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A REVIEW OF STATE FINANCES AND BUILD BACK BETTER

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State and local governments have their day

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Economic and investment implications of the state and local government windfall

State and local government spending is poised for an outsized impact on growth this year from what normally is a staid sector of the economy. An enormous windfall directly and indirectly tied to the pandemic lifted revenues 16% above their pre-pandemic trend by last year's third quarter compared with just 5% above-trend spending, according to estimates by the Committee for a Responsible Federal Budget (or CRFB).[1]

State and local tax receipts collectively were 16% above their pre-pandemic trend in last year's third quarter, far outpacing a 5% increase in spending and lifting states' "rainy day" funds to a record $113 billion.

Source: Committee for a Responsible Federal Budget

The most visible support to state and local finances has come from $885 billion in COVID-19 relief from the series of federal support measures dating back to the first rescue package in 2020. Beyond that, income and sales taxes have been boosted by the powerful economic recovery from the 2020 free fall supercharged by federal stimulus. The housing boom is just beginning to lift property taxes on soaring home values, and capital gains taxes are being propelled by the rally in stocks and other financial assets. Costs also have been contained by cheaper online delivery of certain state and local services, again tied to the pandemic.

Big surpluses in 2021, big spending in 2022

The buildup in state surpluses was as dramatic last year as the rise in revenues propelling them. Chart 1 on the next page shows that so-called rainy day funds — surplus revenues set aside for unexpected shortfalls — collectively soared to a record $113 billion, or 12.4% of total expenditures. That was well beyond the previous record of $79 billion (just over 9% of spending) in fiscal 2019, according to a recent report by the National Association of State Budget Officers (or NASBO).[2]

Early estimates put unfunded pension liabilities below $1 trillion in fiscal 2021 from a record $1.5 trillion in fiscal 2020, lifting the states' aggregate funding ratio to a 2008 high of over 80%.

Source: National Association of State Budget Officers

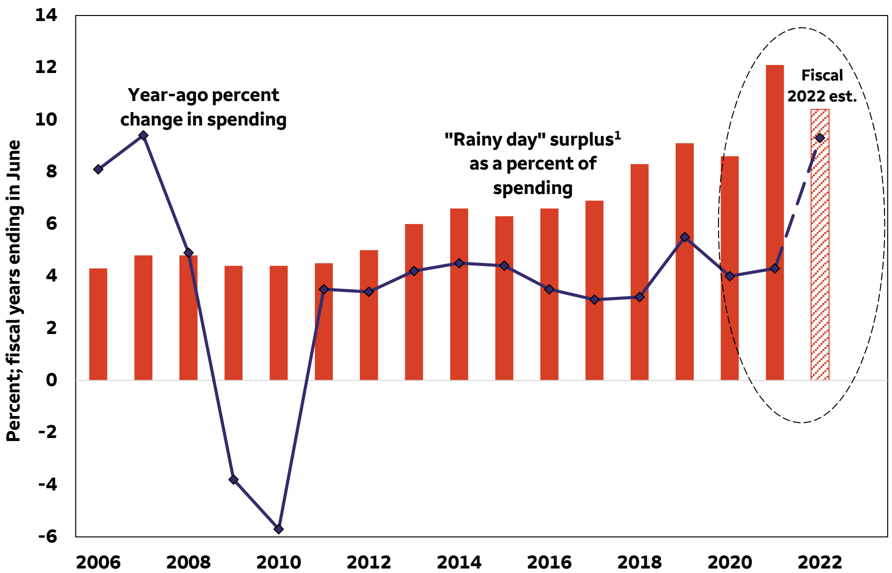
Surpluses are being reduced more aggressively this year by moving beyond one-time tax rebates, increased bonuses, gasoline tax holidays, and teacher retention bonuses to more permanent tax cuts and spending increases. Of the 22 governors with "State of the State" addresses in January, 16 announced plans to cut taxes.[3] Fundamental tax changes have been announced by 7 of the 16, including a flat tax in Arizona and in Iowa and income tax cuts in Idaho, Montana, Nebraska, South Carolina, and Colorado. NASBO's "The Fiscal Survey of States" estimates a 9.3% increase in fiscal 2022 spending, more than double the 4.3% rise in fiscal 2020.

