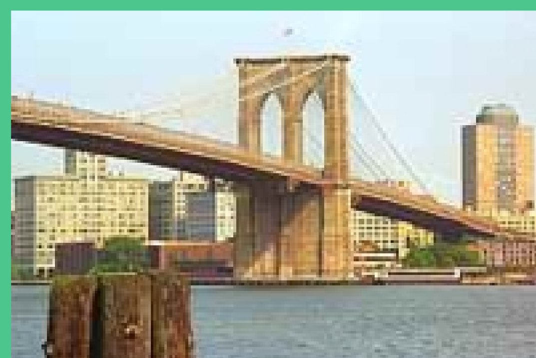
An Investment Strategy for Economic Recovery

January, 2002

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State of New York
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In December 2001, in the wake of the terrorist attacks of September 11th and in the face of a weakening national economy, we convened a meeting of state and local investment officials and pension fund managers from across the country to discuss potential approaches to respond to our nation's economic challenges.

The economic strategy outlined in this document, ***An Investment Strategy for Economic Recovery***, is the result of that initial meeting and the discussions that have ensued – with the investment community, economists, and many others – over the past two months. The proposals contained herein – to bolster the financing of critical infrastructure and economic development projects and to stabilize state and local capital and operating budgets – aim to boost economic recovery today and to strengthen our economy for the future.

It is our hope that, at this critical moment for our economy, the approaches recommended can offer a fresh opportunity to craft an economic strategy of value today and in the future.

EXECUTIVE SUMMARY AND POLICY OVERVIEW

The US economy was already slowing when the tragic events of September 11th accelerated the nation's economic downturn. The terrorist attack on America highlighted the need to strengthen the economy and to spur long term economic growth. Yet, a sharp and divisive debate in Washington ultimately resulted in a stalemate over the measures needed to ensure a recovery.

While opinions differ as to the likely length and depth of the current economic turmoil, there is considerable risk that the recession may be more severe and protracted than some are predicting. The national unemployment rate has climbed from 3.9% to 5.8% - with October 2001 showing the largest one-month increase since February 1986. Unemployment increased by over two and a half million people during 2001. Declining business investment has been joined in recent data by slowing consumer spending. Industrial production continues to fall and capacity utilization is now almost ten full percentage points below its peak values. Exports are off sharply, as are business profits (see section of this report entitled "An Economic Perspective").

The nation's economic uncertainty argues for prudent measures which will help stabilize the economy today *and* contribute to future economic strength. In the case of terrorist threats, the nation has wisely adopted an approach to plan to prevent the worst damage that may occur. The same approach must be embraced on the economic front at a time when a failing economy will, in itself, be considered as a sign of national weakness.

The nation's economic uncertainty argues for prudent measures which will help stabilize the economy today *and* contribute to future economic strength.

▪ A Strategy to Strengthen the Economy Today and for the Future

It is in this context that, in December of 2001, Ambassador Felix Rohatyn, California State Treasurer Philip Angelides, and New York State Comptroller Carl McCall convened a meeting of state and local investment officers and pension fund managers to discuss potential approaches to respond to the nation's economic challenges. Represented at the meeting were officials involved in managing pension and investment portfolios totaling more than $750 billion in assets. Discussions focused on, among other things, ways to expand the capacity of states and localities to finance critical infrastructure projects; to facilitate pension fund investment in infrastructure and economic development projects, consistent with the highest fiduciary standards; and to preserve funding, in a time of financial duress, for needed capital projects and essential services.

Out of that meeting, and the working sessions that followed over the past two months, has emerged a strategy to bolster long term economic growth and provide near term stimulus.

An Investment Strategy for Economic Recovery consists of three components:

- **New capital investment to meet the nation's critical infrastructure and economic development needs.** This proposal calls for $10 billion annually, for the next five years, in federal credit support to finance $250 billion in infrastructure and economic development projects and to bring sound pension fund investments into this sector. Additionally, the proposal would accelerate critical infrastructure projects through pledges of future planned federal expenditures.

- **Increased financing for private sector projects of public benefit such as affordable housing and pollution clean-up.** This proposal would temporarily increase, by $5 billion annually over the next three years, the amount of tax-exempt bonds which state and local governments can issue for private sector projects which bolster community economic development efforts.

- **Temporary and immediate fiscal assistance to states and localities to stabilize capital and operating budgets.** This proposal would enact a one-year, $100 billion program of federal revenue sharing to counter the potentially damaging impacts on the economy of the budget crisis now facing states and localities across the country. This proposal would maintain funding for needed capital projects and essential services such as education, health care and public safety.

