

# BUDGET SCORING, HIGHWAY PROJECTS, AND INNOVATIVE FINANCE

## *How the Tail Wags the Dog*

BRYAN GROTE AND DAVID SELTZER

**I**n recent years, much debate has been generated by the emergence of “innovative finance” as a key element of federal transportation policy. Advocates emphasize how innovative finance approaches can be used to leverage existing governmental funds by encouraging private participation in the delivery of highway infrastructure, which in most cases has traditionally been provided through public procurement and public (tax-supported) funding. Such approaches, it is said, can therefore accelerate and expand capital investment with limited governmental resources. Detractors claim that innovative finance is nothing more than common sense (if that), and is neither innovative nor particularly substantive. The concept is regarded by some as merely a marketing tool used by the federal government to soothe state and local governments frustrated over constraints on federal funding.

Which side of this debate is more persuasive? The answer depends largely on who is “keeping score,” and how.

### **Emergence of Innovative Financing**

Until quite recently, the federal government adhered strictly to a hands-off, programmatic approach to highway funding. (See article by Bloom and Bennett in this issue.) Funds were apportioned among the states under periodic authorization bills. Those funds were used primarily for 80 percent grants to eligible projects under various program categories through construction reimbursements from the federal Highway Trust Fund. As this federal-aid grant reimbursement program grew and matured over an 80-year period, elaborate rules were promulgated to protect a number of legitimate national interests, such as environmental protection, fair labor practices, and fiscal integrity.

Although federal assistance is still dominated by the grant reimbursement approach, the federal role in highway financing has recently been undergoing a subtle but important change, characterized by the introduction of new mechanisms such as flexible match, revolving funds, and credit assistance. This change began, by and large, with enactment of the Intermodal Surface Transportation Efficiency Act of 1991, and continued with the Federal Highway Administration’s Test and Evaluation finance research program (TE-045), the National Highway System (NHS) Designation Act of 1995, and enactment of the latest authorization bill (the Transportation Equity Act for the 21st Century, or TEA-21). The new finance strategies, designed to get more mileage from the federal dollar and attract private capital, comprise what is commonly referred to as “innovative finance” (see box page 16). A better term, however, might be “project finance,” since each of these techniques can be applied to help advance specific highway projects.

### **Importance of Budget Scoring**

To many observers, federal policy initiatives that encourage certain innovative finance tools yet discourage others appear to be inconsistent and inexplicable. For example:

- ◆ Why have federal capitalization grants for state infrastructure banks (SIBs) been spread out over a 9-year disbursement schedule when the banks need up-front capital in order to become effective?
- ◆ Why is it apparently preferable for the federal government to give money away as grants instead of lending it out and getting repaid?

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# Innovative Finance: The Basic Toolbox

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In recent years, states have begun to use a diverse set of financial tools to leverage their federal highway funds, improve cash-flow patterns for federal-aid projects, and ease matching requirements. Following is a brief summary of some of the more common tools.

## **Flexible Match**

A state may meet the nonfederal matching requirement for a given project (typically 20 percent) with a variety of alternative funding sources. Among the newly eligible sources of matching funds are private cash and in-kind donations, including right-of-way donations, and certain federal funds from nontransportation sources (e.g., Bureau of Land Management).

## **Partial Conversion of Advance Construction**

Advance construction permits a state to use its own resources to construct a project while preserving the project's eligibility for future federal-aid reimbursement. The state can then wait until the project is under way or completed before committing federal obligation authority, at which point the project is "converted" to federal aid. Under partial conversion of advance construction, conversion can occur gradually, according to cash-flow requirements. Thus a state can spread its consumption of federal obligation authority for a single project over several years.

## **Program-Level Match (Surface Transportation Program)**

A state may bundle individual Surface Transportation Program projects together for purposes of approval, administration, and matching requirements. In this way, certain projects may be wholly funded with federal funds and others wholly funded with nonfederal funds, as long as the overall federal contribution does not exceed the federal-aid matching limit across the full program of projects.

## **Reimbursable Bond Costs**

States have recently begun to experiment with grant anticipation revenue vehicles, or GARVEEs. A GARVEE is simply a debt instrument (short-term note or long-term bond) that uses a state's future federal-aid apportionments as the credit to support payment of principal and interest. Issuance costs and bond insurance premiums are also eligible for federal-aid reimbursement.

## **Reimbursable Loans**

A state may lend funds to sponsors of projects that generate revenues (e.g., tolls or dedicated tax receipts). The state may then obtain a "double reimbursement": (1) immediate federal-aid reimbursement of the lent funds, and (2) over time, principal and interest payments from the project sponsor. The state may use the repaid funds to support additional transportation projects or to capitalize a revolving loan fund.

## **Tapered Match**

On any given project, the federal-to-nonfederal matching ratio is permitted to vary over time, as long as the overall federal contribution does not exceed the federal-aid matching limit by the time the project has been completed.

