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Rebuilding and Reinvesting in Infrastructure in an Age of Fiscal Constraint
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Good morning Vice Chair Klobuchar and Members of the Committee. I very much appreciate the invitation to appear before you today. The purpose of my testimony is to discuss ways the federal government can engage in new partnerships with public and private investors to invest in infrastructure and, by so doing, put Americans back to work and rebalance the economy.

Of course, our challenge today is that the nation's economic recession and tense new focus on austerity means public resources for infrastructure are strained. As financial markets have contracted, all actors are suffering under tightened credit supplies. While state and local balance sheets are improving, overstretched budgets have led to a larger gap between infrastructure costs and revenues. As a result, meeting the nation's great needs for financing infrastructure requires an "all of the above" strategy.

Today, record low interest rates, coupled with attention from private firms and foreign funds, present growing opportunities for pragmatic public- and private-sector leaders to collaborate and innovate around infrastructure investments at the metropolitan scale, which can motivate state and federal officials to support these efforts. Indeed, leaders in many metros are already driving the development of new and innovative ways to deliver economically important infrastructure projects.

Modern freight and logistics projects in Los Angeles and Miami, state-of-the-art transit investments in Denver and Salt Lake City, advanced stormwater treatment upgrades in Washington and Philadelphia, broadband installations in Kansas City and Chattanooga are emblematic of the growing role states and cities are taking to build the infrastructure that will both support and enable the next American economy.

And so an enormous opportunity exists for Washington to adopt a fresh set of focused initiatives that can drive the nation toward economic renewal and support regional and state empowerment.

Revive Build America Bonds to Support State and Local Investments

Congress created the Build America Bonds (BABs) program in response to the Great Recession's dramatic effect on state, local, and other public entities' ability to issue debt. According to the U.S. Treasury, this credit crunch eventually led to a 68 percent drop in monthly municipal bond issuances and

a doubling of borrowing costs.[1] Established through the American Recovery and Reinvestment Act (ARRA) of 2009, the two-year program authorized state and local governments to issue special taxable bonds that received either a 35 percent direct federal subsidy to the borrower (Direct Payment BABs) or a federal tax credit worth 35 percent of the interest owed to the investors (Tax-Credit BABs).

By harnessing the efficiencies of the taxable debt market, this unique structure decreased average borrowing costs for states and localities by 54 to 84 basis points compared to standard municipal bonds.[2] These lower costs, in turn, allowed borrowers to save an estimated $20 billion. The taxable nature of the bonds also incentivized a much broader group of investors to participate in the program, including pension funds and institutional investors. This expanded the traditional infrastructure investment base beyond the $2.8 trillion market for tax-exempt municipal bonds and made BABs appealing alternatives in the $30 trillion taxable bond market.

BABs proved wildly popular. From 2009 through the program's expiration in 2010, BABs financed one third of all new state and local long-term debt issuances. In total, more than 2,275 separate bonds were issued to finance $182 billion in new infrastructure investment, driven by participation by all 50 states, Washington, DC, and two territories.[3] The greatest share of BAB funding (30 percent) went toward educational facilities. Water/sewer projects (13.8 percent), road/bridge projects (13.7 percent), and transit projects (8.7 percent) accounted for the next highest totals.[4] The use of BABs accelerated many of these major projects, which not only tended to have longer maturities, but also had a $6.2 million higher issuance value on average than tax-exempt municipal bonds.[5]

Despite initial skepticism, the BABs program successfully spurred investment in job intensive and economically important infrastructure projects across the country, while also stabilizing the municipal bond market. Importantly, it proved that bond issuers and investors were extremely receptive to the tax-credit and subsidy model. [6] Concerns about high origination costs for these unique structures also proved to be a minor issue, as prices fell drastically over the life of the program.

Recently, Congressional budget sequestration put a damper on the market as across-the-board spending cuts reduced the federal BABs subsidy by 8.7 percent. Smaller localities, in particular, now face pressure to call their BABs for a full redemption to cut costs and to take advantage of historically low interest rates in the municipal bond market. Some large BABs have been called as well, including a nearly $500 million refinancing in Columbus, Ohio.

However, long maturities, large issuances, and contractual provisions against par-value calls, are likely to limit the number of BAB redemptions. Even in the face of these challenges, BABs still outperform both treasuries and tax-exempt municipal bonds in U.S. markets.

