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OPTIONS FOR AN FY 1996 INFRASTRUCTURE FINANCING INITIATIVE

During the FY1996 budget process, the Administration will consider whether the budget should include new resources to fund an initiative that would offer a distinctive Clinton Administration approach to infrastructure. Two issues are before the Deputies:

- what option or options should be considered during the budget process?
- does this memorandum adequately reflect the arguments that should be made for and against devoting new resources to an infrastructure initiative?

Section I of this memorandum provides background on the Administration's infrastructure policies to date. Section II describes baseline infrastructure policies for 1995. Section III evaluates the option that the Working Group believes should form the core of any large initiative. Section IV considers four additional policy tools that the Administration might adopt either as a complement to the larger initiative, or as a substitute for it should the Administration wish to pursue a smaller initiative.

I. THE ADMINISTRATION'S INFRASTRUCTURE POLICIES TO DATE

A. BUDGET POLICIES. Despite very tight budget caps, the Administration has sought significant spending increases for infrastructure. The Administration's 1995 budget requested funding for infrastructure totalling \$34.0 billion. This represented an 11 percent increase over 1993 spending levels but only a 1 percent increase from the 1994 enacted level.

- The Administration's budget requests (see TAB A) have especially favored transportation programs: the FY 1995 budget sought an increase of 3 percent over FY 1994 levels and 15 percent over FY 1993 levels. The proposed spending would have supported "full-funding" of both federal-aid highways and formula grants for transit capital spending.
- The Administration's 1995 Budget requests for wastewater treatment and safe drinking facilities were up 7 percent from 1994 levels and up 5 percent from 1993 levels.¹

¹ As part of NAFTA, the Administration sought \$56 million to capitalize the first tranche of the U.S. capital contribution to the North American Development Bank. The NAD Bank will be instrumental in providing \$2 to \$3 billion in environmental infrastructure for the U.S.-Mexico border region.

The Administration had mixed success with its budget requests. Total 1995 appropriations for infrastructure were \$33.2 billion, or almost 9 percent higher than FY 1993 levels. FY1995 appropriations for both wastewater treatment and for safe drinking water were 12 percent higher than in 1993. However, the Administration did not achieve its goal of "full-funding" for ISTEA — the 1995 highway program level was \$1.2 billion less than authorized while transit formula grants were \$373 million less than authorized.

B. PROGRAMMATIC REFORMS. In 1993 and 1994, the Administration pursued a number of programmatic reforms in federal infrastructure programs. Congress enacted none of the changes sought by the Administration. The most important of these efforts included:

- Reauthorization of the Safe Drinking Water Act (SDWA) and the Clean Water Act (CWA). The Administration proposals would have created and capitalized a "Drinking Water State Revolving Fund" program and expanded the existing Clean Water State Revolving Fund" program.
- A proposal in the President's 1995 budget to rescind \$4.7 billion in "highway demonstration" projects in order to make available enough funds to fully-fund the core highway programs authorized by ISTEA.
- A proposal to restructure the Federal Aviation Administration as a public corporation.

Congress rejected the Administration's proposed reprogramming of highway funds, and did not complete action on the other Administration proposals noted above. A comprehensive list of the Administration's accomplishments related to infrastructure policies can be found at TAB B.

II. BASELINE INFRASTRUCTURE POLICIES FOR 1995

All agencies agree that the Administration should continue to press the general themes established during the last two years. Although the specific legislative strategy would depend on political developments in coming months, in general the Administration would continue to work on behalf of the legislative initiatives noted above. In addition, the Administration would probably propose or support limited programmatic reforms. These include:

- Reissuing Executive Order 12803, which would stimulate private investment in infrastructure by allowing states and localities to sell certain federally-funded public infrastructure facilities and use the proceeds to make additional public infrastructure investments (see TAB C).
- Supporting legislation that would allow States to set up revolving funds using their Federal highway funds;
- Administrative and regulatory actions to improve the Clean Water SRFs.

III. THE CORE PROPOSAL: CAPITALIZE STATE INFRASTRUCTURE BANKS.²

Under this option, the FY1996 Budget would include increased funding to capitalize "State Infrastructure Banks" (SIBs).³ Although SIBs could be capitalized at any level, the Working Group believes that funding on the order of \$2.5 billion - \$5.0 billion over five years would be needed to induce states to form such Banks.

Permissible Use of Funds -- SIBs would be a more flexible version of existing Clean Water State Revolving Funds. SIBs would be allowed to:

- make below-market loans for local public infrastructure investment;
- provide loan guarantees or other credit enhancements for local public infrastructure debt;
- use the federal grants as a reserve against which the SIB would borrow added funds;
- make subordinate loans in local private projects;
- provide development risk insurance for private projects.
- accept funds from state entities;

Leveraging -- The capitalization grants would be leveraged by requiring that the SIB finance infrastructure projects worth a total of four times the amount of the initial federal grants.