## **Toll Credits**

Subject to maintenance-of-effort requirements, a state may apply the value of certain previous toll-funded expenditures toward the nonfederal match on current projects.

◆ Why are spending proposals now beginning to be assessed with the sorts of budgetary charges normally limited to tax code changes?

◆ And perhaps most important, why do the least effective innovative finance tools tend to be the most easily implemented?

The answers to these questions lie in federal budgetary scoring rules. Scoring is defined simply as estimating the fiscal effects of pending and enacted legislation. These calculations, carried out by federal budgeteers or "scorekeepers," are then compared against limits set in annual budget resolutions or periodic balanced-budget legislation (such as last year's Balanced Budget Act of 1997). The House and Senate Budget Committees, with the assistance of the Congressional Budget Office and the Joint Committee on Taxation, are the scorekeepers for the Congress. The Office of Management and Budget and the Department of the Treasury keep score for the Administration.

The current regime of budget controls was ushered in by the Budget Enforcement Act of 1990 (BEA). The overriding goal of the BEA was to bring discipline to the federal budget process and reduce the deficit, primarily by constricting discretionary spending (annual appropriations). By most accounts, the BEA has achieved remarkable success; federal budgeteers have attributed hundreds of billions of dollars in savings to its budget controls and scoring rules. The federal budget would not now be entering a period of temporary surplus were it not for the BEA.

However, this discipline at the aggregate level has come at the price of distortion at the program level. The centralized, prescriptive, cash-focused budget control process that has so successfully reduced (temporarily eliminated) the deficit has also favored short-term budgetary results over long-term policy goals. A framework in which all policy initiatives and fiscal decisions are viewed primarily in terms of their budgetary impacts over a 5- or 10-year "scoring window" is not necessarily conducive to good program decisions. Indeed, it is with this arcane though necessary process in mind that some refer to the federal budget-scoring "tail" as wagging the transportation policy "dog." And this situation pertains not just to transportation programs, but to virtually all federal spending.

## **Federal Finance Tools To Encourage Capital Investment**

In light of existing budget-scoring strictures (see box page 17), what highway financing tools can the federal government use to leverage public funding

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# Budget-Scoring Parameters for Innovative Finance Tools

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How do federal budget-scoring parameters influence the choice and design of innovative finance tools? Or exactly how does the budget-scoring tail wag the innovative finance dog? To answer these questions and better understand the evolution of innovative finance policies, it is useful to bear in mind the following "top ten list" of budget-scoring axioms:

1. *Cash is king.* Unlike governmental and corporate financial reporting, federal budgeting adheres to a cash basis of accounting. Budget controls focus on cash receipts (tax revenues), cash disbursements (outlays or spending), and budget authority. Moreover, financial impact is measured in nominal, not present-value dollars. ("Present value" is the financial tool used to compare cash flows occurring in different time periods. It involves the use of a discount factor to compute the value today of payments and receipts that are expected to occur in future years.) An important exception is credit assistance, which is treated on an accrual basis.

2. *No capital at the Capitol.* As a corollary of the first axiom, budget scoring does not distinguish between capital and operating expenses. Therefore, a dollar spent on current consumption (e.g., crop subsidies, welfare payments, federal salaries) is treated the same as a dollar invested in long-lived capital improvements.

3. *Single-entry accounting.* Budget scoring measures the fiscal impacts of legislation largely by means of single-entry accounting. It accounts for costs, which are relatively direct and measurable, but not benefits, which tend to be indirect and less readily measurable.

4. *Myopic vision.* Budget scoring calculates only the short-term fiscal impacts of legislation, within a 5-year scoring window generally and a 10-year window for the Senate. All subsequent effects are disregarded.

5. *Static-state universe.* Under budget-scoring conventions, the economy is assumed to be static; federal policies do not "expand the pie" (increase aggregate economic activity). Instead, they merely reslice the pie, shifting resources to a favored sector at the expense of one less favored. The effect of federal policies in spurring net economic growth is disregarded.

6. *Discretionary appropriators.* Under the Budget Enforcement Act of 1990 (BEA), discretionary spending (enacted through annual appropriations) is controlled by statutory "caps" that are established for each fiscal year. (Discretionary spending encompasses most of what is commonly considered general government spending, including national defense, transportation, and various other domestic programs. For fiscal year 1999, the President's Budget estimates an outlay cap on all discretionary spending of about \$570 billion, or just one-third of the proposed \$1.7 trillion total federal budget.) If Congress enacts appropriations that exceed those caps, a sequestration (across-the-board cut) is triggered to eliminate the excess. The "core" Federal Highway Administration spending programs, such as the National Highway System and the Surface Transportation Program, are subject to

annual obligation limitations imposed by the appropriators (the House and Senate Committees on Appropriations), and therefore are treated as discretionary spending. Although the appropriators technically still impose annual obligation limitations on the major highway programs under TEA-21, their ability to deviate from spending levels initially established by the authorizers has been significantly curtailed.

