COMMENTARY REDISCOVERING GOVERNMENT

The Other Debt Crisis

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To say it's been a bad week for government debt might be the understatement of the century. With Greece now in default and Puerto Rico careening toward the same fate, the full impact of their fiscal missteps on the global economy remains to be seen.

Stateside, however, where crumbling roads and bridges are prompting renewed examination of our infrastructure policy, governments are dealing with a different borrowing crisis—one that has received far less media attention.

Simply put, they are not borrowing nearly as much as they should.

It may sound counterintuitive to those who read only the headlines. The truth, though, is that a confluence of factors has created an environment in which issuing new debt would be a wise infrastructure policy choice for many (though certainly not all) state and local governments.

The Need Is Clear

Few doubt that we are in a crisis stemming from lack of investment in our infrastructure. Enough analyses exist that advocates can have their pick of statistics, from the $45 billion that Smart Growth America estimates is needed for annual highway upkeep, to the $3.6 trillion that the American Society of Civil Engineers has called for over the next five years. And these figures only concern quantifiable maintenance needs, without delving into the litany of social and economic benefits that infrastructure investment can bring.

Meanwhile, the cost of capital for government borrowers is about as low as it ever will be. As of Wednesday, the yield on Bloomberg's benchmark index of ten-year AAA bonds was below 2.4 percent. After accounting for inflation, the figure is even lower—close to zero, in fact. Not for nothing that Larry Summers, writing in the *Boston Globe* last year, called infrastructure investment "as close to a free lunch as economics will ever produce" when considering the potential for high-quality infrastructure to act as an economic multiplier.

The Hidden Investment

If governments issue debt in a responsible manner (and most do—the default rate on municipal bonds is extremely low), the arguments for using borrowed money to finance infrastructure make sense both in theory and in practice.

As Aaron Klein of the Bipartisan Policy Center noted at The Century Foundation's recent infrastructure conference, the key advantage of debt financing is that it allows multiple generations of users to pay for the project over the course of its useful life, rather than forcing the entire bill upon those who happen to be alive when the bridge or road is first built.

What's more, state and local borrowing is a relatively easy way to circumvent the federal government's increasingly diminished ability to invest in infrastructure.

While most discussions about infrastructure focus on the Highway Trust Fund, which doled out about $50 billion in 2013, there is another source of federal "spending" that is nearly as big: the revenue that Washington chooses to forego by allowing state and local governments to issue bonds whose interest is exempt from federal taxes.

The special tax status has long been the linchpin of "munis," since it allows governments to offer low interest rates while still appealing to a broad array of investors.

