

WESTERN ASSET MUNICIPAL HIGH INCOME FUND INC.

Form N-CSR

January 08, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM N-CSR

**CERTIFIED SHAREHOLDER REPORT OF REGISTERED
MANAGEMENT INVESTMENT COMPANIES**

Investment Company Act file number 811-5497

Western Asset Municipal High Income Fund Inc.
(Exact name of registrant as specified in charter)

125 Broad Street, New York, NY
(Address of principal executive offices)

10004
(Zip code)

Robert I. Frenkel, Esq.
Legg Mason & Co., LLC
300 First Stamford Place, 4th Fl.
Stamford, CT 06902
(Name and address of agent for service)

Registrant's telephone number, including area code: (800) 451-2010

Date of fiscal year end: October 31,

Date of reporting period: October 31, 2006

ITEM 1. REPORT TO STOCKHOLDERS.

The Annual Report to Stockholders is filed herewith.

Western Asset Municipal
High Income Fund Inc.

ANNUAL REPORT

OCTOBER 31, 2006

INVESTMENT PRODUCTS: NOT FDIC INSURED NO BANK GUARANTEE MAY LOSE VALUE

Western Asset Municipal
Income Fund Inc.

Annual Report October 31, 2006

What's Inside	Letter from the Chairman	I
	Fund Overview	1
	Fund at a Glance	5
	Schedule of Investments	6
	Statement of Assets and Liabilities	17
	Statement of Operations	18
	Statements of Changes in Net Assets	19
	Financial Highlights	20
	Notes to Financial Statements	21
	Report of Independent Registered Public Accounting Firm	28
	Financial Data	29
	Board Approval of Management and Subadvisory Agreements	30
	Additional Information	33
	Annual Chief Executive Officer and Chief Financial Officer Certifications	36
	Dividend Reinvestment Plan	37
Important Tax Information	39	

Letter from the Chairman

Dear Shareholder,

While the U.S. economy continued to expand, it weakened considerably as the reporting period progressed. After expanding 4.1% in the third quarter of 2005, gross domestic product (GDP)(i) growth slipped to 1.7% during the last three months of the year. The economy then rebounded sharply in the first quarter of 2006. Over this period, GDP rose 5.6%, its highest reading since the third quarter of 2003. The economy then took a step backwards in the second quarter of 2006, as GDP growth was 2.6% according to the U.S. Commerce Department. The preliminary estimate for third quarter GDP growth was 2.2%.

R. JAY GERKEN, CFA

Chairman, President and
Chief Executive Officer

After increasing the federal funds rate(ii) to 5.25% in June its 17th consecutive rate hike the Federal Reserve Board (Fed)(iii) paused from raising rates at its next four meetings. In its statement accompanying the December meeting, the Fed stated, Economic growth has slowed over the course of the year, partly reflecting a substantial cooling of the housing market. Although recent indicators have been mixed, the economy seems likely to expand at a moderate pace on balance over coming quarters. The Fed s next meeting is at the end of January, and we believe any further rate movements will likely be data dependent.

Both short- and long- term yields rose over the reporting- period. However, after peaking in late June with two- and 10-year Treasuries hitting 5.29% and 5.25%, respectively rates fell sharply as the Fed paused from its tightening cycle. In addition, inflationary pressures eased as oil prices, which rose to a record \$78 a barrel in mid-July, subsequently fell 15% in the latter part of the third quarter.(iv) Overall, during the 12 months ended October 31, 2006, two-year Treasury yields increased from 4.40% to 4.71%. Over the same period, 10-year Treasury yields moved from 4.57% to 4.61%.

Looking at the municipal market, it outperformed its taxable bond counterparts over the 12 months ended

Western Asset Municipal High Income Fund Inc. I

October 31, 2006. Over that period, the Lehman Brothers Municipal Bond Index(v) and the Lehman Brothers U.S. Aggregate Index(vi), returned 5.75% and 5.19%, respectively.

Please read on for a more detailed look at prevailing economic and market conditions during the Fund's fiscal year and to learn how those conditions have affected Fund performance.

