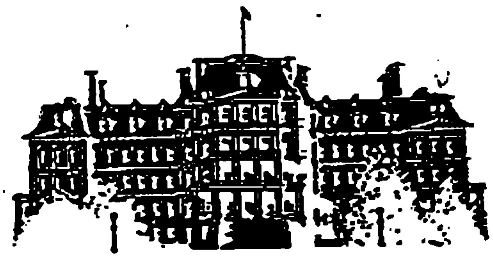
Infrastructure Finance - - 84

EXECUTIVE OFFICE OF THE PRESIDENT



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July 7, 1994

TO: INFRASTRUCTURE FINANCE TASK FORCE

FROM: MARK MAZUR Mark

SUBJECT: TAX CREDIT AND TAXABLE INFRASTRUCTURE BOND PROPOSALS

Attached are descriptions of proposals to help finance additional infrastructure investments. These proposals are: (1) a tax credit bond; and (2) a taxable infrastructure bond. These descriptions are intended to help our discussion on Monday July 11.

You have already seen a longer version of the tax credit bond write-up. The taxable infrastructure bond uses the annual appropriation process to duplicate the economic effect of the tax credit bond to the issuer, but provides an investment vehicle for tax-exempt entities such as pension funds. I would especially appreciate comments on the taxable infrastructure bond component, since I am not entirely comfortable with my description of this item.

draft of July 6, 1994

1. TAX CREDIT BOND

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.

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) increase the aggregate amount of infrastructure that can be supported through debt finance.

Proposal -- A more efficient and transparent capital subsidy for State and local borrowers can be designed, e.g., a "tax credit" bond. State and local governments could elect to issue tax-credit bonds for particular types of infrastructure investments. Possible candidate investments could include: public/private partnerships to construct and/or operate water treatment facilities; transportation facilities (e.g., transit or high speed rail); and toll roads. Current tax-exempt bond rules limit the amount of private sector participation in such projects to prevent transfers of capital subsidies from public entities (e.g., a State) to private entities. However, an argument can be made that public/private partnerships have a legitimate purpose in developing certain types of infrastructure and so should be encouraged through the use of a Federally-provided capital subsidy.

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 percentage of gross interest paid.[1] For

[1] 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".

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). With a 20 percent credit rate, only 80 percent of the nominal interest amount would be paid in cash, with the rest paid in the form of a tax credit.

For example, if the nominal interest rate on a tax credit bond was 8.0 percent (the taxable rate), each $1000 tax credit bond issued would pay cash interest of $64 ($1000 x .08 x .8), and would provide the lender a tax credit equal to $16 (20 percent of the nominal interest cost). The bondholder would report $80 as taxable income (even though only $64 cash was received), 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.

Analysis -- From the issuer's perspective, the tax-credit bond can be designed to cost the same as a tax-exempt bond. From the investor's perspective, the tax-credit bond (with a 20 percent credit rate) has a lower after-tax rate of return than a tax-exempt bond 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.

A possible advantage of tax credit bonds is that they could support additional borrowing by State and local governments, holding the Federal revenue cost fixed. While revenue estimates have not been provided by Treasury, it is not unreasonable to think that the efficiency gains of tax credit bonds over tax-exempt bonds could create the capacity to support 5-10 percent more borrowing by State and local governments, without raising the cost to the Federal Treasury.

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. Using tax credit bond proceeds for infrastructure investments that are prohibited under tax-exempt bond rules could generate a significant volume of tax credit bond issuance. In any event, to the extent that tax credit bonds are utilized at all, the efficiency of the Federal subsidy provided to State and local borrowing would be enhanced.

2. TAXABLE INFRASTRUCTURE BOND

Background -- As an alternative to the tax credit bond proposal, it is possible to construct an alternative subsidy mechanism called a "taxable infrastructure bond" that would: (1) have approximately the same economic effects as the tax credit bond in terms of efficient provision of the Federal capital subsidy to State and local borrowers; (2) generate about the same increase in the aggregate amount of infrastructure as the tax credit bond proposal; and (3) provide an investment vehicle for tax-exempt entities (e.g., pension funds) that are unable to fully utilize a tax credit.

