Backgrounder

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Closing the Spending Gap Between Contending Transportation Reauthorization Proposals

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Efforts by Congress to reauthorize federal surface transportation programs are behind schedule and may not be completed before the current law expires on September 30, 2003. Although there are many sources of contention between Congress and the White House, and within Congress itself, the major disagreement is about how much to spend over the six-year life of the next reauthorization bill.

At present, the greatest dollar difference between contending proposals amounts to as much as $125 billion, or more than $20 billion per year. Between the House and Senate plans, the gap is about $65 billion, or almost $11 billion per year.

Some in Congress and in the road-building industries argue that taxes must be raised to close the funding gap. Others advocate a number of innovative financing and restructuring proposals that could fill that void without a tax increase. At the same time, these innovations could also substantially improve the program's performance and its value to the traveling public.

The most promising proposals center on extensive tolling and use of tax-exempt, private activity bonds to finance improvements in the transportation infrastructure. The Bush Administration's plan endorses the limited implementation of such reforms, but legislation now being drafted in Congress would go much further and could create a win-win outcome for the contending parties.

- The current surface transportation law expires on September 30, 2003.
- Contending reauthorization proposals differ by as much as $125 billion. House Transportation Committee Chairman Young's proposal to increase six-year surface transportation spending to $375 billion—funded by a large increase in the fuel tax—is the most expensive.
- Several similar proposals have emerged that would supplement the existing gas tax revenues by allowing private investors and developers to use tax-exempt private activity bonds to finance road construction, using tolls on the new roads to pay off the bonds.
- Transportation officials in the Milwaukee, Houston, Dallas, Minneapolis, Denver, and Washington, D.C., metropolitan areas are already contemplating many ambitious toll express projects that could benefit from involving private sector participation.

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Costly Differences

At the costliest end of the spectrum is the proposal by House Transportation Committee Chairman Don Young (R–AK) to increase six-year surface transportation spending to $375 billion and fund the increase by raising the federal fuel tax from 18.4 cents per gallon to as much as 33.4 cents per gallon by 2009 to generate an additional $120 billion or more in fuel tax revenue. In contrast, the $247 billion in spending proposed by the President more or less equals the projected fuel tax revenue over the next six years generated by the current fuel tax rate of 18.4 cents per gallon. At $311 billion, the Senate's proposal exceeds projected revenues by $60 billion but includes no significant revenue-raising mechanism to close the gap other than eliminating the ethanol subsidy.[1]

More highway spending certainly has plenty of support in Congress, but there is little support either for the tax increase needed to pay for it or for using general revenues to supplement gas tax revenue, particularly given projected budget deficits of $450 billion per year. Indeed, considerable opposition to Mr. Young's gas tax increase quickly emerged and has stymied legislative progress in the House as fiscal conservatives, the White House, and the House leadership have made it clear that they will oppose any highway bill that requires a tax increase.

Innovative Finance and Revenue Options

There is, however, a third approach brewing in Congress: one that incorporates proposals that have surfaced in the Senate on a number of occasions over the past several years, many which have been incorporated into President George W. Bush's reauthorization proposal, the Safe, Accountable, Flexible and Efficient Transportation Equity Act of 2003 (SAFETEA). These proposals would supplement the existing gas tax revenues with funds raised by road builders through special borrowing privileges, and the debt would be serviced by tolls charged to motorists using the roads or lanes constructed with the borrowed funds. If they were combined with pending legislation such as the FAST Act (H.R. 1767 and S. 1384)[2] or some of the other proposals included in SAFETEA that would allow states greater use of road tolls, tens of billions of additional dollars could be attracted to road building in future years.

Although some might argue that this option to borrow, build, and toll is untried and risky, in fact it has been used extensively since Colonial times and is still in use today, albeit at levels well below its full potential because of regulatory impediments and differential borrowing cost privileges available only to public-sector builders. Long before the federal government embraced the interstate highway system, several states had already implemented a regional system of high-speed, limited-access highways built with borrowed money and serviced by tolls—the model used successfully by New York, Ohio, Pennsylvania, New Jersey, Maryland, Indiana, and Connecticut to build their turnpikes, parkways, and thruways, as well as many major bridges throughout the country.