More spending and tax cuts may be on the way in coming months as governments seek ways to return the outsized surpluses to voters ahead of the midterm elections. These and actions by local governments likely will make a noticeable dent in the fiscal "drag" on the economy from a $1.6 trillion

1. "State and Local Governments Flush with Cash," CRFB, November 3, 2021
2. "The Fiscal Survey of States," NASBO, December 17, 2021
3. "States Are Cutting Taxes," Strategas, January 21, 2022

decline in the deficit this fiscal year, based on actual data and fiscal 2022 estimates by the Congressional Budget Office.[4]

Chart 1. State finances take flight



Sources: Wells Fargo Investment Institute and NASBO, The Fiscal Survey of States, December 17, 2021.
[1]Surpluses set aside for unexpected budget shortfalls. Data as of December 17, 2021.

Key takeaways

- State tax cuts and the biggest increase in state spending since fiscal 2007 likely will trim a record budget surplus and offset some of the fiscal "drag" on the economy from a narrowing federal deficit.
- Credit quality in the municipal bond market has been lifted by bulging reserve funds and the best funding ratio for pension liabilities since 2008, leaving quality spreads between AAA-rated and BBB-rated bonds at little more than half their long-term norm.

More than just a budget issue

Outsized surpluses also may be used to further reduce unfunded pension liabilities, or the gap between the cost of state pension benefits and what states have set aside to pay for them. Public-sector pensions already have been given a powerful, indirect boost by a strong economic and investment recovery, reinforced by successive rounds of stimulus by the federal government. The Pew Charitable Trusts estimates unfunded pension benefits narrowing to less than $1 trillion in the fiscal year ending June 2021 from a peak $1.5 trillion the year before. Behind the improvement is a powerful 25% return on pension fund investments and another year of sizable contributions from public employees and from the rapid growth of state revenues.[5] The decline in unfunded pension assets translates to a funding ratio (that is, the portion of pension liabilities with funds to meet obligations) of over 80% from 70.9% in fiscal 2020, the highest reading since 2008.

Much improved state budget and pension debt conditions have reinforced municipal market credit quality already riding a wave of powerful economic growth and ample financial liquidity. So-called quality spreads have narrowed in response, leaving this year's yield difference between AAA-rated and BBB-rated[6] municipal credits hovering between 30 and 35 basis points (0.30 – 0.35 of a percentage point), or little more than half its average over the past five years. That, plus still-attractive yields are behind our favorable rating on municipal credits.

4. "Ten-Year Budget Projections," Congressional Budget Office, July 2021
5. "The State Pension Funding Gap: Plans Have Stabilized in Wake of Pandemic," The Pew Charitable Trusts, September 14, 2021
6. As rated by a nationally recognized statistical ratings organization

Build Back Better 2.0

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A second shot

In November, shortly after President Biden signed a bipartisan infrastructure bill into law, the Democratic-led House narrowly passed its version of the Build Back Better (BBB) Act, a roughly $2 trillion social-spending bill encompassing climate change, education, poverty, health care, and tax changes for businesses and high-income earners. The bill has since stalled in the Senate. If the legislation passes, the Senate's version of the bill will likely be scaled back from that of the House.

Besides the BBB Act, legislative priorities for 2022 include confirming a Supreme Court nominee, passing an appropriations bill (or continuing resolution), and conferencing China competition legislation.

Rekindling President Biden's BBB plan will be top of mind for congressional leadership ahead of midterm elections, but the path forward is unclear. And as time passes, there are other burgeoning competing priorities (see Sidebar 1). As lawmakers continue parleying the bill's provisions, we suggest that investors adhere to long-term goals and work with their advisor to understand how the BBB legislation might impact their portfolio.

A recent Rasmussen poll found that 51% of likely U.S. voters oppose the BBB Act and 42% support it, suggesting that it may be losing its popularity among constituents.

Source: "Majority of Voters Oppose 'Build Back Better,'" Rasmussen Reports, November 29, 2021

Table 1. Prospective tax provisions in the House-passed BBB Act

Prospective provision	Description
Net investment income tax (NIIT)	Apply the 3.8% NIIT to trade or business income for individual taxpayers with adjusted gross income (AGI) exceeding $400,000.
Excess business losses	Makes permanent the limitation on excess business losses from the Tax Cuts and Jobs Act (TCJA) of 2017.
Surcharge on high-income earners	Apply a 5% surcharge on modified adjusted gross income (MAGI) exceeding $10,000,000 and an additional 3% on MAGI of $25,000,000.
State and local tax deduction (SALT)	For years starting after 2020, the limitation for the state and local tax deduction increased to $80,000 through 2030.
Contributions to Traditional and Roth IRAs	At certain income thresholds, no further contributions to a Roth or Traditional IRA if the total value of IRAs and defined contribution retirement accounts exceeds $10,000,000.
Required minimum distributions (RMDs) from IRAs	At certain income thresholds with IRA balances greater than $10,000,000, an RMD of 50% of the amount above $10,000,000 and 100% of the amount greater than $20,000,000.
Roth IRA conversions	At certain income thresholds, starting in 2032, Roth conversions prohibited from Traditional IRAs or certain employer-sponsored plans.
Backdoor Roth IRA conversions	Effective 1/1/2022, Roth conversions including after-tax contributions from Traditional IRAs or employer-sponsored plans prohibited.
Qualified small business stock deduction	At certain income levels, elimination of the 75% and 100% capital gain deduction for qualified small business stock.