▪ Infrastructure and Economic Opportunity: America's Enduring Challenges

The strategy outlined in the pages that follow recognizes that investments in infrastructure and economic development are sorely needed, in any event, to sustain the nation's future economic prospects and can provide near term benefits, particularly if the recovery is weak.

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In every state, there are billions of dollars in critical, but unmet infrastructure needs. New schools must be built and existing schools need to be repaired and wired for the high-tech age. Transit networks, roads and bridges need to be improved and water systems need to be modernized and made secure against terrorists.

As an example, the Federal Highway Administration (FHWA) estimates that the annual investment required just to maintain the nation's transit systems is $10.8 billion. Traffic congestion costs Americans an estimated $72 billion annually – in wasted fuel and lost time. As another example, $127 billion is needed to repair and improve the nation's public schools. In California alone, over $16 billion is needed over the next five years to fund the State's share of public school construction and renovation and over $1.5 billion is needed immediately to bring student-to-computer ratios to an acceptable level.

Infrastructure needs are particularly acute in those rural and urban communities that have not fully shared in the bounty of the nation's economic progress. For example, a 1999 nationwide study showed that schools with the highest concentrations of poverty reported the greatest school repair needs, while a 2001 survey conducted in California reported that student-to-computer ratios were the worst in schools serving in low-income areas.

Now is the time to renew our national commitment to thoughtful public investment as a foundation for sustained economic progress.

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Beyond these substantial infrastructure needs, communities throughout the nation face other significant economic development challenges. The lack of affordable housing threatens to constrain business expansion in many regions. Tens of thousands of brownfield sites – contaminated properties in urban neighborhoods – stand in the way of community revitalization efforts. And, the lack of investment in inner cities and first ring suburbs is weakening the fabric of regional economies.

A strategic investment program will not only meet well documented infrastructure and economic development needs, but will also provide a needed insurance policy in a weak economic rebound. Studies have shown that every $1 in investment in public works creates $2.50 in economic activity and the FHWA has estimated that every $1 billion in transportation improvements creates 42,000 jobs.

Now is the time to renew our national commitment to thoughtful public investment as a foundation for sustained economic progress. A program of federal financial support can expand investment in needed infrastructure and economic development projects and bring new sources of capital – such as public pension funds with their approximately $2 trillion in assets – to this critical challenge.

▪ A State and Local Budget Crisis Threatens Economic Recovery

While new investment must be deployed to strengthen the nation's economy, it is equally important that action be taken to ensure that the budget crisis facing states and localities across the country does not damage the economy in this critical timeframe.

Preliminary estimates already show budget gaps of $50 billion at the state level and a demand for $5 billion in increased spending on homeland security. When local governments are added, the total state and local budget shortfall could easily reach $75 - $100 billion, the size of the recently debated federal stimulus package.

This budget crisis will lead to cuts in important capital projects at a time when infrastructure investment is most needed. It will precipitate spending reductions, in the midst of an already weakened economy, in education, a key to the nation's economic vitality, and in essential services such as health care and public safety at the very time that the demand for those services is on the rise.

Some of these cuts are already being made, but most of the anticipated cuts will occur in the near future. Thus, unlike the cuts in business capital investment and consumer spending, the impacts of state and local budget actions have not yet been felt in the economy. They are a land mine squarely in the path of economic recovery.

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Critical infrastructure investment and essential spending can be stabilized, to the benefit of the national economy, by an urgent program of temporary federal assistance to state and local capital and operating budgets.

Conclusion

It is in the nation's economic interest to bolster strategic public investment and to stabilize capital expenditures and essential services at the state and local level. There is a broad, bi-partisan consensus on the need to meet the nation's substantial infrastructure needs to sustain long term growth. There is also a rare bi-partisan consensus in principle on the need to sustain spending and investment to support economic recovery, coupled with a growing concern that the state and local budget crisis could threaten economic stability.

The proposals contained herein build on these areas of consensus and seek to merge the need for short term stimulus with investments of long term value. Hopefully, in the aftermath of the failure to enact a federal stimulus package, these proposals can offer a fresh opportunity to craft an economic strategy of value today and in the future.