The observation that tax-exempt bonds are an inefficient subsidy for State and local infrastructure investment is applicable here. Moreover, some observers have argued that tax-exempt entities, particularly pension funds, have expressed a desire to invest in infrastructure projects sponsored by State and local governments, but have not had an appropriate investment vehicle to do so.[2] To attract tax-exempt entities, such an investment vehicle cannot be tax-favored, since the benefit of tax-favored status (e.g., partial or complete tax-exemption) is of no value to tax-exempt entities.

Proposal -- Create a fully taxable debt instrument (taxable infrastructure bonds) where the issuer pays the full amount of nominal interest to the debtholder and the Federal government rebates a portion of the interest payment directly to the issuer.[3] The amount of Federal rebate can be chosen to ensure the cost to the issuer is no more than if tax-exempt bonds had been issued (perhaps a larger rebate could be granted as a way of sharing the efficiency gains between the Federal government and the issuer).

State and local governments could elect to issue taxable infrastructure bonds for particular types of infrastructure investments. Possible candidate investments could include: public/private partnerships to construct and/or operate water treatment facilities; transportation facilities (e.g., transit or high speed rail); and toll roads. Current tax-exempt bond rules

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[2] This argument ignores the existence of taxable debt issued by State and local governments to finance such infrastructure projects as stadiums, convention centers, and transportation projects that primarily benefit private parties.

[3] 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".

limit the amount of private sector participation in such projects to prevent transfers of capital subsidies from public entities (e.g., a State) to private entities. However, an argument can be made that public/private partnerships have a legitimate purpose in developing certain types of infrastructure and so should be encouraged through the use of a Federally-provided capital subsidy.

As an example of how taxable infrastructure bonds would work, assume a 20 percent Federal interest rebate. If the nominal interest rate on a taxable infrastructure bond was 8.0 percent (the taxable rate), each $1000 tax credit bond issued would pay cash interest of $80 ($1000 x .08) and the Federal government would rebate $16 (20 percent of the nominal interest payment) to the issuer. The bondholder would report $80 as taxable income, but the net cost of the bond to the issuer would be only $64 ($80 less $16). The $16 rebate represents the explicit cost to the Treasury of the capital subsidy to State and local borrowers issuing these bonds.

Analysis -- From the issuer's perspective, taxable infrastructure bonds can be designed to have the same cost as tax-exempt bonds. From a taxable investor's perspective, taxable infrastructure bonds are preferred to tax-exempt bonds for those holders in low marginal tax brackets, while the reverse is true for those facing high marginal tax rates (who presumably would continue to hold tax-exempt bonds). From a tax-exempt investor's perspective, taxable infrastructure bonds are preferred to tax-exempt bonds. Tax-exempt investors should be indifferent between taxable infrastructure bonds and other taxable bonds of similar risk (e.g., corporate bonds).

Taxable infrastructure bonds can be expected to compete with other taxable bonds for investors' funds. To the extent that taxable infrastructure bonds are held by investors, other taxable bonds will not be held, perhaps leading to claims of taxable infrastructure bonds "crowding out" other debt.

It is not clear how the budget process would account for the Federal rebate of interest payments to State and local issuers of taxable infrastructure bonds. If the rebate amounts are appropriated on an annual basis, the amounts may be counted as annual spending. However, an annual appropriation process would increase the perception of risk for issuers who may be uncertain if they will receive the entire promised rebate, given budgetary constraints. If the rebate amounts are set up as a permanent entitlement (a multi-year promise) then the budget scoring rules may require that the present value of the entire amount of promised rebates (e.g., 30 years of rebates) be charged against the budget in the year the debt is issued. A large budget cost for these bonds could reduce the acceptability of this financing tool to a budget-conscious Congress.

E X E C U T I V E   O F F I C E   O F   T H E   P R E S I D E N T

E X E C U T I V E   O F F I C E   O F   T H E   P R E S I D E N T

06-Jul-1994 02:25pm

TO: (See Below)

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

SUBJECT: NEC Subgroup on E.O. 12803

The attached is being distributed as requested by Michael Deich for discussion at our meeting on July 11th. A section by section comparison of E.O. 12803 and the attached is in development.