Source: Wells Fargo Bank, November 19, 2021

Where Build Back Better stands today

The House-passed bill faltered in the Senate in December after highly publicized opposition from Senator Manchin D-WV. The core of the bill involves social spending and tax provisions (see table above). Democratic leaders are now working to pass a revised bill. Senate Republicans remain unified against BBB, which means all 50 Democratic senators must be in agreement for it to pass. With the House version stuck in the Senate, President Biden has proposed breaking it into smaller pieces and scaling it back to pass. Speaker Pelosi contends a piecemeal approach is not viable. Senator Manchin expressed skepticism about a revised version of the bill.

Adding to the questions about BBB's future, certain provisos remain unresolved, including the bill's size and caps on state and local tax (SALT) deductions, one of the largest expenditure items. Although the proposed tax increases and budget offsets are mostly permanent, many of the new spending programs and tax credits are temporary (child tax care credit extended for one year; universal pre-K and income-based childcare subsidies will last for six years). Given the Senate's slim Democratic majority, it is unclear what the final bill will look like and when the vote will take place. Although some have pointed to a March 1 deadline, Speaker Pelosi has avowed the bill will pass when there are enough votes to pass it, leaving the time frame open.

Economic and investment implications

The beginning of the year is normally a good time reevaluate short-, mid-, and long-term investment goals, portfolio strategy, and tax and risk exposure. That said, some important cautions seem important to consider regarding this particular legislation. First, near-term economic impacts would likely be minimal. Even if a bill passes this year, we would expect only a modest amount of new stimulus in 2022. Second, some caution is in order regarding the tax provisions listed above. The details of this bill have changed significantly and repeatedly since its introduction in Congress last year. Even if Congress does take up the BBB again (which is not assured), it is likely to be even smaller in its spending and tax consequences. Some of the provisions listed in the table above may not survive further deliberation in Congress.

Fortunately, if BBB does pass we believe the investment opportunities are likely to develop over the coming years, which will give investors time to make decisions. First, we expect that financial institutions would broadly benefit from new government spending. (We currently rate the Financials sector as a tactical favorite.)

We believe infrastructure companies would benefit from funding for environmental initiatives, which are very likely to be prominent spending allocations in any BBB legislation that Congress approves. As we write in our forthcoming special report on infrastructure, "There will always be a need to create, repair, and replace critical societal and transportation assets. However, technological innovation, not to mention an accelerating focus on decarbonization; environmental, social, and governance (ESG) trends; and renewable energy, are shaping and driving an expanded opportunity set, broadening the spectrum of infrastructure investing."[7]

Key takeaways

- Reenergizing President Biden's BBB plan will be top of mind for lawmakers this year ahead of midterms.
- The core of the BBB plan involves social spending and tax provisions; certain provisos remain unresolved as the House-passed bill has stalled in the Senate.
- Potential long-term economic implications of BBB are significant. If BBB does pass, we believe investment opportunities will likely develop over the coming years, giving investors time to make decisions.

7. "Infrastructure: From a Shot in the Arm to a New Era," Wells Fargo Investment Institute, February 23, 2022

The impact of higher inflation on fiscal policy

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How inflation is driving President Biden's agenda

The spike in inflation has reduced real wages, has contributed to increased volatility in equity markets, and will influence Federal Reserve (Fed) policy. What might not be so apparent to investors is how inflation has been impacting fiscal policy. Specifically, President Biden's BBB bill, initially a $2.2 trillion plan that narrowly passed the House, has faced roadblocks in the Senate to a slimmed-down version ($1.75 trillion) due to inflation concerns.

The Congressional Budget Office estimated that the BBB bill would increase the deficit by $3 trillion over 10 years if all of its programs were made permanent.

