

Infrastructure Bank

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07-Jun-1994 03:09pm

TO: Michael T. Schmidt
TO: Randolph M. Lyon
TO: Christoph P. Bertram
TO: Daniel J. Corbett

FROM: David C. Childs
 Office of Mgmt and Budget, TCJS

SUBJECT: Infrastructure

On Thursday, May 26th, there was an informal interagency meeting - sponsored by the NEC (Michael Deich) - to begin discussions on the Administration's goals for several new infrastructure financing proposals. The options discussed included; (1) the infrastructure bank, (2) new or expanded tax subsidies, and (3) E.O. 12803. A preliminary draft discussion paper was requested to outline the issues, concerns and possible recommendations for each option. I was asked to prepare a paper on E.O. 12803. It is understood that these staff papers will be used for internal discussion only and do not represent organizational positions.

As requested, the attached is a draft staff paper outlining the issues surrounding the implementation of E.O. 12803. I believe that it represents our previous discussions on the Order.

- DISCUSSION DRAFT -

EXECUTIVE ORDER 12803 "INFRASTRUCTURE PRIVATIZATION"

June 7, 1994

Issue:

Should Executive Order 12803, "Infrastructure Privatization" be included in the package of proposals to increase infrastructure financing and, if so, what revisions to the current Order are required?

Background

E.O. 12803 was issued by the previous Administration to permit Federal, state and local governments to leverage public and private sector investments and to use the equity in Federally financed infrastructure for investment in new or expanded public infrastructure. The Order begins a process whereby Federal agencies are asked to remove regulatory and other barriers to State and local infrastructure decisions and permits State and local proceeds to be used for infrastructure, debt or tax relief. It does this, primarily, by changing Federal policies regarding sales recoupment. The Order re-establishes the Federal share of sale proceeds (recoupment) from being calculated based upon the original contribution rate and the market value of the asset to the contribution rate applied to the depreciated value of the asset.

Discussion

Recent conversations with the Department of Transportation, the Environmental Protection Agency, NEC and CEA staff suggest their general support for the Order and the idea of leveraging public and private infrastructure investment. Consideration has also been given to the Order within the context of the Administration's larger effort to encourage infrastructure investment, through the creation of an Infrastructure Bank or through new or expanded tax subsidies. One of the primary benefits of the Order is that it can serve to meet the Administration's infrastructure goals independently or as a part of a larger effort that includes other options.

There are concerns for the Order. DOT and EPA, for example, would prefer to limit State and local use of lease or sale proceeds to related infrastructure investment and not debt or tax relief. Concern for the "fungibility" of infrastructure lease or sale revenues also extends to the possibility that State and local governments could use revenues to meet short term operational requirements, under the current Order. Both agencies have also expressed an interest in having the authority to waive all recoupment requirements, if State and local re-investments

plans are determined to warrant such action. States and localities have expressed their interest in the flexibility offered by the Order. Not surprisingly, however, the public employee unions are opposed to the Order. Thus, before the Administration implements the Order, the following policy issues must be resolved.

- (1) Are there Federally-financed assets the lease or sale of which should not be encouraged or facilitated?

This question was raised by AFSCME, who suggested that certain assets should remain in public ownership and operation. The current Order does not address this question. As a Federalism initiative, the Order assumes that State and local officials are in the best position to determine whether a lease or sale is in their community's best interests. Certain facilities, however, may contribute to national or international concerns. As a matter of policy, it may be that certain large international airports, bridges, or even water treatment plants should remain publicly owned and operated facilities.

Recommendation

Appropriate criteria should be developed for the exclusion of national public interest infrastructure assets from the more liberal recoupment and lease/sale provisions of the Order. A revised Executive Order could delegate to the cognizant Federal agencies the authority to identify those national public assets.

- (2) What is the proper level of Federal recoupment and should agencies should be authorized to waive Federal recoupment requirements?

E.O. 12803 recognizes that Federal infrastructure grants are awarded to States and localities based upon the public, social or service value of the asset. They are not awarded with any minimum or expected rate of return. The Order re-established the Federal share of sale proceeds (recoupment) at the original contribution rate applied to the depreciated value of the asset. This represented a change from previous rules that established recoupment at the contribution rate applied to the market value of the asset. The change created new financial incentives for States and localities to consider alternative financing approaches, recognized the time frames and surrounding non-Federal investments at or near the asset and, yet, avoided charges of Federal giveaways. In many cases, the assets in question are fully depreciated or already beyond their useful lives.

Recommendation

As noted above, the public interest in the ownership and operation of certain assets may be such that Federal agencies should be authorized to exempt such assets from the more flexible

recoupment and sale/lease provisions of the current Order. This does not mean to preclude such sales but, simply permits agencies to withdraw current incentives. Likewise, Federal agencies should be authorized to waive all Federal recoupment requirements. Such authority could be limited to assets that have no effective recoupment value, or where the proposed re-investment value of the sale proceeds are determined sufficient to warrant the Federal waiver.

- (3) Should States and localities be limited in how they can use their sale revenues?

The current Order permits States and localities to use lease and sale proceeds for infrastructure, tax and debt reduction. In so doing, the Order acknowledges that infrastructure investment can be achieved through a number of short and long-term investment strategies.

Recommendation

Concern has been expressed for the fungibility of the sale proceeds and the potential use of infrastructure sales to meet operating expenses, under the current Order. The use of funds could, therefore, be limited to; (1) new or expanded infrastructure, (2) new or expanded "like" infrastructure (airport sales revenues could be used only to facilitate airport requirements), (3) new or expanded "common" infrastructure (airports/bridges sale revenues could only be used to meet transportation requirements while waste water and drinking water could only be used for water treatment) or, (4) sales revenues could be limited to use, as authorized by the agency through which the Federal-financing was provided.

- (4) Should additional Federal labor protections be imposed on State and local government decisions, as conditions of sale?

The current Order provides no Federal provisions with respect to labor protection or union representation. The employees impacted by the Order are not, generally, Federal employees.

Recommendation

Labor concerns for the current Order are focused on the removal of Federal barriers to the consideration of lease or sale decisions by States and municipalities. In removing these barriers, the Federal Government should expect States and localities to minimize disruptions to the existing labor force. In many respects, these public employees are in place because of Federal regulations on infrastructure ownership and operations. The revised Order could, as a condition of sale, require that existing employees be offered the Right-of-First-Refusal for jobs created by the lease/sale in the company purchasing the asset or in new or expanded assets facilitated (financed) by the

lease/sale. Other options include; union representation clauses, placement or no adverse action clauses.

- (5) Are there Federal bidding procedures that should be imposed on State and local governments, in considering the sale of Federally-financed assets, to ensure appropriate levels of competition?

The current Order places no specific competitive requirements on States or localities in the sale or lease of Federally financed assets.

Recommendation

Certain Federal procurement provisions could be imposed to offset concerns for competitive bidding and to avoid sweetheart deals.

- (6) Are additional Federal controls or other oversight requirements necessary to ensure the long-term viability of existing assets or to ensure that proposed user fees are appropriate.

Private investors will recoup their investment, plus a reasonable rate of return, through a combination of management improvements, operational efficiencies (labor and equipment investments) and changes to existing user fees. Beyond the deference afforded to States and localities in determining their best interests, the current Order requires assurances that existing assets continue to meet their original grant purposes on a reasonable and nondiscriminatory basis.

Recommendation

The current Order does not establish penalties for failure to live up to established operational requirements. There is also concern that States and localities could turn to the Federal Government after having sold an asset to ensure that public services are maintained. Options that could be outlined in a revised order include the reimposition of Federal recoupment requirements placed against the market or sale value of the asset, imposition of Federally mandated minimum user fees, or loss of operational control. The establishment of State or local utility commissions, which are not mandated by the current Order, could also be required as a condition of sale.

Conclusion:

The Administration is attempting to retool America for the future. It recognizes that public infrastructure investment resources are strained and that they are not keeping pace with existing requirements. As a result, the Administration has expressed its support for the development of public-private



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8 ***Pages to Follow***

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Infrastructure Financing Group

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June 6, 1994

Following is a draft paper on the federal investment in water and wastewater infrastructure prepared by EPA staff. This is the paper that Mike Cook committed to drafting at the meeting of May 26, 1994.

If you also are drafting and distributing a paper, please note that Mike Cook's facsimile number was not included in the list in Michael Deich's memorandum of June 3, 1994. Please add Mike to your distribution and send a copy of your paper to facsimile number 260-1040. Thank you.

From:

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DRAFT**FEDERAL INVESTMENT IN WATER AND WASTEWATER INFRASTRUCTURE****I. Federal Financial Assistance Programs**

The federal government provides subsidies for the capital costs of constructing drinking water supply and treatment and wastewater collection and treatment. The Environmental Protection Agency (EPA) is the principal source of these subsidy programs. Other federal agencies and departments target their investments to particular communities (e.g., small and rural) or for particular purposes (e.g., economic development).

EPA Construction Grants and State Revolving Funds

Between 1956 and 1990 the federal government provided nearly \$59 billion in construction grants for publicly owned treatment works. Most of this funding, over \$51 billion, was dispensed after the 1972 Amendments to the Federal Water Pollution Control Act (commonly referred to as the Clean Water Act or "CWA"). The federal share of projects under the construction grants program varied from 55 percent to 85 percent of eligible costs of wastewater collection, conveyance, and treatment facilities.

The 1987 Amendments to the CWA phased out the grant program and replaced it with the State Revolving Fund (SRF) program. The EPA awards SRF capitalization grants to the states and the states provide 20 percent matching funds. Eighteen states "leverage" their capitalization grants by issuing bonds secured by the grant funds. In this manner they increase the amount of capital in their SRFs. The SRFs provide low-interest rate loans to municipalities for the construction of wastewater systems and for other water quality projects such as nonpoint source pollution control and estuarine protection activities. States are authorized to provide other types of assistance as well, but for the most part have not done so. These additional uses include guaranteeing or purchasing insurance for local debt obligations.

The federal government has provided over \$10 billion in capitalization to SRFs since 1988. State matching funds and leverage funds raise the amount available for loans in the program to approximately \$12 billion. Of course, the key feature of the program is its revolving nature. As loans are repaid by communities the repayment stream is available to provide continuing financial assistance to additional communities. The Administration has proposed authorization levels as part of CWA reauthorization that would be adequate to ensure the program is able to generate at least \$2 billion in loans annually (in 1994 dollars) over the long-term.

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The Administration has proposed establishing a new Drinking Water State Revolving Fund (DWSRF) program to assist communities in meeting requirements of the Safe Drinking Water Act (SDWA). The program would be administered in a similar manner as the SRF program for wastewater and would be authorized to receive \$4.3 billion in federal capitalization between fiscal years 1994-1998.

