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Budget Model

Program Choice and Financing Matter for Infrastructure Plans

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Listen to the entire Knowledge@ Wharton discussion (originally aired on SIRIUS XM Channel 132, Business Radio Powered by The Wharton School)

Summary: PWBM's Jon Huntley and Richard Prisinzano discussed how the financing of a federal infrastructure plan influences its effect on economic growth. Even though infrastructure investments increase productivity, plans that are deficit-financed can reduce GDP relative to current policy.

PWBM's Jon Huntley and Richard Prisinzano discussed the potential impacts of the $2 trillion Congressional Democrat and White House infrastructure proposal on Knowledge@Wharton Business Radio SiriusXM 132. They discussed three key areas:

- Options to pay for infrastructure spending
- Types of public infrastructure
- Types of federal infrastructure programs

The White House and Congressional Democrats did not specify how they would pay for the infrastructure proposal or what types of programs the money would be allocated to.

Huntley talked about three options to finance infrastructure spending: (i) **deficit-financing**, where the federal government finances the $2 trillion by borrowing money (at currently low interest rates); (ii) **user fees**, such as tolls, where people pay based on their use of public infrastructure; and (iii) **a gas tax**, increasing the tax collected on each gallon of gasoline.

Prisinzano indicated that the question comes down to "what the biggest bang for our buck is." Regarding user fees, he emphasized, the first dollar is "free," which means that there would be no change in consumers' behavior. But after the first "free" dollar, consumers begin to change their habits. This finding suggests that an increase in gasoline taxes of $1 would have little effect on consumer behavior. There is a delicate balance between collecting user fees and building facilities to serve the public. Typically, user fees cannot be collected until after a project is complete. Thus, the government may have to initially borrow money for construction. However, Huntley offered another way to collect user fees; by auctioning off the right in advance to collect the fees, the government can collect money immediately to pay or subsidize some of the construction cost.

Often it is state and local governments that make the decision of what to build and where to build it. Prisinzano pointed out that "It's hard to build a [subway] after a city reaches a certain size," and transportation systems crossing multiple political jurisdictions require coordination. Moreover, when making public infrastructure investments, many trade-offs must be made. An underground subway, for example, is more expensive, but staying at street level can cost space for cars, walking and biking.

Huntley cited real world evidence to show that when the federal government gives money for infrastructure investment to state and local governments, not all of the money is used to fund new infrastructure projects. In fact, state and local governments often shift their existing or planned spending to other priorities, including lower taxes. This behavior dilutes the impact of federal infrastructure programs. "It's like the sports stadium financing," Prisinzano commented. "The team may spend X and the locality may spend Y … It's a moral hazard problem making sure everyone spends their share. It's the same dynamic between the locality and the federal government." Huntley said a solution to the problem might be federal programs that "make it cheaper for states to invest." However, he acknowledged that such a program may be expensive.

In terms of the $2 trillion infrastructure project's effects on GDP, Huntley pointed out that deficit financing, could crowd out private capital. "[Deficit financing], that's been an offset, and in some cases, more than an offset, against the positive effects of having more infrastructure available. Therefore deficit financing tends to lower GDP," Huntley explained. "When you finance with user fees or lump-sum tax, if the infrastructure is reasonably valuable, you probably will see a little bit of an increase in GDP."