Written by: David Seltzer

Edited by: Nida Mahmud

Given the divisive atmosphere in Washington these days, it is difficult to find common ground on policy initiatives. Nevertheless, one topic for which there seems to be general agreement is the need for greater investment in America's infrastructure. The President made this one of his campaign themes and congressional leaders have said they are supportive of new policies to encourage investment. The challenge, of course, is deciding on the most effective policies, and then how to pay for them.

Understanding Federal Policy Tools

Federal policymakers have three broad sets of financial policy tools they can use to encourage infrastructure investment[1]:

Federal grants such as the Department of Transportation's (DOT) federal-aid grants through the Highway Trust Fund or the Environmental Protection Agency's Clean Water State Revolving Fund (CWSRF) capitalization grants have been widely used to assist infrastructure projects over the years. However, grants by their nature involve 'growing the government' through increases in federal expenditures. Each dollar of grant funding must be supported by an additional dollar of appropriations, and, to the extent the federal grants require only a twenty percent matching contribution from the state or local grantee, they result in only limited leveraging of non-federal funding sources into projects.

Federal credit programs such as the DOT's "TIFIA" program and the EPA's "WIFIA" program[2] provide loans to project sponsors at favorable rates that are often tied to the U.S. Treasury's own borrowing rate. The federal government as a lender bears the credit risk if the loan defaults. For state and local project sponsors with mid-investment grade ratings, direct federal loans at today's Treasury rates can represent a savings of about fifty basis points (half a percent) in annual borrowing costs when compared to tax-exempt debt financing. The scored budgetary cost of federal credit is relatively small, based on expected losses due to defaults. The DOT's TIFIA program, for example, makes loans with an average cost (or loan loss reserve) of only about seven cents of budget authority required for each dollar loaned out. But, the government must still issue Treasury obligations to fund the full face amount of TIFIA loans it makes, so the increased borrowing does count against

federal statutory debt limits.

Tax incentives involve exemptions, deductions, exclusions, and credits under the Internal Revenue Code that can lower the cost of financing or be used to attract funding to a project. Unlike federal grants or loans, most tax code measures do not involve federal outlays or borrowing. Additionally, unlike federal credit, they do not expose the government to default risk. However, they do have a fiscal impact in the form of foregone tax receipts over the claiming period (i.e. tax expenditures).

Tax-exempt municipal bonds represent the largest federal tax incentive for infrastructure projects today. The exemption reduces the borrowing cost because the interest received on such bonds is generally not taxable to the bondholder. It may result in a present value savings of about fifteen percent compared to taxable rate debt financing through commercial banks or the corporate bond market.

Tax credits are another form of tax incentive that allow an investor to apply them towards reducing its federal income tax liability. Tax credits have been used in connection with both debt financing (to subsidize part or all of the interest cost of borrowing, such as through Build America Bonds) and equity investment through investment tax credits (ITC). Current examples of ITC include historic tax credits for building restoration, low-income housing tax credits, and new markets tax credits for business investments in lower-income communities. The ITC can either be retained by the asset owner to augment its equity return or be "monetized" (converted to cash) by selling them to another investor with federal tax liabilities.

A Proposal for a New Investment Tax Credit

A new infrastructure-based ITC has recently been proposed for projects serving the general public– "Public Benefit Infrastructure"(PBI) investment tax credits. This proposal contemplates ten billion dollars of ITC being made available for projects each year over the next decade, totaling 100 billion dollars in tax credits. It would allow the state or local sponsor of a project to sell a stream of tax credits associated with a transportation or water project to a third-party investor who is not necessarily involved in delivering or managing the project. As proposed, the PBI tax credits would be sized at up to forty percent of eligible project costs and could be claimed in the amount of four percent per year over ten years, starting in the year the project enters public service.

The tax credit has been proposed at the forty percent level for two reasons: (1)

There is policy precedent with two similar successful federal ITC programs: Low-Income Housing Tax Credits (which are set at a level of forty percent for projects using tax-exempt debt) and New Markets Tax Credits (set at thirty-nine percent); and (2) It would provide a meaningful capital subsidy to projects while still requiring the majority of funding to be derived from other sources.

