CBO PAPERS

AN ANALYSIS OF THE REPORT OF THE COMMISSION TO PROMOTE INVESTMENT IN AMERICA'S INFRASTRUCTURE

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SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

PREFACE

This Congressional Budget Office (CBO) paper analyzes the report of the Commission to Promote Investment in America's Infrastructure. The commission's report considered the need for more investment in public infrastructure by the federal and state and local governments and recommended several new means--including a National Infrastructure Corporation and an Infrastructure Investment Company--to provide credit assistance to state and local governments for infrastructure projects. As requested by the House Committee on the Budget, this paper reviews how the commission's recommendations could affect the allocation of society's resources and examines alternative ways to organize the two corporations. Consistent with CBO's mandate to provide impartial analysis, the paper makes no recommendations.

Ron Feldman and Robin Seiler of CBO's Special Studies Division wrote the paper, under the supervision of Marvin Phaup and Robert W. Hartman. Steve Celio, Elizabeth Pinkston, Pearl Richardson, Elliot Schwartz, and David Torregrosa of CBO made valuable contributions. Outside of CBO, John Petersen, Thomas Stanton, and Dennis Zimmerman offered helpful suggestions. Useful information and comments were also received from the staff and advisors of the Commission to Promote Investment in America's Infrastructure and officials of the Capital Guaranty Insurance Company, the College Construction Loan Insurance Association, the Department of Justice, the Financial Guaranty Insurance Company, Fitch Investors Service, the Government Finance Officers Association, and Standard & Poor's Corporation.

Leah Mazade edited the manuscript, and Christian Spoor provided editorial assistance. Mary V. Braxton prepared the paper for publication.

Robert D. Reischauer
Director

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SUMMARY

In 1991, the Congress created the Commission to Promote Investment in America's Infrastructure to identify new ways of encouraging investment in the nation's stock of physical infrastructure. The commission found that current levels of spending and traditional means of financing are inadequate to meet current and future U.S. infrastructure needs. The commission attributed the projected inadequacy to resource constraints, limitations of current financing arrangements, and lack of political support for infrastructure projects at the state and local levels. It found that the federal government would have to provide leadership in developing new means of financing infrastructure, especially for projects paid for with user charges.

The commission proposed that the federal government intervene in the financing of infrastructure by state and local governments in three ways. A new National Infrastructure Corporation (NIC) would purchase and bear the credit risk of municipal bonds issued to provide long-term financing for infrastructure projects; the corporation would also insure a portion of the risk of developing new facilities. A new Infrastructure Insurance Company (IIC) would insure infrastructure bonds issued to provide long-term financing for new projects. Both corporations would support investment in transportation and environmental projects financed with user charges, and could support investment in other forms of infrastructure as well. The commission also asked policymakers to consider easing current restrictions on tax-exempt financing for infrastructure that is used for private activities and giving a new tax break to participants in pension plans that purchased qualified infrastructure securities.

This Congressional Budget Office paper examines the commission's recommendations. It describes the municipal bond market, reviews several factors that may cause investment in infrastructure by state and local governments to be less than optimal, and analyzes how the commission's proposals could affect the allocation of resources in the economy. It also discusses the advantages and disadvantages of alternative approaches to organizing the NIC and the IIC. The major conclusions of the analysis are the following:

- The commission's proposals would increase investment in municipal infrastructure by subsidizing the development and financing of new projects. The NIC would lower the interest rates that municipalities pay on their infrastructure bonds by bearing credit and development risks on subsidized terms. The changes in tax law that the commission proposed would provide subsidies that would also lower the interest rates paid by municipal borrowers.

- The primary effect of the commission's proposals would be to divert resources from investments such as business plant and equipment, housing, and other government spending and direct them toward state and local infrastructure projects financed with user charges. This shift would improve the allocation of resources if it directed them toward activities that produced greater benefits. The commission's proposals could achieve such a shift if they corrected for "spillover benefits" (benefits from a project that spill over to residents of other jurisdictions who do not pay for the project). Improved allocation would also result if the proposals led municipalities to borrow at interest rates more in line with the risks of the debt they issued.

- The municipal bond market, which is the source of most financing for state and local infrastructure, has many of the attributes of a well-functioning credit market. For example, it is extremely large and active, with massive numbers of investors and municipalities participating in transactions. Recent innovations in financing techniques are helping to lower borrowing costs. Favorable federal tax treatment also benefits municipal borrowers by allowing them to pay significantly lower interest rates on their debt.