Beneficiary Pays -- To reduce local reliance on financing by general taxpayers, some portion of SIB loans would have to be used to construct or repair facilities that were paid for directly by users (dedicated taxes could be used to repay other SIB subsidies). The exact fraction specified in the Administration proposal would be determined after consultation with the Congress.

Pro:

- During the campaign, the President emphasized the role of public investment in economic growth. The Administration has continued to build a public case for the importance of public investment. The 1994 *Economic Report of the President*, for example, described at some length why "the Administration believes the United States has underinvested in its public infrastructure." Capitalizing SIBs would underscore the importance that this Administration attaches to public investment, and would advance an important part of the President's economic agenda.
- SIB funding would be dramatically more efficient than current federal infrastructure programs. SIBs would "reinvent" federal programs in five principal areas:

(1) *SIBs would leverage federal funds far more than do current programs.* In most existing infrastructure programs, each dollar in federal spending is associated with \$1.25 in total

² A number of proposals have been made to capitalize an off-budget federal infrastructure bank. TAB D discusses why the Working Group opposes the many proposals that have been floated for such a bank.

³ All agencies agree that SIBs would be far more efficient than current programs. In principle, SIBs could be funded by reallocating existing infrastructure outlays. This memo assumes, however, that political constraints require SIBs to be funded as a supplement to, not substitute for, existing outlays.

infrastructure investment. SIBs, in contrast, would be required to leverage federal funds by four-to-one.

(2) *Shallow subsidies would provide incentives to fund only the most productive investments.* Current federal transportation programs cover an average of 80 percent of project costs. Because of the leveraging requirement, however, SIB loans and credit enhancements would provide subsidies that, on average, were economically equivalent to about 25 percent of project costs. (The SIB would tailor each loan or other subsidy to fit local conditions. SIBs could provide subsidies that were economically equivalent to direct grants ranging from zero up to a maximum of 50 percent of project costs.) The shallow subsidy provided by the SIB would provide states and localities with incentives to be more selective in the projects that they choose to build.

(3) *SIBs would give states greater flexibility in the use of federal funds.* Compared to current programs, SIBs could better tailor solutions to fit local problems. SIBs would have more discretion over the type of infrastructure to be built, and the depth of the subsidy needed to build it. Greater flexibility would lead to more efficient solutions to local problems.

(4) *SIBs would increase the amount of private investment in infrastructure.* The vast majority of infrastructure investment is now undertaken by the public sector. SIBs would be allowed to join with private sector firms that wished to invest in infrastructure. The greater private sector investment in infrastructure would result in competition for public providers; greater competition would bring a more rapid adaptation to changes in demand and technology, and would free public resources for other needed infrastructure projects.

(5) *SIBs would reduce the need for general taxpayers to fund infrastructure investments.* At present, much infrastructure is paid for by taxpayers generally rather than those who use the infrastructure. The shallow subsidy rate provided by SIBs, together with the explicit requirement that beneficiaries pay, would work to channel SIB subsidies to projects that were more likely to be self-supporting. Increased payments by beneficiaries would provide new revenues for further investment and better signals about where and how much new investment was needed.

- This initiative would provide new funding that could be used to support other Administration policies, such as efforts to address problems in urban areas.

Con

- Some believe that the requirements for leveraging and pricing would sharply limit the political appeal of this initiative.
- Undertaking this initiative would divert budgetary resources and political capital from other Administration priorities, such as health care reform or welfare reform.
- The Administration already has sought a limited "reinvention" of federal infrastructure programs through the programmatic reforms undertaken to date. More extensive reinvention efforts could be pursued in the context of routine reauthorizations.

- Although infrastructure spending has fallen short of what the Administration had hoped to achieve, it nonetheless has remained high relative to other priorities -- funding has been preserved and slightly increased at a time of severe budget constraints. Section I showed how the budgetary and programmatic efforts of this Administration have advanced the agenda of those who would invest more -- and more efficiently -- in America's infrastructure. Given the Administration's infrastructure achievements to date, and the severity of existing budget constraints, the limited available resources might be better spent on other Administration priorities.
- Congress might not enact any of the programmatic reforms embodied in this option, but instead use proposed funding simply to increase spending on existing programs. Yet achieving programmatic reform would be one of the most important justifications for undertaking this initiative. Some agencies do not believe that an adequate case has been made for increasing spending on existing infrastructure programs.
- The options considered in this memo would tend to focus spending on projects that can be justified on economic merit alone, and might give less weight to some of the distributional concerns that are reflected in current programs. Specific provisions might need to be added to the SIB proposal in order to address federal concerns about the distribution of SIB subsidies. For example, special provisions might be needed to insure that the subsidies addressed the infrastructure needs of economically troubled areas.