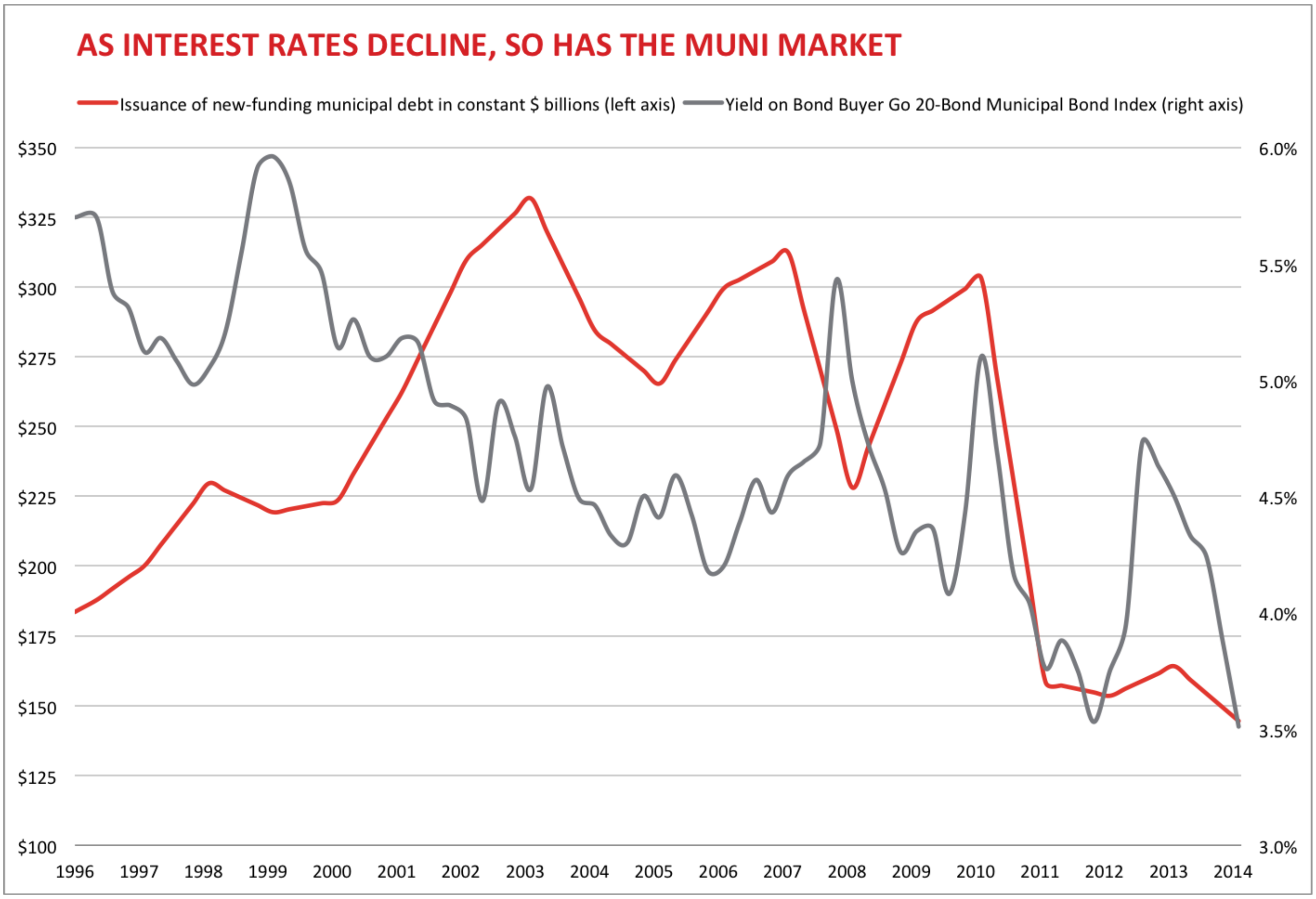
And while the merits of the system have faced scrutiny, no one can deny its popularity. A recent study from the Congressional Budget Office and the Joint Committee on Taxation estimated that the tax exemption is equivalent to an annual subsidy of $26 billion for infrastructure-related bonds alone—the equivalent of half a Highway Trust Fund.

It is also a unique kind of spending, in that Washington has virtually no control over its size or scope. If Michigan decided tomorrow to issue tax-exempt debt to finance a brand-new superexpressway through downtown Detroit, the federal government could not prevent it from doing so just because it's a terrible idea.