7. *Mandatory authorizers.* Under the BEA, mandatory spending (enacted through legislation other than annual appropriations) and tax receipts legislation are controlled by a separate requirement that such legislation enacted for a fiscal year must be deficit-neutral in the aggregate. If Congress enacts mandatory spending or tax receipts legislation that is estimated to cause a net increase in the deficit, Congress must offset that increase by either increasing revenues or decreasing mandatory spending elsewhere in the budget. The two FHWA spending programs that are exempt from annual obligation limitations—Emergency Relief and a portion of the new Minimum Guarantee program—are under the direct purview of the authorizers (the House Transportation and Infrastructure Committee and Senate Environment and Public Works Committee) and therefore are treated as mandatory spending.

8. *Bifurcated budget scoring.* Under the BEA, savings (reductions in spending) on the discretionary ledger generally cannot be used to offset costs (increases in spending or reductions in revenues) on the mandatory ledger, and vice versa. For example, reductions in core FHWA spending programs cannot be used to make room for increases in mandatory programs, even within a single account such as the Highway Trust Fund. This segregated treatment holds appropriators and authorizers accountable for legislative initiatives within their respective domains of the federal budget; however, it does not facilitate the resolution of budget-scoring problems that arise when a program funded from one side of the ledger is scored with costs on the other.

9. *The devil is in the details.* Budget scoring (the "tail") is driven by underlying assumptions (perhaps the "tailbone"?) of the budgeteers regarding disbursement schedules, participation rates, demographic factors, and economic assumptions. These essential but highly technical factors are often quite difficult to ascertain, and so can be somewhat arbitrary and subject to change, depending on the judgments (biases?) of individual scorekeepers. Moreover, there is no real forum for appealing what may appear to be a dubious or illogical scoring decision.

10. *The most important rule: There are no rules.* One last point to keep in mind is that there really is no fixed set of budget-scoring rules. Although a number of guidelines accompanied the original BEA provisions in 1990, the scoring of the federal budget occurs by means of conventions that are continually evolving. As can be seen by examining recent legislative proposals, the evolution of innovative finance is being significantly affected by wigs and wags in the budget-scoring process.

by encouraging additional capital investment? The specific tools available fall into three categories:

- ◆ Expanding regulatory incentives
- ◆ Pursuing tax incentives
- ◆ Encouraging alternative spending incentives

### ***Expanding Regulatory Incentives***

Regulatory incentives range from straightforward administrative guidelines to major policy-driven requirements. Most of the innovative finance tools developed to date for highway funding are administrative improvements to the existing grant reimbursement program. Generally, these changes do not significantly leverage public funds with additional sources of capital. But they do improve cash flows and give the states greater flexibility in managing their programs and projects, as demonstrated by the application of “tapering” in Washington State (see box below).

Examples of “cutting red tape” and otherwise streamlining procedures include the following:

◆ Allowing flexible matching of federal funds, for example, allowing private donations or “toll credits” to count toward the nonfederal share of project costs, or allowing the nonfederal share to vary over the life of a project.

◆ Permitting federal funds for state-advanced projects to be obligated (committed) in stages instead of all up front (partial conversion of advance construction).

◆ Approving greater participation of federal funds in toll projects, including demonstrations of congestion or value pricing.

Although the above tools generally support improved grants management rather than improved leveraging, they are viewed favorably by the states and are attractive to federal policy makers because they have no discernible budgetary impact.

The major policy-oriented regulations also tend to have minimal budgetary effects, but their political costs can be considerable. Some of the more notable examples include environmental



Innovative financing enabled WSDOT to complete SR 520 HOV lanes in Bellevue, Washington, 2 years early.

## **Regulatory Incentives**

### ***Tapering on SR 520, Bellevue, Washington***

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Administrative innovations that solve cash-flow problems generally have a minimal effect on capital formation. However, regulatory incentives can prove quite helpful when state and local transportation planners must overcome timing mismatches in funding for individual projects.

In 1995 the Washington State Department of Transportation faced just this kind of budgetary predicament. The state has a biennial budget process, which compels WSDOT to predict expenditures for individual projects and programs from 24 to 32 months in advance. If WSDOT errs in its predictions, the amount of state matching funds available to cover the nonfederal share of federal-aid project costs may prove insufficient.

By 1996 WSDOT officials recognized that a cash-flow crunch in matching funds was imminent. They also recognized that a significant portion of this shortfall was for the nonfederal share of a

permitting; labor protections, especially Davis-Bacon prevailing wages; affirmative action; and procurement provisions, such as Buy America requirements and design-build restrictions.