EXECUTIVE ORDER __________

"FEDERAL INTERESTS IN STATE AND LOCAL INFRASTRUCTURE INVESTMENTS"

Draft of
July 6, 1994

An adequate and well-maintained public infrastructure is critical to economic growth. Consistent with the principles of Federalism enumerated in Executive Order 12612, and Executive Order 12893, "Principles for Federal Infrastructure Investments," State and local governments should be encouraged to consider private participation in the provision of our nation's infrastructure. I find, however, that no effective use has been made of Executive Order 12803, "Infrastructure Privatization," dated April 30, 1992. Therefore, by the authority vested in me as President by the Constitution and laws of the United States of America, I order that the following supersede the provisions of Executive Order 12803.

Sec. 1. Definitions. For the purposes of this order:

(a) "Public-Private Partnership" means the ownership, or interest in, operation, maintenance or financing of an infrastructure asset, through contract or other means, by public and private sector sources. This may include the development of a lease, license, concession agreement, right to cure, or real property sale instrument.

(b) "Infrastructure Asset" means any asset, financed in whole or in part by the Federal Government and needed for the functioning of the economy. Examples of such infrastructure assets include, but are not limited to: roads, tunnels, bridges, electricity supply facilities, mass transit, rail transportation, airports, ports, waterways, water supply facilities, recycling and wastewater treatment facilities, solid waste disposal facilities, housing, schools, prisons, and hospitals.

(c) "Like Infrastructure Asset" means: infrastructure of the same general purpose.

(d) "Originally authorized purposes" means the general objectives of the original Federal grant program; however, the term is not intended to include every condition required for a grantee to have obtained the original grant.

(e) "Transfer price" means: (i) the amount paid or to be paid by a private party for an infrastructure asset, if the asset is transferred as a result of an open competitive bidding process; or (ii) the appraised value of the infrastructure asset as approved by the head of the executive department or agency, if the asset is not transferred as a result an open competitive bidding process.

(f) "State and local governments" means: the government of any State of the United States, the District of Columbia, any commonwealth, territory, or possession of the United States, any county, municipality, city, town, township, local public authority, school district, special district, or interstate government entity, council of governments and any agency or instrumentality of a local government, and any Federally recognized Indian Tribe.

Sec. 2. Principles for Fostering State and Local Infrastructure Investment.

Consistent with Executive Order 12893, "Principles for Federal Infrastructure Investments," dated January 28, 1994, executive departments shall be guided by the following:

(a) State and local governments shall be authorized to employ innovative ownership, or interest in, operations, maintenance and financing concepts. This includes the right to develop and employ a wide range of public-private partnerships.

(b) Federal financing of infrastructure should not act as a barrier to public or private ownership of infrastructure assets or State or local government capital formation opportunities. The achievement of economic efficiencies through market funding and other competitive practices is to be encouraged.

(c) State and local governments, subject to assuring compliance with Federal requirements, shall be authorized to make decisions concerning the operation, maintenance, expansion, enhancement and disposition of their Federally funded infrastructure assets. This includes the oversight of user fees, to ensure that they are reasonably structured and that mechanisms exist for their public review.

(d) Operational continuity and good labor relations are essential ingredients to the successful development of public-private partnerships. Consistent with this principle, transactions authorized pursuant to this Order shall deal with labor concerns in a fair and forthright manner.

Sec. 3. State and Local Infrastructure Investments.

To the extent permitted by law, the head of each executive department and agency shall undertake the following actions:

(a) Review existing regulations, grant agreements or other procedures affecting the management and disposition of Federally financed infrastructure, owned by State and local governments, and modify those regulations, grant agreements or other procedures to ensure the removal of obstacles to State and local decisions regarding public and private ownership, operations, maintenance and investment.

(b) Establish the three-tiered Federal recoupment requirement provided by the "Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments" or Common Rule (Federal Register of March 11, 1988) and this Order, as follows:

(1) The Federal recoupment provisions of the "Common Rule" shall apply to all Federally financed infrastructure where there is no longer a continuing originally authorized purposes need for the infrastructure asset.

