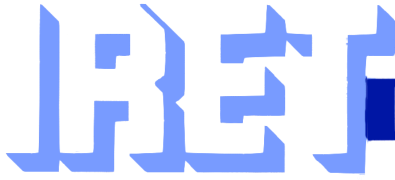

POLICY BULLETIN

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A BRIDGE TOO FAR

One of President-elect Clinton's major proposals during the campaign was a $200 billion program to rebuild America's infrastructure, with special emphasis on communication, transportation and environmental systems. His white paper, "Putting People First: A National Economic Strategy for America", declared: "My strategy puts people first by investing more than $50 billion each year over the next four years to put America back to work..." Later, it states: "To create millions of high-wage jobs ... we will create a Rebuild America Fund, with a $20 billion Federal investment in each year for four years, leveraged with state, local, private sector and pension fund contributions. User fees such as road tolls and solid waste disposal charges will help guarantee these investments."

These sentences have been widely interpreted to mean that Mr. Clinton intends to finance this fund with $20 billion a year in federal money and $30 billion a year derived from state and local sources and the private sector. Since the details of this proposal have not yet been presented to the public and the Congress, the white paper leaves many interesting questions regarding the sources of the non-federal monies and the means of obtaining them. The answers to these questions will be of great interest to those who manage private sector and state and local government pension funds and the current and future retirees who depend upon them, and to banks, insurance companies, and other lenders.

What Kind of Fund?

What will be the nature of this Rebuild America Fund (RAF)? Will it be a government managed and sponsored agency with appropriated contributions from the federal, state and local governments? Or will the state and local governments "contribute" through the purchase by their pension funds of bonds issued by the RAF? Will the private sector "contributions" consist of pension fund, bank, and insurance company purchases of bonds issued by the RAF? Will such purchases be voluntary or mandatory? Will such bonds be backed by the full faith and credit of the government? Who will decide what infrastructure will be built? Will the amount of spending in a state be related to the size of the state's contribution to the fund, making the RAF into a matching fund program such as the interstate highway program and Medicaid?

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What Will "Back" the RAF Securities?

Mr. Clinton says that "User fees such as road tolls and solid waste disposal charges will help guarantee these investments." That implies that the securities issued by the RAF will not be U.S. Treasury bonds, but something more like Ginnie Maes, backed by a dedicated revenue stream (user fees rather than mortgages) but not enjoying the support of the full faith and credit of the federal government or state and local governments either. If this is the case, and if these bonds are offered to the credit market for voluntary purchase, they will have to carry a significantly higher interest rate than ordinary federal securities.

Many states or state authorities have issued tax exempt bonds to finance toll roads and bridges, water supply systems, and public housing, and many of these have dedicated tolls and rents to service the debt. The bond issuers have had to do at least a rudimentary analysis of the likely revenues expected from these projects.

The federal government, however, has never felt the need for realistic cost-benefit analysis or projection of likely user fees to service a bond issue, doesn't issue bonds backed by anything less than the full faith and credit of the government, and doesn't issue tax exempt securities. Federal public works projects have never had to face even a minimal test of worth, and often reflect more political than economic value. Would these federally-influenced spending projects generate enough revenue to service the bonds? If they did not receive tax exempt status, would the RAF bonds be as marketable as state and municipal securities? Would taxpayers be at risk as ultimate guarantors of the securities, much as they have been the ultimate backers of the liabilities of failed S&Ls?

Forced Saving?

The talk of leveraging the federal contributions with a specific sum — $30 billion a year — from specific sources — state and local government and pension funds — raises another possibility, that these "contributions" might not be voluntary. If the government were unwilling to pay a higher interest rate on these bonds, its only alternative would be to <u>require</u> their purchase by banks, insurance companies, and pension funds, either directly or, as was the practice during World War II, by pressuring regulated financial institutions to include such bonds in their portfolios. This would constitute a forced draft on the nation's private sector saving (and/or state and local government pension funds) to finance federally-sponsored public works.

Fears of Pension Fund Beneficiaries

Some pension fund contributors and beneficiaries may fear that pension fund purchases of RAF issues might jeopardize their future benefits. It is unlikely that the bonds issued by such an agency would default, even if the projects they funded were not economically viable, because the RAF would undoubtedly have access to the Treasury and the taxpayer in some form or other. Rather, the potential damage to the beneficiaries would be in the form of a possibly lower than optimal yield, or greater than optimal risk, on the total pension fund portfolio.

Managers of private or state and local government pension funds must feel the assets they buy offer a good return for the level of risk attached to them. Each pension manager's portfolio consists of a diversified holding of stocks, bills, notes, CD's, commercial paper, and bonds. Some of the credit instruments are short term, others of longer maturity. Some are very secure but low-yielding assets and some are higher-yielding but of somewhat greater risk. Some are government obligations, some private.