Sponsors of smaller projects tend to identify Davis-Bacon wage requirements as fertile ground for regulatory relief that would reduce project costs. Sponsors of larger projects want the federal government to do more to enable procurement using design-build contracts that would help control construction risks by offering incentives to private developers. (Under TEA-21, a state or local transportation agency may award a design-build contract, under regulations to be developed by FHWA, for a project costing at least \$50 million generally, or \$5 million for an intelligent transportation systems project.) Almost all project sponsors point to the National Environmental Policy Act review process as a candidate for federal streamlining. Not surprisingly, the above three measures are strongly opposed by organized labor, small contractors, and environmentalists, respectively.

Although waiving or otherwise rolling back such policies would arguably bolster highway investment by reducing costs and improving efficiency, the federal government has a legitimate interest in enforcing certain requirements related to national policy goals. It is at this end of the regulatory spectrum that promotion of infrastructure investment must be balanced with protection of national interests. This policy dilemma was evident in the contentious reauthorization debate concerning whether Davis-Bacon wage requirements should apply to SIB recyclings (funds that are repaid to the banks from nonfederal sources and then relent to subsequent rounds of borrowers)—a debate that resulted in the new SIB pilot program under TEA-21 being limited to just four states.

#### *Observing the Tail*

As far as we can tell, the budget-scoring tail for regulatory incentives is fairly short and harmless (like a Chihuahua's). This is to be expected, since such measures have little or no budgetary impact

\$21.3 million segment of a high-occupancy vehicle (HOV) project near the city of Bellevue. Postponing the HOV project until the spring of 1997 offered one way for WSDOT to stay within the rigid bounds imposed by state spending limitations that had been enacted the year before. At the same time, however, all parties acknowledged that deferral was an imperfect solution, for it would delay a badly needed improvement and subject the project to potential cost inflation.

A grants management strategy known as "tapering" came to the rescue. Tapering allows a more flexible schedule of federal reimbursement by permitting states to vary the percentage share of nonfederal matching funds over the course of construction. The state may vary its match in whatever manner it chooses, as long as the overall federal contribution on a given project does not exceed the prescribed federal-aid limit. For

example, the state may submit vouchers to the Federal Highway Administration for 100 percent of its expenditures in the early phases of a project's development and wait until later in the construction process to assume responsibility for the nonfederal share.

In the case of SR 520, WSDOT has begun by submitting periodic vouchers to FHWA to obtain federal reimbursement of 100 percent of the state's actual expenditures. WSDOT will continue to do so until the entirety of the permissible federal contribution has been met. From that point on, WSDOT will bear 100 percent of the cost of remaining expenditures until the project has been completed. Tapering allowed this project to get under way 2 years sooner than might otherwise have been the case.

(that is, they generally are not scored). Regulatory incentives may be the least effective finance tools in terms of leveraging federal funds with private capital, but they are helpful at the margin. And it is important to note that since they are not commonplace practices in many states, they have not yet reached their full potential.

### ***Pursuing Tax Incentives***

Tax incentives involve changes to the Internal Revenue Code to induce the flow of private capital into certain activities through tax-advantaged investment. Because such measures occur through tax legislation outside the appropriations process, they show up on the mandatory rather than the discretionary side of the budget ledger. The specific mechanisms may involve either debt (e.g., allowing tax-exempt status for certain types of otherwise taxable uses) or equity (e.g., encouraging tax-oriented equity investment in activities that otherwise would not occur, as with the “safe-harbor” leasing of transit rolling stock in the 1980s).

Because of the lower interest rates available in the tax-exempt bond market, most debt for transportation infrastructure projects is being issued through public agencies or special nonprofit corporations. The opportunities and shortcomings associated with the nonprofit corporation strategy are illustrated by the “63-20” arrangement (see box page 21).

Even though tax incentives require no explicit appropriations by Congress, they represent “tax expenditures” from a federal budgetary perspective. Tax expenditures are foregone receipts to the Treasury arising from a legislative provision. Under the “static-state universe” axiom (see box page 17), tax incentives are deemed to merely shift resources to tax-advantaged investments from presumably fully taxable investments that would have been undertaken absent the code change. Accordingly, tax incentives are victims of the “single-entry accounting” syndrome, whereby costs (tax expenditures) are measured assuming a constant level of activity, and any benefits that might stimulate the economy and generate additional tax revenues are disregarded. Paying for tax incentives becomes problematic, as scoring rules require tax expenditures to be offset by either revenue increases or spending reductions in other mandatory programs.

Tax incentives can be viewed as a helpful but not always sufficient condition for inducing private capital investment. For example, in 1988 Congress established a new class of tax-exempt private activity bonds for high-speed rail, allowing

privately developed or operated passenger rail projects to access the municipal market. Yet in the decade since, not a single high-speed rail project has been able to take advantage of the measure. The reason is that to be commercially viable, projects require greater financial assistance than the approximately 20 percent present-value subsidy of tax-exempt financing. Therefore, although tax incentives are generally more effective than regulatory incentives at leveraging public investment, they may not by themselves be enough to advance projects.