(2) The Federal recoupment requirements applied to the transfer price or disposal of Federally financed infrastructure that will continue to meet originally authorized purposes and consistent with the criteria of section 4, shall be distributed, as paid in a lump sum or over time, in the following manner: (i) State and local governments shall first recoup in full the unadjusted dollar amount of their portion of total project costs (including any transaction and fix-up costs) associated with the infrastructure asset involved: (ii) if proceeds remain, the Federal Government shall recoup in full the Federal contribution rate associated with the original infrastructure investment applied to the depreciated value of the asset (calculated using the Internal Revenue Service accelerated depreciation schedules for the categories of assets in question); and (iii) the State and local governments shall keep any remaining proceeds.

(3) The Head of the grant agency may determine that a proposed reinvestment of Federal proceeds, as defined in paragraph (b)(2) above, justify the waiver of all Federal recoupment requirements. To grant a waiver of Federal recoupment requirements, the agency head must find that the criteria of section 4 of this Order are met and that the reinvestment of all State, local and Federal proceeds and the interest on such proceeds shall be made available only for investment in like infrastructure.

Sec. 4. Criteria. To the extent permitted by law and consistent with the public interest, the Head of the grant agency is authorized to deny access to the Federal recoupment provisions of this Order, including the provisions at Section 3 (b)(2) and (b)(3), if the grantee's proposal:

(a) Fails to demonstrate that State and local proceeds are designated for investment in additional or new infrastructure.

(b) Fails to demonstrate all state and local procurement regulations have been adhered to, in the development of the transfer price.

(c) Fails to demonstrate that a market mechanism, legally enforceable agreement, or regulatory mechanism will serve to ensure that: (i) the infrastructure asset or assets will continue to be used for their originally authorized purposes, as long as needed for those purposes, even if the purchaser becomes insolvent or is otherwise hindered from fulfilling the originally authorized purposes, without Federal involvement; and (ii) user charges will be consistent with current Federal conditions that protect users and the public.

(d) Fails to certify that the transaction is in compliance with all Federal, State and local labor laws.

Sec. 5. Government-wide Coordination and Review. In implementing Executive Orders Nos. 12291 and 12498 and OMB Circular No. A-19, the Office of Management and Budget, to the extent permitted by law and consistent with the provisions of these authorities, shall ensure that policies of the executive departments and agencies are consistent with the principles, criteria, and requirements of this Order. The Office of Management and Budget shall review the agencies' implementation of this Order and issue appropriate guidance.

Sec. 6. Preservation of Existing Authority. Nothing in this order is in any way intended to limit any existing authority of the heads of the executive departments and agencies to approve proposals that are otherwise consistent with the law.

Sec. 7. Judicial Review. This order is intended only to improve the internal management of the executive branch, and is not intended to create any right or benefit, substantive or procedural, enforceable by a party against the United States, its agencies or instrumentalities, its officers or employees, or any other person.

- GROUP/STAFF REVISED DISCUSSION DRAFT -

EXECUTIVE ORDER 12803 "INFRASTRUCTURE PRIVATIZATION"

Draft of
July 6, 1994

Issue:

Should the principles of Executive Order 12803, "Infrastructure Privatization" be included in an Administration proposal to increase infrastructure investment?

Background

E.O. 12803 (attachment 1) was issued by the previous Administration to encourage Federal, state and local governments to leverage public and private sector investments in infrastructure and to use the equity in existing Federally financed infrastructure for investment in new or expanded infrastructure. Prior to the issuance of the Order the disposition of Federally financed real property was controlled by the Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments" or "Common Rule." (see attachment 2 or the Federal Register, March 11, 1988, page 8095) The "Common Rule" provides, in part, that title to real property acquired under grant or subgrant vests with the grantee or subgrantee. The "Common Rule" provides that when the property is no longer needed for the original authorized purposes the grantee may sell the property by paying to the grant agency the percentage of participation in the cost of the original purchase multiplied by the market value, after deduction for the cost of sale.