- Of course, no market is perfect. Regulators contend that investors may have incomplete information on some bonds. Other experts argue that the municipal bond insurance industry is not fully competitive and that interest rates on municipal debt vary by geographic region. As a result, state and local governments may invest too little in infrastructure. Given alternative policies and the nature of the problems, however, the commission's proposals are neither necessary nor likely to address these market imperfections.

- The NIC and IIC could not correct spillover problems. In fact, the projects that the commission wanted the corporations to target would be unlikely to have spillovers that would justify federal subsidies.

- The new tax subsidies recommended by the commission would also be unlikely to improve the allocation of resources. By permitting subsidies for private-purpose activities, the changes in tax law could increase the costs of financing public-purpose infrastructure facilities and further distort private and municipal decisions about investment. Pension funds already benefit from substantial federal tax subsidies, which account for the low level of pension fund investment in municipal infrastructure that the Congress noted when it established the commission.

- Achievement of some of the commission's general goals--encouraging user fees to finance infrastructure projects and requiring state and local governments to pay a larger portion of the costs of federally assisted projects--could improve the allocation of resources. But policymakers could achieve those goals more simply by modifying existing grant programs or by reforming policies for pricing the use of existing infrastructure. There is little evidence that diverting funds to the NIC and IIC from alternative private investment or current federal grants for state and local infrastructure would produce more benefits for society.

- How the activities of the NIC and the IIC would affect the allocation of resources may be analyzed independently of how the corporations should be organized. If the NIC was set up as an on-budget federal agency, policymakers could obtain accurate, complete information about its activities and directly control the cost of the subsidies that it provided to municipal borrowers. As an on-budget agency, the NIC would also require much smaller initial appropriations than if it was established as an off-budget entity, as the commission appeared to propose. Moreover, it could use loans or grants to provide subsidies directly to a broad universe of infrastructure borrowers. The corporation would also, however, have a significant competitive advantage over private firms that insure or otherwise bear the credit risk of infrastructure bonds.

- If the NIC was established as a private, for-profit finance company and subsidized with a long-term federal loan that had a below-market interest rate, the cost of the subsidy that the loan provided would be controlled in the appropriation process and recorded in the budget. The company would be subject to less direct control by policymakers than an on-budget agency and could operate as a revolving fund. But a finance company would have to stand on its own after it repaid the government's loan. That requirement would subject the NIC to significant market discipline and give it a strong incentive to use the limited, one-time subsidy it received to build its capital and establish a track record, rather than provide ongoing subsidies to municipal borrowers.

- Organizing the NIC as either an on-budget agency or a finance company would have fewer risks than establishing the corporation as a government-sponsored enterprise (GSE). If the NIC was organized as a GSE, the federal budget would not measure, and policymakers could not directly control, the subsidies provided by the implicit federal guarantee of its obligations. Those subsidies would be relatively large because the corporation's business prospects would be uncertain. Some of the federal subsidies would benefit investors in the NIC's obligations, and some could benefit the corporation's owners; its management would be relatively free of direct federal control. The corporation would also have a competitive advantage over private firms and investors, although the advantage would probably be smaller than that possessed by an on-budget agency. Yet as long as the NIC was profitable, it would have an incentive to limit its risk taking and manage itself prudently. A GSE could also operate as a revolving fund, as the commission desired, and subsidize an indefinite volume of infrastructure bonds. The demand for the NIC's lending could be quite small, however, unless, as the commission proposed, policymakers provided a new tax subsidy for qualified pension plans that invested in its debt.

o As a federal agency, the IIC could not insure tax-exempt infrastructure bonds unless policymakers reversed the long-standing federal policy of not providing explicit federal guarantees of tax-exempt debt. If the company made loans at tax-exempt rates, the cost of the interest subsidies would have to be appropriated each year.

o If the IIC was organized as a private, for-profit bond insurer that was partially owned by the federal government, the budget would record the cost of purchasing stock in the company. A private insurer would be subject to less direct control than a federal agency but could insure tax-exempt infrastructure bonds. The company would have an incentive to manage itself prudently, because investors would be unlikely to perceive an implicit federal guarantee of the bonds that it insured. But there would be some uncertainty about the IIC's profitability and ability to obtain a triple-A credit rating. By establishing a sunset date for the company, policymakers could use this organizational form to provide temporary federal support for insuring infrastructure bonds that existing insurers do not now insure.