Department of Agriculture/Rural Development Administration

The Rural Development Administration (RDA) provides several forms of financial assistance for water and wastewater infrastructure in programs that formerly were under the Farmers Home Administration. The principal purpose of this RDA assistance is protection of public health and economic development through the installation, repair, improvement, or expansion of water systems and wastewater collection and treatment systems. These programs are targeted to facilities that primarily serve rural areas or communities of less than 10,000 population. They provide grants, loans, and loan guarantees at various levels and terms depending on affordability criteria.

Estimated total (not just water and wastewater) obligations for the program in fiscal year 1993 were \$600 million for loans and \$398 million for grants.

Department of Housing and Urban Development/Community Development Block Grants

The Community Development Block Grant (CDBG) program is intended to finance projects and activities that benefit low- to moderate-income residents of economically distressed areas. States administer the grants to most communities and establish their own criteria for selecting recipients. However, large metropolitan areas receive CDBG assistance as entitlement grants directly from HUD. Water and wastewater treatment facilities are eligible to receive CDBG funding. It is difficult to determine the extent to which the program has supported such environmental infrastructure because of the variance among the states. While CDBG funds can be critical to the success of certain water and wastewater projects, EPA does not believe that CDBG funding plays a large role in general in water and wastewater construction nationwide.

Estimated total (not just water and wastewater) obligations for the program in fiscal year 1993 were approximately \$2.73 billion for metropolitan areas and \$49.8 million for other communities.

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Department of Commerce/Economic Development Administration

The Economic Development Administration (EDA) administers a Public Works and Development Facilities Grant Program. The EDA awards grants to finance construction of facilities that will promote long-term economic development and contribute to private sector job creation and retention in areas experiencing severe economic distress. Water and wastewater systems are eligible for this assistance but the program provides a very small level of funding to these facilities on a national scale.

Estimated total (not just water and wastewater) obligations for the program in fiscal year 1993 were approximately \$137.5 million.

Coordination of Federal Funding for Water and Wastewater

The federal financial assistance programs discussed above are administered by different federal agencies pursuing different objectives. The goal of EPA's assistance programs is to improve and protect ecological and public health. The water and wastewater systems funded through the other programs also provide this protection, but the purpose of the programs themselves is geared more toward economic development. Efforts to coordinate federal investment in water and wastewater facilities across programs is complicated by these dissimilar objectives.

The various programs also afford a wide range of state participation and autonomy in selecting projects and administering assistance. This can further complicate any efforts to weave the programs into a comprehensive federal infrastructure investment policy. On the other hand, substantial state participation in these programs does facilitate greater coordination at the state level. Several states have formal processes for ensuring that communities eligible for SRF, RDA, and CDBG assistance, for example, receive the most appropriate and effective "bundle" of financial assistance available.

The EPA is working with states and other federal agencies to encourage and facilitate coordination of federal water and wastewater financing programs with those of the states and other organizations. President Clinton's Clean Water Initiative commits the Administration to improving coordination at the federal level between EPA and RDA and between these agencies and the states.

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II. Needs for Investment in Water and Wastewater Infrastructure

Federal funding accounts for a substantial portion of the Nation's capital investment in water and wastewater systems. The EPA recently estimated that federally-funded programs provide approximately 35-40 percent of annual expenditures on construction of water and wastewater facilities. The current total annual capital investment in wastewater by all levels of government is approximately \$10 billion. The analogous figure for drinking water would be \$6.5 billion with the Administration's proposed drinking water SRF program.

The EPA conducts a "Needs Survey" every two years to document wastewater collection and treatment and other water quality needs. The 1992 Needs Survey estimates total needs of \$137 billion. By annualizing these needs over 20 years and adding estimates of needs not captured in the survey, EPA believes the total annual expenditure necessary to build and maintain effective wastewater treatment facilities for the country is \$13 billion.

Information on needs for drinking water infrastructure is much more limited. The EPA does not conduct and publish a Needs Survey under the SDWA as it does under the CWA. Internal Agency estimates, however, put the total annual expenditure required to meet all water supply and treatment needs at approximately \$9.5 billion.

III. Benefits of Investing in Water and Wastewater Infrastructure

The extent of the needs the Nation faces for infrastructure to ensure clean water also is illustrated by the condition of the Nation's waters. The 1992 National Water Quality Inventory (known as "the 305(b) report") concludes that even with the great progress made by our investments in improving water quality, we continue to face an enormous challenge in cleaning and protecting rivers, lakes, and estuaries. The report finds that, of the waters assessed, 44 percent of rivers, 57 percent of lakes, and 44 percent of estuaries evaluated are not fully supporting the "fishable and swimmable waters" goals of the Clean Water Act.

Despite the challenge ahead, it is important to understand the magnitude of the progress we have made since the Nation set these goals in 1972. The quality of water throughout the country has been improved. This widespread success highlights the primary rationale behind the federal government's participation in the partnership funding clean water. Because the benefits of reducing pollution to a large degree accrue "downstream," there can be little incentive for a locality to provide secondary or better treatment its own wastes; however, it would prefer that the locality upstream does so. The federal government's role in regulating and funding ensures that people everywhere both pay

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for and benefit from wastewater treatment. Similarly, ensuring a common minimum quality of drinking water is essential for a mobile society such as ours. People expect that their health will be protected as they travel and that safe water will flow from their taps if they relocate. They also expect that water across the country will be safe for infants and the minority of the population with sensitive and impaired immune systems. The federal role helps to create confidence in the quality of our water.

The money that the federal government has invested in the construction grants and SRF programs, along with many billions of dollars more invested by state and local governments and private industry, have significantly reduced the discharge of pollutants into surface waters. Between the beginning of substantial federal financing of municipal wastewater facilities in 1972 and 1988, the total national daily discharge from municipal plants of biological oxygen demand, a critical indicator pollutant of water quality, decreased 36 percent from 6,764 to 4,347 metric tons per day. This reduction was achieved during a time of great population growth that increased the pollutant loadings into municipal wastewater plants.

This investment in environmental protection also is an investment in economic growth. The portion of our Nation's waters that fully support ecological and recreational uses drive vast economic activity. Sport fishing in our fresh and salt waters generates about \$24 billion annually in consumer spending and more than \$3 billion in federal and state tax revenues. Commercial fishing adds to the economic activity from healthy fish populations that benefit from clean water. Hunters of wetland-dependent wildlife alone spend over \$686 million each year. Recreational visits to lakes, beaches, streams, and wetlands for non-hunting wildlife uses result in spending of over \$18 billion annually. Boating in the clean waters of the United States is big business. In 1993 consumers spent over \$11 billion on boats, equipment, and related services. This does not include ancillary spending on travel, food, lodging, etc.

These numbers show an enormous economic benefit from fishable and swimmable waters. And this benefit occurs even though a substantial portion of our waters do not yet fully support these economic uses. Our efforts continue to improve the condition of the Nation's waters and to reach the goal of making them all fishable and swimmable. Our success will increase the return we are already seeing on our investment.

The economic benefits of investing in clean water are obvious to all who enjoy the activities above at their favorite lake, river, wetland, or ocean beach. Other benefits may not be as obvious. Water and sewer pipes in the ground and treatment plants at the edge of town are not something most residents of

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communities think about or "enjoy." However, they are important to businesses and developers and others looking to invest in a community by building or expanding businesses or residences. These development activities are central elements of economic health and growth and are dependent on effective water and wastewater infrastructure.

Investing in water and wastewater infrastructure also has the very important economic benefit of creating jobs. The Bureau of Labor Statistics estimates that every \$1 billion invested in water and wastewater construction creates 22,400 direct and indirect jobs. And beyond immediate construction-related jobs, the resulting recreational activity and commercial development noted above support many more jobs.

IV. Potential Improvements to the State Revolving Fund Program

The SRF program is a successful and effective mechanism for investing federal funds in local infrastructure. Its primary benefit is that it allows each federal dollar to revolve and to fund many times that dollar's value worth of wastewater facilities over long periods of time. This spreads limited federal assistance to many more communities than could be reached through one-time grants. An additional key element of the SRF program is state flexibility. Each state has developed and can refine its SRF to address the particular water quality needs of its residents and communities. Within a broad federal framework, states are free to manage an investment program that works best for them.

The SRF program could, however, be improved. The program has difficulty meeting the needs of small and economically disadvantaged communities. A loan program does not provide the level of subsidy needed by some communities. The requirement to repay even a low- or no-interest rate loan may make SRF assistance unaffordable to a community and its wastewater system users. To help extend the reach of the SRF program to these communities the Administration has recommended permitting states to provide a limited amount of loans at rates of down to negative two percent and to extend the repayment period from 20 to 30 years. The Administration, as noted above, also will attempt to further coordinate SRF assistance for these communities with RDA and CDBG grant programs.

Another aspect of the SRF program that may make it difficult for some potential loan recipients to afford a loan is the cost of complying with various project-level federal requirements. These requirements include CWA provisions such as facilities planning considerations. The cumulative impact of meeting, documenting, and reporting on these requirements may significantly increase the cost of projects. The Administration has recommended in President Clinton's Clean Water Initiative

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that some of these requirements be eliminated for communities with populations under 10,000. Our proposal would exempt these communities from requirements to consider alternative and innovative technologies, to analyze opportunities for recreation and open space, to consider developing capital financing plans. In addition, value engineering studies would be required only for projects with total costs exceeding \$25 million.

One sensitive problem with the SRF program is the allotment of federal funds among the states. The CWA sets a statutory formula for distributing appropriated amounts to the states and territories. The formula is based on population and needs. The data upon which the formula was built are now rather dated and do not necessarily reflect the current distribution of the Nation's wastewater treatment needs. Historically, some discrepancy in the distribution of needs and the allotment of funds was not a serious problem because overall needs were so great that available funds could effectively be used by all states. More recently, however, as the wastewater treatment needs in some states have essentially been addressed by federal, state, and local spending. Congress is considering adjustments to the formula as part of CWA reauthorization in an attempt to ensure the best investment of limited federal funds.

V. Potential Sources of Revenue for Funding Water and Wastewater Infrastructure

Several reports and legislative proposals over the past few years have suggested that a federal "Clean Water Trust Fund" be established and capitalized with one or more dedicated sources of revenue. The intended benefit of such a funding mechanism would be a stable supply of federal funds to invest in the water and wastewater needs of the country. Most proposals would authorize funding of water program administration and operations as well as capital infrastructure needs.

The source(s) of revenue would be fees or taxes on selected products or activities that contribute to the need for water and wastewater treatment facilities. Typical of recent suggestions are the taxes proposed in a bill, H.R. 2199, introduced last year by Rep. Studds (D-MA). These taxes would be applied to the manufacture, sale, or use of fertilizer, pesticides, and animal feed; the discharge of chemical pollutants; and commercial and industrial consumption of water.