Executive Order 12803 permits Federal, state and local agencies to consider the sale of continued original use assets. Federal agencies were asked to remove regulatory and other barriers to State and local infrastructure decisions. The Order permits State and local proceeds to be used for infrastructure, debt or tax relief, by authorizing the disposition of assets, even though the original purpose has not expired, and by reducing the Federal share of proceeds recoupment. To the extent that infrastructure sales/leases meet the criteria of Section 4 of the Order, the Order calculates Federal recoupment by multiplying the original contribution rate by the depreciated value of the asset.

Concerns:

Executive Order 12803 has not been fully implemented and has not been widely used in the formation of infrastructure investment capital. The principle that private sector participation should be encouraged in Federal investment planning was confirmed by E.O. 12893. Packages that reflect these principles are not, however, being widely used. There appears to be several reasons for this:

- o There is confusion over Federal recoupment requirements. When does the "Common Rule" apply and how does it relate to the Order?"

- o Federal agencies, State and local governments and private sector investors have expressed uncertainty over the Administration's commitment to the Order and have been unwilling revise regulations or develop investment packages.

- o Federal, State and local agencies may not have sufficient incentives to eliminate existing regulations.

- o The Order is perceived to promote privatization, rather than present a neutral position between public and private capital being used to provide services to the public.

<u>Discussion</u>

Each of the following presents a more technical discussion of the concerns identified above, with recommendations.

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

Federally financed infrastructure is available for sale by the State and local governments. The "Common Rule" assumes that sales will occur when the original purpose of the grant has been met and establishes four recoupment scenarios. They are; (1) the State/local government wishes to obtain full title, under which the agency receives the original Federal contribution rate applied to the market value of the asset; (2) the State/local government wishes to replace the asset to meet original purposes, under which all net proceeds may be applied to the replacement property; (3) the State/local government wishes to sell the property, under which the agency receives the contribution rate applied to the market value after deduction for the costs of selling; and (4) the State/local government wishes to transfer the asset to the Federal Government, under which the State/local receives its contribution rate of market value. Executive Order 12803 effectively added a fifth scenario to the "Common Rule," whereby State/local governments can consider the sale of assets that have a continuing original purposes need and second, by revising the recoupment rate for such sales to the Federal contribution rate applied to the depreciated - not market - value of the asset.

Recommendation

Maintaining the recoupment rules of the current Order is desirable. These rules expand the opportunities for State and local infrastructure capital formation, without raising questions of Federal giveaways. It is recommended, however, that additional authority be given to grant agencies to waive Federal recoupment, when all Federal, state and local proceeds are designated for investment in like infrastructure, or not allow State and local governments to take advantage of the recoupment rules provided by this Order when, in the opinion of the head of the agency, the sale does not meet the criteria of the Order.

This approach builds on the "Common Rule" and authorizes a three tiered Federal infrastructure recoupment policy. The Federal contribution rate applied to market value, as provided in the "Common Rule," should be applied to proposed sales that do not meet the minimum criteria of the Order. The Federal contribution rate applied to the depreciated value of the asset is appropriate for those sales that meet the continuing original purpose and other public policy criteria of the Order. The authority to waive Federal recoupment would be provided when the reinvestment merits the reuse of Federal funds for new or expanded "like" infrastructure. It is believed that these provisions provide expanded opportunities for State and local governments to consider the formation of private sector investment capital. It is also believed that the proposal creates new and necessary incentives to agencies to encourage the development of permitted investment strategies.

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

This question suggests that certain infrastructure should remain in public ownership and operation as a national asset. The question raises uncertainty within State and local governments and within the investment community over which assets could be subject to the provisions of the Order.

The "Common Rule" refers only to the original purpose of the asset. Neither the "Common Rule" or the Order make reference to the existence of national infrastructure assets owned by the State and local governments.

Recommendation

Concerns for the needs of interstate or international commerce are protected by existing grant provisions and by the original intent provisions of the Order. However, if the Federal Government determines that such a national asset exists, that asset should be purchased, managed and operated by the Federal Government, such as national parks, forests and other such assets. There are no known assets that meet the requirements for Federal purchase.

