

THE BOND BUYER

What's at stake for the muni market in midterm elections?

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Whatever the outcome of the midterm elections that are now only weeks away, municipal bond market advocates will remain committed to core priorities while investors will be focused on interest rates and inflation.

Protect the tax exemption. Bring back tax-exempt advance refunding. Raise the ceiling on bank-qualified debt. Create a direct-pay bond program. Reduce the state and local tax cap deduction.

It's the same agenda that the muni lobby has promoted for the last two years with disappointing results despite one-party control by Democrats, who are generally considered more friendly to the market.

Hopes aren't high among market participants that their agenda will gain traction in the 118th Congress, especially if Republicans notch victories in one or both chambers.

For investors, the midterms aren't expected to be a market mover, with rising interest rates, inflation, and infrastructure spending all carrying a bigger impact on portfolio decisions.

"I don't think this midterm election cycle is quite as potent to the muni market as the 2020 presidential election, or the 2016 election or even 2018," said Adam Stern, co-head of research at Breckinridge Capital Advisors.



The 2022 midterm elections aren't as "potent" for munis as other election cycles, said Adam Stern, co-head of research at Breckinridge Capital Advisors. **Breckinridge Capital Advisors**

Issuers head into the midterms armed with strong balance sheets and a pipeline of federally-supported infrastructure projects after Washington provided nearly \$5 trillion in stimulus and infrastructure aid since 2020.

In the short-term, the post-election lame duck session promises to be busy, particularly if Republicans make gains.

The lame duck will offer a fresh chance to advance the muni agenda, said Brett Bolton, vice president of federal legislative and regulatory policy at the Bond Dealers of America.

"There will be multiple bills that will roll through in lame duck, and we remain optimistic that further tax policy can be enacted and we are pushing for muni provisions in the tax policies," Bolton said.

The market will also be on guard against new threats, like a [provision currently tucked in the National Defense Authorization Act](#) that would mandate data standards for states and local government financial reports. Congress will [also need to enact a PAYGO waiver](#) for the American Rescue Plan or risk having subsidies on direct-pay bonds denied. That action has to start in the House Budget Committee, lobbyists said.

Many analysts are looking past the midterms to 2024, when the presidential election will raise the stakes for the market and states and locals will start to see their federal stimulus money ebb.

"I'm envisioning situations where whatever happens in November of this year, stack on top of that November 2024, and there could be some significant fallout, both pro and con, for the municipal bond market," said Tom Kozlik, head of research and analytics for Hilltop Securities.

In the Senate, 34 seats are up for election and all 435 seats are up in the House. The Senate currently has 48 Democrats, two Independents, and 50 Republicans. The House has 220 Democrats, 209 Republicans, and six vacancies.

Bipartisan threat

Traditionally, Republicans are considered less friendly to municipal market priorities, but market participants warn that threats could come from both sides of the aisle.

"There is a sense that at least since the Trump years some Republicans, particularly in the House, have been antagonistic to tax-exempt bonds because they see them as a source of financing for what they perceive as bloated state and local programs and even putting pressure on healthcare costs," said Chuck Samuels, of Mintz Levin, who is counsel to the National Association of Health & Educational Facilities Finance Authorities.

"I think as time passes some of this possible hostility has abated," Samuels said. "And it is critical to point out that at all times there have been many senior and junior Republicans in the House and the Senate who have supported the public finance community, through their legislative actions, through their membership in the Municipal Finance Caucus and in many cases with their background in state and local government or the nonprofit sector."

The tax-exemption is a "piggy bank that people love to flirt with," said Emily Brock, lobbyist for the Government Finance Officers Association. "The threat is real."

Brock added that tax-exempt market advocates like [Rep. Terri Sewell, D-Ala., a former public finance attorney](#), will continue to sit on the House Ways and Means Committee, which has the power to write tax laws that influence the market.

The tax-exemption is vulnerable to attacks from both parties, Kozlik said.

"I could foresee a situation where Republicans take the House and maybe the Senate, and the White House in 2024, and then we're back to a situation like where we were prior to 2017 tax cut," Kozlik said. "The other side of that is the far left. If there are expensive policies that the progressive agenda wants to include, it seems to me there's the potential that they will consider" the tax-exemption, he said.