A UNRESOLVED DESIGN ISSUES. A number of issues remain open: project eligibility criteria; whether the SIBs should provide special treatment for "federal priorities," and whether the program should be mandatory or discretionary.

1. Project Eligibility -- all infrastructure or transportation only. A broad-based initiative would cover all transportation and water-supply facilities now eligible for federal aid. Such a program would address concerns about underinvestment in "public infrastructure" generally, and has the potential to generate the widest support among infrastructure advocates.

On the other hand, a broad-based initiative would run the greatest risk of being attacked as being unnecessary in a time of fiscal constraint. Moreover, unless the SIBs receive substantial resources, environmental advocates may want to focus all available resources on existing Clean Water SRFs, rather than have water projects compete for the same pot of money as transportation projects. Nor would limiting the SIBs to transportation projects necessarily sacrifice the support of environmentalists, for the conditions under which SIB subsidies would be made available are exactly those that environmentalists have championed for some time: relatively low matching rates, greater reliance on beneficiary pays, and increased private sector investment in infrastructure.

2. "Federal Priorities" Window -- SIBs would not be well-suited to address specific federal priorities. If desired, special provisions could be added to achieve various federal priorities. SIBs could be required to allocate a specified portion of subsidies: for projects in designated urban areas; for qualifying congestion relief projects; for projects addressing regional or interstate problems; and/or to make below-market loans to private entities that need to clean

up "brownfields." Adding such provisions would increase the likelihood that the SIBs furthered specific federal goals, but would reduce state flexibility and its attendant benefits.

3. Mandatory or Discretionary. Legislation establishing the SIBs could determine that federal capitalization grants were mandatory spending, discretionary spending, or both:

- A mandatory program could be paid for on a PAYGO basis. In addition, a mandatory program would provide more predictable funding streams, allowing better planning and more efficient resource use at the local level. Congressional oversight would be maintained through routine oversight hearings and the reauthorization process.
- A mandatory program might provide somewhat less Congressional oversight and afford Congress somewhat less control over federal revenues. In addition, designating such a program as "mandatory" would run the risk of opponents charging the Administration with trying to avoid the intent of the Budget Enforcement Act (opponents might charge that the Administration was using artificial categorization in order to use PAYGO offsets to fund spending that otherwise would be capped.)

IV. OTHER OPTIONS. None of the options below could provide an initiative of the scope and magnitude of SIB grants. At the same time, the options that follow might be attractive either as complements to a larger SIB initiative, or as a substitute for it should the Administration wish to pursue a smaller initiative.

A. CREATE A "TAXABLE INFRASTRUCTURE BOND". SIBs, or perhaps state and local governments generally, would receive a direct federal subsidy for a portion of the interest that they pay on taxable bonds issued to support specific classes of infrastructure projects. Taxable bonds would be attractive to SIBs if (1) the interest subsidy lowered borrowing costs below what they could achieve through tax-exempt borrowing, or (2) it were made available for projects that cannot now get tax-exempt financing, e.g., privately-owned roads and intermodal facilities.

The taxable bond interest subsidy would be a mandatory appropriation in order to allay issuer concerns that the subsidy might not continue for the life of the bond. The total subsidy paid out each year would be capped by limiting the amount of debt eligible for subsidy each year. The market for taxable bonds would encompass both those investors that currently invest in tax-exempt debt and those that do not now purchase tax-exempt bonds (e.g., pension funds and foreign investors). Bond volume would be allocated to states either on a per capita basis (a la the existing cap on tax-exempt, private activity bonds) or would be auctioned off by some federal entity.

Pro

- Would give SIBs another tool to subsidize state and local infrastructure investment. This option would have none of the economic inefficiencies associated with tax-exempt financing.
- Pension fund managers may support this option, for it would allow them to earn taxable returns on investment in public sector infrastructure.

Con

- All of the objections raised against Option 1 apply equally to this option.
- State and local officials and the tax-exempt bond industry would be likely to oppose the proposal strongly as a threat to the existing Federal subsidy for tax-exempt debt. Fierce opposition greeted a similar proposal by the Carter Administration. Some of the opposition to this instrument might be blunted by providing direct interest subsidies only for bonds issued by SIBs or only for projects that cannot now receive tax-exempt financing.
- Would divert resources from the basic option.

Other

- Much of the budgetary cost of taxable bond subsidies would take place outside the budget window. Unlike grants, which are scored as an up-front appropriation, the interest subsidy on a taxable bond would only require an appropriation each year equal to the amount of subsidy paid in that year.