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

The "Common Rule" does not limit State and local proceeds from the sale or lease of Federally financed infrastructure. It assumes that the original purpose of the existing asset has been met and establishes different recoupment requirements depending upon the proposal. The current Order permits States and localities to use sale or lease proceeds for infrastructure, tax and debt reduction.

Recommendation

Concern has been expressed for the fungibility of sale proceeds and the potential that proceeds could be used for operating expenses. It is recommended that the Order be revised to limit the use of proceeds generated by the sale of continuing use assets to infrastructure, when Federal recoupment is limited to the contribution rate applied to depreciated values and to like infrastructure, when Federal recoupment is being waived.

(4) How should labor concerns be addressed?

The "Common Rule" makes no provision for labor protections with respect to the sale of Federally financed infrastructure nor does E.O. 12803. The employees impacted by the "Common Rule" and E.O. 12803 are not Federal employees. Nevertheless, concern has been expressed that in creating new opportunities for the sale of existing infrastructure and in facilitating State/local decisions to transfer existing assets to the private sector, the Federal Government may have some responsibility to ensure that employee impacts are minimized.

Recommendation

Labor is understood to have two basic concerns with the current Order. First, the Order is seen as pejorative toward public ownership and operations. It is recommended that the Order be revised and reissued in more neutral terms.

Second, there is concern that the existing Order does not provide protections to current employees, who may be adversely affected by a transfer of ownership. It is recommended that the Order require certification that all Federal, State and local labor laws will be complied with.

Other options were considered but are not recommended, including requirements to provide, as a condition of access to the recoupment rules of the Order, the Right-of-First-Refusal for jobs created by the sale/lease and/or Service Contract Act wage and fringe benefits. These options were rejected as interjecting the Federal Government into State and local government labor issues.

(5) Are additional Federal controls or other oversight necessary?

Concern has been expressed that the current Order is not sufficiently precise with respect to requirements for competitive awards, the establishment of market value and the establishment of user fee oversight.

In assuming that existing assets will no longer be in use to meet original intent purposes, the "Common Rule" has no provisions for oversight, beyond those that would apply if proceeds were reinvested into other grant requests. The current Order refers to the Federalism principles of Executive Order 12612 and affords a significant amount of deference to States/localities in determining their best interests, including oversight. The current Order but relies on competitive procurements. To the extent that market value is not established by competitive award, the market value of the existing asset may be established by the agency.

The Order requires that the state or local entity sponsoring the proposal demonstrate that a market mechanism, legally enforceable agreement or regulatory mechanism ensure that: (1) the infrastructure asset or assets will continue to be used for originally authorized purposes, even if the provider becomes insolvent and (2) that user charges are consistent with current Federal conditions that protect users.

Recommendation

No additional Federal controls or other oversight are recommended. It is, however, recommended that the revised Order clarify the discretionary authority of agencies to disapprove of the use of the Order's relaxed recoupment rules if State and local proposals do not address the need for full and open competition.

(6) Should the current Order be revised and amended or reissued?

There is some evidence to suggest that Federal agencies, State/local governments and private venture capitalists have been unwilling to invest sale/lease packages, in part, due to the uncertainty that exists with respect to the Administration's view toward the Order. While this uncertainty has been reduced by the issuance of Executive Order 12893 and its references to private sector participation in Federal infrastructure investment planning, this commitment has not been sufficient to generate many sale proposals.

Recommendation

It is recommended that a new Order be issued to supersede E.O. 12803 within the context of a larger Administration infrastructure investment initiative.

Conclusion:

The principle that private sector participation should be encouraged in Federal infrastructure investment is supported by the "Common Rule," and Executive Orders 12612 and 12893. Adding a new Executive Order to this body of policy should help to the clarify the Administration's commitment to public-private partnerships for infrastructure investment. The proposed Order offers the opportunity for the formation of significant capital formation for infrastructure investment alone or within a larger Administrative initiative.

