

Chicago Fed Letter

Best practices for financing Illinois infrastructure: A conference summary

by Richard H. Mattoon, senior economist and policy advisor, and Sarah Wetmore, vice president and director of research, Civic Federation

On April 5, 2019, more than 140 academics, business leaders, government officials, and policy researchers came to the Federal Reserve Bank of Chicago to explore how best to design and finance an infrastructure program for Illinois. The program, presented by the Civic Federation and the Chicago Fed, focused on how to improve the transparency of infrastructure project selection and to ensure that sustainable funding is identified to support efficient infrastructure operation.

Diane Whitmore Schanzenbach, Northwestern University, provided an economist's framework for understanding the potential value of infrastructure investments.¹ She began by asking why public dollars should be used to fund infrastructure. Infrastructure projects often provide broad public benefits, she said, and underinvestment in infrastructure may be an element in poor productivity growth in the U.S. economy. Schanzenbach noted that despite attractively low borrowing costs in an environment of low interest rates, infrastructure investments have lagged.

The conference agenda and some of the presentations are available online, <https://www.civicfed.org/events/unlocking-the-box>.

Schanzenbach suggested three criteria for selecting infrastructure projects. First, is there a role for government (specifically, is there an identifiable market failure)? Second, do the benefits from the project outweigh the costs? And third, are downstream costs properly recognized (for example, will the construction be durable and are maintenance and repair costs included)?

So who should decide what projects are undertaken? There are advantages and disadvantages to federal, state, or local decision-making on infrastructure, Schanzenbach said. State and local funders may be better able to gauge the value of a project, but may have more difficulty funding the effort. Federal authorities may have easier access to finance and may be able to create criteria that identify costs/benefits across jurisdictions. An important criterion, she added, is that the decision-maker should be insulated from political influence so projects are undertaken based on the technical merits of the proposal. In addition, having a transparent set of metrics to score projects is important, she said. Studies suggest that investment returns to infrastructure maintenance can be very high, but often these sorts of investments are less attractive politically than highly visible new construction. A scoring system can identify the benefits of a given project.

How are projects to be funded? The traditional mechanisms are debt financing and user fees. Given that infrastructure can be long-lived, using debt that matches the life of the infrastructure can be efficient. Similarly, projects based on user fees (such as toll roads) can be calibrated to reflect the stress that the user places on the infrastructure and provide sustainable and predictable funding. Schanzenbach suggested that using general taxes can be distortionary, given that there is no market test for relating the value of the taxes paid to the benefit from the asset. Finally, she said, public-private partnerships (PPPs) can be used to provide external funding, and this approach has the advantage of spreading not only the costs but also the risks of the project.

Building an infrastructure plan that meets critical needs

Nicholas Donohue, deputy secretary of transportation, State of Virginia, described Virginia's SMART SCALE (System for the Management and Allocation of Resources for Transportation) project prioritization process, which was passed unanimously by the legislature in 2014. It requires the state Transportation Board to use quantifiable and objective measures for scoring infrastructure projects. The legislation was in part a reaction to a \$1 billion increase in transit funding that had been approved the previous year and a desire to show that money was being spent effectively.

Donohue said the keys to political support include recognizing that different parts of the state have different infrastructure needs, as well as not favoring a specific mode of transportation. In addition, a campaign of public engagement was undertaken throughout the state that led to 27 Transportation Board public hearings, as well as individual meetings with every metropolitan planning organization and stakeholders in every construction district.

All Virginia infrastructure projects (regardless of type) are evaluated in the following six categories:

- Congestion mitigation;
- Economic development;
- Accessibility;
- Safety;
- Environmental quality; and
- Land use (in areas with populations over 200,000).

This produces a transparent score for every project that is submitted for funding. Currently, 21% of the projects submitted receive funding based on this scoring system. Donohue suggested one of the big benefits of the process is that it creates an incentive for the local agency submitting the project to consider creative ways to achieve their goals at significantly lower cost. In addition, by having the project scores available publicly, the rationale behind why some projects are funded and others rejected becomes clear. Once a project is selected, it is fully funded.

Next, Tom Kotarac, vice president of transportation and infrastructure, Civic Committee of the Commercial Club of Chicago, made the case for why the business community is interested in reforming Illinois's process for creating capital bills. In the past, capital spending was often tied to one-time, nonsustainable revenues and was used to fund infrastructure often without regard to its financial or economic return. What has been lacking, Kotarac argued, is a performance management system like Virginia's that objectively scores the value of capital projects. Further, he said, a capital plan should try and incentivize innovation and leverage federal resources.

Michael Pagano, dean, College of Urban Planning and Public Affairs, University of Illinois at Chicago, explained why infrastructure maintenance is often overlooked and undervalued in infrastructure investments. First, grant formulas have tended to favor building new infrastructure, Pagano said, and this is compounded when economic downturns hit states, usually leading them to further reduce maintenance spending in favor of operating programs. The costs of deferral are often invisible.