### ***Observing the Tail***

Since scorekeeping dominates the evaluation of tax proposals, the policy dog is wagged vigorously by the scoring tail (much like a Golden Retriever's). Nonetheless, it is possible for tax incentives to receive consideration. A recent example is the Highway Infrastructure Privatization Act (HIPA), which was part of the Senate's ISTEA reauthorization proposal, but ultimately was not incorporated into TEA-21. HIPA called for a pilot program that would have allowed up to \$15 billion of tax-exempt debt to be issued on behalf of highway projects with private participation. The future success of such a proposal may depend as much on the ability to identify unrelated offsets on the mandatory side of the budget as on any policy evaluation of the measure's economic or public benefits.

### ***Encouraging Alternative Spending Incentives***

Compared with regulatory and tax incentives, federal spending incentives are the most direct and effective way of inducing additional capital investment. Historically, spending incentives for federal-aid highways have aimed rather low, consisting principally of construction reimbursement grants that demanded no more than a 25 percent match (equal to 20 percent of total costs) from non-federal sources.

More recently, federal transportation policy makers have attempted to introduce new spending initiatives that would result in greater leveraging of federal budgetary resources. The two most conspicuous examples thus far have been SIBs and direct federal credit. As described below, however, these initiatives differ significantly in their fiscal feasibility and leveraging potential, again because of their budget-scoring treatment.

**State Infrastructure Banks.** SIBs were authorized initially by the NHS Designation Act of 1995 as a 10-state experiment. SIBs are state-established revolving funds empowered to make loans, pro-

## Tax Incentives

### *Nonprofit Corporations and South Carolina's Southern Connector*

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Within certain bounds, current tax law permits public-private partnerships to use tax-exempt debt when financing specific kinds of infrastructure. However, if a private entity develops and owns a highway or bridge project, issuance of tax-exempt bonds is prohibited. Moreover, project sponsors (including public agencies) cannot access tax-exempt debt when their plans include long-term performance-based management contracts with private operators.

In response to these constraints, both public and private project sponsors occasionally establish a financing conduit in the form of a nonprofit corporation. By virtue of its nonprofit status, the corporation is eligible to issue tax-exempt debt, and its position as an intermediary between private developer and public agency also permits entry into agreements for private development and operation of the project. The South Carolina Department of Transportation is employing this approach on a 16-mile tolled beltway segment, the Southern Connector. By means of a nonprofit corporation, SCDOT will realize the cost savings of a tax-exempt debt issue while deriving the benefits of private development and operation of this \$200 million project.

Most experts agree that this so-called "63-20" nonprofit financing conduit is currently the best means of preserving projects' eligibility for tax-exempt financing while enabling public agencies to enjoy the efficiencies of sharing risks and responsibilities with private-sector partners. The 63-20 designation refers to the relevant Internal Revenue Service ruling that authorizes this financial arrangement.

Notwithstanding the benefits of a 63-20 arrangement, insertion of a nonprofit intermediary into the middle of an arrangement complicates the flow of funds and may have other



South Carolina Department of Transportation Chair H. B. "Buck" Limehouse calls bulldozer operator to initiate construction of Southern Connector. *Right*, SCDOT Executive Director Elizabeth S. Mabry; *left*, Interwest Company President Bob Farris.

disadvantages as well. Karen Hedlund of the law firm of Nosaman, Guthner, Knox & Elliott, LLP, argues that while the 63-20 model works well for some projects, the nonprofit structure can suffer from three potential shortcomings. First, private developers are prohibited from making equity contributions to the project, and thus have no long-standing economic stake in the project. Second, payments to private operators may not be linked to net revenues generated by the project, a prohibition that rules out many kinds of performance-based incentives. And third, the need for public agencies to distance themselves from their private partners can potentially cause the private partners and even the nonprofit corporations to lack political accountability.

Greater flexibility in laws regarding private-activity bonds could offer project sponsors a wider array of choices in deciding how to couple public-private partnerships with tax-exempt debt. The Highway Infrastructure Privatization Act (HIPA), proposed by the Senate as part of its Intermodal Surface Transportation Efficiency Act reauthorization package, would have permitted 15 highway and bridge projects to move onto a level playing field with other types of infrastructure (including airports, docks, and energy facilities) by allowing them to be financed with tax-exempt debt as qualified private-activity bonds. However, HIPA did not win a place in the Transportation Equity Act for the 21st Century. Unless or until HIPA wins legislative approval, project sponsors may wish to pursue the 63-20 option if the savings offered by tax-exempt debt compare favorably with the efficiency gains associated with private-equity partnerships and long-term incentive-based contracts.



Financing construction of Southern Connector in Greenville, South Carolina, was facilitated by creation of a "63-20" nonprofit corporation.

vide credit enhancement, and offer other forms of nongrant assistance to surface transportation projects. SIBs are being capitalized with federal highway and transit grants from funds made available in fiscal years 1996 and 1997, plus the typically required state match.