B. CREATE A "TAX-CREDIT INFRASTRUCTURE BOND". This option would be similar to the taxable bond option in all but its budgetary effects. Under this option, SIBs would issue taxable bonds to support specific infrastructure projects. The holders of these bonds would receive a subsidy from the Federal government in the form of a non-refundable income tax credit (the value of the credit would be included in gross income). The total Federal subsidy would be capped by limiting the total amount of tax credit bonds that may be issued by a State.

Pros/Cons/Other -- same as taxable bond subsidies except that:

- Budget considerations -- unlike taxable bond subsidies, tax-credits would appear in the budget as a tax reduction rather than as direct spending.
- Political considerations -- Unlike taxable bonds, tax-credit bonds would not enjoy the support of pension funds (who would be unable to invest profitably in tax-credit bonds). On the other hand, tax-credit bonds would not carry the albatross of the words "taxable bond." Some agencies believe, however, that all those who oppose taxable bonds would equally oppose the substantively similar tax-credit bonds.

C. EXPAND TAX-EXEMPT BOND SUBSIDIES. State and local governments currently are able to finance public infrastructure projects with bonds that pay interest that is exempt from Federal income tax. Most infrastructure projects with significant private involvement, however, either cannot be financed with tax-exempt bonds or else can be so financed only if a portion of the relatively scarce State private activity bond volume cap is allocated to the project. Under this option, the Administration would seek to:

- provide a partial exemption from the state private-activity volume cap for certain infrastructure facilities;
- allow highways and intermodal facilities to be financed with private activity bonds.

Pro

- Tax-exempt bonds provide only a shallow subsidy. The value of tax-exempt financing varies with interest rate levels, individual and corporate income tax rates, and other factors affecting the tax-exempt market. At present, tax-exempt financing provides a subsidy that is economically equivalent to a direct grant for roughly 15-20 percent of a project's costs.
- Because these subsidies generally would benefit private investments, they would lead to facilities paid for by the beneficiaries rather than general taxpayers.
- Easing constraints on tax-exempt debt at the same time that a taxable bond option is proposed might reduce fears that the taxable bond was intended to undermine support for tax-exempt financing.

Con

- All of the objections raised against Option 1 apply equally to this option.
- Most economists believe that tax-exempt financing is inefficient, for the benefits of lower interest rates to issuers are smaller than the Federal revenue foregone through the grant of tax-exemption. A rough estimate suggests that state and local borrowing costs are reduced by about \$90 dollars for every \$100 in revenue that the federal government loses due to tax-exemption for municipal bonds.
- Would take money from the basic option.

Other

- The tax subsidies would be scored as revenue losses, rather than direct outlays. Unlike direct subsidies, which require an up-front appropriation of the present value of the subsidy being offered, tax-exempt bond subsidies would require budget resources equal to the annual loss from the increased use of tax-exempt debt during the budget window.

D. PROVIDE TAX SUBSIDIES FOR PRIVATE ENVIRONMENTAL FACILITIES. The Administration would seek two tax subsidies for private sector investors in wastewater treatment and drinking water facilities:

- accelerated depreciation (the depreciable life of this property would be reduced from the current levels of 15 or 20 years to a shorter period, e.g., 7 or 10 years).
- contributions in aid of construction (CIAC) -- CIACs are contributions of capital assets or the cash equivalent made to investor-owned water utilities by new customers to reimburse the utility for the cost of improvements needed to serve the customer (e.g., the land developer). Current law includes the value of CIACs in a regulated utility's gross income subject to federal income tax. This option would allow utilities to exclude from gross income the value of CIACs if such contributions were also excluded from the utility's rate base.

Pro

- These changes would provide relatively shallow subsidies. The accelerated depreciation, for example, would provide a subsidy that was economically equivalent to a direct grant for something less than 5 percent of the amount of project costs. CIAC would provide a subsidy roughly on the order of 30 percent of capital costs.
- The CIAC change would provide incentives to consolidate small, public systems into larger, private systems. Larger systems may be more likely to comply with EPA regulations.

Con

- These proposals would effectively reinstate provisions of the Tax Code that were repealed in the 1982 Tax Act and the Tax Reform Act of 1986. In 1982, Congress repealed accelerated depreciation for these facilities, arguing that depreciable lives for income tax purposes should be at least somewhat tied to economically useful lives. Similarly, Congress decided in the Tax Reform Act of 1986 that CIACs should be treated for income tax purposes as compensation for a service provided. Supporting a reversal of the 1982 and 1986 decisions would make it more difficult to oppose other exceptions to what the Administration believes is good general tax policy.
- All of the objections raised against Option 1 apply equally to this option.
- Would take money from the basic option.