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[1] U.S. Department of the Treasury, "Analysis of Build America Bond Issuance and Savings," 2011.

[2] U.S. Department of the Treasury and Council of Economic Advisors, "A New Economic Analysis of Infrastructure Investment," 2012.

[3] U.S. Congress, Joint Committee on Taxation and the U.S. Department of the Treasury, "The Federal Revenue Effects of Tax-Exempt and Direct-Pay Credit Bond Provisions," 2011.

[4] Robert Puentes and Istrate, Emilia, "Whither Go the BABs?" *The New Republic*, 2010.

[5] Andrew Ang and others, "Build America Bonds," Cambridge: National Bureau of Economic Research, 2010.

[6] Lily Batchelder and others, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits," Stanford Law Review 59 (23) 2006.

Relative to the cost-savings for borrowers, the costs of administering a BABs program are quite low for the federal government. Based on initial government estimates, the annual cost of subsidizing the program under ARRA was approximately $340 million. Since the bonds were taxable, the government also expected to recoup some of these costs through the additional tax revenue produced. More recent estimates from the Joint Committee on Taxation put the annual net cost of a new BABs program at under $100 million.

The U.S. Treasury, furthermore, has indicated that lowering the tax subsidy from 35 to 28 percent would make the program revenue neutral "relative to the estimated future federal tax expenditure for tax-exempt bonds."[7] States and municipalities do not need the same aggressive subsidy they did after the 2008 financial crisis when borrowing costs spiked and the monthly issuance of bonds dropped by nearly one-third. It is important to note, however, that a significant drop in maturities would probably accompany the lower subsidy rate. At the same time, the true costs of the program to the federal government would not be known with complete precision, given the need to measure the amount of revenue currently being collected from tax-exempt debt.

Exempt Private Activity Bonds from the Alternative Minimum Tax

While municipal bonds are geared toward infrastructure projects with a public benefit, Private Activity Bonds (PABs) are directed at those projects that primarily benefit private entities but also serve some public purpose. PABs are issued by state and local governments for projects where more than 10 percent of the proceeds benefit a nongovernmental entity and are directly or indirectly paid back by a private business. In many cases, PABs are not tax-exempt and mainly cover privately-owned and operated facilities. Depending on the specific project, however, there are a range of qualified private activities that can be financed by tax-exempt PABs, including sewage facilities and high-speed intercity rail facilities.

Federal tax policy, however, has undercut the potential of PABs to pull sorely needed private financing into critical infrastructure projects. The Alternative Minimum Tax (AMT), in particular, has limited their ability to attract potential investors over time. As a tax on individuals and corporations, the AMT is enforced beyond the regular income tax and takes into account the taxpayers' alternative minimum taxable income, which includes interest earned on PABs. PABs are also not necessarily tax-exempt for certain airport facilities and are further burdened by the AMT.

Lacking an AMT exemption, then, PABs hold less appeal for investors in many cases, thereby driving down demand for future investment and hindering the development of new infrastructure. State and local governments, as a result, must pay higher interest rates on PABs—more than 25 basis points on average compared to other tax-exempt bonds—to compensate investors for their tax liability, which in turn leads to higher infrastructure costs.[8]

To address these challenges, ARRA included provisions that exempted new PABs from the AMT in 2009 and 2010 and allowed refinancing of PABs issued from 2004 to 2008, which has helped promote increased infrastructure investment. Still, if private investors are continually dissuaded from PABs as a result of the AMT, necessary infrastructure upgrades may be delayed or put off altogether. Without the proper incentives in place, as they appeared under ARRA, project delivery will remain slow, innovation

[7] U.S. Department of the Treasury, 2011.
[8] Government Finance Officers Association, "Issue Brief: AMT and Tax-Exempt Bonds," Washington, 2010.

will be stifled, and users will be subjected to rapidly outdated and increasingly inefficient facilities. Ongoing financial and regulatory uncertainty, moreover, will continue to impede the competitiveness of metropolitan areas.

Based on estimates from the Joint Committee on Taxation, eliminating the AMT on all PABs (including airports) could potentially cost the government about $49 million annually from 2012 to 2017.[9] At the same time, the exemption would generate billions of dollars in additional economic activity and lead to cost savings of almost $748 million for airports alone over the next ten years. Policymakers should be encouraged by these factors when considering a possible AMT exemption.

