

## A National Infrastructure Bank: A Road Guide to the Destination<sup>1</sup>

President Obama has proposed a National Infrastructure Bank, a simple declarative sentence that left most listeners wondering what he meant. The confusion arises partly because the Administration did not follow up the President's remarks with a specific proposal, but also because the operations of such a bank have never been fully fleshed out. Felix Rohatyn and I have elsewhere laid out the broad outline of how such a bank would function,<sup>2</sup> and that description serves as a good starting point for our expectations regarding the President's proposal and what Bank-type proposals generally ought to do.

As many writers have noted, American infrastructure is depreciating rapidly – we are likely well below the replacement rate of investment in roads, mass transit, airports, ports, rail, and water assets. The logical implication is that we need to invest more. But more investment in and of itself will not move us towards having the right mix of infrastructure assets in place.

The current mix of infrastructure investments now results from one of two selection processes. The first is devolution to the states (for example the cost-sharing grants delivered by the Highway Trust Fund), and the second is selection by Federal agencies (e.g., the Corps of Engineers). At worst, these processes lead to politically motivated outcomes, either because state governments favor some projects for wholly non-economic reasons, or because the Congress can muscle the selection process from the federal agencies. The most recent transportation authorization bill, passed in 2005, made the word “earmark” famous by incorporating a stunning \$24 billion of them, the price of having a law passed. Insofar as we have given the task of project selection to the political process, it would be surprising if this kind of event *didn't* happen, not that it sometimes does.

Politicized project selection is one of several problems associated with the current process. But it is one of the reasons why a National Infrastructure Bank is so important and so urgently needed: not just because a Bank might be able to lever federal dollars, but because it can use the existing dollars more wisely and obtain a higher public return.

What follows, then, is a description of the role a National Infrastructure Bank could play, taken from the perspective of the specific problems in the current process it might solve. This perspective also allows us to evaluate the Administration's proposal.

In a nutshell, Rohatyn and I propose that we collapse all of the federal “modal” transportation programs into the Bank. Any entity – whether state, local, or federal – would have standing to come to the Bank with a proposal requiring federal assistance. The Bank would be able to negotiate the level and form of such assistance based on the particulars of each project proposal. It could offer cash participation or loan guarantees, underwriting or credit subsidies, or financing for a subordinated fund to assure creditors. Any project requiring federal resources above some dollar threshold (on a credit scoring

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<sup>2</sup> <http://www.nybooks.com/articles/archives/2008/oct/09/a-new-bank-to-save-our-infrastructure/?page=1>

basis) would have to be approved by the Bank. Additionally, we imagine that some part of the funding for existing modal programs would be converted into block grants sent directly to the states and large cities to be spent on projects too small for the Bank's oversight. Such grants could also be used for those programs desired by the States that do not pass muster on terms proposed by the Bank.

This is more a vision of infrastructure policy than a blueprint for the immediate future. Admittedly, it will take years and a meticulous reorganization to produce this configuration. But the best way to measure our progress in infrastructure policy (and the merits of the administration's proposal) is not to see how quickly we adopt the Bank's specific features, but to see how the Bank addresses the underlying infrastructure policy flaws it is designed to fix.

**1. *A Bank will evaluate infrastructure "needs" from an economic, not engineering, perspective.***

"Needs" are a biological, not economic, term. When engineers speak of national infrastructure "needs," they do so based on a standard related to the condition of an asset, not costs and benefits. That's not to disparage the work of engineering bodies that have far too often been our sole link to understanding the deficiencies of current policy. But there is a difference – an economic estimate has been subjected to a test that reflects willingness to pay. Absent this context, we may build perfectly good bridges, but some of them will go nowhere.

The primary feature of current policy that works to obstruct this test is cost-sharing grants. Too many programs operate under cost-sharing rules, which specify that approved projects will receive either 75 or 90 percent of project costs (in the case of roads), or 100 percent (in waterways). Absent some local "skin in the game," a local "want" can easily morph into a "need." A sizable improvement in the allocation of federal infrastructure resources would occur if we were to eliminate these modal cost shares and move to a more rational system. In many ways, all that follows is an extension of that principle.

**2. *Apples to Apples.***

Emerson may have called consistency the hobgoblin of little minds, but it is the foundation of rational investment calculation. In infrastructure, this means, at a minimum, consistency in the assumptions made for future economic growth and its constituents: inflation, the cost of capital and the discount rate, and the value of human life and the time lost to delay. The public financing of infrastructure also requires a consistent approach to such policy measures as environmental degradation, the fiscal carrying capacity of states and localities, the level (if any) of second-round employment and output multipliers effects, and the treatment of such diverse variables as the distribution of income and ancillary homeland security benefits.

Federal agencies are now obliged by the Office of Management and Budget (OMB) to use consistent values in their project analysis and capital allocation decisions, but their obligation to do so is ultimately not binding. These are opt-outs and, ultimately, the invisible but decisive weighting given to projects with political sponsorship.