The fiscal year 1997 Department of Transportation Appropriations Act expanded the original pilot program to allow additional states to participate and provided \$150 million from the General Fund to help capitalize the SIBs. Presently, 38 states plus Puerto Rico have been approved to set up SIBs, and several of them are actively originating loans. As mentioned earlier, TEA-21 establishes a new SIB pilot program. Under this program, just four states—California, Florida, Missouri, and Rhode Island—may capitalize their banks with federal transportation funds provided in fiscal years 1998 through 2003. The other 35 approved SIBs may continue to operate under the provisions of the NHS Designation Act of 1995, but they are not authorized to use federal transportation funds provided under TEA-21 for capitalization.

To date, most of the states have been planning to make loans through their SIBs, using contributed funds, to project sponsors seeking to fill gaps in their finance plans. At least one state, California, is seeking to establish a leveraged loan guarantee program, using fractional reserves of the SIB's contributed capital. By and large, the loan programs offer flexible terms such as below-market interest rates and junior liens on project cash flows. These flexible terms can be especially helpful when the loan is combined with a senior revenue bond issue, as illustrated by the State Highway 190 (George Bush Turnpike) project in Texas (see box page 23).

A recent report to Congress (1) indicates that the SIBs could achieve a 4:1 leveraging ratio; that is, they could induce 4 dollars of capital investment for each public dollar contributed. Ultimately, SIBs may be able to issue debt and enter into guarantees beyond their capital footings, but for the foreseeable future they are likely to be constrained in their scope of potential assistance. Thus they are best suited to helping small and intermediate-size projects of local or regional significance.

Even though SIB funds are employed by the states to provide projects with loans and other nongrant assistance, the federal funds used to capitalize SIBs are scored like traditional grants. From a federal perspective, this treatment is appropriate, because the dollars used to capitalize SIBs are remitted by U.S. DOT to the states in the same

manner as any other federal-aid funds. Consequently, any leverage that occurs (through private coinvestment) is external to the federal budget scoring.

However, there is a "tail" to be told here as well. The initial deal to accommodate SIBs in an outlay-neutral fashion required that any federal funds used to capitalize SIBs conform to the assumed spend-out pattern for conventional grant-funded highway projects. Thus arises the otherwise illogical disbursement constraint whereby a state that received \$1 million from the 1997 appropriations act to help capitalize its SIB could draw down only \$150,000 in fiscal year 1997, \$530,000 in fiscal year 1998, and so forth over 9 years. This delayed payout of paid-in capital, which was driven by overzealous budget scoring, has needlessly impeded the ability of the SIBs to get up and running. (Unconstrained SIB capitalization should have an imperceptible effect on the overall highway spending pattern, as it almost certainly would be lost in the "background noise" generated by the technical assumptions underlying the spend-out rate of the \$27-billion-per-year federal-aid program.)

**Direct Federal Credit.** U.S. DOT is pursuing a different spending incentive approach to assist "mega-projects," defined as major infrastructure typically beyond the capacity of traditional grant funding or SIB assistance. Direct federal credit involves the provision of financial assistance in the form of direct federal loans, federally guaranteed loans, or standby lines of credit. The federal government currently has more than \$1 trillion of credit outstanding in such sectors as agriculture, education, and housing. Until now, there has been no standing federal credit program to assist surface transportation projects, although in recent years three major projects in southern California have received credit assistance pursuant to special legislation (a \$120 million standby line of credit for the \$1.5 billion San Joaquin Hills Corridor toll road project, two standby lines of credit totaling \$145 million for the \$1.8 billion Foothill/Eastern Transportation Corridor toll road project, and a \$400 million direct loan for the \$2.1 billion Alameda Corridor freight rail project).

TEA-21 establishes a formal federal credit program for surface transportation projects through the Transportation Infrastructure Finance and Innovation Act (TIFIA). TIFIA is funded with \$530 million of contract authority to cover the budgetary or subsidy cost of up to \$10.6 billion in direct loans, loan guarantees, and lines of credit. These credit instruments will be used as supplemental and subordinate capital to finance up to

## Spending Incentives: Apportionment-Based Credit State Highway 190 (George Bush Turnpike), Dallas, Texas

MIRIAM A. ROSKIN AND JOANNE CARTER

To date, states have mainly used two apportionment-based mechanisms to offer credit assistance to project sponsors. The first is a Title 23, Section 129 loan, whereby a state lends a share of its regular federal-aid highway funding to a public or private entity. The second option is capitalization of a state infrastructure bank (SIB), which involves a transfer of apportioned highway or transit funds to a revolving fund. While most project sponsors would naturally prefer a grant over a loan, competing demands for scarce funds can make credit an appealing option. For projects on a tight timeline, credit today can be just as attractive as a promise of a grant many years from now.