Special Shareholder Notices

Following the purchase of substantially all of Citigroup Inc.'s (Citigroup) asset management business in December 2005, Legg Mason, Inc. (Legg Mason) undertook an internal reorganization to consolidate the advisory services provided to the legacy Citigroup funds through a more limited number of advisers. As part of this reorganization, at a meeting held on June 20, 2006, the Fund's Board approved a new management agreement with Legg Mason Partners Fund Advisor, LLC (LMPFA), under which LMPFA became investment manager for the Fund effective August 1, 2006.

Western Asset Management Company (Western Asset) became subadviser for the Fund, under a new sub-advisory agreement between LMPFA and Western Asset, effective August 1, 2006. LMPFA and Western Asset are wholly-owned subsidiaries of Legg Mason.

The portfolio managers who are responsible for the day-to-day management of the Fund remained the same immediately prior to and immediately after the date of these changes. LMPFA provides administrative and certain oversight services to the Fund. LMPFA has delegated to the subadviser the day-to-day portfolio management of the Fund. The management fee for the Fund remains unchanged.

Prior to October 9, 2006, the Fund was known as Municipal High Income Fund Inc.

Information About Your Fund

As you may be aware, several issues in the mutual fund industry (not directly affecting closed-end investment companies, such as this Fund) have come under the scrutiny of federal and state regulators. Affiliates of the Fund's manager have, in recent years, received requests for information from various

government regulators regarding market timing, late trading, fees, and other mutual fund issues in connection with various investigations. The regulators appear to be examining, among other things, the open-end funds response to market timing and shareholder exchange activity, including compliance with prospectus disclosure related to these subjects. The Fund is not in a position to predict the outcome of these requests and investigations, or whether these may affect the Fund.

Important information with regard to recent regulatory developments that may affect the Fund is contained in the Notes to Financial Statements included in this report.

As always, thank you for your confidence in our stewardship of your assets. We look forward to helping you meet your financial goals.

Sincerely,

R. Jay Gerken, CFA
Chairman, President and Chief Executive Officer

December 13, 2006

All index performance reflects no deduction for fees, expenses or taxes. Please note that an investor cannot invest directly in an index.

- (i) Gross domestic product is a market value of goods and services produced by labor and property in a given country.
- (ii) The federal funds rate is the interest rate that banks with excess reserves at a Federal Reserve district bank charge other banks that need overnight loans.
- (iii) The Federal Reserve Board is responsible for the formulation of a policy designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.
- (iv) Source: *The Wall Street Journal*, 9/29/06.
- (v) The Lehman Brothers Municipal Bond Index is a broad measure of the municipal bond market with maturities of at least one year.
- (vi) The Lehman Brothers U.S. Aggregate Index is a broad-based bond index comprised of government, corporate, mortgage and asset-backed issues, rated investment grade or higher, and having at least one year to maturity.

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Fund Overview

Q. What were the overall market conditions during the Fund's reporting period?

A. During the reporting period, the bond market faced a number of challenges, including six additional short-term interest rate hikes by the Federal Reserve Board (Fed)(i), inflationary pressures and a continued economic expansion. However, as the period progressed, oil prices fell sharply, a cooling housing market triggered slower economic growth and the Fed paused from raising rates during its meetings in August, September and October of 2006. All told, the municipal bond market generated positive returns during the one-year period ended October 31, 2006 and outperformed the overall taxable bond market. Over that period, the Lehman Brothers Municipal Bond Index(ii) returned 5.75%, while the Lehman Brothers U.S. Aggregate Index(iii) returned 5.19%.

Performance Review

For the 12 months ended October 31, 2006, the Western Asset Municipal High Income Fund Inc. returned 9.24%, based on its net asset value (NAV)(iv) and 16.66% based on its New York Stock Exchange (NYSE) market price per share. In comparison, the Fund's unmanaged benchmark, the Lehman Brothers Municipal Bond Index, returned 5.75% and its Lipper High Yield Municipal Debt Closed-End Funds Category Average(v) increased 10.21% over the same time frame. Please note that Lipper performance returns are based on each fund's NAV.