The driving idea behind the Infrastructure Bank is that we can do much better than that. It would be utopian to believe that the Bank's presence would wipe the blight of political interference from the process. But it is possible to hope that projects above some threshold of federal involvement be publically and visibly evaluated and ranked by the Bank, so that their relative merits can be known. And it is not impossible to imagine that funding decisions be the rule rather than the exception.

The closer we get to such a rule, the better off we are, and the more rapidly so. Replacing a project anointed by a non-rational mechanism that has, let us charitably assume, a zero economic return with a positive rate of return above some threshold related to the cost of capital produces a prospectively mathematically infinite improvement in project benefits.

Rational project selection maximizes the effectiveness of spending. It also delivers better budgeting decisions and economic information. For one, it leads us to spend the next dollar on infrastructure on the project with the highest available return. It also allows us to understand far more accurately the level of net investment in infrastructure, by improving the value we assign to both the creation and depreciation of public wealth. It also allows us to more easily monitor our progress making up the backlog of viable infrastructure projects. This may be unduly idealistic or utopian as well, but no policy should be put in place without some idea of its ongoing success and when its job may one day be done.

### 3. ***“Because that’s where the money is.” (And a note on “leverage.”)***

So Willie Sutton responded when asked why he robbed banks. Infrastructure is almost the flavor of the month in private portfolio allocation. The landmark refinancings of the Chicago Skyway, Indiana Toll Road, and other projects have demonstrated the viability if not eagerness of private capital to enter this area. But, ultimately, these refinancings of old assets are tantamount to structured financings of toll receivables. This falls short of what would be regarded as optimal from an infrastructure policy perspective for two predominant reasons. First, the current structure of tolls is generally not the one that rationalizes the use of the asset – tolls are not used to respond to the level of congestion or to maximize asset use. And while such an approach *could* be subsumed within a private ownership framework, it inevitably involves capturing some portion of a road's monopoly rents. This implies that these private deals are not correctly structured; they need, as my colleague David Lewis has remarked, some sort of rate of return regulation that reconciles the public purposes of pricing with the perquisites of private ownership, a feature lacking to my understanding in existing deals.

Second and perhaps more importantly in the long term, the current arrangements for infrastructure finance fail to marry the private appetite to provide infrastructure financing with the availability of potentially profitable infrastructure projects. Investors will readily confess that the risks associated with building new infrastructure assets are too large and complex for them to bear. That is because no mechanism exists to calculate and separate public (social) and private (appropriable) benefits and that distinguishes among the risks accordingly. For example, cost overruns due to public sector project management are not fair game for a private investor, but failure to achieve traffic targets might be.

A Bank, beyond rationalizing project selection, offers the prospect of finding terms on which private money can enter the active provision of capital for new projects. Advocates for a Bank often speak of

gearing or leverage ratios when discussing the advantages of such an institution. But this leverage will be built from the ground up, on a project-by-project basis —if the government puts up ‘x,’ then private investors will be invited to put up ‘y.’” This is more likely than investors buying bonds or preferred stock from a Bank simply because it announces it is open for business. And if investors *do* flock to offer money in such a fashion, then it is likely because they have come to believe that the Bank has the same kind of implicit guarantees that other government enterprises have famously abused. One good measure of any infrastructure proposal’s success, therefore, is its ability to bring private risk capital to these investments on a case-by-case basis.

This raises the issue of “leverage.” Many Bank advocates talk about a Bank being able to “gear” or “lever” its investments by attracting three or four dollars of private money for each dollar of federal money. Yes, that is likely, but it is not pre-ordained, and the manner in which the Bank is designed will determine how this leverage occurs.

For example, some Bank advocates imagine that the government will capitalize a Bank by buying, say, \$50 billion of its bonds, and that the private sector will respond by buying \$150 billion of the same issue, leaving leverage of three to one. Others may equivalently suggest pre-determined shares of total Bank funding, “x” from the government and “y” from private parties. But if private investors provided money in this fashion, it would be because the Bank was regarded as another government-sponsored entity, as they did Fannie Mae or Freddie Mac, likely with the same result. The investors would not be buying the individual projects, but instead would be buying the implicit government guarantee.

This should be regarded as a failure, because it would mean that the opportunity to impose discipline on infrastructure project selection would have been squandered. The point of a Bank is *not* to extend government guarantees to the existing project selection process; it will get us “more” infrastructure, but “more of the same.”

Instead, this proposal achieves leverage on a *project-by-project basis*. A bridge is to be built, with a cost of \$8 billion. A reasonable appraisal of its engineering costs, traffic, and resulting financials suggests that private investors could finance \$6 billion at market rates of interest (hopefully, not tax-free rates of interest, so as to expand the lending pool to pensions funds and other institutional sources of funds). If some combination of state and local governments, together with the Bank’s subsidy window, were to provide the first \$2 billion, therefore, \$6 billion in private funds would enter to fund that specific project, either on a stand-alone basis or for a structured pool of projects developed in a comparable manner.

