Financing Infrastructure with Inattentive Investors
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Summary of Main Findings

1. Tax-exempt securities are primarily attractive to retail investors who are “inattentive”

2. Therefore, “attentive” mutual fund conduits for retail initially purchase new issues before redistributing them over time to retail investors

3. In periods of reduced retail demand and/or mutual fund outflows, the cost and availability of capital for infrastructure investment is impeded

4. This retail demand dynamic is a primary reason for the poor state of U.S. public infrastructure

5. The Federal Reserve should intervene during periods of mutual fund outflows to support state and local infrastructure investment
### Discussion of the Main Assumptions

**Retail Investors are “Inattentive”**
- Low sales commissions relative to other investment products
- Timing/size of retail demand vs. issuer supply
- Maturity mis-match of retail demand vs. issuer supply

**“Attentive” mutual funds buy municipal issues upfront**
- Entire par amount of bond issue must clear the market at one price
- Mutual funds provide “synthetic” demand for longer term maturities
- Non-exempt “cross-over” buyers support periods of weak demand

**Absence of retail demand inhibits state/local infrastructure investment**
- Impact on cost vs. availability of infrastructure investment capital
- State/local debt capacity limitations: affordability and politics
- Mutual fund redemptions: COVID Mar/Apr 2020 vs. recent 2022-23 experience
- Taxable investor alternatives: 2009-10 BABs and 2020-21 issuance surge
Data and Empirical Tests

1. Role of mutual fund “principal reinvestment” vs retail inflows

2. Increasing importance of SMAs and other non-mutual fund conduits

3. Differing impacts of separating out new money vs. refunding issuances

4. Impact on conclusions if large/repeat issuers selected vs only counties
Comments on Policy Recommendations

Limitations on use of the Fed’s “emergency” lending powers [Section 13(3)]

- “Unusual and exigent circumstances”
- “Inability to secure adequate credit accommodations”
- “Providing liquidity to the financial system”
- “Penalty interest rate set to encourage repayment ASAP”
- Stand-alone municipal facility unlikely absent broader market disruptions

Moral hazard risks

- “Under-investing” replaced by “over-borrowing”
- Implications for diminished credit quality and market discipline
- Implied federal guaranty

Funding vs. financing dilemma

- U.S. capital markets are largest and most liquid in the world
- Access to capital vs capacity for repayment
- Absence of debt capacity and political support for repayment taxes, user fees or other revenue streams
- Alternative delivery mechanisms (P3s) can enhance DBOM but don’t change debt capacity challenge

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