Attracting outside investors to purchase the ITC is expected to instill financial discipline, since the investors will need assurance from the entity delivering the project that it can be completed on time and within budget. The investor's ability to claim the tax credits would be dependent upon the project being completed and remaining open for business for at least ten years. There is no similar financial "hook" on grant-funded projects, which history has shown are vulnerable to cost overruns, project delays, and technical performance issues. In contrast, the tax credit investors will require the project owners to demonstrate that the project can be delivered and operated successfully.

The market value of the PBI tax credit (the amount that can be generated as a source of project funds) would be based on the return a "tax-oriented investor" would require. It would be a function of i) the period over which the credits could be claimed; ii) the annual amount of the tax credits; and iii) the return an investor would require, based on risk, liquidity, and other factors.

Under the similarly structured low-income housing program, investors generally seek returns in the five percent range for ten years. Based on this trend, the Public Benefit Infrastructure ITC sized at forty percent of eligible project costs is estimated to induce a net cash contribution of approximately twenty-five percent of eligible project costs, representing the present value of the tax savings after transaction costs. In this way, an infrastructure project— even if publicly owned and operated— could attract tax-oriented equity investment that is equivalent to a twenty-five percent capital grant. So, for a transportation or water system project costing 100 million dollars that would be eligible under the PBI program to receive forty million dollars in tax credits over the decade following project completion, tax investors seeking an effective five percent return should be willing to pay twenty-five million dollars upfront.

There could even be a way to make this tax incentive suitable for the nation's defined benefit pension funds, which represent nearly six trillion dollars in financial assets. Since pension funds are non-taxable entities, the primary financing tool of tax-exempt bonds does not benefit them. As a result, they invest very little in

American infrastructure presently. However, the program could be made attractive for pension funds *if* the ITC could be applied against the amounts they typically withhold from their monthly distributions of benefits to retirees for federal income tax purposes on behalf of the Treasury. By applying the credits against these withholdings, the pension funds could effectively convert a tax benefit into a cash benefit for their portfolios.

Conclusion

The Public Benefit Infrastructure proposal takes advantage of a concept that many federal policymakers support— investment tax credits— to generate a twenty-five percent upfront cash subsidy for participating projects.

The program could be applied not just to projects backed by user charges or those with private investors but also for traditional tax-supported government projects. Conditioning the tax credits on project completion and continued operations of the project should promote timely project delivery and continued project performance. The program would apply to both new projects as well as capital renewal of existing projects.

Compared to grants, ITC would have a much lower scored budgetary cost and a significantly reduced administrative burden. Compared to credit assistance, ITC would offer a much deeper subsidy and avoid subjecting the government to default risk. Furthermore, designing the program based on successful tax code precedents for housing and community development is anticipated to be much more politically palatable than seeking a massive increase in congressional appropriations. The coming months will tell if Congress is willing to give “credit” where it is due.

1. Regulatory streamlining of environmental and other permitting is not a financial tool *per se* but can be of great assistance to projects by expediting the pre-construction approvals. ↑
2. TIFIA stands for the Transportation Infrastructure Finance and Innovation Act (23 U.S.C. chapter 6) and WIFIA stands for the Water Infrastructure Finance and Innovation Act (33 U.S.C. chapter 52) ↑



David Seltzer

David Seltzer is a Principal and co-founder of Mercator Advisors LLC, a Philadelphia-based registered financial advisor formed in 2001. Mercator Advisors provides financial consulting services to governmental, corporate and non-profit organizations sponsoring major transportation projects and programs. Mr. Seltzer has over 40 years of experience in the field of public and project finance, working in both the governmental and private sectors, with an emphasis on transportation projects and policy. As Senior Advisor to the Federal Highway Administrator for three years, Mr. Seltzer was actively involved in designing and implementing new federal loan and other financial assistance programs. Before joining USDOT, Mr. Seltzer spent 20 years in investment banking, assembling public and project financings for transportation and other infrastructure programs, including Lazard Frères and Lehman Brothers. Mr. Seltzer holds a BA in Urban Studies from Trinity College, Hartford and an MBA from The Wharton School.
View all posts