These taxes would be implemented in an effort to modify environmentally detrimental behavior as well as to raise revenue for investing in water and wastewater systems. The EPA in general supports the idea of market incentives for pollution prevention as well as dedicated funding for critical environmental investments. However, there are many questions associated with these matters that must be answered. The Agency

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is concerned about equitable application of taxes, the potential impact on small businesses or particular industries, ranking of pollutants and differential impact of pollutants on receiving waters, monitoring and enforcement, and the potential impact on similar state or local tax or fee systems. In addition, the fundamental questions of how much revenue could be raised and/or to what extent behavior may be modified must be carefully considered for any serious proposals.

The EPA simply does not have the answers to these questions. President Clinton's Clean Water Initiative proposes that EPA undertake a study on the feasibility, implementability, and cost-effectiveness of these types of funding mechanisms.

Mike Schmidt

To: Infrastructure Finance Group
From: Chris Bertram and Dan Corbett

Attached is a draft of the Infrastructure Bank paper prepared by OMB staff.

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National Infrastructure Bank (NIB)

This paper describes the possible structure, purpose and likely effectiveness of a federal infrastructure bank that could be an initiative in the 1996 budget.

The basic function of the bank would be to make funds available for infrastructure projects. To be attractive to State and local governments, the rates would need to be below tax-exempt rates that the States can already obtain through the municipal bond market. This extra supply of cheaper financing should increase the amount of infrastructure projects undertaken by State, local, quasi-public, and private entities.

There are three basic ways the "Bank" could make such funds available.

- The Bank could make *Direct Loans* to the entity undertaking the project.
- The Bank could capitalize a *Revolving Fund* at the State level that makes loans to undertake the project.
- The Bank could issues *Loan Guarantees* for financing used to undertake the project.

This paper describes these three options, how they would lower the cost of financing, and lists the pros and cons of each.

Before these specific options are explored, the pros and cons of stimulating infrastructure investment through a Bank rather than through a more traditional federal grant program are considered.

Advantages of the Bank Concept

- But need \$ up front for loans --
where will \$ come from in Budget, BEA

- A Bank would provide the Administration with a tangible infrastructure initiative for little immediate cost in a tight fiscal environment that makes increases in traditional infrastructure programs difficult.
- The Bank could produce new infrastructure investment at a fraction (25-50% or so) of the cost to the Federal Government of a grant program.
- The increased flexibility of the program and the discipline required by the loan process may raise the overall return on Federal funding over that from current, more narrowly focused, programs.
- Overall targeting of infrastructure funding could also be enhanced because, to the extent Federal grants are augmented with borrowing, State and local infrastructure projects would face more of a national market test as to their relative cost effectiveness than they would with Federal grants with low match rates.
- The Bank is a clean slate on which the Administration can draw its infrastructure principles before the legislative re-authorization cycle for the major Federal grant

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programs, especially ISTEA.

Disadvantages of the Bank Concept

- Advocates of transportation programs may respond that the Administration should simply spend the taxes already being collected rather than devising new ways of financing infrastructure.
- Depending on the size of the Bank proposal, the program could look marginal rather than bold when compared to the size of some of our Infrastructure problems (e.g., a \$290 billion highway deficiency backlog) and the campaign pledge to spend \$20 billion more annually on infrastructure.
- Substitution is likely. Cheaper financing would, to some degree, provide better financing terms to projects that would have occurred in any case, thus reducing the net increase in infrastructure. The marginal addition of infrastructure is likely to be smaller than the amount of loans that would be disbursed. However, the substitution effect also applies to infrastructure grant programs.
- Subsidized Infrastructure activity could inefficiently soak up private investment that could be spent more effectively elsewhere.
- Private sector (e. g., the Public Securities Association) would likely oppose.
- The Federal government could be guaranteeing and financing projects with substantial credit risk, thereby creating a contingent liability.
- Projects may be of low return and low relative value. There is no obvious market failure that is being corrected given the successful tax-exempt financing market. There is no evidence that at current rates financing demand is going unmet or that a market imperfection exists.

Direct Loans

Description of Direct Loans

A direct loan program for infrastructure projects would have the Bank assume the same role as the current municipal debt markets. The Bank would receive applications for projects, evaluate them, negotiate loan terms, and then manage the repayment. The Federal government already runs a number of such direct loan programs.

Under the Budget Enforcement Act, the subsidy cost of a direct loan is scored "up front" in the Federal Budget. This cost consists of two main components: an interest subsidy and a default or risk subsidy. When making a direct loan, a subsidy amount must be appropriated

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to cover the costs of these two components.¹

A direct loan program could be run by a Federal entity staffed with Federal employees or by a privately-controlled Government Sponsored Enterprise (GSE). A direct loan program run by a Federal entity could provide credit at a lower cost than a GSE (about 30 basis points). This is because the implicit Federal backing of a GSE is not quite as good a risk as that which can be offered directly by the Federal Government.

Advantages of Direct Loans

- Provides a more tangible and understandable form of assistance than either State Revolving Funds or Loan Guarantees. (e.g., a \$4 billion loan program versus a \$1 billion capitalization of a State Revolving Fund).
- Allows greater control and accountability than the other options. Subsidy can be more easily targeted to different areas and/or types of projects.
- Has the flexibility to provide a deeper subsidy than loan guarantees.

Disadvantages of Direct Loans

- Requires continued appropriation / financing of the credit subsidy.
- Requires the Bank to assess levels of risk among different proposals. Creating the institutional capacity to do this will be difficult. The Federal government has historically had a hard time doing this for loan programs.
- Creating a process that allows the Bank to make decisions that target the funds at the best projects, rather than have to follow a "political" formula that distributes the funds at a pre-set rate to States and localities will be difficult.
- Large contingent liability.

State Revolving Funds

Description of State Revolving Funds

State Revolving Funds (SRF) have been successfully used in the wastewater treatment

¹ Under the Budget Enforcement Act, credit subsidy consists of the net present value of repayments and fees offset by the net present value of the interest rate subsidy (usually defined as the difference between the interest rate charged to the borrower and the Treasury borrowing cost) and the default subsidy.

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program since the 1980's when the Federal Government began phasing out project-specific grants for wastewater treatment and replaced them with grants that capitalize State Revolving Funds (SRF's). EPA has contributed over \$6 billion to set up SRF's in all 50 States.

There is no reason that SRF's could not be applied more broadly for infrastructure projects. Under such a program, local governments and authorities would borrow money from the SRF for projects. The loans from the SRF can be repaid from project revenues or broader sources such as local option taxes. The mechanics are not much different from the direct loan option except that the States step in and assume the operational and administrative duties of the National Bank. Furthermore, since the loan is originating from the SRF, not the Federal government, such a program would not be scored under Credit Reform. The grants for capitalization would be simple appropriations.

Although SRF's are often described as "self-sustaining" this is only true as long as the interest and repayments are sufficient to offset the effects of inflation and defaults. If the SRF makes loans at below market rates or for risky projects, the value of its capitalization will drop over time.

Furthermore, the SRF itself could go to the credit markets, and using a certain amount of its capital as collateral, borrow additional funds that are then passed on. It is conceivable that there are economies of scale from a single large bond issue that could reduce the cost of borrowing funds by a series of smaller entities.

Advantages of Revolving Funds

- State control eliminates the need for setting up a new Federal entity with expertise in evaluating projects.
- State control allows better and quicker adjustment of the loan program to meet local needs.
- SRF's could foster a greater amount of infrastructure investment to the extent they encourage States to seek greater leverage.
- The likelihood of Federal-level political interference is reduced.
- The Federal government faces no contingent liability risk.

Disadvantages of Revolving Funds

- Requires large, up-front appropriations for the capitalization of the revolving fund.
- Less ability to direct the program at national priorities.

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- Since the loan terms are subject to local control, there are fewer levers for the Federal government to ensure that the substitution effect of SRF loans is minimized. A "level of effort requirement" might help offset this problem.

Loan Guarantees**Description of Loan Guarantees**

Similar to direct loans, loan guarantees could be offered by either the Federal Government or an off-budget private entity such as a Government-Sponsored Entity (GSE).

Federal Loan Guarantees

The advantages and disadvantages of the Federal Government offering loan guarantees are very similar to the advantages and disadvantages of a Federal Direct Loan Program. However, the value of loan guarantees is relatively small for most infrastructure programs because the borrower is a State or Local government that is already considered to be an excellent credit risk. If loan guarantees are offered by a Federal entity, the guarantee would be scored under credit reform and an appropriation would be required to cover the default/risk subsidy.

Loan Guarantees by a GSE

The specific concept most often described under this option is to create a new off-budget Government Sponsored Enterprise that would transform the existing College Construction Loan Insurance Association (Connie Lee). This Infrastructure Government Sponsored Enterprise (IGSE) would be authorized to provide bond insurance on State and local government borrowing to enhance its valuation in the private marketplace. ²

Whereas Connie Lee currently provides insurance primarily to higher education facility bonds rated below the third highest rating of nationally recognized statistical rating agencies (Triple B), the IGSE would be authorized to insure and reinsure all infrastructure-related bonds that are rated Triple B and below. (The Administration is currently considering a similar expansion of Connie Lee's mandate to cover elementary and secondary education bonds.) In addition, IGSE would be authorized to insure bonds rated above Triple-B if such obligations have been declined for coverage by all other primary insurers of infrastructure bonds.

IGSE would be a private, for-profit bond insurance company. It would expand its capital base through retained earnings from insurance fees and the issuance of stock. Given that Connie Lee is presently up and running, IGSE would need no additional funding from the

² A variant of this option is to have an on-budget Federal Bank issue the guarantees. The pros and cons are similar. The major difference is that the guarantee would be scored under credit reform and an appropriation is required.

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Federal Government.

With the exception of its statutory mandate and creation by the Federal Government, IGSE would have no additional ties to the Federal Government. Consequently, connections that currently exist between Connie Lee and the Government would be severed. Specifically, the Secretary of Education and Sallie Mae would fully divest their equity positions in Connie Lee; appointments to Connie Lee's Board of Directors made by the Secretary of Education, the Secretary of the Treasury, and Sallie Mae would need to be eliminated; and statutes that give Sallie Mae the first right of refusal on all new stock issuances would need to be removed. (All of these provisions are currently in the above-mentioned proposal to give Connie Lee elementary and secondary education bond insurance authority.)

IGSE would be required to provide notice as well that its guarantees are not backed by the full faith and credit of the U.S. (similar to Fannie Mae.)