Pagano raised three issues that might improve maintenance funding. First, he said, infrastructure funding should reflect life-cycle costs. Maintaining the asset ensures that the performance of the asset is protected over its useful life. Second, if a capital budget is adopted, he argued, it should establish a maintenance fund that can provide sustainable support to maintain capital assets. Third, he added, a good infrastructure plan should incentivize repair and maintenance. The failure to do this often reflects a pricing problem, in the sense that the infrastructure asset outlasts the political term of office of any elected official. As such, he argued, elected officials often lack the incentive to invest in maintenance when the costs of deferred maintenance will become evident only when they are out of office.

Currently, only four states actually measure their maintenance costs. Utah has gone as far as establishing a maintenance fund, with 1.1% of the cost of a new building dedicated to maintenance. Finally, Pagano touched on the need for a federal infrastructure bill. He suggested now would be the time to design an infrastructure mechanism that could be used as countercyclical support in an economic downturn. The plan would only be triggered, he said, in the case of a recession.

Dorval Carter, president, Chicago Transit Authority (CTA), described the infrastructure challenges facing the CTA, which is the second-largest transit system in the U.S. The CTA has recently made \$8 billion in new investments and yet is still facing capital needs of \$23 billion. Carter noted that state support for both the operating and capital budget has been eroding for a decade. The CTA receives 57 cents per ride in state support, versus a state subsidy of \$1.12 per ride in New York City and \$3 per ride in Boston.

Carter argued that new revenue has to be considered. Options include hiking the state's gas tax for the first time in 30 years, as well as congestion management fees and/or ride-hailing fees for Uber and Lyft. Currently, the CTA is trying to meet its backlog by issuing bonds, taking federal TIFIA² loans, and creating tax increment financing districts for transportation. The reliance on issuing debt is creating stress in the operating budget; the CTA's debt service costs have risen to \$48 million in 2019. Carter argued that the city's economy receives \$4 in value for every \$1 of transit system assets.

Bang for your bridge? How Illinois should (and shouldn't) fund infrastructure

State of Michigan treasurer Rachael Eubanks described the \$2.5 billion road construction plan that Governor Gretchen Whitmer included in her inaugural budget proposal. Eubanks said that the State of Michigan is at a crossroads: Will it invest in its future to compete and grow, she asked, or will it decline? Governor Whitmer ran on the idea of fixing the roads in Michigan, which are in a poor D+ to D- rated condition and projected to get worse without intervention. The governor's proposal is to increase the gas tax by 15 cents every six months in three stages, starting in October 2019 and ending in October 2020. The program is intended to prioritize high-value, high-traffic roads with a goal of getting 90% of Michigan's roads in good or fair condition by 2030. Governor Whitmer has also proposed a \$120 million supplemental plan to address Michigan's clean drinking water infrastructure needs. Putting the Michigan gas tax increase in a national context, Eubanks noted that 22 states have passed legislation increasing their motor fuel taxes on a bipartisan basis in the past several years. She acknowledged that the governor's proposal has received some pushback, but said it has also received support from business and civic groups concerned about the repair costs to vehicle owners from traveling roads in poor condition and the overall economic cost of poor transportation infrastructure.

Carol Spain, S&P Global Ratings, gave an overview of how the State of Illinois currently funds capital spending and its myriad financial challenges. Roughly 41% of Illinois's capital spending is funded through debt and 59% is pay-as-you-go funding, mostly from the motor fuel tax, license and registration fees, and federal funds. However, revenue streams to fund debt come out of the state's general operating budget, so debt service crowds out other spending and competes with pension payments. A problem Illinois faces is that its revenues from the motor fuel tax only increased by 6% between 2012 and 2018, well below inflation, due in part to more fuel-efficient cars, which means that revenues are not keeping up with ever-growing needs. The state plans to issue \$5.6 billion in debt in the coming year, Spain said, but only \$1 billion of this will be for infrastructure. She added that Illinois has the lowest bond ratings of any state by far, which increases the cost of borrowing.

Looking at Illinois's debt burden relative to other states, Spain said, its debt service as a percentage of general government spending is high but not the worst in the nation, and the same is true

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for its tax-supported debt affordability ratio. Spain said that if the State of Illinois were to issue more debt for infrastructure, whether that would tip its rating into noninvestment grade would depend on the state's liquidity and how the debt could affect the operating budget. Overall, Spain said, Illinois is in a weaker position than many other states to

finance debt, given its fiscal distress. However, if the state doesn't spend on infrastructure, she argued, the state's economy and ability to repay debt could weaken further anyway. The key to the state's future infrastructure spending is going to be finding a sustainable source of revenue, she concluded.