Other

- The budgetary cost of accelerated depreciation would be equal the annual difference between depreciation deductions under current rules and those under the proposed rules multiplied by the investors' marginal tax rates.

TAB A

PUBLIC INFRASTRUCTURE SPENDING

Table 1
Administration Budget Requests and Enacted Levels
for Major Infrastructure Categories
(\$ in billions)

	1993	1994 Request	1994 Enacted	1995 Request	1995 Enacted
Transportation	24.5	28.6	27.4	28.3	27.2
Highways _1/	(17.4)	(20.4)	(19.9)	(20.0)	(19.7)
Transit (capital)	(2.6)	(3.4)	(3.4)	(3.8)	(3.5)
Railroads	(.4)	(.4)	(0.4)	(0.5)	(0.5)
Air Transport	(4.1)	(4.4)	(3.7)	(4.0)	(3.5)
Water Treatment and Supply	3.0	2.5	3.0	3.2	3.4
Water Resource Development	2.2	1.9	2.2	1.6	1.7
Other / CDBG	0.8	0.8	0.9	0.9	0.9
Total	30.6	33.8	33.5	33.9	33.2

_1/ - excludes emergency spending

Infrastructure Spending Summary

The term "infrastructure" refers here to transportation, environmental, and water resources facilities. This definition corresponds to the role of infrastructure in supporting the national economy, and also to the areas in which the Federal government plays the largest role in project selection and funding.

Total Spending

Table 2 displays government spending on major infrastructure categories in 1990. Spending by all levels of government on all forms of infrastructure (including operations) totalled \$147 billion in 1990². Net of Federal grants, State and local governments spent \$110 billion, or 75% percent of this total.

² Congressional Budget Office, August 1993

Capital Spending

For 1990, about \$66 billion or 45% of total infrastructure spending was for capital purposes, the remainder was for operations and maintenance. The Federal government contributed \$26 billion or 40% of total spending. The vast majority (83% or \$21 billion) of this capital assistance was provided in the form of grants or loans.

Debt Financing

Much of the \$110 billion in State and local spending is financed with tax-exempt debt. In 1992, States and localities issued more than \$78 billion in infrastructure debt; total outstanding municipal debt was \$1.2 trillion at the end of 1992. The Federal tax exemption for interest on state and local debt provides a major subsidy to State and local infrastructure spending. In 1992, the Federal revenue loss from tax-exempt debt on infrastructure bonds totalled \$26 billion. Many State and local governments also exempt such debt from State and local taxes.

Table 2
1990 Capital Spending by All Levels of Government for Infrastructure
(\$ in billions - nominal \$)

	Total	Federal	State and Local	Federal as % of Total
Highways	34.3	13.9	20.4	41%
Transit	5.5	3.1	2.4	56%
Railroads	0.0	0.0	0.0	0%
Air Transport	4.8	2.6	2.2	54%
Water Transport	1.2	0.3	0.9	25%
Water Treatment and Supply	15.4	3.0	12.4	19%
Water Resource Development	4.7	2.8	1.9	60%
Total	65.9	25.7	40.2	39%

TAB B

Infrastructure Accomplishments & Outstanding Proposals

Department of Transportation

Budget Summary:

- The Administration's budget requests have favored transportation programs: the FY 1995 budget sought an increase of 3 percent over FY 1994 levels and 15 percent over FY 1993 levels. The proposed spending would have supported "full-funding" of both federal-aid highways and formula grants for transit capital spending.

Other Accomplishments/Proposals:

- Innovative Financing Initiative. In March 1994, the Federal Highway Administration established an Innovative Financed - Test and Evaluation Project (TE-045) to help identify actions to encourage increased investment in transportation. Working with the States, FHWA has identified projects, developed a plan of finance and offered those projects as examples of creative financing solutions. With this initiative, FHWA hopes to de-mystify the financial options made available by ISTEA and Title 23. FHWA is clarifying for States what they can already do under current law. They are also making FHWA guidance more flexible so States can take advantage of what ISTEA or Title 23 permits. Twenty-six states have submitted a total of 60 innovative financing projects. FHWA will use the findings of this effort to examine the current operating and change regulations or guidance where there is administrative discretion. Where the results suggest that changing the statutory framework is necessary, the results will help shape future legislative proposals.
- Implementation of E.O. 12893. A Draft plan covering FHWA, FTA, FRA, FAA, and Coast Guard was submitted March 30, 1994, covering formula and discretionary grant programs of these agencies. Final plan to be submitted shortly and incorporates several of the items discussed below, especially Infrastructure Investment Criteria.
- Infrastructure Investment Criteria FHWA and FTA issued guidance for conducting the ISTEA-required major investment studies of significant transportation investments in metropolitan areas. FTA also issued criteria for funding of transit new start projects. FAA has developed criteria for award of airport discretionary grants, which include benefit-cost analysis for large projects, and for signing Letters of Intent to award future-year grant funds. As DOT grant recipients comply with these requirements, transportation decisionmakers will have better information to make informed decisions on proposed infrastructure investments.
- Management and Monitoring Systems. Interim Final Rule published in the Federal Register on December 1, 1993, implementing the ISTEA requirements for State