State Highway 190 is a 26-mile segment of a tolled beltway around Dallas. The Texas Turnpike Authority (TTA) is the sponsor of this \$696 million project. Sources of funds for the project include \$28 million in right-of-way donations, \$20 million from the TTA capital improvement fund, \$67 million in interest earnings, a \$446 million toll revenue bond issue, and a \$135 million toll-backed loan from the Texas Department of Transportation. Two of five loan disbursements were made under Section 129. These obligations have since been adopted by the Texas SIB, which will also disburse the remaining funds and receive repayment of the full loan amount, plus interest.

The \$135 million loan plays an essential role in the total financing package and proved critical to ensuring the affordability of the \$446 million revenue bond issue. The loan's terms were driven primarily by a bond covenant that required debt service coverage on outstanding senior debt obligations to equal or exceed 1.20 times debt service, or 1.20x. The flexibility of the loan provisions is evident in three categories:



George Bush Turnpike was completed 15 years earlier than would otherwise have been possible as a result of \$135 million state infrastructure bank loan from Texas Department of Transportation.

**Interest rate.** Financial analysis revealed that the interest rate on the loan could not exceed 5 percent without reducing coverage below the 1.20x threshold. Ultimately, the lender (TXDOT) and the borrower (TTA) agreed on a 4.2 percent rate. At this level, the rate was affordable for TTA, given its coverage constraint, and also represented a fair repayment rate for TXDOT.

**Subordinate status.** Estimated toll revenues were not expected to be sufficient to provide 1.20x coverage on a \$700 million bond issue (the full cost of construction). TTA and TXDOT offset approximately \$120 million with a variety of cash and in-kind contributions. TXDOT displaced an additional \$135 million of revenue bonds with the loan. Because the loan occupies a subordinate position, it allows toll revenues to be available first and foremost to provide coverage of debt service on the senior revenue bonds.

**Repayment stream.** Repayment of the TXDOT loan will begin in 2004 and be completed in 2029. Debt service has been structured to escalate, mirroring the expected flow of toll revenues. This schedule allows TTA to demonstrate 1.20x coverage on both the loan and senior debt obligations, after paying operations and maintenance. Although the 1.20x coverage ratio was required only for the senior debt, demonstration of a 1.20x coverage level on all project debt underscores TTA's credit strength. Coverage on the senior debt is projected to range from 1.33x to 2.27x over the life of the bonds, and even uninsured, the bonds were awarded investment grade ratings of A, A-, and A-1 by the three leading rating agencies. With insurance, the bonds received a triple A rating.

Ultimately, the loan's inclusion in the mix of financing sources accomplished three things. First, a below-market rate was obtained for almost a quarter of TTA's borrowings, reducing the debt service burden on the project. Second, the loan's subordinate status helped enhance the ratings on the TTA revenue bond issue. And third, as the loan is repaid with toll revenues, the repayments will transform a one-time grant of federal-aid funds into a foundation for a self-sustaining revolving fund. Taken together, these financial benefits and the innovative partnership between TXDOT and TTA have enabled an important extension to the beltway to be accomplished at least 15 years sooner than would have been possible under traditional pay-as-you-go financing.

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33 percent of project costs, with the balance to be financed from private capital market debt or other nonfederal sources.

The Federal Credit Reform Act of 1990 (FCRA) governs the provision of all federal credit activity (nongrant assistance). FCRA sets forth a consistent set of budget-scoring rules for evaluating the cost of credit assistance. Significantly, federal credit is virtually the only element in the scoring process that is accounted for on an accrual, present-value basis. For this reason, both a direct federal loan (whereby the federal government funds 100 percent of the loan amount) and a federally guaranteed loan (whereby some other party funds the loan, but the federal government retains the default risk) are treated similarly under FCRA: the budgetary cost to the federal government is based on a present-value calculation of expected losses due to defaults and (if applicable) interest rate subsidies below the government's own cost of funds. The scored budgetary charge is known as the "subsidy cost."

This refreshingly logical scoring treatment makes federal credit extremely potent from a budgetary viewpoint, since funding a direct loan, loan guarantee, or line of credit may require an appropriation equal to only a fraction of the face amount of credit. For example, the Alameda Corridor loan was scored at 15 cents on the dollar, and the three standby lines of credit were scored at about 7 cents on the dollar.

To the extent that the federal share is limited to a minority portion of the investment (such as with TIFIA, which caps the federal share at 33 percent), there is thus both internal leveraging (fractional budget scoring) and external leveraging (significant

coinvestment) of the budget authority required. The combined leverage multiplier can be many times greater than traditional grants or even SIBs, as shown in Table 1 and illustrated by the San Joaquin Hills and Foothill/Eastern transportation corridors. (See article by Kreutzen and Roskin in this issue.)