Source: "The Real Cost of Biden's Spending Plan," The Wall Street Journal (via the Congressional Budget Office), December 12, 2021

The possible connection between BBB and inflation

The debate surrounding fiscal spending and BBB as it pertains to inflation is divided into two camps and is heavily influenced by political agendas, not surprisingly. The Biden administration and other Democrats contend that the $1.75 trillion spending plan will have a limited impact on inflation, even implying that it would lower overall costs to consumers based on the following:

- Inflation's path will largely depend on transitory factors unrelated to the BBB bill, such as COVID-19-related bottlenecks affecting supply chains and labor shortages.
- BBB will ease inflationary pressures for low-income families by increasing access to child care.
- Unlike the American Rescue Plan, which dispersed funds to generate demand in the short run, BBB spending would be spread over 10 years with limited impact on the deficit.

House and Senate Republicans claim that trillions of additional spending is risky when inflation is near record levels. Key arguments include:

- The rapid increase in prices has not been transitory, but rather broad-based and would be subject to further pressures with additional government spending.
- Prominent Democrats including Senator Joe Manchin and economist Larry Summers argue that BBB following the $1.9 trillion American Rescue Plan would drive total spending past the economy's potential to supply goods and services, fueling higher inflation.
- The Congressional Budget Office (CBO) and Tax Foundation state that the bill would increase the cumulative budget deficit over the next 10 years — contrary to claims that the legislation is "fully paid for."

Impact of deficits on inflation

The impact of government debt and deficits on overall inflation has been hotly debated for decades. However, up until the COVID-19 crisis, there has not been a strong relationship between rising deficits and higher inflation in the U.S. and most major developed countries. The absence of a one-to-one relationship between federal budget deficits and inflation reflects the fact that the private economy is still much larger than the government share. Deficits could add inflationary pressure if businesses and consumers also are increasing their demands on the economy's resources. However, the availability of production via imports from overseas to meet U.S. private spending demands has done much to blunt the inflationary impact of government spending in recent decades. We do not expect that trend to change in the near future, but more production could return to the U.S. during the coming decade. In that event, inflationary pressures have the potential to ebb and flow with the economic cycle.[8]

As it relates to overall costs, the Biden administration has emphasized CBO estimates showing that the House-passed BBB plan would increase the deficit by 0.6% of gross domestic product in fiscal year 2022 and then diminish through 2026 before starting to reduce deficits in 2027. BBB would reduce deficits after 2026 because most of its investments are temporary but its revenue-raising measures such as new taxes are assumed to be permanent.

Republican Senators Lindsey Graham and John Cornyn countered by asking the CBO to calculate the costs of the BBB bill that recently passed the House if all of its programs were made permanent. The CBO estimated that the bill under the aforementioned scenario would increase the deficit by $3 trillion over 10 years, significantly higher than the estimate assuming that most investments are temporary.

Economic and market implications

The final outcome of President Biden's BBB legislation and further fiscal policies will in large part be determined by how lawmakers — and by extension the general public — think it will impact inflation.

The final legislation for the BBB plan will likely cost less than the recently proposed $1.75 trillion in the Senate due to inflation concerns of lawmakers. This should lower the long-term deficit outlook, all else equal, but not have a meaningful impact on future inflation. However, a lower amount of fiscal spending could still influence Fed policy going forward, as Chairman Powell has repeatedly emphasized the need to achieve price stability across the economy. And although he has not directly linked widening budget deficits with higher inflation, a lower government debt ratio could allow for a more stable transition toward interest rate normalization with less volatility in risk assets — which is consistent with our current policy of favoring stocks over bonds.

Key takeaways

- The spike in U.S. inflation is affecting fiscal policy, specifically the final outcome of President Biden's BBB plan.
- How lawmakers perceive the connectivity between fiscal policies and deficits with future inflation is sharply divided along party lines but will ultimately have a significant impact on future government spending.

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8. For more details, please see our September 2021 report, "The Future of Globalization"

Risk considerations

Forecasts and targets are based on certain assumptions and on views of market and economic conditions which are subject to change.

Different investments offer different levels of potential return and market risk. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Equity securities** are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. Investments in **infrastructure companies** expose an investment to potentially adverse economic, regulatory, political and other changes affecting such companies. Infrastructure companies may also be subject to various other risks, including, governmental regulations, high interest costs associated with capital construction programs, costs associated with compliance and changes in environmental regulation, economic slowdown and surplus capacity, competition from other providers of services and other factors.

Definitions

Bond rating firms, such as Moody's, Standard & Poor's, and Fitch, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's credit quality rating. 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ('BB', 'B', 'CCC', etc.) are considered low credit quality, and are commonly referred to as "junk bonds".

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