management systems for (1) highway pavement of Federal-aid highways, (2) bridges on and off Federal-aid highways, (3) highway safety, (4) traffic congestion, (5) public transportation facilities and equipment, and (6) intermodal transportation facilities and systems. These systems will enhance the States decision-making process for use of transportation funding.

- Statewide and Metropolitan Planning. Final rules published in the Federal Register on October 28, 1993, implementing the ISTEA requirements for revised statewide and metropolitan planning processes for the Federal highway and transit programs. These rules require a comprehensive approach to planning and programming transportation projects at the State and urbanized area levels that will improve the overall decision-making for funding transportation projects and assure that transportation projects help meet Clean Air Act air pollution improvement goals.
- Highway Life-Cycle Cost Analysis (LCCA). Interim policy statement published in the Federal Register on July 11, 1994, establishing LCCA principles to be applied by FHWA in its infrastructure analysis and in evaluating the adequacy of State highway agency procedures used for evaluating projects funded by the Federal-aid Highways program.
- Highway Economic Requirements System (HERS). The FHWA-developed HERS model is undergoing final internal and external review prior to being applied by FHWA in the development of the system-level highway "needs" report due to Congress in January 1995. The HERS model overlays an engineering-based needs model with an investment/performance model that incorporates benefit-cost analysis.
- Congestion Pricing. A cooperative agreement was signed in August 1993 with the California Department of Transportation and the Metropolitan Transportation Commission for the first project under the Congestion Pricing Pilot Program authorized by ISTEA. The program was funded with contract authority of \$25 million per year for FY 1992 through FY 1997. To expand opportunities for additional projects, the initial project solicitations have been extended indefinitely and criteria for acceptable projects have been refined. In addition, pre-project development studies have been made eligible for funding.
- National Highway System (NHS)/National Transportation System (NTS). The Department announced and submitted to Congress its NHS map and designation in December 1993. At the same time it started an effort to identify a National Transportation System. Both concepts are important for helping to set priorities for investment and for focusing the Nation's attention on an integrated transportation system designed to meet mobility and economic needs in the most cost-effective manner possible.
- Intelligent Vehicle-Highway Systems (IVHS). The IVHS program has moved aggressively to establish the structure and process by which the Department will make use of improvements in information infrastructure to promote more efficient use of the physical infrastructure. Automated Highway developments along with operational tests and research and development have pushed the envelope on techniques to enhance highway/transit systems productivity. The program covers a whole range of diverse information and control technologies to make highway use safer and more efficient. Self-

diagnostic sensors on, for example, "smart" bridges, report when a bridge needs repairs and can help target maintenance and renewal when it is most timely.

- Next Generation High-Speed Rail. The Department has developed a program that will support the advancement of high-speed rail, particularly on existing infrastructure. Proposed legislation -- which has passed both Houses of Congress -- would establish Federal programs to support both high-speed rail corridor planning and the development, testing and demonstration of high-speed technologies for application in existing rail corridors. The Department is working on a high-speed rail commercial feasibility study that will be used to support the development of a comprehensive national policy that will form the basis for establishing a long-range Federal role in high-speed ground transportation development.

Environmental Protection Agency

Budget Summary:

- The Administration's 1995 Budget requests for wastewater treatment and safe drinking facilities were up 5 percent from 1994 levels and up 7 percent from 1993 levels. (As part of NAFTA, the Administration sought \$116 million to capitalize the North American Development Bank, which will be instrumental in providing \$2 to \$3 billion in environmental infrastructure for the U.S.-Mexico border region.)

Other Accomplishments/Proposals:

- As noted in Section 1.B., the Administration has proposed improving investment in the Nation's water infrastructure through reauthorization of the Safe Drinking Water and Clean Water Acts. The Administration's specific recommendations include the following:

Safe Drinking Water Act

- Increase flexibility for communities to meet SDWA requirements and better target resources to effective protection of the environment and public health;
- Extend eligibility for DW-SRF assistance to all public, non-profit, and private community water systems;
- Protect sources of drinking water to reduce the need for costly treatment infrastructure;
- Ensure the viability of small systems to maximize the Nation's investment in drinking water infrastructure;
- Establish treatment technology standards specific to small systems to lower the cost and increase the efficiency of systems unable to benefit from economies of scale;
- Implement a comprehensive system of operator training and certification to ensure efficient use of infrastructure;
- Increase flexibility for selecting drinking water contaminants to be regulated and for setting compliance time-frames to help control infrastructure costs;
- Streamline and strengthen the enforcement provisions of the SDWA to improve compliance with the law and to encourage needed investment in infrastructure.

