the Pell grant program, the federal work study program and the Perkins Career and Technical Education (CTE) program, all of which are outlined in the infrastructure plan, each had proposed cuts in the earlier Trump administration's FY2018 budget introduced in mid-2017. There is no discussion of additional federal aid dollars to support this initiative; essentially workforce development students that seek this aid will compete with current need-based students for these federal programs.

Over the next two months, investors and state and local governments should watch carefully as budget legislation unfolds. This is both to ensure that key programs that could contradict the effort to improve and modernize infrastructure are not added, as well as making sure that the positive parts of the proposals are included in the two -year budget.

Trump Infrastructure Plan		
Competitive Grant "Incentives" Program	$100 billion	This is a grant program with 20% federal funding. Proposals that maximize "own source" cash would be favored; funds would be administered by the US DOT, Army Corps of Engineers and the EPA; incentive grants could not exceed 20% of new revenue; strings include an "incentive agreement" setting out milestones toward obtaining increased revenue. this agreement could be voided if milestones are incomplete after two years. The way this program is written it is only applicable to revenue generating projects.
Private Activity Expansion	$14 billion	Expand existing credit programs: TIFIA, WIFIA, RRIF and rural utility lending.
	$ 6 billion	Expand private activity bonds. This does not require direct federal spending but is an estimate of the "tax expenditure" that might result from expansion of definitions of potential projects.
Transformative Projects	$10 billion	Reserved for "bold, innovative and transformative" projects, likely to be commercially viable but have unique technical and risk characteristics that may deter private sector investment. These grants also apply to revenue generating proposals. Department of Commerce to oversee.
Rural Project Block Grants	$50 billion	direct $ with few strings since less likely to attract private $ (80% is up to governors to distribute while 20% is granted directly); may be used for transportation, broadband, water and waste, power and electric and flood risk management; project areas include populations of less than 50,000; some funding for tribal and territorial infrastructure are also included.
Capital financing fund	$10 billion	Fix federal buildings
Workforce training		Broadening eligibility for Pell grants; ease rules for licensing trade professionals and expand apprenticeships.
		Allow short-term programs that provide certification or credential to be eligible for Pell
		Reform Perkins Program
		"Better target" Work-study funds for apprenticeships
Regulatory Reform		Speed up permitting for federal projects; delegate environmental review and permitting.
		Divest federal assets to state or local governments or the private sector. (Agencies get to reinvest sale proceeds)
		Create "one agency, one decision" for environmental reviews.
		Shorten environmental review to two years.
		Create two new pilot programs.
Source: White House: "Legislative Outline for Rebuilding Infrastructure in America", February, 2018		

Qualified Private Activity Bonds, Current IRS Definitions

Internal Revenue Code Section	Type of Private Activity (Italicized activities must be owned by the issuing government to qualify)	Subject to Volume Cap	Year Established
Sec. 142	**Exempt facility bonds**		
Sec. 142(c)	*Airports*	No	1968
Sec. 142(c)	*Docks and wharves*	No	1968
Sec. 142(c)	*Mass commuting facilities*	Yes	1981
Sec. 142(e)	Water furnishing facilities	Yes	1968
Sec. 142(a)(5)	Sewage facilities	Yes	1968
Sec. 142(a)(6)	Solid waste disposal facilities	Yes/No[a]	1968
Sec. 142(d)	Qualified residential rental projects	Yes[b]	1968
Sec. 142(f)	Local electric energy or gas furnishing facility	Yes	1968
Sec. 142(g)	Local district heating and cooling facilities	Yes	1982
Sec. 142(h)	Qualified hazardous waste facilities	Yes	1986
Sec. 142(I)	High-speed intercity rail facilities	Yes[c]	1988
Sec. 142(j)	*Environmental enhancements of hydroelectric*	No	1992
Sec. 142(k)	Qualified public educational facilities	No[d]	2001
Sec. 142(l)	Qualified green building and sustainable	No[d]	2005
Sec. 142(m)	Qualified highway and surface freight	No[d]	2005
Sec. 1400U-3	Recovery zone facility bonds	No[d]	2009
Sec. 143	**Mortgage revenue bonds**		
Sec. 143(a)	Qualified mortgage bond	Yes[b]	1968
Sec. 143(b)	Qualified veterans' mortgage bond	No	1968
Sec. 144(a)	**Qualified small issue bond**	Yes	1968
Sec. 144(b)	**Qualified student loan bond**	Yes	1976
Sec. 144(c)	**Qualified redevelopment bond**	Yes	1968
Sec. 145	**Qualified 501(c)(3) bond**	No	1968

a. Exempt from the cap if governmentally owned. Subject to the cap if privately owned.
b. Bonds for residential rental projects and mortgages were allocated an additional $11 billion for 2008 that can be carried forward through 2010 by the Housing Assistance Tax Act of 2008.
c. 25% of the bond issue is included in the cap. If the facility is owned by a governmental unit, no cap allocation is required. In addition, if the facility is not governmentally owned, to qualify for tax-exempt status, the owner must elect not to claim any depreciation deductions or investment tax credits with respect to the property financed with the bonds.
d. Educational facility bonds are subject to a separate state cap: the greater of $10 per capita or $5 million. Green building bonds are subject to a national aggregate amount of $2 billion through the expiration of the program, scheduled for October 1, 2009. Highway bonds are subject to the following annual issuance limits: $130 million in 2005; $750 million each year for 2006 through 2009; $1.87 billion in 2010; and $2 billion each year for 2011 through 2015, zero thereafter. Recovery zone facility bonds are subject to a separate cap of $15 billion.

Source: Congressional Research Service, "Private Activity Bonds: An Introduction", March 30, 2016

Additional information is available on request.

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