If RAF issues were sold competitively in the bond market, they would pay a market interest rate, and they would give the buyers the same return available on similar securities. However, if pension funds were required to purchase a certain quantity of new RAF issues at less than the rate available on similar issues, the funds would clearly suffer some deterioration of the total return or structure of their portfolios. Pension fund managers might sell a like amount of similar securities already held (or refrain from purchasing more), maintaining an optimal portfolio mix at a lower yield. Or they could allow the purchases of the RAF issues to alter their portfolio mix, making up the yield with a riskier mix of assets, which would reduce their risk-adjusted yield outlook.

The Real Cost of the RAF

Whether the nation's saving is diverted to these government-favored projects through higher interest rates or mandated bond purchases, the real damage is the diversion of real resources from other, more valuable uses. The resources to be used up by the government in producing the infrastructure, modernizing communications networks, or improving waste management, could be used for other things, such as private investment in plant and equipment. If the infrastructure does less to enhance the productivity of the work force than the private investment it displaces, the infrastructure spending will reduce wages, employment, and GNP.

It is true, in the short run, that there will be a lot of high-wage jobs associated with the infrastructure creation in the construction trades, especially if they are built under Davis Bacon rules requiring "prevailing", i.e. union, wages. However, many of these construction jobs will displace other high-wage jobs in private sector activity, including privately-initiated construction or waste management projects, both by bidding up the price of the resources used in the projects and by loading up the private sector with additional taxes and debt service to pay for them.

After the infrastructure is in place, its ongoing contribution to employment opportunities and GNP will be the services it provides users, such as manufacturers shipping goods to market in competition with businesses abroad. The key question is, would those firms be better off and be hiring more people with an additional highway interchange down the street or an extra runway at the local airport, or with a more modern assembly line or more advanced product design? Getting goods to market appears to be less of a problem for American business than producing a high quality product cheaply at the plant. Ask any firm whether it would prefer an added interchange to an investment tax credit or a cut in the payroll tax, and, unless it is a road-building company, it will reply "you must be joking!".

More generally, when a pension fund buys a bond or a share of stock issued by a private sector borrower, the proceeds of the stock or bond issue are used to create an asset that earns future income that is used to pay interest or dividends to for the lender. For example, a modernized factory may double its output, and the revenues from the increased sales, in addition to paying larger wages to the factory's expanded work force, pay the shareholders a higher dividend. A new apartment building earns rents that pay the interest and principal on the mortgage, thereby servicing the mortgage-backed bond held by the lender. These earnings reflect added economic output that the lender has made possible and in which the lender shares.

When a pension fund buys a government bond, however, the proceeds are seldom used to finance an income-earning project, and the debt must generally be serviced with future taxes, transferring a portion of existing income from taxpayers to bondholders. This is clearly the case with spending on transfer payments; it is also the case with spending on defense, which yields defense services but no market sales and revenues. Occasionally, bond proceeds are used to finance government infrastructure, such as roads, bridges, ports, or airports. Such facilities produce some future services and enhance productivity to some degree. If they increase national productivity by more than the private sector assets they displace, they will generate a net addition to GNP, and whether the debt is serviced by tolls, user fees or taxes, they will leave the national income higher than before. If they enhance productivity by less than the private activity they displace, however, they will reduce the national income however they are paid for. (Note that a highly productive infrastructure project could be built and owned by the private sector and funded through user fees and tolls. If a private project proved to be less productive than alternative uses of the resources, it would be unprofitable, and the private owners would suffer the losses instead of the taxpayers.)

Conclusion

Before undertaking a major expansion of federal infrastructure spending, the purpose of doing so should be clearly understood. First, Mr. Clinton seems to think a massive new public works program is needed to create jobs and reduce unemployment. This is Roosevelt pump priming, no more likely to succeed in expanding employment than in the 1930s. Federal infrastructure spending should not be used to provide make-work jobs as was done by the Depression-era WPA. Infrastructure or other federal spending should be undertaken only if it enhances the productivity of the nation's resources in the future, and by more than the private activity it displaces.

Second, Mr. Clinton asserts that "The only way America can compete and win in the 21st Century is to have the best educated, best trained work force in the world, linked together by transportation and communication networks second to none." He implies that this huge public works program will help America compete in the global economy. Nations do not compete in the international economic arena; businesses do, one by one, product by product. U.S. productivity and competitiveness will be enhanced by letting the private sector invest in the machinery, training, communications channels, and even the transportation facilities it feels it needs, not by expanding government intervention in these areas.

To get America onto a higher growth path, Mr. Clinton should consider what the real sources of economic slowdown have been. They include rising taxes on American capital and labor, and increasing regulatory burdens on all businesses, small and large. The best way to renew vigorous economic expansion is to reduce businesses' production costs, and the best way to cut these costs is to cut government spending and taxes on capital and labor and to roll back regulations. Increasing government activity, even infrastructure spending, will raise costs confronting business.

In World War II, Winston Churchill, speaking about another RAF, said, "Never have so many owed so much to so few." If Mr. Clinton's RAF proves as ineffective as many other federal programs, Americans may say of it, "Never have so many owed so much for so little."

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.