Clean Water Act

To continue and extend the success of the Clean Water SRF program, the Administration proposed continuing Federal capitalization of the program through 2004 at a level sufficient to allow CW-SRFs to provide a least \$2 billion (in 1994 dollars) per year in assistance over the long term. The recommended authorizations are:

FY 1995 -- \$2.00 billion
FY 1996 -- \$2.00 billion
FY 1997 -- \$2.00 billion
FY 1998 -- \$2.00 billion

FY 1999 -- \$1.50 billion
FY 2000 -- \$1.25 billion
FY 2001 -- \$1.00 billion
FY 2002 -- \$0.75 billion
FY 2003 -- \$0.50 billion
FY 2004 -- \$0.25 billion
Total -- \$13.25 billion

The Administration also made the following recommendations to better target Federal resources to critical projects and to provide flexibility to States and local governments in protecting and cleaning the Nation's waters:

- Expand the eligibility for CW-SRF assistance to include activities such as pollution prevention and water use efficiency that can reduce the need for costly treatment infrastructure;
- Remove restrictions on CW-SRF funding of combined sewer overflows, storm water controls, and sewer rehabilitation, which represent critical infrastructure needs for some communities;
- Remove certain Federal requirements for engineering and planning from assistance to small communities in order to reduce the cost burden of wastewater projects;
- Authorize States to provide additional subsidies to economically disadvantaged communities through the CW-SRF program with negative interest rate loans, principals write-downs, or similar mechanisms;
- Remove impediments to private investment in municipal wastewater facilities by defining the term "publicly-owned treatment works" in a manner that would ensure equitable permitting and enforcement for all public-purpose facilities, regardless of ownership structure (this provision would not extend eligibility for CW-SRF assistance to private wastewater entities).

Water Resources Infrastructure

[Army Corps of Engineers & Interior's Bureau of Reclamation]

Budget Summary:

- The Administration sought a decrease in water resource programs (e.g., dams, ports and harbors).

Other Accomplishments/Proposals:

- Prior to authorization for construction, water resources infrastructure projects must be evaluated for economical feasibility and environmental acceptability.
- The Army Corps of Engineers received more than \$1.7 billion in 1994 to continue work on about 160 projects. In 1994, the Bureau of Reclamation received about \$0.4 billion for various construction projects. The Bureau of Reclamation devoted substantial funds to the completion of its last multiple objective, water resources development (the Central Arizona Project). Funding enacted for water resources infrastructure investments decreased between 1994 and 1995.
- Consistent with E.O. 12893, Principles for Federal Infrastructure Investment, both the Corps and Bureau are making serious efforts to operate existing infrastructure more effectively and efficiently. In fact, the Corps entire operations and maintenance program (not part of the table of infrastructure investments) is included in its GRPA pilot project.

HUD's -- Community Development Block Grant (CDBG) Program

CDBG funds can be used for a wide range of eligible activities related to housing, economic development, public services, and public works. Choice of which eligible activities to fund is made at the local level. Based on available information, about 20% of CDBG funding is used for infrastructure (i.e., street and sidewalk repairs, water, sewer, flood control, and drainage systems). Most CDBG funds are used for housing-related activities, construction of public buildings, economic development activities, and planning/administration.

Budget Summary:

- The Administration sought minor increases for HUD's Community Development Block Grants program related to infrastructure. About 20% of the CDBG program goes to "public works" type investments.

Other Accomplishments/Proposals:

HUD's FY 96 budget may include a new economic development proposal that would provide additional funding for infrastructure for distressed communities.

TAB C

Revise E.O. 12803, "Federal Interests in State and Local Infrastructure Investments."

The Working Group recommends that the Administration issue a revised Executive Order 12803. The Deputies will receive a separate decision memorandum outlining this recommendation in more detail.

Background

E.O. 12803 was issued by the previous Administration to encourage Federal, State and local governments to sell public investments in infrastructure. The order reduced federal recoupment requirements for the sale of existing assets, and instructed agencies to remove regulatory and other barriers to State and local sale of infrastructure assets that had been financed in part with federal funds.