Certain investors may be subject to the Federal Alternative Minimum Tax, and state and local taxes may apply. Capital gains, if any, are fully taxable. Please consult your personal tax or legal adviser.

During the 12-month period, the Fund made distributions to shareholders totaling 0.408 per share. The performance table shows the Fund's 12-month total return based on its NAV and market price as of October 31, 2006. **Past performance is no guarantee of future results.**

Performance Snapshot as of October 31, 2006 (unaudited)

	12-Month Total Return
Price Per Share	
\$8.22 (NAV)	9.24%
\$7.84 (Market Price)	16.66%

All figures represent past performance and are not a guarantee of future results.

Total returns are based on changes in NAV or market price, respectively. Total returns assume the reinvestment of all distributions, in additional shares.

Q. What were the most significant factors affecting Fund performance?

What were the leading contributors to performance?

A. During the period, lower rated municipal bonds outperformed their higher quality counterparts. As a result, the Fund's exposure to high yield, lower quality securities enhanced results. In particular, our security selection in the healthcare sector was beneficial to performance. A number of the Fund's holdings were pre-refunded during the period, also boosting returns. Finally, our defensive posture, which included the use of hedging, aided the Fund's returns.

What were the leading detractors from performance?

A. Based on our analysis of the market, we chose not to overweight more speculative areas of the market, such as the airline and tobacco sectors. However, these riskier securities outperformed over the period and our underweight in them served to detract from performance.

Q. Were there any significant changes to the Fund during the reporting period?

A. There were no significant changes during the reporting period. While the bond market rallied sharply toward the end of the reporting period, we did not believe it was prudent to adjust the portfolio to a more neutral position. Rather, we maintained a defensive posture and chose not to extend the portfolio's duration(vi). Looking ahead, we will continue to closely monitor the market and economic environment and continue to look for pockets of opportunities in the municipal market.

Looking for Additional Information?

The Fund is traded under the symbol *MHF* and its closing market price is available in most newspapers under the NYSE listings. The daily NAV is available on-line under symbol *XMHFX* on most financial websites. *Barron's* and *The Wall Street Journal's* Monday edition both carry closed-end fund tables that provide additional information. In addition, the Fund issues a quarterly press release that can be found on most major financial websites as well as www.leggmason.com/InvestorServices.

In a continuing effort to provide information concerning the Fund, shareholders may call 1-888-777-0102 Monday through Friday from 8:00 a.m. to 6:00 p.m. Eastern Time, for the Fund's current NAV, market price and other information.

2 Western Asset Municipal High Income Fund Inc. 2006 Annual Report

Thank you for your investment in the Western Asset Municipal High Income Fund Inc. As ever, we appreciate that you have chosen us to manage your assets and we remain focused on achieving the Fund's investment goals.

Sincerely,

Western Asset Management Company

November 29, 2006

The information provided is not intended to be a forecast of future events, a guarantee of future results or investment advice. Views expressed may differ from those of the firm as a whole.

The mention of sector breakdowns is for informational purposes only and should not be construed as a recommendation to purchase or sell any securities. The information provided regarding such sectors is not a sufficient basis upon which to make an investment decision. Investors seeking financial advice regarding the appropriateness of investing in any securities or investment strategies discussed should consult their financial professional. Portfolio holdings are subject to change at any time and may not be representative of the Fund's current or future investments. The Fund's top five sector holdings (as a percentage of net assets) as of October 31, 2006 were: Hospitals (19.7%), Pre-Refunded (17.1%), Education (13.2%), Miscellaneous (12.0%) and Transportation (8.3%). The Fund's portfolio composition is subject to change at any time.

RISKS: The Fund may use derivatives, such as options and futures, which can be illiquid, may disproportionately increase losses, and have a potentially large impact on Fund performance. High yield bonds involve greater credit and liquidity risks than investment grade bonds. Certain investors may be subject to the Federal Alternative Minimum Tax (AMT), and state and local taxes may apply. Capital gains, if any, are fully taxable.

All index performance reflects no deduction for fees, expenses or taxes. Please note that an investor cannot invest directly in an index.

