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

3

Differing impacts of separating out new money vs. refunding issuances

2

Increasing importance of SMAs and other non-mutual fund conduits

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