Discussion

To date, no state or locality has taken advantage of the provisions of E.O. 12803. The revised order would be designed to end the uncertainty that has surrounded the current order and to encourage more private investment to supplement existing public investment in infrastructure. The proposed new Executive Order would: (1) remove elements of the current order that favor private sector ownership and operation over continued public ownership and operation; (2) limit the use of State and local proceeds to new or expanded infrastructure investment; (3) clarify the rules for disposing of federally-financed infrastructure; and (4) accommodate the Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments or "Common Rule."

Tab D
National Infrastructure Corporation

Several groups have proposed creation of an off-budget "infrastructure bank" or National Infrastructure Corporation (NIC). Such an entity was envisioned, for example, in *Financing the Future*, the 1993 report of the Commission to Promote Investment in America's Infrastructure. Most recently, an NIC is the subject of H.R. 2150, the National Infrastructure Development Act of 1994.

Typically, an NIC would be a government-sponsored enterprise (GSE), capitalized in whole or in part with Federal funds, and with at least three branches and functions. First, an infrastructure insurance subsidiary (termed the Infrastructure Insurance Company or IIC in *Financing the Future*) would insure and reinsure certain taxable and tax-exempt senior infrastructure debt issues that other bond insurers will not handle. Its activities would be similar to those currently carried out by the GSE *Connie Lee* within the narrower college construction loan sector. Second, the NIC would use borrowed or appropriated funds to invest in senior or subordinated securities. Third, a development insurance service would provide insurance to infrastructure projects for the initial development stages, when financing may be difficult. An NIC could raise funds in several ways, including issuance of equity securities. In conjunction with establishing an NIC, *Financing the Future* and H.R. 2150 recommend creation of an infrastructure security for pension funds that could be distributed tax-free to participants at retirement.

The proposed IIC was modeled after the College Construction Loan Insurance Association (*Connie Lee*), an existing GSE, which is authorized to insure and reinsure certain academic facility bonds. Shortly after *Financing the Future* was released, *Connie Lee* proposed legislation to authorize it to insure and reinsure infrastructure bonds. On February 17, 1994, the Administration submitted legislation to Congress that would authorize *Connie Lee* to insure and reinsure elementary and secondary education bonds. No action has been taken on this legislation.

By lowering the hurdle rate of return necessary for an investment to acquire funding, the lending and insurance activities of an NIC would stimulate additional investment in infrastructure. As a GSE, it would also have some budgetary advantages over an on-budget program or corporation. Its equity and debt securities would be taxable, and therefore would facilitate infrastructure investment by pension funds. Finally, an NIC could in theory provide a vehicle for implementing a consistent and coherent infrastructure investment strategy, with an extensive role for public/private partnerships.

However, the Working Group does not support calls for an NIC. The Federal Government has generally opposed proposals for new or expanded GSEs because of concerns about increased taxpayer exposure, potential distortions of private credit markets, possible increases in Treasury borrowing costs, and potential misdirection of the Government subsidy.

One problem is that the earnings potential of an NIC is questionable. Without additional federal subsidies, it may not be able to overcome the problem of using taxable-rate debt and equity issues to finance the purchase of tax-exempt municipal infrastructure bonds. At the same time, financing or insuring below-investment-grade issues would be risky, and few issuers might wish to pay the premiums required to make such NIC activities profitable.

The need for the NIC's insurance rôle is also questionable. The bond insurance market is very competitive and is growing rapidly. Although market imperfections may exist, there is no convincing evidence that inherently profitable investment opportunities cannot find private insurance. Private bond insurers would certainly object to what they would consider needless and unfair competition from a federally-backed GSE.

A GSE also has several disadvantages in terms of control and accountability. As a private corporation, its investment policy is outside the direct control of the government. Its activities would not be subject to explicit on-budget review concerning its ongoing effectiveness and justification in terms of current public policy priorities. Accrued changes in its net worth are not reflected in any federal accounts, but the government may be forced to recapitalize the NIC, at great cost, if it becomes insolvent. This implicit federal guarantee of the NIC's investors and creditors could create a moral hazard problem in which the NIC undertakes more risky investments than would an ordinary private company.

In response to an NIC's attraction as a focus for pension fund investments in infrastructure, many observers would point out that money is fungible. The fact that pension funds do not invest in tax-exempt securities does not necessarily limit the supply of funds to the tax-exempt market. The proposal for preferential tax treatment of withdrawals of pension investments in infrastructure securities is also problematic, and raises significant tax policy concerns. This incentive is insufficient to make tax-exempt bonds as attractive to pension funds as corporate bonds or other taxable-rate issues, even if returns from the latter could not be distributed tax-free. Relative to municipals, the taxable securities would have roughly the benefits of tax deferral; paying tax at the time of distribution will generally be preferable to accepting a lower, tax-exempt rate throughout the life of the investment.