More recently, the private sector has entered the road development business and has done so by borrowing to build roads and servicing the debt with tolls—the Dulles Greenway in Virginia, El Camino in Texas, and SR 91 in Orange County, California, are three recent instances of private initiative. The private sector has also worked in partnership with the state governments to build toll roads. Highway I-185 in Greenville, South Carolina, and the Pocahontas Parkway in Richmond, Virginia, are examples of such partnerships.[3]

1. Erin Hymel, "Ethanol Producers Get a Handout from Consumers," Heritage Foundation *Backgrounder* No. 1603, October 16, 2002, at *www.heritage.org/Research/EnergyandEnvironment/bg1603.cfm*.
2. See Ronald D. Utt, "New Highway Proposal Fights Congestion with Fee-Based Express Lanes," Heritage Foundation *Executive Memorandum* No. 882, May 22, 2003, at *www.heritage.org/Research/SmartGrowth/EM882.cfm*.
3. See Ronald D. Utt, "Reauthorization of TEA-21: A Primer on Reforming the Federal Highway and Transit Programs," Heritage Foundation *Backgrounder* No. 1643, April 7, 2003, at *www.heritage.org/Research/SmartGrowth/bg1643.cfm*, and Peter Samuel, "Tolls and Surface Transportation Reauthorization," Heritage Foundation *Backgrounder* No. 1650, May 2, 2003, at *www.heritage.org/Research/SmartGrowth/bg1650.cfm*.

Regulatory Obstacles to Reform

Despite the growing interest, private investors and road developers are at a significant cost disadvantage relative to the public sector because of advantageous financing arrangements allowed the public sector. Under the U.S. tax code, state and local governments, as well as the public authorities they create, are allowed to borrow at interest rates that are exempt from income taxes by the lender. As a result of this privilege, the state and local borrower pays about two-thirds the interest rate that a private-sector borrower would pay on a comparable bond because the lender would have to pay federal income taxes on the interest earnings.

In mid-August 2003, high-quality 10-year corporate bonds were priced to yield 6.18 percent, while seven-year to 12-year AA tax-exempt bonds were yielding 4.04 percent.[4] Because the cost of capital is a significant component of capital-intensive infrastructure projects such as highways, these tax differences effectively give the public sector about a 30 percent cost advantage over comparable investment by a private firm.

In turn, this has discouraged private investors from entering the American public infrastructure market, in contrast to the growing partnership activity occurring in Europe and Canada, where no such tax differences between private and public debt exist. For example, one of the problems challenging the privately financed and built Dulles Greenway when it opened in 1993 was the 10.2 percent interest rate on its debt.[5]

Recent Innovative Proposals

Over the past several years, a number of proposals have been put forward to allow private investors and developers access to tax-exempt borrowing privileges so that they can compete or partner more effectively with state and local governments in providing traditional public infrastructure such as roads, schools, and waste water treatment. In 1999, former Senator John Chafee (R–RI) introduced the Highway Innovation and Cost Savings Act (S. 470), which would have allowed as much as $15 billion in tax-exempt private activity bonds to be issued by private investors in a national demonstration project to build private toll roads, thereby easing traffic congestion by supplementing the existing flow of revenues from the federal fuel tax. Although passed by the Senate, Senator Chafee's bill was not enacted.

In 2001, former Senator Bob Smith (R–NH) introduced the Multimodal Transportation Financing Act (S. 870), a similar bill that would have allowed the use of tax-exempt private activity bonds to finance privately developed highways, as well as other transportation infrastructure. His bill died as well, but in May 2003, the Bush Administration introduced as part of SAFETEA a proposal to expand the use of private activity bonds for highways and related infrastructure and proposed that as much as $15 billion of such debt be made available for private toll road projects throughout the nation.

Specifically, these proposals would allow private investors to use tax-exempt private activity bonds to raise the funds to invest in private or public–private partnerships to build new toll roads or toll express lanes. In effect, roads could be built with borrowed funds at low interest rates, and the tolls collected on the roads would be used to pay off the debt. By using debt whose interest payments are exempt from federal income taxes, the private sector could more readily participate in highway investment, no longer having to compete with the public sector from a 30 percent cost disadvantage.

Tolls to Finance the Debt

Because it is increasingly unlikely that Congress will raise the federal fuel tax to fund more highway spending, transportation officials and elected representatives are beginning to look more seriously at other forms of revenues such as tolls and fees to provide the revenue needed to build more roads. Indicative of the growing interest in alternative fee arrangements is the introduction of the Freeing Alternatives for Speedy Transportation (FAST) Act to expand toll-financed construction of express lanes to relieve congestion in metropolitan areas.

4. *The Wall Street Journal*, August 18, 2003, p. C12.
5. "Dulles Greenway Poised for Profit," *Public Works Financing*, July–August, 2003, p. 24.