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TO: Christoph P. Bertram
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E X E C U T I V E   O F F I C E   O F   T H E   P R E S I D E N T

04-Jul-1994 06:25pm

TO: Michael T. Schmidt

FROM: Carol H. Rasco
Economic and Domestic Policy

CC: Kathryn J. Way

SUBJECT: Native Americans

As a follow up to the last DPC meeting I think you should prepare a memo to POTUS that we can attached to the weekly report in another week or two when he is back that outlines the activities going on in the various depts. regarding Native American issues. It can be sent to me when finished. Thanks.

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N T
E X E C U T I V E   O F F I C E   O F   T H E   P R E S I D E
N T

07-Jul-1994 05:53pm

TO: (See Below)

FROM: Christoph P. Bertram
Office of Mgmt and Budget, TCJ

SUBJECT: Paper on Infrastructure Finance for Monday's NEC Me
eting
SUBJECT:

Report from Working Group
on "Innovative" Finance for Infrastructure
June 21, 1994

This report discusses possible "non-traditional" Federal assistance for infrastructure and options for getting pension funds involved in infrastructure finance.

A: "Non-Traditional" Federal Assistance for Infrastructure

Discussions at the NEC meetings indicate that there two major approaches that a Bank can take.

Non-Revenue Generating Projects

The first approach is traditional projects with loan financing. This option would finance the same type of projects that the Federal Government currently funds through grant programs. The difference is that we would provide the subsidy through direct loans, revolving funds or loan guarantees. This option is the one described in the paper entitled "National Infrastructure Bank." It should be possible to spend a significant amount of funding (at least several billion per year) through such a mechanism. This would result in additional infrastructure as long as the interest and issuance costs to the borrower would be less than traditional bond issues.

Projects in this category would probably not be revenue generating. The loans would be paid back by the State or Local government from either general revenues such as income taxes, or dedicated taxes such as fuel taxes.

Revenue-Generating Projects

The working group focused on the second approach tentatively entitled Non-traditional Projects with Non-traditional Financing. Projects in this category are likely to be revenue generating either through very direct fees, such as tolls, or through more general fees such as charges to rental car companies at airports. Such projects are typically financed through revenue bonds.

The cost of financing a project using revenue bonds is generally higher than using general obligation bonds. This is because the market requires two things:

1) Such projects are required to borrow more than the cost of building the project in order to fund Debt Service Reserves or D.S.R. (typically equal to one year's cost of debt service).

2) Revenues in the first year, and all subsequent years, must cover at least 1.25 times the annual debt service.

This is referred to as "coverage." The excess revenue is typically used to pay off the bonds early.

General Obligation (G.O.) bonds do not face the same requirements.

The group concluded that there are two relatively low cost ways in which the Federal government can help reduce the cost of revenue bonds to be more in line with G.O. bonds. The key to both concepts is that future Federal transportation grants from Federal trust funds could be withheld by a Federal bank if the project defaults[1]. Such an option is not available to private sector lenders since they don't have access to the trust funds. The two mechanisms are:

1. Contingent Line of Credit: This line of credit would be offered by "the Bank" and could be accessed if revenues are not sufficient to pay for the debt service. This line of credit would be used in lieu of the debt service reserve. The cost would be lower since revenues would not have to be at a rate sufficient to pay interest on both the loan to build the facility and the loan to establish the reserve. For example, on a $100 million project the net present value of eliminating the need to finance a D.S.R. is over $9 million. It is also likely that the rating of the bonds would increase, hence lowering the interest rate that must be paid.

In most projects today the D.S.R. is accessed rarely and usually only for the time period needed to restructure the project's financing. Under the working group's proposal, the line of credit would charge competitive interest rates when accessed and the project would pay an annual fee to have the line of credit. When the project no longer needed the line of credit it could terminate the payments.

In order to encourage the construction of revenue backed projects it may be advisable for lines of credit to be subsidized to some degree through either waiving the fee and/or reducing the interest rates.

2. Subordinated Loans: The coverage requirements only apply to the senior debt issued for a project. Any additional financing through the bank would not need the same coverage. Therefore, if 20% of a project's financing could be through subordinated debt that would not require coverage and would not be sold in the (market which requires predictable constant payments), the revenue hurdle required would not be as high as in a traditional project. On a $100 million project the net present value of the revenue not needed to pay for coverage on 20% of the project

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1. The Federal Highway Administration's (FHWA) Right of Way Revolving fund uses a similar concept to secure loans from the fund that are used by States to acquire land for future projects.

costs would be about $45 million. These savings could be used to pay for other projects or be translated into reduced fees.