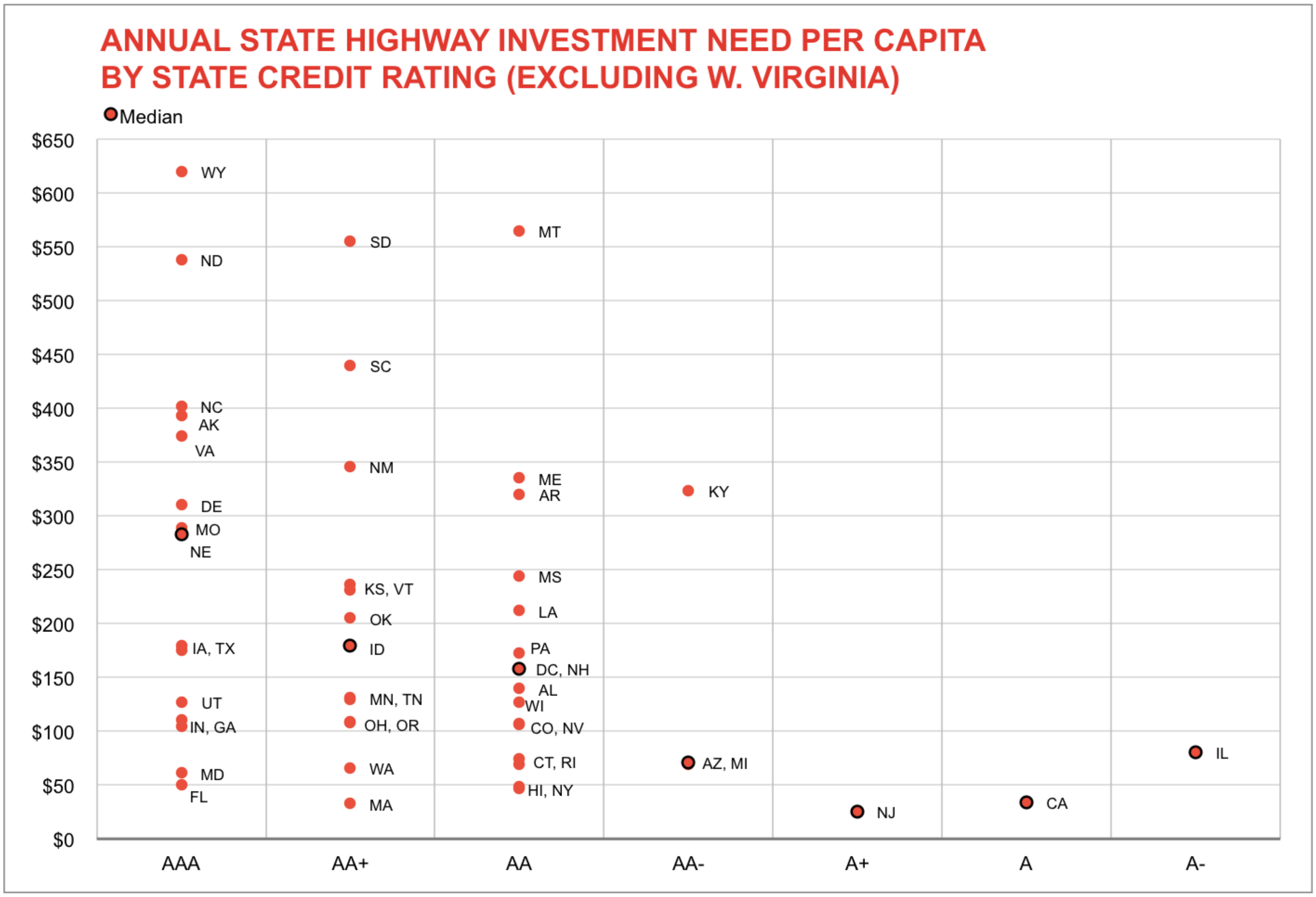
Conversely, there is little that Washington can do to encourage muni financing of the most severely needed infrastructure projects—such as a new rail tunnel under the Hudson River between New York and New Jersey—until stakeholders at the state and local levels amass both the political will and the necessary borrowing capacity.

The Political Roadblock

This reliance on the particulars of state and local governance helps explain why, despite the historically great need for spending and the historically low cost of capital, there has been no subsequent increase in borrowing. On the contrary, issuance of new-capital municipal debt was lower in 2014 than any other year in the past two decades, after adjusting for inflation.



For some governments, particularly those with looming pension-related crises, this hesitance to issue new debt is simply good policy. But this is hardly the case across the board. Returning to the study from Smart Growth America, which focuses exclusively on highways, it is clear that there are many states with substantial investment needs that also have easy access to cheap debt. In fact, the median per-capita investment needed for highways is *higher* in states with AAA credit than in states with lower-quality ratings.



This scenario suggests that there is a non-negligible amount of borrowing capacity for infrastructure that some states simply aren't taking advantage of.

In certain cases, this is because of stringent state-level rules on how infrastructure projects can be funded, as well as caps on the amount and kind of debt a state government can issue. Iowa, for example, is constitutionally limited to $250,000 in general obligation bonds, a drop in the ocean in the world of infrastructure. (Similar provisions often apply to municipal governments, as Patrick Sabol and Rob Puentes of the Brookings Institution recently noted.) In addition, twenty-one states have policies that discourage borrowing for infrastructure in favor of "pay-as-you-go" spending.

Elsewhere, however, it seems more likely that the only roadblock to issuing new bonds for infrastructure is the political process, fueled by the misguided perception that borrowing is *by definition* reckless. This should come as no surprise, given conservatives' obsession with reducing debt and the recent dominance of Republicans in gubernatorial and state-legislature elections.

Yet amid the prattle about fiscal irresponsibility in Greece and Puerto Rico, the biggest risk stemming from those governments' troubles would be to neglect the important role of debt in crafting a sound infrastructure policy. As long as interest rates stay so low, a lot of money is being left on the table. In time, state and local governments will regret not taking it—and our infrastructure will continue to suffer.

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