Bond Case Briefs

Municipal Finance Law Since 1971

Trump’s Infrastructure Mistake.

The president-elect wants to draw in private money—but do investors swoon to fix leaky school roofs?

Divining what Trumponomics will look like is guesswork at this stage, but there is one prominent exception. Late in the campaign, two of Donald Trump’s top economic advisers—Peter Navarro and Wilbur Ross, who is now the nominee for commerce secretary—offered a detailed infrastructure plan. Unsurprisingly, the program seems more about rewarding private-equity investors than about rebuilding America’s crumbling infrastructure.

Infrastructure plans come in three phases: selecting projects, lining up financing, and executing construction. The third step is normally left to private contractors, because state and local governments don’t employ stables of construction workers. As such, government’s role is concentrated in the first two steps.

Traditionally, a higher level of government sends money to a lower level (from federal to state, or from state to local). The Trump plan would rely more on private investors motivated by huge tax breaks.

Follow the money. Messrs. Navarro and Ross propose an 82% tax credit to attract private-equity investors into the infrastructure business. Yes, 82%! A $3 billion public-private “partnership,” according to their plan, could be financed like this: $2.5 billion in municipal bonds, $410 million in tax credits from the federal government, and $90 million in private equity. This means $90 million in private money winds up controlling a $3 billion asset. Mr. Trump likes leverage, but isn’t 33-to-1 a little ridiculous?

What return on capital would private investors demand on such investments? Messrs. Navarro and Ross say between 9% and 10%. Add in the general partner’s carried interest, and that is about 12%. It could be higher, however. History suggests that building roads and bridges is not a low-risk investment. According to a 2015 Congressional Budget Office report, 14 privately financed road projects have been completed in the U.S. since 1995. Of these, three went bankrupt and one required a public buyout—29% failure rate.

By contrast, the New Jersey Turnpike authority can still borrow for 30 years at 3.4% despite the best efforts of Gov. Chris Christie to destroy his government’s credit rating. States with higher ratings pay less.

So much for financing. What about selecting projects?

To attract private money, projects must offer investors cash returns—derived, for example, from tolls on highways. In some cases, this is possible, even desirable. But for many important projects, charging fees can be impractical. Think of building schools in poor neighborhoods or repairing crumbling bridges that have no tolls.

In truth, much of America's most critical infrastructure needs are for repair and maintenance work—whether it is pothole-laden roads or schools with leaky roofs. Economists find that such unglamorous repair work often offers the highest returns for society.

Infrastructure projects selected in the traditional way, by governments, are chosen based on public benefits, the community's ability to pay—and sometimes crass political favoritism. It would be nice to get rid of the latter, which is the main argument for a public infrastructure bank.

Under the Trump plan, project selection would be left to profit-seeking investors, using the same criteria they use to decide which hotels to build, for example. Ironically, Messrs. Navarro and Ross criticize President Obama's modest 2015 infrastructure proposals because, "These will not fix the 237,600 water mains that break each year. Nor will they stop the 46 billion gallons of water lost each day from pipe leaks." Does the Trump team really think private-equity investors will swoon over repairing plumbing?

There are many better alternatives. One example is Build American Bonds (BABs), a special breed of municipal bonds whereby municipalities issue taxable debt but receive a subsidy from the federal government—35% under the 2009 Recovery Act. In the two years the program lasted, more than $180 billion of bonds were issued, financing thousands of projects from community college construction to road maintenance.

BABs leave project selection to municipalities, which can use them for routine maintenance and other projects that lack a revenue stream. Unlike Mr. Trump's plan and conventional tax-exempt bonds, BABs are attractive to investors who do not pay U.S. taxes, such as pension funds, endowments and sovereign-wealth funds. That increases demand and lowers borrowing costs.

There may be some projects for which private-equity investments, encouraged by tax incentives, make sense. But for the great bulk of infrastructure needs, BABs would be a far superior solution. If the Trump administration is serious about making our public infrastructure great again, it should worry less about finding ways to make the rich richer.

THE WALL STREET JOURNAL

By ALAN S. BLINDER and ALAN B. KRUEGER

Dec. 18, 2016 5:13 p.m. ET

Messrs. Blinder and Krueger are professors of economics at Princeton University.