PABs play a large role in financing infrastructure projects across the country. Although many PABs are subject to a statewide volume cap (which creates a ceiling on the aggregate amount of qualified tax-exempt PABs that can be used in states each year), they help promote several short-term and long-term projects annually, ranging from highways to freight transfer facilities. Roughly $15 billion of qualified tax-exempt PABs have been issued annually in each of the past two years, with a notable increase following the AMT exemption in 2009. For example, the number of qualified tax-exempt PABs issued in 2010 marked the first increase in over three years. In contrast, when the exemption expired in 2011, the number of qualified tax-exempt PABs issued saw a marked decline (13 percent) across these projects nationwide.[10]

While some may emphasize the cost of an AMT exemption for PABs, the return on such an exemption far outweighs the expenditure. By making PABs more attractive to private investors, an AMT exemption can promote private and public sector involvement, which helps draw from a larger pool of investors and spread the financial risk involved in projects. This increased investment can consequently drive the construction of new infrastructure, improve public safety, fuel economic output, and create numerous jobs in the short and long term—all of which have stood as clear benefits in different proposals.

Establish a National PPP Unit to Support Bottom-up Infrastructure Investment

Leveraging private financial resources and expertise to design, build, operate, maintain, and/or finance infrastructure has growing appeal. Whether repairing, upgrading, or augmenting an existing asset or constructing new infrastructure, the intent is to improve project delivery, and better share responsibilities and costs between the public and private sectors. The evidence from other countries—including some with less friendly business environments than in the U.S.—shows that these arrangements, if designed and implemented correctly, have the potential to improve on infrastructure delivery.

However, public/private partnerships (PPPs) are complicated contractual arrangements that can vary widely from project to project and from place to place. As the challenges to infrastructure development throughout the U.S. become more complex, there is a constant concern that public entities in some states, cities, and metropolitan areas are ill equipped to consider such deals and fully protect the public interest.

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[9] U.S. Department of Transportation, "Final Report: The Future of Aviation Advisory Committee," 2011.
[10] Council of Development Finance Agencies, "2011 National Volume Cap Report," Columbus, 2012.

The U.S. Government Accountability Office recently noted that while the U.S. has done much to promote the benefits of PPPs, it needs to do more to assist states and metro areas in thinking through potential costs and trade-offs, as well as assessing national interests.[11]

A possible solution is the creation of a specialized institutional entity to assist with the expanding opportunities for PPPs. These so-called "PPP units" fulfill a variety of functions, including quality control, policy formulation and coordination, technical advice, standardization and dissemination, and promotion of PPPs.

Creating a federal PPP unit would provide states, cities, and metropolitan actors with the support and technical assistance needed from the procurement stage through long-term management of the projects by helping public actors determine the best Value for Money investment, assess long-term economic benefits of projects, and increase capacity to deal with contract changes over the life of the PPP. It would also create a more attractive, open, and robust environment that encourages private investment by creating predictability in the procurement process and demonstrating that the government actors involved want to "do business."

Looking around the world, PPP units are often located in a central government ministry (such as the Treasury Department) or in a line ministry that is closely related to infrastructure policy (such as the Department of Transportation). In the U.S., the Office of Management and Budget (OMB) is the most appropriate agency to house a PPP unit.[12]

Budget costs for a federal PPP Unit should be no more that $3 million annually. The PPP unit will be roughly the size of the Council on Environmental Quality (CEQ), located within the Executive Office of the President, which has a similar annual budget that covers support and administrative staff, as well as salaries and office and communications expenses.

There is no one-size-fits-all design of a PPP unit, but U.S. public entities could learn from experiences of other countries and from the growing track record in several U.S. states. A PPP unit reflects not only the needs of a particular PPP program, but also the administrative capacity and political structure of a specific government. Ultimately, the success of an American PPP unit will depend on a clear and consistent national plan and strategy for infrastructure development.

Create a Repatriation Tax Holiday to Capitalize a National Infrastructure Bank

Another way to provide technical assistance and expertise to states and other public entities that cannot develop internal capacity to deal with the projects themselves is through the creation of a national infrastructure bank (NIB.)