Advantages of Loan Guarantees

- Could help make infrastructure projects feasible that currently cannot obtain financing.
- An IGSE could correct a market imperfection that may exist by which communities or States are unable to get financing as a result of the overly risk-averse nature of private bond insurance and the bond financing market.
- More participants in the bond insurance and bond financing business may promote greater competition and risk-taking by private insurers and lending sources.
- Would not require continued appropriation / financing.
- Uses private assessment of risk.

Disadvantages of Loan Guarantees

- Despite legal qualifications to the contrary, GSE's enjoy the implicit backing of the Federal Government and the market tends to rate GSE debt as only slightly riskier than Government Debt. Issuing guarantees to marginal risks could carry significant default risk, resulting in increased contingent liability to the Federal Government. An independent IGSE may not be subject to Federal financial safety and soundness oversight.
- A GSE would not be subject to explicit on-budget review concerning its ongoing effectiveness and justification in terms of current public policy priorities.
- The private bond insurance industry would vehemently oppose the creation of a quasi-Government competitor. To the extent the IGSE is perceived to have an implicit government guarantee, it would have a competitive advantage over the private bond

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insurance industry in Triple B credits.

- It is unclear that an IGSM could foster new infrastructure investment given a very successful tax-exempt financing market. No evidence has been presented that at market rates infrastructure financing demand is going unmet or that a market imperfection exists.
- Since the guarantees would only be available to poorly rated bond issues, a great many potential projects would not be able to eligible under this option. The overall pool of projects would probably have a lower rate of return than under other options.

Summary

- *Direct Loans* can provide cheap and well-targeted infrastructure financing but would require the creation of a new entity that would need the technical resources and judgement to evaluate and select projects. It is probably the most easily understood option and most easily creates a "large Administration initiative" (e.g., a \$x billion loan program).
- *Revolving Funds* have the advantage of using State expertise in project selection, but are more expensive and make it harder to target the Federal investment.
- *Loan Guarantees* have less value than the other options since the subsidy is very low and would still have the problem of needing to develop a method for project selection.

Possible Hybrid

In order to overcome the main disadvantage of a direct loan option, which is the need to create a method of selecting good projects, it may be prudent to use some of the project selection features of the other options.

For example, if a State applied for a below market direct loan for a toll road the bank could impose one of the following conditions:

- The State must finance 30% of the project through general obligation bonds that receive at least a rating of X and that are not senior to the Federal loan;
- The State must guarantee 100% of the tolls for the first 10 years; or,
- The State must guarantee 30% of the cost of loan.

The advantage of this hybrid is that the project would still benefit from the subsidized loan terms, but the Bank would have advantage of receiving an outside signal of the relative risk of the project by requiring another entity (the State) to assume some of the risk or to use more experienced and capable entities to rate the risk (Bond Rating Agencies). Such a hybrid approach has the potential to minimize the Bank's exposure to risk while ensuring that the return on the projects is good.

This concept is not exclusive to States, it could also be applied to cities, counties, and authorities. The key is to try to spread risk and work of selecting projects, but to still have the advantage of a cheaper credit.

June 6, 1994

DRAFT

June 6, 1994

TO: INFRASTRUCTURE FINANCE TASK FORCE

FROM: MARK MAZUR *mark*

SUBJECT: TAX CREDIT BOND PROPOSAL (PART OF INFRASTRUCTURE FINANCE TASK FORCE ASSIGNMENTS)

Attached is a description of a proposal to utilize "tax credit bonds" to help finance additional infrastructure investments. I expect that this will be discussed at our Thursday meeting, but feel free to call me before then if you have comments.

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TAX CREDIT BOND PROPOSAL

draft of June 6, 1994

Introduction -- Tax exempt bonds are an inefficient way to transfer a Federal subsidy to State and local infrastructure projects. It is possible to construct an alternative subsidy mechanism (e.g., a "tax credit" bond) that would: (1) transfer a greater proportion of the Federal subsidy to State and local borrowers; and (2) also increase the aggregate amount of infrastructure that can be supported through debt finance.

Background -- There is a significant consensus among economists that tax-exempt bonds are an inefficient method of providing a capital subsidy to State and local governments. While lower interest rates on tax-exempt debt reduce the cost of capital to borrowers (relative to the rate on fully taxable debt), the overall transactions are economically inefficient because the costs to the Federal Treasury (foregone income taxes) are greater than the interest savings to borrowers. This inefficiency arises because market interest rates on tax-exempt bonds relative to those on taxable bonds of similar maturity and risk reflect the income tax rate faced by the marginal investor (the investor who is just indifferent between holding the tax-exempt bonds or the taxable bonds of similar maturity and risk). An investor whose marginal income tax rate exceeds this market-determined rate receives a relatively high after-tax rate of return (which may be considered a windfall benefit) while the Treasury and/or the issuer of the tax-exempt debt suffers a corresponding detriment.

This can be shown by example. Suppose the market interest rate on general obligation tax-exempt bonds is 6.4 percent, while the market interest on taxable bonds of similar risk and maturity is 8.0 percent. The difference between the two interest rates (1.6 percentage points) indicates the value the marginal investor puts on the tax-exempt status of the bonds. The lower interest rate on the tax-exempt bonds can be viewed as an implicit tax on the holders of these bonds. Because the after tax rate of return on the tax-exempt bonds equals the after-tax rate of return on taxable bonds for a holder with a 20 percent marginal tax rate, the implicit tax rate in this example is 20 percent. Investors with marginal tax rates greater than 20 percent will prefer to hold tax-exempt bonds over taxable bonds, and the reverse will be true for investors with marginal tax rates less than 20 percent.

Ah, much clearer!

Note that the overall social cost of a bond (interest payments less taxes collected on these interest payments) issued by a State government is the interest paid to the investor less any taxes paid on this interest. In the example above, a \$1000 tax-exempt bond will pay \$64 interest each year. Since this interest is not subject to income tax, such a bond has a social

cost of \$64. If instead the State had issued a \$1000 taxable bond of similar maturity and risk, the interest cost to the State government would be \$80. However, the Federal government would receive income tax payments on this interest. For an investor with a marginal tax rate of 31 percent, income taxes paid would equal \$24.80, yielding a social cost for this bond of \$55.20. The \$8.80 difference in social costs is a measure of the inefficiency of tax-exempt finance in this example.

Proposal -- This inefficiency may be addressed by a more direct capital subsidy for State and local borrowers -- a "tax credit" bond. Under this proposal, State and local governments could elect to issue tax-credit bonds instead of tax-exempt bonds. The interest on a tax-credit bond would be fully taxable, but the investor would be allowed to claim a nonrefundable income tax credit equal to a certain percentage of gross interest paid. For illustrative purposes, assume a 20 percent credit rate (the actual credit rate chosen would depend on how the financial benefits of the proposal are to be divided between the Federal Treasury and State and local issuers of these bonds).

Using the example above, an issuer could elect to issue a \$1000 tax credit bond rather than a \$1000 tax-exempt bond. The nominal interest rate on this bond would be 8.0 percent (the taxable rate), but only 80 percent of this amount would be paid in cash and the rest paid in the form of a tax credit. In terms of the above example, the issuer would pay cash interest of \$64 ($\$1000 \times .08 \times .8$), and would also transfer to the lender a tax credit equal to \$16 (20 percent of the nominal interest payment). The bondholder would report \$80 as income, but would have a tax credit equal to \$16 available to offset a portion of overall income tax liability. The \$16 credit represents the explicit cost to the Treasury of this capital subsidy to State and local borrowers issuing these bonds.

The tax credit bonds would be subject to the same rules as tax-exempt bonds regarding issuance and the ability of State and local governments to earn "arbitrage profits". However, the types of investments financed by these bonds could be broader than those permitted under current tax-exempt bond rules. It would be desirable to list exactly the types of infrastructure investments that could be financed using tax credit bonds to ensure that the subsidy provided was appropriately utilized. Possible candidate investments for these bonds could include: water treatment facilities that are not owned by governments; stadiums; high speed rail facilities not owned by governments; and toll roads not owned by governments.

Analysis -- From the issuer's perspective, the tax-credit bond costs the same as the tax-exempt bond. From the investor's perspective, the tax-credit bond has a lower after-tax rate of return for those with marginal tax rates above 20 percent. From

the Federal government's perspective, use of the tax credit bond would change revenues by the aggregate effect on individual investors. This proposal could generate revenue, depending on the size of the tax credit rate. Some or all of this potential revenue could be shared with the issuers of the bonds.

Additional borrowing could be undertaken by State and local governments using tax-credit bonds instead of tax-exempt bonds, while holding the Federal revenue cost fixed. Using the figures in the above example, for \$1 financed by tax-exempt bonds, \$1.11 in tax-credit bonds could be financed if the holder was in a 28 percent tax bracket; if the investor was in a 31 percent tax bracket, the tax-credit bond alternative could finance \$1.16 for the same social cost as \$1 of tax-exempt debt.

The effect of this proposal on the overall level of infrastructure investments undertaken by State and local governments is unclear. Clearly, the rate at which State and local governments use tax credit bonds will be positively related to the credit rate. If current law restrictions on uses of tax-exempt bond proceeds were maintained for tax credit bonds, inertia on the part of State and local decision-makers likely would limit the volume of tax-credit bonds (at a 20 percent credit rate, tax credit bond issuance might be less than one percent of current tax-exempt bond issuance). However, if tax credit bond proceeds could be used for infrastructure investments that are prohibited under tax-exempt bond rules, the volume of tax credit bonds could be significant. Moreover, if State and local governments were required to use tax credit bonds for a specified proportion of their total bond issuance, tax credit bonds might become a major borrowing tool for subnational governments. In any event, to the extent that tax credit bonds are utilized at all, the efficiency of State and local borrowing would be enhanced.



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Number of pages: 8

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UNCLASSIFIED

Draft of June 6, 1994
M. Rapaport (622-0871)

TAX-EXEMPT BOND PROPOSALS

Summary of proposal. The proposal suggests a number of amendments to the federal tax laws relating to tax-exempt bonds in order to increase investment in infrastructure. First, the private activity bond rules would be changed by liberalizing the definition of private activity bond; broadening the types of infrastructure facilities that can be financed with private activity bonds, and providing additional exceptions to the volume cap. The arbitrage rules would be changed by expanding the application of the small issuer and spending exceptions to the rebate requirement. Finally, the rules that affect the demand for tax-exempt bonds would be modified by increasing the small issuer exception to the bank deductibility rules and eliminating private activity bond interest as a preference for alternative minimum tax ("AMT") purposes.