#### Observing the Tail

SIBs and direct federal credit show how budget scoring can either undermine or support federal policy initiatives (and sometimes do both simultaneously). The 9-year disbursement schedule associated with SIB capitalization grants cushions the scoring impact but dilutes program effectiveness—a classic case of the tail wagging the dog. In contrast, the fractional scoring of federal credit instruments on an accrual basis—reflecting their true economic cost—aligns budgetary treatment with the policy objective of leveraging federal resources with private capital.

Yet paradoxically, federal budgeteers have resisted credit initiatives. Some budgeteers appear to prefer traditional programs under which federal funds are disbursed in the form of grants (where the full budget cost is known with certainty) to credit programs under which assistance is extended to projects that can afford to repay (but where the fractional budget charge could underestimate the default risk). The perverse result is a bias toward less cost-effective grants over more cost-effective loans, loan guarantees, and lines of credit for certain revenue-generating projects.

Recently, federal budgeteers have begun assigning tax expenditures (mandatory costs) to discretionary spending provisions. For example, the SIB proposal in the Senate's reauthorization bill (which

TABLE 1 Grant Reimbursements, State Infrastructure Banks, and Credit Assistance<sup>a</sup>

Program	Federal Share of Project Costs	Budget Scoring (cost per dollar of federal assistance)	Effective Cost of Federal Share	Leverage Ratio (capital investment vs. budget impact)
Traditional Federal-Aid Grant Reimbursements	\$80.00	\$1.00	\$80.00	1.25:1
State Infrastructure Banks	25.00 <sup>b</sup>	1.00	25.00	4:1
Direct Federal Credit	33.00 <sup>c</sup>	0.10 <sup>d</sup>	3.30	30:1

<sup>a</sup> Assumes an infrastructure project costing \$100.

<sup>b</sup> Will vary from project to project. Based on June 1997 Report to Congress (1).

<sup>c</sup> Maximum federal share under TIFIA in many cases would be smaller; will vary by project.

<sup>d</sup> Estimated average; will vary by project, depending on creditworthiness.

would have allowed all states to capitalize SIBs with federal transportation funds authorized for fiscal years 1998 through 2003) was assigned a tax expenditure based on a scorekeeping assumption that the measure would induce a greater issuance volume of tax-exempt debt. This outcome is far from certain; in fact, the limited activity of SIBs to date suggests that the program could actually reduce the amount of tax-exempt debt as projects substitute lower-cost, subsidized SIB loans for bond proceeds. Clearly, the relationship between spending provisions such as SIB capitalization and secondary tax revenue effects is ambiguous at present and requires further study before a decision is made on whether any mandatory costs (or savings) should be assessed.

SIBs and direct federal credit therefore appear to be two cases in which the scoring tail is not only wagging the policy dog, but also at times chasing it—a veritable German Shepherd.

## Every Dog Has Its Day

Innovative finance, at least in the context of recent federal transportation policy, essentially involves the use of regulatory, tax, or spending incentives to support private participation in project financing. The presumed end result is greater and more efficient capital investment in transportation infrastructure. But to what extent have innovative finance tools been utilized, and how effective have they in fact been?

If one looks at the number of finance innovations or tools that have been introduced in recent years, innovative finance appears to be a success. On the one hand, it is possible to identify nearly a dozen initiatives at FHWA that have been gathered under the innovative finance rubric. On the other hand, many of these are regulatory incentives that are not particularly powerful levers for stretching federal funds. Yet given the fact that most of a state's projects will not generate their own revenue and must be financed through grants, these enhancements are to be welcomed.

The central fact affecting innovative finance (and indeed federal policy making generally) is that because of the various budget-scoring para-

meters, innovative finance favors programs that are the lowest scored (or most easily paid for), instead of those that are the most effective in attracting private capital. Therein lies the answer to the fundamental question posed at the beginning of this article: why the least effective innovative finance tools tend to be the most readily implemented.

It is unfortunate that federal tax and credit proposals, which have by far the greatest leveraging potential, also are affected the most by budget-scoring restrictions. To date, this has significantly curtailed their use. However, based on the most recent action of Congress in passing TEA-21, the environment may be changing. The establishment of federal credit programs for surface transportation projects offers a national laboratory for testing the prudence and effectiveness of a new innovative finance tool for stimulating capital investment in transportation infrastructure.

As the new authorizing legislation is implemented, we should keep in mind that the “dog”—federal transportation policy—will continue to be wagged by the “tail”—budget-scoring rules. In considering innovative finance initiatives, Congress and the Administration will have to answer the question not just of “whether that dog will hunt” (whether the program will be politically attractive), but perhaps more important “whether that tail will hunt” (whether the program will be scored reasonably). And that question will remain a bone of contention between policy makers and budgeteers for many years to come.

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NOTE: *The opinions expressed in this article are those of the authors, and should not be construed as representing the views of the Federal Highway Administration.*

## Reference

1. *Report to Congress: Evaluation of the U.S. Department of Transportation State Infrastructure Bank Pilot Program.* Federal Highway Administration, U.S. Department of Transportation, June 1997.