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- (i) The Federal Reserve Board is responsible for the formulation of a policy designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.
- (ii) The Lehman Brothers Municipal Bond Index is a broad measure of the municipal bond market with maturities of at least one year.
- (iii) The Lehman Brothers U.S. Aggregate Index is a broad-based bond index comprised of government, corporate, mortgage and asset-backed issues, rated investment grade or higher, and having at least one year to maturity.
- (iv) NAV is calculated by subtracting total liabilities and outstanding preferred stock from the closing value of all securities held by the Fund (plus all other assets) and dividing the result (total net assets) by the total number of the common shares outstanding. The NAV fluctuates with changes in the market prices of securities in which the Fund has invested. However, the price at which an investor may buy or sell shares of the Fund is at the Fund's market price as determined by supply of and demand for the Fund's shares.
- (v) Lipper, Inc. is a major independent mutual-fund tracking organization. Returns are based on the 12-month period ended October 31, 2006, including the reinvestment of all distributions, including returns of capital, if any, calculated among the 15 funds in the Fund's Lipper category.
- (vi) Duration is a common gauge of the price sensitivity of a fixed income asset or portfolio to a change in interest rates.

Take Advantage of the Fund's Dividend Reinvestment Plan

As an investor in the Fund, you can participate in its Dividend Reinvestment Plan (Plan), a convenient, simple and efficient way to reinvest your dividends and capital gains, if any, in additional shares of the Fund. A more complete description of the Plan begins on page 37. Below is a short summary of how the Plan works.

Plan Summary

If you are a Plan participant who has not elected to receive your dividends in the form of a cash payment, then your dividend and capital gain distributions will be reinvested automatically in additional shares of the Fund.

The number of shares in the Fund you will receive in lieu of a cash dividend is determined in the following manner. If the market price of the shares is equal to or higher than 98% of the net asset value (NAV) per share on the date of valuation, you will be issued shares for the equivalent of either 98% of the most recently determined NAV per share or 95% of the market price, whichever is greater.

If 98% of the NAV per share at the time of valuation is greater than the market price of the common stock, the Fund will buy shares for your account in the open market or on the New York Stock Exchange.

If the Fund begins to purchase additional shares in the open market and the market price of the shares subsequently rises above 98% of the NAV before the purchases are completed, the Fund will attempt to cancel any remaining orders and issue the remaining dividend or distribution in shares at 98% of the Fund's NAV per share. In that case, the number of Fund shares you receive will be based on the weighted average of prices paid for shares purchased in the open market and the price at which the Fund issues the remaining shares.

To find out more detailed information about the Plan and about how you can participate, please call American Stock Transfer & Trust Company at 1 (877) 366-6441.

Fund at a Glance (unaudited)

Investment Breakdown

As a Percent of Total Investments

Schedule of Investments (October 31, 2006)

WESTERN ASSET MUNICIPAL HIGH INCOME FUND INC.

Face Amount	Rating	Security	Value
MUNICIPAL BONDS 97.2%			
Alabama 0.7%			
\$ 615,000	NR	Capstone Improvement District of Brookwood, AL, Series A, 7.700% due 8/15/23 (a)	\$ 135,300
1,000,000	AAA	West Jefferson, AL, Amusement & Public Park Authority Revenue, Visionland Project, Call 12/1/06 @ 102, 8.000% due 12/1/26 (b)	1,023,340
		Total Alabama	1,158,640
Alaska 1.7%			
1,055,000	NR	Alaska Industrial Development & Export Authority Revenue, Williams Lynxs Alaska Cargoport, 8.125% due 5/1/31 (c)	1,138,187
1,650,000	AAA	Alaska State Housing Financial Corp., General Housing, Series B, MBIA-Insured, 5.250% due 12/1/30	1,782,281
		Total Alaska	2,920,468
Arizona 2.7%			
1,500,000	NR	Casa Grande, AZ, IDA, Hospital Revenue, Casa Grande Regional Medical Center, Series A, 7.625% due 12/1/29	1,673,340
1,760,000	Aaa(d)	Phoenix, AZ, IDA, MFH Revenue, Ventana Palms Apartments Project, Series B, 8.000% due 10/1/34	2,005,432
1,000,000			