Deconstructing the Infrastructure Bill

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Executive summary

New York Life Investments recently hosted a webcast with Jeff Bush from The Washington Update; Scott Sprauer, Managing Director and Portfolio Manager with Mackay Municipal Managers; Jeremy Anagnos, Chief Investment Officer – Infrastructure and Portfolio Manager with CBRE Securities; and Lauren Goodwin, Economist and Director of Portfolio Strategy with New York Life Investments to deconstruct the Infrastructure Bill and discuss potential portfolio implications.

The Infrastructure Bill – Macro and Asset-Class Perspectives

Three current megatrends—decarbonization, asset modernization, and digital transformation—are driving a long-term investment opportunity in the infrastructure asset class, through both fixed-income and equity strategies. Municipal bonds (taxable and tax-exempt) ARE infrastructure—where the rubber meets the road, so to speak. And global listed infrastructure companies are long-duration assets, which offer the potential for income growth, competitive returns, and lower volatility.

Nearly everyone (on both sides of the political aisle) agrees there's an urgent need for infrastructure funding. The American Society of Civil Engineers gives the U.S. a C-grade for our current infrastructure. However, as in any negotiation, the devil is in the details. What to include in the legislation, and how to pay for it? To raise that grade to just a C+ would require over $2 trillion over 10 years. To raise that grade to world-class level would require more than $4 trillion over 10 years.

What's In, What's Out of the Infrastructure Bills

The bipartisan, "hard" infrastructure bill (the Infrastructure and Investment Jobs Act), recently sent to President Biden for signing, includes $450 billion previously allocated by both Houses of Congress for infrastructure investment, along with $550 billion of new money just approved by the House—months after approval by the Senate last

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summer. The total of $1 trillion includes allocations among 12 spending priorities. The top five allocations are for roads and bridges ($110B), updating the power grid ($73B), rail ($66B), broadband access ($65B), and clean water ($55B).

The “soft” or “human” infrastructure bill (the Build Back Better plan), currently being negotiated in Congress, includes $1.75T in allocations for a range of spending priorities. The top five include clean energy and climate investments ($555B), childcare and preschool ($400B), child tax and earned income tax credits ($200B), home care ($150B), and housing ($150B). Other provisions would include increasing Medicaid payments, government-negotiated drug pricing, extending Medicare to include hearing benefits, four-week paid family and medical leave, etc.

How to Pay for Them?

The total spent to date on Coronavirus relief ($5.6T), combined with the already approved “hard” infrastructure bill ($1T)—and the proposed $1.75T “soft” infrastructure bill—amounts to $7.35T. That far outstrips total federal spending (pre-pandemic) in 2019 of $4.45T and the $3.46T in total tax revenue. And of that $7.35T, it’s estimated as much as $6.2T will end up as additional federal debt—with long-term implications about how that will be paid for, if ever.

There are a range of funding sources or ‘pay-fors’ for the “hard” infrastructure bill, ranging from unspent pandemic-relief monies to unemployment fraud collection, anticipated economic growth, crypto transaction reporting, “pension smoothing,” and selling petroleum reserves—to name a few. According to various bipartisan estimates, those funding sources would provide approximately $554B to be spent on hard infrastructure improvements over the next five years. The Congressional Budget Office (CBO) suggests that these revenue sources will fall short of fully funding the bill. Any shortfall will add to the accumulated federal debt.

With no Republican Senate votes expected for the Build Back Better plan, and a narrow majority in the House of Representatives, Democrats have a tiny margin for error in their effort to pass the Build Back Better plan. A single Democrat Senator or small group of Democrat House members can derail the initiative. For example, Senator Kirsten Sinema (D-AZ) ruled out changes to tax rates for individuals and corporations. Democrats subsequently dropped those provisions as possible ‘pay-fors’.

Revenue generating proposals, primarily tax changes, to date include:

- **Individual tax changes**—in the form of a 5% surtax on incomes above $10MM, with an additional 3% on incomes over $25MM (Trust income thresholds are $200,000 and $500,000 for the same 5% and 3% surtaxes).
  - Note: surtaxes based on adjusted gross income (AGI), which includes capital gains
- **Corporate tax changes**—in the form of a 15% global minimum tax (calculated on a country-by-country basis), a 15% minimum book-profit tax on corporations with profits exceeding $1B in 2023, and a 1% stock buyback tax.
- **Increased IRS enforcement**—more agents and improved technologies to increase tax code compliance (audits) by individuals and families earning more than $400K.
  - Estimates for the tax gap—the difference between legitimately owed taxes and taxes collected—range from $50 billion to $1 trillion annually.
- Increasing the SALT deduction cap to $80K through 2030, beginning in 2021
  - The Senate prefers to keep the cap at $10,000 but set income thresholds when the cap would apply
- **Various changes to ROTH provisions, effective in 2022**—only pre-tax contributions would be eligible for Roth conversion through 2031.

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- Beginning in 2029, aggregated IRA distribution requirements would begin at $10MM, with even more draconian distribution requirements once aggregated balances reach $20MM.
- For pass-through business owners, the plan extends the limitation that restricts the use of business losses to offset non-business income. Additionally, proposed provisions would close the Medicare tax loophole for net investment income.

Several strategies for consideration for high-income investors subject to the surtaxes in the new year, should the bill pass, include the following.

- After 2021, accelerate deductions into tax years when the taxpayer is subject to the surtaxes.
- Defer income into years when the taxpayer is not subject to the surtaxes.
- Group charitable giving efforts in years when the taxpayer is subject to the surtaxes.
- Consider investment strategies such as tax-free, tax-efficient, tax-managed, annuities for tax deferral/timing, and life insurance for possible tax-free income.
- Consider the future value of aggregated retirement assets today when determining if one might reach the $10MM or $20MM thresholds effective in 2029. It might make sense to distribute some monies before one's RMD age to avoid the distribution requirements.

At the time of this writing, the House of Representatives has not passed its version of the BBB. Once passed, the Senate will debate their version. The two versions will likely not match. If the bills do not match, the chambers will conference to negotiate the differences. All this to say, the above is likely to change, tweak, items subtracted from and added to the Build Back Better plan until, and if, there is a final bill.

Policy Implications for Portfolios

Infrastructure will be a durable and definable portfolio theme for years into the future. As for today, it's an attractive investment opportunity for individual investors and institutions. Two strategies are well worth consideration.

There are 380 global listed infrastructure companies with approximately $4T in equity value. These are companies that own their long-duration assets, which are expected to earn sustainable cash flows over a very long period of time. In addition, these companies are 'inflation-pass-through assets" (passing through to customers their increased costs helps their earnings), and have historically outperformed other equity classes in times of rising prices. Many of these companies don't require government support. In fact, pension funds generally allocate 6-8% of their portfolios to this asset class to seek to generate income and competitive returns with lower volatility, and to provide global diversification.

Muni bonds, both taxable and tax-exempt, ARE infrastructure, touching human lives daily. While government support will drive some cash flows into munis, typically, user fees account for the majority of cash flows. Historically there's less volatility with munis; it's a high-quality asset class with a low default rate and a yield comparable to investment-grade corporates. For individual investors, it's appropriate to consider munis as a core part of their fixed-income asset allocation. Institutions should consider munis as a strategic allocation within their fixed- income portfolio.

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