Current law

Private activity bonds. The private activity bond ("PAB") rules attempt to prevent the subsidy provided by tax-exempt bonds from being used to benefit private persons. In general, interest on PABs is not tax-exempt. Generally, bonds are taxable PABs if more than 10 percent of the bond proceeds are used for a "private business use" (e.g., a loan of bond proceeds to a private person or a lease of a bond-financed facility to a private person). The PAB limit was reduced from 25 percent to 10 percent as part of the Tax Reform Act of 1986 (the "1986 Act"). Bonds are also PABs if: (1) private use that is unrelated or disproportionate to the governmental use of the issue exceeds 5 percent; (2) private use exceeds \$15 million unless PAB volume cap is allocated to that excess private use; (3) for financings of power plants and other output facilities, the amount of private use exceeds \$15 million; or (4) more than \$5 million or 5 percent of the bond proceeds (whichever is less) are used to make private loans.

Certain PABs qualify for tax-exempt treatment, including bonds for: (1) governmentally owned airports, docks and wharves, mass commuting facilities, (2) sewage, solid waste, and hazardous waste disposal facilities, and (3) residential rental projects ("exempt facilities"). The PAB "volume cap" limits the amount of PABs that may be issued in each State during a calendar year to the greater of \$150 million or the product of \$50 and the State population. The volume cap does not apply to bonds for airports, docks and wharves, and mass commuting facilities, and bonds for governmentally owned solid waste disposal and high-speed rail facilities. PABs cannot be advance refunded.

Arbitrage and advance refundings. For issuers of tax-exempt bonds, arbitrage is the ability to borrow at tax-exempt rates and invest the amounts borrowed in higher-rate, taxable investments. Arbitrage provides an incentive to increase the volume of outstanding tax-exempt bonds, resulting in a federal revenue loss and the potential for arbitrage motivated transactions to crowd the tax-exempt market leading to higher municipal bond interest rates. The arbitrage rebate requirement requires that issuers pay to the United States any arbitrage

that is earned. Exceptions to the rebate requirement apply to issuers that issue less than \$5 million of bonds per year, issues where all the proceeds are spent within 6 months of issuance, and certain construction issues if all the proceeds are spent within 2 years.

Primarily to take advantage of lower interest rates, municipalities issue new debt to "refund" outstanding debt. Because most bonds may not be retired for at least 10 years after being issued, issuers usually cannot immediately retire their outstanding debt. By issuing new refunding bonds and without retiring the outstanding debt until the first call date for that debt (an "advance refunding"), an issuer can lock in lower interest rates and immediately obtain the benefit of this interest rate savings. As a result of the 1986 Act, bonds issued after 1985 can only be advance refunded once, while bonds issued before 1986 can be advance refunded twice.

Demand for tax-exempt bonds. Deductions that are generally permitted to taxpayers for interest paid on borrowings are denied if the borrowed amounts are used to acquire tax-exempt bonds. This prevents a double benefit to the taxpayer: interest deductions and tax-exempt interest. In 1986 this rule was extended to bonds held by banks (except for bonds of small issuers that issue less than \$10 million of bonds in a calendar year).

The alternative minimum tax ("AMT") is designed to ensure that individuals and corporations do not completely avoid income tax by applying a specified tax rate to a broader concept of income that includes various tax preference items. Interest on most PABs is a preference item.

Proposals

Private activity bonds. Many have suggested changes to the PABs rules to permit increased private use without subjecting those bonds to limitations on the types of property that can be financed, the volume cap, limits on advance refundings, and the AMT. These proposals include: (1) increasing the private use limitation to 25 percent; (2) liberalizing the definition of private use (e.g., to ignore use of governmentally owned or controlled facilities if the private user pays an arm's length price or otherwise passes on the benefit of the tax-exemption to the public); (3) treating bonds for governmentally owned infrastructure as governmental bonds regardless of private use; (4) expanding the types of facilities financable with tax-exempt PABs (e.g., to include infrastructure, facilities necessitated by federal mandates, or facilities in distressed areas); (5) eliminating governmental ownership requirements for facilities financed with PABs; (6) exempting bonds for infrastructure from the volume cap; and (7) indexing the volume cap for inflation. Other proposals include eliminating the special unrelated use, output facility, \$15 million volume cap, and \$5 million private loan rules.¹

¹ Other simplifying changes have also been suggested, such as repeal of the public approval requirement and the 2 percent cost of issuance limitation.

Arbitrage and advance refundings. The arbitrage related proposals include: (1) repeal of the arbitrage rebate requirement; (2) expanding the small issuer exception by increasing the size of issuers qualifying for the small issuer exception to \$25 million; and (3) adding a new, simple spending exception to the rebate requirement (and repealing the 2 year exception) under which rebate would not apply if one-third of the proceeds are spent within one year, seventy-five percent within two years, and all proceeds (other than a de minimis amount) within 3 years, but only if arbitrage earnings are used for the purpose of the issue (or for other capital costs).²

For advance refundings, some suggest a return to the rules applicable prior to 1986. Alternatively, advance refundings with savings exceeding 5 percent could be ignored in applying the limit on the number of permissible advance refundings. Another approach would be to permit an issue to be advance refunded after the original bonds are retired (i.e., no more than two sets of bonds outstanding at any time). Each of these proposals could be adopted temporarily, to provide a one-time stimulus, or could be limited to infrastructure financings.

Demand for tax-exempt bonds. With respect to the demand for tax-exempt bonds, the suggestions include: (1) repeal the changes to the bank deductibility rules made in 1986; (2) increase the small issuer bank deductibility exception; and (3) eliminate PAB interest as a tax preference item for AMT purposes.

Comprehensive proposal. The following suggestions represent the best combination of the tax-exempt bond proposals to benefit infrastructure: (1) increase the private use limit to 15 percent; (2) include "infrastructure facilities" as exempt facilities; (3) provide a complete volume cap exemption for bonds for governmentally owned infrastructure and a 50 percent exemption for other infrastructure bonds; (4) provide consistent rules for other exempt facilities; (5) revise and index the volume cap to take into account these changes; (6) repeal the special PAB definitions (e.g., the \$15 million output facility rule) and the \$5 million private loan rule and make other simplifications; (7) increase the small issuer exception to rebate to \$25 million and provide a 3 year spending exception; and (8) increase the small issuer bank deductibility exception to \$25 million and eliminate private activity bonds as an AMT preference item.

² Several other simplifications have been suggested, including: (1) exemption of bona fide debt service funds from rebate if the issue is eligible for the 2 year exception; (2) repeal of the 150 percent limitation on reasonably required reserve funds; (3) increase the scope of the various de minimis rules; (4) repeal the loss of temporary period rule in section 149(d); and (5) conform and simplify the technical requirements of the small issuer rebate and bank deductibility rules. Certain of these changes would be unnecessary if other changes described herein are made.

Arguments in favor of proposals

General comments. Most importantly, given budgetary constraints, the changes in the proposal would provide widespread benefits at a cost that is relatively modest in comparison to other proposals. The proposal would be greeted extremely favorably by State and local governments as well as by the members of Congress interested in changing these rules. Tax-exempt bonds have always been viewed as a productive subsidy by State and local government officials because it can be accessed without the involvement of the federal government. The proposal would facilitate greater private investment in infrastructure. In addition, many believe that the changes made by the 1986 Act have too severely limited the ability of State and local governments to borrow for their needs. Simplification of the existing limitations would, at a minimum, reduce the borrowing costs of State and local governments and thereby enhance the efficiency of the subsidy; these simplifications have significant merit even if another proposal is selected.

Private activity bonds. The PAB rules restrict investment in infrastructure by limiting the types of facilities for which tax-exempt bonds may be issued and the manner in which bond-financed facilities may be operated. The proposals to increase the private use limit, liberalize the definition of private use, and treat all infrastructure bonds as governmental bonds would each make lower-cost, subsidized financing available to a larger class of infrastructure projects without subjecting those bonds to the volume cap and other restrictions on PABs and would assist efforts to increase privatization and create more public-private partnerships. The 10 percent limitation may well be unnecessarily strict, especially given other limits (e.g., the 5 percent private loan limit), and may encourage inefficient behavior (e.g., renting facilities for less than fair market value to avoid PAB status).

Liberalizing the definition of private use would also provide relief from the PAB restrictions but would result in less of revenue loss than more general PAB changes. Reclassifying certain PABs used to provide infrastructure as governmental bonds provides similar benefits while being a more direct method of encouraging infrastructure financing.

The list of permissible exempt facilities, the requirement that certain exempt facilities be governmentally owned to be eligible for tax-exempt financing (or to qualify for a volume cap exception), and the definitional limitations applicable to a number of the exempt facilities are inconsistent, arbitrary, narrow, and discourage privatization. For example, because property with value, even value solely as waste, is not solid "waste", facilities to dispose of such materials (e.g., paper and glass recycling facilities) cannot be financed.

Increasing the volume cap is a relatively simple way of increasing infrastructure spending since the volume cap limits the issuance of PABs, including bonds for infrastructure. PABs for infrastructure facilities have difficulty competing for volume cap with mortgage revenue bonds. In addition, the volume cap fails to provide parallel treatment for similar facilities. The present structure of the volume cap often discourages privatization. Finally, inflation has adversely impacted States and local governments by reducing the value

of the volume cap (although inflation since 1986 may have been less than what Congress would have expected).

The special PAB definitions relating to unrelated use, output facilities, private use in excess of \$15 million, and private loans in excess of \$5 million are each difficult to apply and greatly increase complexity with relatively minor policy benefits.

Arbitrage and advance refundings. The rebate rules fail to properly balance the significant costs imposed on issuers and the goals of the arbitrage rules to reduce significant arbitrage incentives and prevent abuse. Thus, the current small issuer exception is set at too low a level. A \$25 million exception would remove a large number of issuers from the rebate rules without affecting larger transactions having a significant arbitrage potential. While 85 percent of the aggregate volume of bonds would remain subject to the rebate requirement, a \$25 million exception would remove 83 percent of the issuers from having to comply with these rules. Workable exceptions to the rebate requirement should also apply when issuers spend bond proceeds quickly since there is reduced opportunity for arbitrage abuse. Although well intentioned, the numerous technical requirements have made the 2 year spending exception almost unusable. Further, most infrastructure projects require more than 2 years to complete. Accordingly, there remains a need for a workable spending exception to rebate.

With respect to advance refundings, once an issuer has used up its permissible advance refundings, it cannot take advantage of further decreases in interest rates. Although an issuer can always wait and refund bonds at their call date, interest rates may be higher at that point and it is difficult for issuers to gamble on rates remaining low. While interest rates have increased recently, rates remain relatively low and there is great interest in liberalizing these rules. Most importantly, the savings from an advance refunding represents additional funds that are, for the issuer, produced with no new taxes or revenues.