MEMORANDUM

To: California State Treasurer Philip Angelides
Ambassador Felix Rohatyn
New York State Comptroller Carl McCall

From: James Galbraith, Professor, Lyndon B. Johnson School of Public Affairs,
The University of Texas at Austin and Senior Scholar, Jerome Levy Economics Institute
Stephen Levy, Director, Center for the Continuing Study of the California Economy

Subject: The Need to Strengthen the National Economy, Stabilize State and Local Governments, and Finance the Nation's Infrastructure Needs

Date: January 10, 2002

1. Why A New Effort to Help Stabilize the Economy Is Needed

The economic downturn continues to deepen, and there is no substantial evidence of a turnaround yet in view. Declining business investment has been joined in recent data by slowing consumer spending. Industrial production continues to fall, especially of business equipment, and capacity utilization is now almost ten full percentage points below its peak values. Exports are off sharply, as are business profits. Meanwhile unemployment is up by two and a half million, and African-American unemployment rates now exceed ten percent.

Present underlying economic circumstances are exceptional in several respects. Households and business are laboring under high debt loads, built up over the entire previous expansion. They are becoming unwilling to continue to spend far ahead of their incomes, as they have been doing for the past several years. Personal saving has accordingly risen sharply in recent data. Households are likely to remain cautious about spending until the economic climate stabilizes and their balance sheets improve.

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Meanwhile, the collapse in asset prices in the technology sector has crippled a major motor of business investment. A synchronized downturn in the world economy is reducing U.S. exports. Finally, there is the imponderable longer-term effect of the September 11 trauma on consumer and business attitudes; this effect could prove minor but could, on the other hand, be substantial. While many forecasters express confidence that growth will resume this spring, such forecasts are based on historical patterns that developed under less exceptional circumstances. They are therefore not a foolproof guide to present conditions. We fear that the recession may prove long and deep if there is no early effort to stabilize conditions.

It is true that the economy did not collapse as rapidly after September 11 as some feared.

However, the principal reason it did not was a boost to real personal income from the tax rebates and falling oil prices, combined with loss-making sales in the auto sector. Neither event will continue into 2002. A second reason lies in a large decline in imports, which buffered the domestic economy from declining domestic investment and consumption. On the positive side, the stock market rebound was encouraging, and helped sustain consumer confidence if not actual retail sales.

Even if the slide in the private sector stops in the next six to nine months, the prognosis for a rapid recovery and return to full employment will remain bleak. It will take time for credit institutions to return to active lending patterns and even more time before investors are taken with enthusiasm for a return to technology or other sectors. The climate associated with September 11 also darkens the outlook for investment activity – and businesses' willingness to borrow – in the period ahead. For these reasons, a long period of higher unemployment seems inevitable if nothing is done. As in 1991-1994, even under a favorable outlook, the country will feel itself to be in recession long after growth statistics show the recession formally to be over.

During this time, state and local budgets will crater. This is true even if economic growth overall resumes, and it will be doubly true if recovery is weak or does not occur. State and local budget deficits lead inevitably to spending cuts and tax increases, and these will further damage the private sector. It appears that states alone are already foreseeing budget gaps of $50 billion; adding in localities could raise this to the range of $75 - $100 billion next year. These estimates are based on relatively optimistic economic projections; under worse economic outcomes the numbers will be larger. Given the need for national solidarity in the face of the emergency, this prospect is intolerable. It is also unnecessary and it can be avoided.

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It is very possible that cuts in state and local sector spending could drag the larger economy down to new lows next year. Purchases of goods and services by states and localities today account for almost ten percent of GDP -- substantially more than those of the federal government. States and localities are already slashing their budgets to close these projected budget gaps, cutting both capital and operating expenditures. In other words, cuts in state and local budgets already in view would have completely offset the "stimulus" package that died in December 2001. We have, moreover, so far only seen the beginning of this process, and analysts have tended to overlook the state and local fiscal crisis in addressing the effects of government action on the economy.

The correct economic policy under present conditions is NO CUTS in essential state and local services and capital projects. States and localities should serve, at a minimum, as stabilizing anchors in a drifting economy; they should not add to the slump by cutting their activities (other than for efficiency reasons or changing policy priorities) or failing to meet the increased needs for services. In principle, states and localities should also not be obliged to increase their tax rates in order to sustain current spending; raising current tax rates in a recession has the same depressing effect on private activity at the state as at the federal level.

Indeed, if a strong and spontaneous private recovery does not materialize, expanded activity from state and local government will be necessary to provide additional services for those in need. There should, in that event, be an expansion, not only of current services to meet emergency needs for relief, security, and employment, but also of capital spending to deploy resources that would otherwise remain idle. With private demand for resources low, and with commodity and import prices down, this is an excellent time to meet national, state and local infrastructure needs for the long term. States and localities have the existing plans, priorities and organizational capacity to meet these needs, but they must be able to close their budget gaps and avoid damage to their standing in the capital markets.