Subordinate loans issued by the Bank could still charge market rates. If there is a short-term short-fall in revenues, it too could be financed and repaid with future revenue. If the project defaults on all or part of the subordinated debt, then the State or Locality's transportation funding would be reduced. Once again, these loan could be subsidized to encourage revenue projects.

Estimated Effect of the Two Mechanisms: The group was unable to develop an estimate of how many projects would actually be undertaken if lines of credit or subordinated loans were offered. Their hunch is that these options, while important in the long run, in the short term will mainly have an effect on the margin. It seems clear, however, that there would not be billions of dollars worth of projects as is envisioned by the Commission to Promote Investment in America's Infrastructure report.

Non-traditional Projects with Traditional Financing. Another option to encourage such projects would be to combine the non-traditional projects with traditional financing. The bank would make below market rate loans for the full or partial cost of revenue generating projects. The loans could still be at least partially collateralized with future transportation funds. This approach would likely do more to encourage additional projects of this sort.

B: Options for Pension Fund Involvement in Infrastructure Finance

It has been widely suggested that inducing Pension Fund investment in infrastructure is desirable. In fact, the major charge to the Commission to Promote Investment in America's Infrastructure was to explore this issue. This section of the paper explores this issue and discusses the options that could be used to attract pension fund investment.

Reason for Lack of Investment by Pension Funds: The reason pension funds currently do not invest in bonds used to finance infrastructure is that the funds are not subject to taxation and therefore have no reason to buy tax-exempt debt. They rather invest in corporate or U.S. Treasury debt which pay higher interest rates than tax-exempts.

Effect on Lack of Pension Fund Participation: A recent CBO report concluded that "the low level of pension fund investment does not appear to prevent states and localities from financing investment in infrastructure, and there is no evidence of a shortage of funds in the municipal debt market." In fact it has been argued that the main constraint on municipalities' ability to issue debt is user and voter resistance, and ultimately limits on household budgets. The CBO study also pointed out that pension fund investment would not occur unless accompanied by additional tax subsidies. The only ways to increase pension fund investment in public infrastructure projects without additional tax subsidies would be to repeal the Federal tax break for municipal debt which is estimated to cost about $25.5 billion in Federal tax expenditures in 1992 or to change the tax-free nature of pension funds which is estimate to cost about $30 billion per year. Neither of these options is attractive from a political perspective.

Methods for Spurring Investment: Other than eliminating the tax exemption for municipal bonds or taxing pensions funds, there are several alternatives for creating investment opportunities for pension funds:

- Taxable Bonds: The Federal government could allow state and local governments to issue taxable infrastructure bonds and subsidize their interest costs through a direct subsidy to the issuer rather than the holder. This option would a more efficient way of targeting the Federal subsidy. (See the separate paper by Mark Mazur of CEA on taxable bonds). Pension funds would buy such bonds to the extent they provide risk-adjusted market returns. The total volume issued could be controlled through a national cap or through the appropriations process. Taxable bonds may be desirable if targeted at very specific types of projects or if accompanied by a parallel tightening of the tax exempt rules.

- Infrastructure Securities: The Commission proposed that Congress allow part or all of the investment earnings attributable to "infrastructure securities" to be distributed tax-free upon retirement to workers who participated in qualified pension plans. This would constitute an additional Federal subsidy for pension and retirement funds. It is also likely to be administratively complex and expensive.

- Stock and Bond Issues: Once a Bank or Infrastructure Corporation has established a track record, it could raise additional capital through issuing stock or bonds. Pension funds would be just as likely to buy these as other investors based on the risk profile. It is unlikely, however, that the Bank would be able to issues stocks or bonds in its early years that would be risk free enough to attract pension funds.

Overall the group concluded that having pension fund investment would be nice but not essential, their reasons for currently not participating are totally rational, and creating the incentives for their participation would be expensive.

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