Demand for tax-exempt bonds. The AMT and bank deductibility rules reduce the demand for tax-exempt bonds and increase the volatility of the market. Banks have reduced their holdings in tax-exempt bonds from \$232 billion in 1985 to \$98 billion in 1992. This reduced demand translates into higher borrowing costs for municipalities (estimated by some to be as much as 10 to 40 basis points per borrowing). Increasing the small issuer exception to \$25 million would benefit 83 percent of all issuers for a relatively low cost. Smaller issuers are disproportionately affected by the bank deductibility rules because these borrowers issue bonds in amounts that are too small for public distribution. As a test for "small", \$10 million per year is too low.

AMT bonds pay interest rates that are up to one-quarter of one percent higher than on other tax-exempt bonds. Subjecting interest on specified PABs to the individual AMT seems not to work as intended: these bonds are avoided by those who expect to have an AMT liability, while those who will not have an AMT liability purchase these bonds to obtain higher interest rates. Thus, little federal revenue is produced while significant costs are

imposed on these financings.

Arguments against proposals

General comments. The strongest argument against the proposal is that tax-exempt bonds are an inefficient method of providing a subsidy; the value of the subsidy provided to the borrower is less than its cost in lost federal tax revenues. More direct federal subsidies do not have this inefficiency. Second, many of the changes in the proposal are not well targeted specifically to infrastructure. It is unclear how much of the savings from reduced borrowing costs would be used to increase infrastructure investment. Finally, in contrast to the annual budgetary review process for grants and other forms of direct expenditures, subsidies that are included in the Internal Revenue Code, once enacted, tend not to be revisited.

Private activity bonds. The PAB definition is the principal mechanism to limit the use of tax-exempt bonds to benefit private persons. Increasing the 10 percent limit to 25 percent would be a relatively expensive means of benefiting infrastructure and could lead to significant abuse. Further, this change would reverse a major reform made by the 1986 Act and provide an opportunity for abuse.

The proposal to create a new class of infrastructure bonds that are treated as governmental bonds would set a bad precedent and could lead to an inappropriate expansion of these special rules to other types of bonds. Proposals to ignore private use where the private user does not obtain benefit of tax-exempt rates would be nearly impossible to administer. Treating bonds for federally mandated facilities more favorably is a poorly targeted and expensive mechanism of dealing with the problem of such mandates. Bonds to benefit "distressed communities" would primarily benefit private business, rather than infrastructure.

Based on the inherent inefficiencies and cost of tax-exempt PABs, the 1986 Act dramatically reformed the rules for these bonds by limiting the types of bonds eligible for tax-exemption and imposing a volume cap that, over time, would significantly limit the availability of tax-exempt financing for private persons. The proposals to expand the types of PABs, eliminate governmental ownership requirements, and amend the volume cap are directly contrary to these goals.

The volume cap acts as a significant limitation on the volume of PABs. The volume cap forces States and local governments to finance only those projects that are most important to the States. From a tax policy perspective, all PABs should be subject to the volume cap. A recent GAO report (although flawed) generally concluded that the volume cap may not be a significant barrier. Excluding more bonds from the cap could effectively eliminate the volume cap as a limitation on PABs. Finally, even if it makes sense to index the volume cap for inflation, it is important to first determine the "right" level for the cap.

Arbitrage and advance refundings. The arbitrage rebate requirement was enacted because of, and remains necessary in order to prevent, significant abuse and revenue loss. Expanding the exceptions to rebate would increase the opportunities for abuse.

Advance refundings double the amount of tax-exempt bonds outstanding for a single project and, therefore, liberalizing these restrictions could cost billions of dollars. Although permitting an additional advance refunding after the original bonds are retired reduces the relative revenue loss, the loss would still be significant. In recent years, alternatives to tax-exempt advance refundings have been developed to capture a significant portion of the available savings. Proposals to temporarily change the advance refunding rules or to change these rules for infrastructure bonds would be difficult to limit.

Demand for tax-exempt bonds. Demand for municipal bonds continues to be very strong and recent increases in tax rates will further increase demand. There are strong tax policy reasons to continue to prohibit banks from "double-dipping".

Impact of the proposal. State and local governments are the primary providers of infrastructure and finance nearly all of their capital spending through the issuance of tax-exempt debt. The proposal will reduce the costs of these borrowings, by easing administrative burdens, allowing investment earnings to be retained, and reducing interest costs. Reducing borrowing costs will enable State and local governments to spend more on infrastructure, for example, by freeing up revenues to use for additional projects. In addition, since State and local governments have limited resources to use for infrastructure, privatization of infrastructure is viewed as an important method of increasing infrastructure investment. Liberalizing the rules for private involvement in tax-exempt bond financed projects will, by making the tax-exempt bond subsidy available to private entities, result in an increased amount of private investment in infrastructure.



U.S. Department of
Transportation

Office of the Secretary
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U.S. DOT TELECOPIER COVER SHEET

June 7, 1994
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PHONE: 366-6092

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COMMENTS REQUESTED BY: _____

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MEMORANDUM

TO: Infrastructure Finance Group

FROM: Steve Martin 

SUBJECT: Two Draft DOT Papers: Infrastructure Needs
Enhancing Existing Programs

DATE: June 7, 1994

Attached are two draft papers responding to DOT's assignments at the last meeting. Because I did not get this done until the last minute, they have not been reviewed internally at DOT.

If you have any questions or comments before the meeting my telephone number is 366-6092.

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S. Martin, DRAFT, 6-6-94

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Summary Paper

Transportation Needs Assessments

In order to provide an order of magnitude assessment of the "infrastructure gap" for the transportation sector of the economy, the following points have been consolidated from a number of reports to Congress as well as needs assessments prepared within the Department. Also attached "Appendix A" is a background summary of the methodologies used in developing the needs assessments.

I. Transportation's Role in the Economy

The United States spends nearly \$1 trillion a year -- 17% of the gross domestic product -- on transportation services. Each person in the U.S. spends on average \$2500 per year on personal transportation.

The transportation system's capital stock is valued at over \$1.4 trillion.

A one percent improvement in the overall efficiency of America's transportation system would translate into nearly \$100 billion in savings across the economy within a decade.

By 1995, it is estimated that more than half of the country's manufacturing plants will be using just-in-time inventory systems.

Japan and other Asian governments will spend upwards of \$1 trillion on infrastructure by the end of the century. European governments are spending \$1.5 trillion on a continent-wide system of high-speed rail and motorways.

II. Costs to the Economy of Investment Shortfalls

Poor highways add as much as 40% to the per mile cost of operating vehicles. The Federal Highway Administration estimates that congestion in the Nation's 50 most populous urban areas costs over \$39 billion a year in travel and fuel wasted.

Deferring one dollar in highway resurfacing can mean up to \$4 in highway reconstruction costs in two years.

Buses are used for an average life of 16 years, much longer than the expected life of 12 years, which results in higher costs for operation and maintenance.

There are 23 airports are currently experiencing delays of more than 20,000 aircraft hours per

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year. Without improvement, there will be 33 airports experiencing this degree of delay by the year 2002.

Airport congestion nationwide costs airlines and passengers \$2.8 billion per year.

III. Existing Conditions

Nearly 250,000 miles of the major highways (20% of the total miles) are in need of major repair. Approximately 235,000 miles of arterial or collector roads were rated as "poor" or "mediocre".

Of the Nation's 575,000 bridges, 21% were rated as structurally deficient. Of the total, nearly 200,000 (35% of the total) are either functionally or structurally obsolete.

Roughly 40% of the urban rail infrastructure is in less-than-good condition.

More than 10,000 urban transit vehicles are past their normal replacement age.

IV. Closing the Gap

The 1991 estimated cost of eliminating highway pavement, capacity, bridge and transit deficiencies was \$290 billion. About \$78 billion of this figure is for bridges.

The average annual capital investment (over the next 20 years) needed to maintain 1991 conditions and performance on highways, bridges and transit systems is \$55.5 billion.

The average annual investment needed to improve conditions and performance to specific cost-effectiveness engineering guidelines associated with moderate performance is \$73.7 billion (1991 dollars; no inflation adjustment) on average for the next 20 years.

Total annual investment needed just for projects eligible under the AIP program is estimated at \$7 billion (\$1.7 billion of which would be Federal). Current funding levels fall short of this figure by \$800 million per year.

Over the past decade, the Federal investment in Amtrak's capital program has been less than \$100 million. Average annual depreciation has exceeded \$150 million and is now approaching \$200 million per year. As a result, the accumulated depreciation of Amtrak's plant and equipment has exceeded capital investment by almost \$600 million in the past decade.

Not all demand can be met with construction of new lane-miles. It is assumed in the numbers outlining the shortfall that 77,000 "needed" lane miles will not be built as a result of demand management systems or constraints preventing construction.

In contrast, a total of \$36.4 billion from all levels of government was spent in 1991 on capital investment for these assets.

At current funding levels an increase of \$19 million per year by all levels of government would be required to maintain 1991 levels of performance.

An improvement to moderate performance would require a doubling of the current investment levels for a 20 year period. This would require an increase of roughly \$38 billion by all levels of government for each year in the future.

V. DOT's Role in Infrastructure Investment

In 1991, the share of overall capital investment in transportation that was comprised of Federal funds was:

- 41% of highways and bridges
- 60% of transit
- 27% of airports

Of DOT's FY 1995 budget, 71% was programmed for infrastructure investment, an increase from 69% in the prior year. The FY 1995 DOT budget figure included an increase of \$800 million over FY 1994.

Of the Federal infrastructure budget, DOT's investments represent an 83% share of the total for FY 1995.

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Text from:

Statement of Mortimer L. Downey, U.S. Deputy Secretary of Transportation
Before the Subcommittee on Investigations and Oversight
of the House Committee on Public Works and Transportation
March 15, 1994

Early last year, the Department submitted its biennial report on "The Status of the Nation's Highways, Bridges, and Transit: Conditions and Performance." That report was the twelfth such report on highway and bridge conditions and the first to formally combine information on our highway systems with information on our transit systems.

The Department's highway capital investment estimates are developed using data from the Highway Performance Monitoring System (HPMS). The HPMS was developed jointly by the Federal and State governments in the late 1970s to provide a continuing source of standardized data on highway conditions and performance. The data system includes a statistically drawn sample of about 105,000 highway sections representing approximately 1.2 million miles of highway functionally classified as arterials or collectors. Bridge condition information is obtained from the National Bridge Inventory, which contains detailed data on the structural, deck condition, and performance characteristics of all bridges and culverts 20 feet or greater in length. Transit information is developed from the data reported to the Federal Transit Administration (FTA) by transit agencies as required by Section 15 of the Federal Transit Act and from results of the Nationwide Personal Transportation Survey.

Highway investment estimates come from an engineering-based simulation using

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HPMS data to estimate future highway deterioration and the effects of capital improvements. Bridge requirements are estimated by a similar simulation model using the Bridge Inventory data. Transit estimates for buses and paratransit are developed by applying generally accepted equipment and facility replacement rates to the existing transit stock and adding costs for new stock to meet increasing demand. Rail estimates are taken from the "Rail Modernization Study," a separate FTA engineering study covering each of the Nation's rail transit systems on an individual basis.