If designed and implemented appropriately, an NIB has the potential to leverage billions of dollars of private investment in important projects across the country. An NIB can not only provide a streamlined selection process for projects, but also apply a more rigorous standard for evaluating critical investments in energy, transportation, water, telecommunications, and other infrastructure assets

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[11] U.S. Government Accountability Office, "Highway Public-Private Partnerships: More Rigorous Up-front Analysis Could Better Secure Potential Benefits and Protect the Public Interest," GAO-08-44, 2008.

[12] Emilia Istrate and Robert Puentes, “Moving Forward on Public Private Partnerships: U.S. and International Experience with PPP Units," Washington: Brookings Institution, 2011.

attractive to private investors. Beyond bridges, roads, and other conventional projects, the NIB could spur cutting-edge investments in clean technologies, efficient energy distribution, and new resilient infrastructure assets.

The establishment of an NIB will send a strong signal to the private sector: the federal government is committed and open to private involvement in infrastructure financing and delivery. Today, private-sector financiers and investors are understandably frustrated with the lack of clarity concerning the rules of engagement when working with the federal government. This confusion hinders the development of robust public-private partnership markets in many states and localities.

Among the possible ways to capitalize an NIB, a one-time repatriation tax holiday could be used to unlock billions of dollars of domestically untaxed capital to fund the creation of a national infrastructure bank. In total, American corporations hold over $1.5 trillion in domestically untaxed deferred dividend payments that are routed through foreign countries including Ireland, the Netherlands, the Cayman Islands, Barbados, and other so-called "tax-havens." Because of the complexity and risk of these tax structures, the majority of firms that take advantage of these shelters are large and well-established corporations.

While a similar repatriation holiday created through the 2004 American Jobs Creation Act failed to generate significant domestic stimulus, a targeted program focused on infrastructure has the potential to deliver job creating and economy building projects for decades to come.

By directing a percentage of the recovered taxes into the NIB or compelling corporations to invest a portion of the repatriated funds into a special class of bonds that supports this institution, Congress can encourage infrastructure investment in a time of political gridlock. Depending on the specific goals of the NIB, capitalizing it can occur in a flexible manner as well, with levels ranging from $10 billion to $50 billion.

Of course, there are real costs associated with any repatriation based program. Firm behavior after 2004, for instance, illustrated how a new repatriation holiday can reduce government revenues in following years. The Joint Committee on Taxation estimates that a one year seventy percent deduction on repatriated profits capped at $500 million per firm would cost the Treasury $41.7 billion over the next decade.[13]

The overall cost of the holiday is driven both by the direct loss of revenue on regularly repatriated funds that are taxed at standard rates, but also by the long-term consequences of corporate behavior change. A repatriation holiday may incentivize corporations to restructure their foreign subsidiaries to hold more funds overseas, and they may relocate workers to tax-haven countries, hoping to reap the benefits of future tax breaks. Among other effects, the holiday can further complicate an already byzantine tax-code and increase horizontal tax inequality by giving special privileges to firms that chose to hold funds overseas, which in effect rewards tax-evading behavior. However, policymakers must also weigh the long- and short-term tax consequences of a repatriation holiday against the strategic and financial benefits of an NIB.

[13] U.S. Congress Joint Committee on Taxation, "Revenue Estimates for Two Dividends-Received Deductions Proposals," 2011.

Madam Vice Chairman, in this era of fiscal constraint I firmly believe the federal government will need to optimize the workings of the emerging federal-state-metro order. The urgency and complexity of the challenges facing the nation today suggest the need to devise new ways to increase impact and do more with less. At every turn, then, Washington should consider how to enhance the performance of the coming wave of co-developed, bottom-up problem-solving and then how to scale it up.[14] Most of what I have described would require legislative action, possibly as part of a major tax reform bill or through budget negotiations. It won't be easy but the time is ripe to invest in infrastructure projects that put us on the path to a more productive and sustainable economy.

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the staff, officers, or trustees of The Brookings Institution.

[14] Bruce Katz and Mark Muro, "Remaking Federalism | Renewing the Economy: Resetting Federal Policy to Recharge the Economy, Stabilize the Budget, and Unleash State and Metropolitan Innovation," Washington: Brookings Institution, 2012.