That is the right way to achieve leverage; private money joins the Bank’s money because it believes in the way the Bank analyzes projects, not because the government has winked and nodded and assured that money that it will earn a return through guarantees. Subsidies should be transparent, targeted, and negotiated so that they are sufficient to induce private financing on a project-by-project basis, with leverage the result. Blanket statements that “we will get three private dollars for each federal dollar we commit” presume a great deal, and should be probed to see *why* the private funds will appear.

#### **4. Getting off the Appropriations Merry-Go-Round**

The current funding system has a tendency to encourage state and local governments to put off needed projects in hope that they can secure appropriations funding in the future. The absence of an alternative to the current infrastructure project funding system holds state and local governments captive to that system, and leads good and important projects to be deferred or delayed.

Many believe that an improved levy system in New Orleans was postponed because there was always the chance that the city would be able to grab the brass ring in the merry-go-round of the annual appropriations process. Certainly, the state's political apparatus preferred that federal money first go to the state's barge navigation system (even if any calculations that demonstrated the superiority of that project, if they exist, were subsequently proved false). An associated source of delay is the carrying capacity of the jurisdiction in question. It seems unlikely that good, overdue projects in Illinois or Harrisburg – places in different stages of insolvency -- will get built anytime soon. More generally, funds allocated to infrastructure project too often follow the creditworthiness of the jurisdiction, not that of the project itself. This makes it harder for communities and regions to make the investments that might help in their economic improvement.

#### **5. Expanding the Search For Solutions**

Robert Moses became famous (and infamous) for pouring great amount of concrete. Will anyone ever become “the next Moses” by devising the greatest traffic optimization algorithm ever? At first, this suggestion might sound a bit odd, since planners always look to construction first to solve infrastructure services gaps, owing mostly to the the federal subsidies for building and the invisibility of non-structural solutions.

But the kind of Bank we have described could change in the way we think about this trade-off. In fact, it would most likely require such a change by forcing state and local governments to plan more rationally and put more of their own “skin in the game” when proposing new projects. This would give local governments strong incentives to think creatively to maximize efficiencies and returns on their own resources.

The modal infrastructure programs were designed to create a national set of facilities such as roads, airports, water treatment facilities, and so on. In their early stages, virtually any segment of the Interstate Highway System or new airport had a very good chance of having a positive economic return. But now that these systems are mature, there can be no doubt that other related activities can produce returns competitive with new construction. Writing almost two decades ago, Ned Gramlich found that the maintaining the Interstate to its current condition had an annual rate of return of 35, while the return to new segment construction was minimal.<sup>3</sup> That finding is likely to be even more true today.

We also face a challenge of managing existing assets in order to optimize their use. Pricing, technology, land use, and other non-structural solutions all have an increasingly important role to play here, but

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<sup>3</sup> “Infrastructure Investment: A Review Essay,” *Journal of Economic Literature* 32, (September 1994), pp. 1176-96

these are either not funded by construction-oriented programs or they require that costs be imposed on local users. On-the-ground infrastructure managers know this better than outside analysts or critics, but the system does not reward these solutions.

I believe that these local managers would welcome federal involvement that forces them to exhaust, or at least exhaustively review, these non-structural alternatives. This would free them up to implement solutions in which they had confidence and avoid pressures to devise new ways to spend free federal dollars.

But the good news is that having local users put some “skin in the game” is a good starting point for getting localities to broaden their search for solutions. Moreover, the Bank itself can move this process along. It can require that proposals be accompanied by a discussion of non-structural solutions, and by using its above-mentioned assumptions regarding state and local fiscal carrying capacity, social benefits, and the distribution of income, determine whether the costs borne by local users are adequate.

### **Looking Forward**

I believe a Bank is the right step in the evolution of federal infrastructure programs. We should implement one now, focusing it on a handful of national projects to begin – perhaps rapid inter-city rail, upgrading of the Chicago freight rail nexus, and modernization of the air traffic control system. We can then gradually expand the Bank – in part by imposing and gradually lowering the threshold of federal involvement that requires the Bank’s approval until the major projects of the modal programs have all been moved to the Bank’s selection process.

A Bank offers the prospect of dramatic improvement in infrastructure programs, but its proponents must temper their enthusiasm. The Bank is not a fountain of free money. The Bank model works because somewhere, somehow, someone must pay something that can be turned into a stream that repays private lending – that somewhere the salami can be sliced so that there is enough left to feed those private lenders profitably. This requires fees, bills, fares, or some other kind of payment; otherwise, private lending is only a veil for more public borrowing, and at a higher cost.

For that reason, a Bank needs to separate its credit enhancement and go-to-market activities in order to make clear the level of subsidy going to any project regardless of the form it takes. It will be a long time before a National Infrastructure Bank replaces the modal programs and imposes rationality on the current infrastructure financing system. But by looking at the way we appraise and select projects, the terms on which we invite private resources to the challenge of financing new assets, and giving localities and their users the right signals, we can measure our progress towards the horizon goal.