While highway and transit information was combined in last year's report, it was not truly integrated, but that must be our goal. A key factor in estimates of investment requirements is future demand, both in total and by mode. Performance of the highway system--and, to a lesser extent, its condition--is almost entirely a measure of congestion, which is directly influenced by traffic growth. Projections of how many people will use highways and how many transit in the years to come are obviously interdependent and influence estimated investment requirements.

We have to see our surface transportation system as a whole and assess the interrelationships as we estimate investment needs. Your committee can help in that regard: the highway and transit conditions and performance reports are on different cycles by statute. In order to meet the transit reporting requirement, we will issue another report this year, which will have updated transit information but old highway information. Next year, when we will owe you a highway report, we will issue

another report with updated highway information to meet your requirement but year-old transit information. You could help by putting the requirements on the same time basis, so that we can not only be timely, but be realistic in evaluating the interrelationships between the modes.

But we are making improvements. Last year's report estimated investment needs based on maintaining current conditions and performance for highway and transit systems independently. This year's report will be based on maintenance of overall conditions and performance. Since we do not believe that all projected highway travel demand can or will be met by adding highway lanes, but, instead, that a portion will have to be handled by transportation system management, transportation demand management, and transit, this year's report will explore implications of an increasing market share for transit as a measure of transit investment needs.

Our airport needs estimates are developed from data reported by airport operators and compiled in the "National Plan of Integrated Airport Systems." The data they report is basically the capital improvements they are tentatively planning for the next five years. The Federal Aviation Administration reviews the project lists and removes projects that seem unlikely to be advanced, but the report is not a performance-based analysis of investment needs. It is our goal to move in that direction in the years to come.

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S. Martin, DRAFT, 6-7-94

Discussion Paper

Expanding the Capabilities of Federal Transportation Infrastructure Investment Programs.

Summary of Concept:

DOT operates an effective grant reimbursement program within each modal administration. Despite this, a substantial and growing gap exists between DOT's current capacity to fund infrastructure investment and the needs of the economy. The magnitude of the gap suggests that merely expanding existing programs to eliminate the investment shortfall is impractical or not achievable. DOT has developed an initiative designed to assess the options available for enhancing investment in infrastructure and optimizing the role of Federal dollars. The initiative has been developed within each modal administration with oversight and coordination provided by the Office of the Secretary.

Results from this undertaking are preliminary and subject to refinement. In a number of cases, DOT is currently in the process of developing new financial tools to address identified problems. This task is not yet complete. DOT expects to have a comprehensive menu of options and initiatives in the next one to two months.

Background:

Through its programs, U.S. DOT provides the majority of the funds for virtually all Federal-aid transportation projects. Projects are implemented at the State and local level. The principal points of contact for U.S. DOT during implementation are State-DOT officials. State and local governments invest significant funds in Federal-aid projects and fund many projects without Federal assistance.

The effectiveness of Federal funds is limited by a number of factors.

- 1) DOT's programs are limited by a fixed ratio "equity reimbursement" structure for State/local expenditures of construction-related expenditures.

Unlike private capital project proponents, State and local governments have only one financial technique available for the majority of funding for projects which receive Federal-aid. Because each project has unique financial needs based upon its characteristics (such as cash flow, revenue growth, risk, etc.), Federal money would be more effective if it were available in a number of forms from which the States could choose. The reimbursement approach also burdens projects with unnecessary cash flow costs that are more costly for projects sponsors to absorb than they would be for the

Federal participant.

In addition, for State and local projects that do not qualify for "Federal-aid" no alternative Federal financial support programs are available.

- 2) DOT generally operates programs whose financial participation in project development does not recognize the "risk phases" of projects (i.e. pre-construction, construction, ramp-up early years, stabilized "pro forma" years, long run residual/refinancing opportunities).

Each of these phases has a very different risk profile, particularly when viewed by a potential private investor. Commercial markets "segment" financing into similar risk/reward periods because of the varied demands of different investors. Because DOT treats a project as an undifferentiated financial whole, a "least common denominator" defines the risk profile for the entire project. Potential investors (including State and local governments), in effect, have to be willing to accept the highest risk period in order to put money into the project.

Additional financing tools to target higher risk periods, which are generally on the front-end of a project, would leverage more money into transportation investments.

- 3) Federal level authorization risk, appropriation risk, obligation and outlay rules are inconsistent with large scale investment projects if there is a goal of attracting private capital in the form of bonded project debt and/or up-front equity.

Currently, there is no "backstop" for funds flow upon which investors could rely during construction if any of the Federal sources of capital are interrupted. DOT's Project Completion Agreements, Letters of Intent and Phased Funding Agreements seek to address this issue. DOT's efforts in this area have limited marketability because they cannot overcome the inherent risk in the budget and political processes. Bond insurance, securitization and other recapitalization concepts do not address this issue.

Reducing "construction funding risk" may be as important as expanding tax exemption status in reducing overall interest costs added to projects. A potential role for an Infrastructure Bank would be to offer a source of credit to ensure construction completion. This would permit more projects to be initiated simultaneously by the States. Current practice for obligating Federal funds results in "accumulation" budgeting at the State and local level. This causes transportation investments to lag behind the private economy that these investments seek to serve.

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Discussion:

DOT's innovative financing initiative is structured as a project-based effort to identify obstacles and constraints on the ability of States to advance needed infrastructure investments. In effect, this effort has resulted in a sampling of the needs of transportation infrastructure project proponents. Based upon the responses to date, a number of preliminary observations can be made about the common needs of projects.

1) Much greater response from States (and Counties) than anticipated.

- Number of States is 23.
- Number of projects is 63.

A number of projects could commence construction in calendar '95 and '96.

2) Explicit demand to expand the capacity of the traditional Federal-State "reimbursement program" to also act as a project "construction finance" program.

3) Minimal number of requests for "more money" (i.e. outlay capacity). Much greater interest is expressed for various Federal "credit support" concepts.

- "Loan Guarantees" are much less in demand than expected.
- Lines of credit, credit enhancement, and project-specific loans are in demand particularly during construction and "ramp-up" periods.
- There is noteworthy demand for Federal-level revolving fund particularly for projects targeted toward interstate commerce or having multi-state implications. These would generally be secured by future State apportionments of formula funds from Trust Fund.
- Continued desire exists to establish State-level revolving loan funds for county/city/authority projects if States can avoid forgoing their current construction in order to capitalize the fund.

4) The share of State/Federal money is reduced in many project proposals, thereby permitting more projects to advance earlier. (The share of local and/or private money is increased.)

If the decisions of the States, as reflected in the proposals, became more widespread there would be three logical outcomes:

- Federal funds would play a role in a greater number of projects.
- More projects would advance earlier.

- Where lower Federal shares were used, capital market review of projects would be more likely.
- 5) There is greater than anticipated willingness to levy local fees and tolls to accelerate projects.
 - The need for transportation infrastructure to support local economic initiatives is a key factor in supporting direct fees such as local option gas taxes.
 - Development impact fees are proposed by many.
 - 6) Although tolling and other user fees have been promoted by the Federal government, the credit marketability of these revenue sources at the State level is hampered by limited experience. DOT's may want to enhance credit in cases where States are willing to commence tolling, include a rate covenant, and pledge revenues to debt service.
 - 7) Current reimbursement practices lead to construction of projects in "serial" not "parallel". Current practices create a bias against starting larger projects due to single-year obligation constraint.
 - 8) Reform is needed in the definition of "non-Federal match". There is demand to expand the definition to permit more than just State cash expenditures by allowing credit for private capital, assets, as well as local/authority/district financial participation.
 - 9) There is a need to modernize and standardize obligation and outlay rules to smooth the role of Federal money in the construction stage of projects. Permitting, encouraging and supporting "anticipation notes" is a way of improving project cash flow and can foster more project starts.
 - 10) Multi-modal and intermodal projects, particularly those involved with privately owned freight rail related infrastructure, have difficulty accessing existing Federal programs. Demand exist for credit instruments, particularly loans and bridge-loans, to complete such projects.
 - 11) As States contemplate using bonds and other debt instruments for project finance, there is a need to assist States in addressing rating agency/debt market concerns regarding authorization risk, appropriation risk, trust funds, contract authority, budget authority, etc.

THE WHITE HOUSE

WASHINGTON

January 7, 1994

MEMORANDUM BOB RUBIN

FROM: Michael Deich

SUBJECT: The Limited Budget Advantages of an Off-Budget Infrastructure Bank

This memorandum examines the budgetary advantage of using an off-budget "Infrastructure Bank" to subsidize state and local infrastructure. The memorandum concludes that the budget advantages of such a Bank would depend on whether it offered taxable or tax-exempt bonds. **Under either approach, an off-budget Bank would offer little or no budgetary advantages.** If the Bank issued taxable debt, it would provide no budget advantage over an on-budget program (indeed, there would be a small budget penalty). A Bank that was allowed to use tax-exempt debt, however, would have some budgetary advantage. Such a Bank could provide a small benefit to states and localities; under current scoring rules, the federal budget would not reflect all of the costs imposed by the Bank. Perhaps because of the nonbudgetary costs imposed by this latter approach, however, there does not yet appear to be any support -- within Executive Departments, in Congress, or even amongst constituent groups -- for this latter approach.

This memorandum does not address the *nonbudgetary* benefits and costs of an off-budget Infrastructure Bank.

Two Models of an Infrastructure Bank. The structure chosen for an Infrastructure Bank will greatly affect both the subsidy that can be provided and the resulting budget cost to the federal government. Two general structures are possible:

Model One: The Bank Issues Taxable Debt, Receives an Annual Federal Appropriation. Under this approach, the Bank would be capitalized with an initial grant from the federal government. The Bank would then borrow funds from private markets and provide the proceeds to state and local authorities. Responsibility for repaying the Bank's bonds either would rest with the federal government alone, or would be shared by the federal government and the state and local beneficiaries. The federal share of the Bank's debt would be repaid with an annual, on-budget appropriation.

To date, every proposal for an Infrastructure Bank has followed this approach. The Bank's need for an annual federal appropriation stems from the fact that states and localities now finance infrastructure with tax-exempt debt. States and localities would borrow from the Bank

only if it could provide funds at an equivalent rate. To be helpful to states and localities, the Bank would have to operate at a loss: the Bank would borrow funds at a higher taxable rate, and would relend the funds at a rate equal to or less than the rate on tax-exempt bonds. The resulting loss would have to be offset by the federal government.