Tax-exempt advance refunding on its face enjoys bipartisan support, but that's not always the case when it comes down to the writing-legislation level, Bolton said.

"I think that bonds in general remain a bipartisan issue. It does get complicated with individual provisions with a good example being advance refundings," Bolton said. "In both House and Senate legislation, [advance refunding] continues to receive bipartisan sponsorship and praise, but partisanship remains a hurdle to get the provision over the finish line at this point."

A Republican win

If Republicans win one or both of the chambers, expect gridlock.

Even must-pass bills like government funding could run into turbulence as is already happening with the current continuing resolution.

President Biden will remain in office and will have veto power, which can only be overridden by two-thirds of both the House and the Senate.

"If there is a Republican House, we're going to fall back into a comfortable norm of gridlock, and trying to make sure that they understand our bipartisan issues," Brock said. "It will be different in that it will be more deliberate and we'll have a lot more educating that we have to do because there will be a lot more members."

If Republicans win the House, it will likely mean investigations into issues like stimulus aid spending and the Securities and Exchange Commission's focus on ESG issues. The powerful House Ways and Means Committee, which writes many muni-related bills, may be headed up by Rep. Vern Buchanan, R-Fla., who's a top contender for the seat, or Rep. Jason Smith, R-Mo. In the Senate Finance Committee, Sen. Chuck Grassley is a top contender if GOP gains control.

Republicans have also said they're opposed to a new global minimum tax deal that features a 15% minimum tax that opponents [warn could hurt interest](#) in tax-exempt debt and other tax incentives.

Looking ahead, a Republican victory in the midterms could portend trouble for certain credits, particularly those that have relied heavily on federal aid since the pandemic, analysts said.

Exhibit A is New York's Metropolitan Transportation Authority, said Breckenridge's Stern.

Without New York champion Sen. Chuck Schumer and widespread Democratic support, the MTA — which is one of the largest and most widely held credits in the muni market — faces major challenges in the next few years, Stern said.

The agency "has a nice runway of aid to mid-2024 or early 2025, and then the MTA's budget gets really tough," he said. "I don't think they're likely to get more federal support unless the Democrats control both houses and Schumer remains head of the Senate," he said. "In other scenarios, you don't see that."

New York City is another large muni credit that could face problems depending on the future of the work from home trend, said Joseph Krist, who publishes a weekly muni market newsletter.

In general, Krist said, investors should analyze which credits have been tapping stimulus aid for ongoing operations, a red flag for future budget challenges.

"I don't think whoever wins is going to re-stimulate the economy again," Krist said. "People aren't going to get bailed out anymore."

A Democratic victory

If Democrats retain control of Congress, most participants think it would open opportunities for the muni agenda. And things could move quickly, as they have over the last two years and as they did in 2017 with Republicans, Brock said.

"Things happen really fast when there's no gridlock," she said.

If Democrats manage to hold onto both chambers, but hold less than the required 60-vote majority in the Senate, then that means at least two more budget bills that will be passed by the reconciliation process, Stern said.

And that may offer a fresh chance for muni priorities, including [reform to state and local tax cap deduction](#), which is important to large, high-taxing states like California and New York as well as holders of paper from those states.

"The scenario in which we conceivably could make some [portfolio] changes are if the Democrats retain control of both the House and the Senate, because that creates the environment with another round or two of reconciliation bills, which could potentially be transformative in some way, whether it's by bringing back direct-pay bond or another big tranche of federal support for infrastructure, or Medicaid, or hospitals," Stern said.

The future makeup of the Congress will set the stage for 2024 and also could determine the type of infrastructure projects across the country as cities and states begin to spend the \$1.2 trillion Infrastructure Investment and Jobs Act.

Republicans tend to favor projects like highway expansion, [which the Biden administration has attempted to minimize](#), while Democrats are pushing for more climate-related projects like renewable energy.

Other priorities for muni lobbyists are Treasury's development of rules for spending the American Rescue Plan Act funds and the notice of funding opportunity for the Inflation Reduction Act, Brock said.

A new Congress will mean new staff, and lobbyists will have to rededicate themselves to the task of educating them about public finance priorities.

"It's another Congress and we're going to have the same message: the tax-exemption is still imperative to protect, and fixed income has a place at the table," Bolton said.