Introduced in the House (H.R. 1767) by Representatives Mark Kennedy (R–MN) and Adam Smith (D–WA) and in the Senate (S. 1384) by Senator Wayne Allard (R–CO), the legislation is picking up considerable support, partly because it could substitute for the unpopular tax increase recommended by Chairman Young. As of mid-August 2003, the FAST Act had garnered 65 co-sponsors in the House from members of both parties.

A few weeks after the FAST Act was introduced, the Bush Administration introduced SAFETEA, which includes its own proposal to expand the use of tolls. In addition, SAFETEA includes an extension of authority for the Interstate Toll Pilot Project (which was included in previous reauthorization but never used) and a new Variable Pricing Program similar in purpose to the FAST Act.

An Opportunity to Compromise

With interest growing in Congress and the White House for new forms of fees and finance to expand road capacity, and with federal transportation programs scheduled for reauthorization by September 30, 2003, Congress has a narrow window of opportunity to craft a reauthorization bill that utilizes the innovative funding proposals that would both improve the federal program and create an effective compromise between the contending factions in Congress.

As noted earlier, by far the most contentious point of disagreement is the $125 billion gap between what Chairman Young wants to spend over the next six years and the revenues that his House colleagues are likely to provide. One way to bridge this gap is to include an expansive tolling proposal such as the FAST Act in the transportation bill and facilitate that revenue-generating reform with companion legislation that amends the tax code to allow for $125 billion (roughly $21 billion per year) in statutory authority to issue private activity bonds dedicated to transportation infrastructure.

Some pro–tax increase skeptics will be inclined to argue that expanded borrowing authority will not close the $125 billion gap because there is no assurance that it would be fully used, unlike fuel tax revenues that would be spent as collected, as per current law. However, transportation officials in many metropolitan areas are already contemplating many ambitious toll express and HOT (high occupancy/toll) lane projects that could easily absorb the proposed borrowing authority.

Based on cost estimates of proposed congestion-relieving toll projects in urbanized areas, there is reason to believe that a six-year debt limit of $65 billion to $125 billion could be used in its entirety by urban projects now on the drawing boards. In the San Diego metropolitan area, a 9.2-mile four-lane toll road to be constructed and owned by a private investment group and financed by European banks is expected to cost $642 million.[6] Wisconsin's Department of Transportation is considering using tolls to fund $6.2 billion of highway reconstruction in the Milwaukee metropolitan area.

In Virginia, the more ambitious of the several proposals to add toll express lanes on about one-fourth of the Washington, D.C., Beltway in the suburbs of Northern Virginia is projected to cost as much as $11 billion, and Maryland recently announced interest in a comparable project on its portion of the Beltway. Many other congested metropolitan areas such as Houston, Dallas, Minneapolis, and Denver are in advanced stages of developing similar proposals to relieve traffic congestion in their regions.

Static Versus Dynamic Cost Estimates

U.S. Treasury officials and some congressional tax committee members might also object to the potential revenue loss to the federal government of extending tax-exempt borrowing status to another class of borrowers. If revenue estimators assumed that this proposed $125 billion of bonds were a net new addition to the tax-exempt debt market, current interest rates would suggest that the revenue loss to the U.S Treasury on $125 billion of outstanding bonds would be as much as $2.4 billion per year. If $65 billion were issued, the maximum revenue loss would be about $1.2 billion per year.

However, because some of these tolled projects would ultimately be built by state and local governments in the event that the private sector received no encouragement to participate, the projects would still be financed with tax-exempt debt, and the Trea-

6. *Ibid.*, p. 21.

sury would forego some amount of tax revenues, suggesting that the actual net loss would be some fraction of the $2.4 billion estimated above. Either way, the figure is much less than the $20 billion in new fuel taxes and federal spending per year needed to achieve the same level of new construction.

Conclusion

Recent proposals by the Bush Administration and some Members of Congress to use tolls and other user fees to supplement the revenues from the existing federal fuel tax could raise billions of additional dollars to construct new road capacity throughout the United States. In turn, this new capacity could help reduce the worsening road congestion that now confronts most major metropolitan areas by targeting the resources to places that need it the most and limiting the burden of paying for the improvement to just those who benefit.

At the same time, such financing innovations have the potential to bridge the gap between contending factions in Congress that are now at loggerheads over how much to spend and how much to tax. By encouraging toll roads built with borrowed money and financed with tolls, they could enable more roads to be built in congested areas without raising taxes.

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