In its need for a continuing appropriation, an Infrastructure Bank would differ fundamentally from existing government-sponsored enterprises (GSEs), all of which channel funds to private sector borrowers -- e.g., in housing, education, and agriculture -- who have access only to taxable debt. Since GSEs can issue taxable debt more cheaply than can their private sector counterparts, they can benefit private borrowers without relying on a continuing appropriation from the federal government.

Because of the Bank's need for a continuing federal appropriation, the budget scoring rules contained in the Credit Reform Act of 1990 (CRA) eliminate any budgetary advantages of an off-budget Bank. Proponents of an Infrastructure Bank have assumed that the costs incurred by the federal government would appear in the budget only as the Bank's debt was repaid. Proponents have assumed, for example, that the cost of repaying a 20-year bond would be stretched out over a twenty year period. In fact, the CRA requires the present value of the *entire* federal liability be appropriated and obligated in the year that the liability is incurred. In the case of a 20-year bond, for example, the present value cost of all payments that will be made over twenty years must be appropriated and obligated in the year that the bond is first issued.

Because of the CRA, **an off-budget Bank actually would be more expensive** than an on-budget program of direct federal loans or grants. The federal government can borrow more cheaply than can any other entity. The federal government would face lower costs, therefore, if it borrowed funds and made reduced-rate loans directly than if it subsidized the higher-cost loans originated by an Infrastructure Bank (the interest rate on the bonds of existing GSEs, for example, is about 0.3 percentage points higher than the rate on Treasury bonds).

Model Two: The Bank Issues Tax-Exempt Debt, Receives No Ongoing Federal Appropriations. An alternative approach would establish a traditional GSE. As in Model One, the Infrastructure Bank would be capitalized with an initial grant from the federal government. Model Two would differ from Model One, however, in that the Bank would receive no further funds from the government, and would retain sole responsibility for repaying all of its debts. To enable such a stand-alone entity to make loans at rates that were attractive to states and localities, the Bank would be given the power to issue tax-exempt bonds.

Proponents of an Infrastructure Bank have so far eschewed this solution. The reasons for this include:

- ***Limited and Uncertain Benefits to States and Localities.*** Since states and localities already can finance infrastructure with tax-exempt debt, an Infrastructure Bank that borrowed at tax-exempt rates would offer states and localities with little further benefit. Neither the Treasury nor OMB has made any formal estimate of the interest rate that would obtain on tax-exempt debt issued by an Infrastructure Bank. As a rough guide, however, one can assume that the Bank would make available to average state and local

issuers an interest rate somewhat better than the rate now enjoyed by the most creditworthy state and local borrowers. If so, **the Infrastructure Bank would lower state and local capital costs by less than ten percent.**

- *Congressional Opposition.* Any bonds issued by the Bank would enjoy, at least implicitly, a federal guarantee (the reasons for this are noted at TAB A). If the Banks' bonds were also tax-exempt, they would become more attractive than Treasury bonds; if issued in large volume, they would increase the cost of all federal borrowing. The Congress therefore has long refused to allow such debt instruments.
- *Revenue Losses.* As the amount of outstanding tax-exempt debt increased, federal revenues would fall. The lost revenue would be scored as a cost of the Bank.
- *The Inefficiency of Tax-exempt Financing.* The federal government could subsidize a greater amount of infrastructure through direct grants than it could by allowing greater use of tax-exempt debt. All of the benefits from direct grants accrue to borrowers in the form of lower interest costs. In contrast, the benefits provided by tax-exempt bonds are divided between bond issuers and bond buyers.

TAB A -- Implicit Federal Guarantees on GSE Debt

Investors are likely to impute a federal guarantee to any bonds issued by an off-budget Infrastructure Bank. Even if legislation that created the Bank explicitly disavowed any federal responsibility for the GSE's debt, investors would treat the bonds as if they were the debt of a federal agency, with backing nearly as good as the "full faith and credit" that lies behind Treasury bonds.

In the past, investors have found many reasons for ignoring disclaimers of federal guarantees of GSE debt. Lenders have found some of these reasons in Congressional action. In the 1980s, for example, the Congress provided a multibillion-dollar refinancing of the Farm Credit System--a nominally private GSE lacking federal debt guarantees. The federal government also has been willing to help even nonfinancial private corporations (such as Lockheed and Chrysler) in an effort to avoid the disruption that might follow the collapse of a large firm. Buyers of debt from an infrastructure GSE would be likely to assume that similar assistance would lie behind the GSE's bonds.

Investors also have found federal debt guarantees inherent in the structure of the GSE itself. Most important are the tangible benefits available to GSEs, such as: a line of credit at the Treasury; the ability to issue bonds that bank regulators often treat as being as secure as Treasury bonds; and the ability to issue bonds that are exempt from the securities laws intended to protect investors (lenders have taken this exemption as a sign that the Congress believes the debt of these GSEs to be more secure than other privately issued debt--a belief that can be rationalized by assuming a Congressional willingness to provide needed financial support, but not always by the balance sheet of the GSEs).

DRAFT

February 7, 1994

MEMORANDUM FOR

FROM:

SUBJECT: A Proposal to Develop Options for an Infrastructure Bank

All major transportation programs -- including those for highways, transit, and aviation -- are likely to require reauthorization in 1997. You will have an opportunity in 1996, therefore, to propose a new approach to financing public infrastructure. We believe that one potentially fruitful method of meeting this policy challenge would be to establish a federal Infrastructure Bank. Various Bank proposals already enjoy some support in Congress (Rep. Gephardt and the Democratic Study Group) and among outside interest groups (the Rebuild America Coalition, Felix Rohatyn, and Peter Goldmark of the Rockefeller Foundation). This memorandum provides our initial thoughts on this issue, and asks whether you wish your staff to develop options for an Infrastructure Bank in greater detail.

Description of an Infrastructure Bank. Proponents have considered many variations of an Infrastructure Bank. The prototypical Bank would be off-budget, and would be capitalized with an initial grant from the federal government. The Bank would then borrow funds from private markets and provide the proceeds to state and local authorities. Responsibility for repaying the Bank's bonds either would rest with the federal government alone, or would be shared by the federal government and the state and local beneficiaries. The federal share of the Bank's debt would be repaid with an annual, on-budget appropriation.

Budget Effects under Current Budget Rules. Because the Bank would rely in part on continuing federal appropriations, the budget scoring rules contained in the Credit Reform Act of 1990 (CRA) mean that an off-budget Bank would have no budgetary advantage over a direct federal grant or loan program. Proponents of an Infrastructure Bank have assumed that the costs incurred by the federal government would appear in the budget only as the Bank's debt was repaid. Proponents have assumed, for example, that the cost of repaying a 20-year bond would be stretched out over a twenty year period. In fact, the CRA requires the present value of the *entire* federal liability be appropriated and obligated in the year that the liability is incurred. In the case of a 20-year bond, for example, the present value of all payments that will be made over twenty years must be appropriated and obligated in the year that the bond is first issued.

The CRA ensures that economically equivalent subsidies have identical effects on the budget, regardless of whether those subsidies are provided in the form of grants or credit assistance. At current interest rates, for example, a locality would benefit financially as much from a zero-interest, 20-year loan covering the entire cost of a project, as it would from a direct grant covering 50 percent of the project's cost. The CRA ensures that both the 50 percent grant and the zero-interest, 20-year loan have the same federal budget cost. In our view, passage of the CRA represented an important step toward more rational budgeting.

Changing the BEA to Lower the Budgetary Effect of an Infrastructure Bank. In order to lower the apparent cost of an Infrastructure Bank, many proponents would like to amend the BEA to allow amortizing certain capital costs over a multi-year period. One approach would establish a capital budget for infrastructure (and perhaps other federal investments). A capital budget would permit the cost of capital assets to be scored in the budget only as the assets depreciated. Your advisors remain deeply split over whether the benefits of capital budgeting outweigh its drawbacks.

Bank proponents have also put forth a second option: either repeal the CRA outright or craft an exemption for the Bank alone, so that the budget would score federal credit subsidies only as they were paid out over the life of a bond. To our knowledge, none of your advisors supports this approach. Even proponents of this second option view it as no more than an imperfect substitute for a capital budget.

Potential Advantages of an Infrastructure Bank. Although it offers no budgetary advantage over direct grants or loans, a Bank could be used to address other concerns about existing federal infrastructure programs. We note that all of the changes listed below could also be accomplished in the context of existing programs. These changes are more likely to be adopted, however, if they are framed as new purposes for new money, rather than as added conditions being attached to existing funds. An Infrastructure Bank could:

- Put both infrastructure outlays and any associated dedicated revenues on the mandatory side of the budget. Under current law, infrastructure outlays are subject to the discretionary caps even when they are supported by dedicated revenue streams. If supported by a dedicated revenue stream such as the gas tax, an Infrastructure Bank could be established as a mandatory program whose outlays were limited only by the balances in the relevant Trust Fund.
- Increase local control over infrastructure spending. A Bank could be used to make loans available on similar terms for all types of infrastructure projects. This would further a trend that began with the passage of ISTEA to give states and localities more control over how federal funds are allocated across different types of infrastructure.
- Target funds for regional economic development. Some portion of Bank loans could be set aside, and/or made available at especially concessionary rates, for projects in economically-

distressed areas. Bank loans might be combined with funds for retraining and employment programs.

- More financing of public works from those who benefit from public works. The Bank could encourage further acceptance of user-fee financing by making loans available at lower rates for projects that are repaid through user fees.
- Achieve modest economic efficiencies by substituting subsidized taxable bonds for some tax-exempt debt. The federal government could subsidize a greater amount of infrastructure through direct interest subsidies than it could by allowing greater use of tax-exempt debt. All of the benefits from direct interest subsidies accrue to borrowers in the form of lower interest costs. The benefits provided by tax-exempt bonds, in contrast, are divided between bond issuers and bond buyers.

Disadvantages of an Infrastructure Bank. An Infrastructure Bank would have two principal limitations:

- Limits on the federal share of project costs. Federal loans would provide less help to states and localities than current grants program. Current infrastructure grant programs cover between 55 percent and 80 percent of a project's cost. At current market interest rates, however, an interest-free loan covering the entire cost of a project would help localities as much as a direct grant covering only 50 percent the project's cost.
- The potential need for new funding. An Infrastructure Bank could be funded either by reprogramming existing infrastructure outlays or taking money from elsewhere in the budget. Bank proponents all hope that the Bank would be funded by a new, dedicated revenue source such as a tax on gas, energy, or consumption. This leaves a dilemma: either redirect existing funds into a program that is somewhat less generous than existing ones, or propose a new tax.

Recommendation. Although an Infrastructure Bank would not necessarily offer an escape from current budget constraints, it would provide an opportunity to redefine the federal role in providing public works. We recommend that your staff develop these options in greater detail.

___ Approve

___ Disapprove

___ Discuss Further