Ted Hamer, KPMG LLP, said the recently approved gas tax increase in Ohio and proposed measure for Michigan are both much needed and that some additional source of infrastructure funding is also required for Illinois. However, he added, it is important to recognize that the gas tax has diminishing returns because of technology and changing transportation patterns. Electronic vehicles and microtransit options like Uber will profoundly impact Illinois by changing congestion patterns and reducing the value of the motor fuel tax. Given these pressures, it will be important for the state to look to a number of different possible solutions to fund current and future infrastructure needs. On the revenue side, that might include a vehicle miles-traveled tax, tolls, and user fees, among other options. Partnerships with the private sector should be another lever to manage risk and perform maintenance, he concluded, and public-private partnerships can be asset-management tools.

Mitchell Holzrichter, Mayer Brown, offered an inside perspective of an alternative structure for funding infrastructure investment: Indiana's long-term lease of its toll road. Former Indiana governor Mitch Daniels was looking to unlock the value of the state's assets, use the proceeds to spend on the state's infrastructure needs, and shift the burden of asset maintenance to another party, Holzrichter said. The Indiana Toll Road was a good candidate, he added, because it is used mostly for truck and interstate commerce travel and, thus, any negative impact from the lease would not be borne only by local users. Additionally, the toll road was operating at a loss, so the state would not be losing a revenue-generating asset. This situation is in contrast to that of the Chicago Skyway, which was operating at a positive \$5 million when it was leased.

Holzrichter said that then-Governor Daniels wanted not only to avoid the loss the Indiana Toll Road was producing, but also to avoid future revenue risk. The final deal was for a 75-year lease with the concessionaire pledging to maintain and operate the toll road in exchange for the revenue generated by the asset. Tolls were stipulated in the contract for the first five years and then indexed. The State of Indiana received \$3.8 billion in cash, and the concessionaire pledged to make an immediate \$200 million in capital improvements and another \$4.4 billion over the life of the lease. Indiana

dedicated the proceeds mainly to a ten-year capital improvement program that financed infrastructure repairs across the state. This is in contrast to Chicago's privatization of the Skyway, parking meters, and underground parking, Holzrichter said, whereby most of the proceeds went to cover operating gaps in the wake of the financial crisis. The concessionaire for the Indiana Toll Road eventually went bankrupt, but the asset was always available for use. Eventually another company bought out the original purchaser, so the state's revenue risk remained transferred to the private sector and Indiana retained the value generated by the original lease.

Selling an infrastructure plan to a skeptical public

Civic Federation president Laurence Msall interviewed a panel of local and national reporters who cover infrastructure issues about the politics of capital spending: Jason Grotto of *ProPublica Illinois*, Yvette Shields of the *Bond Buyer*, and Mary Wisniewski of the *Chicago Tribune*. Grotto said that his reporting on the State of Illinois's 2009 *Illinois Jobs Now!* capital plan and its flawed reliance on video gambling as a key source of revenue uncovered important lessons for Illinois lawmakers as they work on a new capital plan. It will be very important for any capital plan to include a reliable source of revenue, he said, but also provide for transparency and avoid Illinois's tendency to do important legislation hurriedly without the possibility of input from the public. He noted that it was impossible to determine from the state's records where all of the tens of billions of dollars appropriated under the capital plan were spent.

Shields said that the "Illinois penalty" is crucial to understanding the possibilities for the State of Illinois to borrow billions for capital. The Illinois penalty means that the State of Illinois and local governments pay more in interest on their borrowing than other governments with similar ratings. The penalty has decreased somewhat since the depths of the two-year budget impasse, but it is still much more expensive for Illinois to borrow than other states. For this reason, asset transfers and public-private partnerships might be an opportunity that the state could explore, though Shields emphasized that such deals were not a panacea.

Wisniewski said that as a columnist who focuses on transportation, she knows her readers are most interested in the problems that directly affect them, such as crumbling infrastructure—such as the large crack discovered in a Lake Shore Drive overpass in downtown Chicago, worsening commuter rail delays due to obsolete equipment that Metra cannot afford to replace, and car repairs necessitated by the poor condition of roads. So the people of Illinois are well aware of the need for more infrastructure spending, but they are distrustful of the state and local governments and want to know how political leaders will use any increased taxes that would be necessary to fund an eventual capital plan.

Conclusion

There is little doubt that Illinois faces real infrastructure needs. However, the potential returns to the state's infrastructure investments will depend critically on how projects are selected and financed.

¹ Diane Whitmore Schanzenbach, Ryan Nunn, and Greg Nantz, 2017, "If you build it: A guide to the economics of infrastructure investment," Brookings Institution, The Hamilton Project, paper, February, available online, http://www.hamiltonproject.org/papers/if_you_build_it_a_guide_to_the_economics_of_infrastructure_investment.

² Transportation Infrastructure Finance and Innovation Act; see more information online, <https://www.transportation.gov/buildamerica/programs-services/tifia>.

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ISSN 0895-0164