There is national bipartisan consensus on the need to sustain services and to meet the nation’s substantial infrastructure needs.

With the failure of the stimulus bill, Congress has demonstrated the difficulty of reaching bipartisan agreement on a recovery effort at the federal level. While those efforts will no doubt continue, an approach that concentrates on funding the existing priorities of states and localities would avoid political and ideological gridlock. There is national bipartisan consensus on the need to sustain services and to meet the nation’s substantial infrastructure needs. Moreover, there is rare bipartisan consensus in principle on the need for increased spending -- consumption and investment -- to support economic activity and to bolster employment. State and local expenditure meets this need effectively, in ways that benefit the civilian population directly by providing income and also indirectly by providing services including fire and police protection, education and transportation, around which Americans are united. Both parties can and should support these measures.

In thinking about size of initiative, we do not know precisely what to expect in the near term. An important question is, how to prepare for risks and uncertainties? In the case of military or terrorist threats, the accepted approach is to plan to prevent the worst damage that may occur. In economic policy, in contrast, the most widely accepted approach until now has been to assume an optimistic forecast, and so to keep the level of desired "stimulus" small -- less than 1.5 percent of GDP by generous count. This is partly from a caution about budget deficits, and partly for fear that a larger number might collide with a strong underlying recovery and produce inflation. But we believe this approach is inappropriate at a time when the nation is under challenge and a failing economy will, in itself, be considered as a sign of weakness.

There is little economic danger of doing too much. In particular, the threat from inflation is now minimal. Price deflation is a more serious danger right now, as it is already occurring in commodity markets around the world, and producer prices have actually been falling in the U.S. However, if a strong recovery should occur, demands for state and local services would fall.

Given the balance of risks and the cost of failing, our approach is therefore more akin to defense planning. Accordingly, we would recommend providing states and localities with enough resources in the form of grants, guarantees and subsidies to meet a bad scenario, and so to provide insurance against worse-than-projected conditions. In a time of general national threat, we believe that this is the prudent course.

Thus we need support for both state and local capital programs and for current operating expenditures. The right approach should thus combine GENERAL FISCAL ASSISTANCE (revenue sharing) for states and localities to support operating and capital budgets, and also NEW PROGRAMS OF GUARANTEES, CREDIT SUPPORT AND ENHANCED BORROWING CAPACITY to maintain and expand state and local capital expenditures. The funds made available for operating and capital budgets can help states and localities meet the needs of the population in difficult times, while enhanced borrowings can be put to uses that will improve living conditions and standards long into the future on schools, universities, transportation networks, affordable housing, environment, parks and amenities, and so forth. However, the important immediate benefit in both cases is to stabilize state and local budgets and to ensure that this large sector does not act in ways that will prolong the recession or slow any impending recovery of the larger economy.

In sum, conditions today call for an approach that goes well beyond the failed stimulus package of last fall. We need, first and foremost, to stabilize the vital functions of government at all levels, and particularly at the state and local levels where the direct effect of government spending on GDP is considerably larger than at the federal level, and where deep cuts are getting underway now. To prevent such cuts is an urgent priority, to help avert one of the darkest near-term threats to hopes for an economic recovery. Beyond this, fiscal assistance can help states and localities meet the needs of American families for essential services during hard times; they can provide jobs; and through needed investment in education, transportation, conservation and other areas, they can help lay the foundation for sustained expansion into the future.

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2. Why Immediate Federal Assistance to States and Localities is Essential

Without immediate federal assistance, state and local spending will be cut. The National Governors Association (NGA) estimates that state deficits could reach $50 billion in early 2002. If local governments and school districts are added in, the total could easily reach $75-100 billion, the size of the recently debated federal stimulus package.

Some cuts are already being made in state spending but the important point is that most of these cuts will occur in the near future. Thus, unlike the cuts in business capital investment and consumer spending, the impacts of cuts in state and local spending have not been felt yet. These cuts in spending will occur just as the national economy is struggling to end the downturn. They are a land mine squarely in the path of economic recovery.

It is true that states can avoid cutbacks in program expenditures by raising taxes and this is a choice that is being weighed carefully in each state. In the absence of immediate federal financial assistance, some states may choose to raise taxes temporarily to protect vital services. Such tax increases will act as a drag on private activity, however necessary they may be on social policy grounds.

There is a better alternative. Federal assistance to states and localities serves the twin objectives of promoting national economic stability and recovery and avoiding the budgetary and program disruption that will occur for states, local governments and school districts. This works because the federal government, unlike state governments, can add spending to the economy during periods of economic weakness.

Cuts in education and infrastructure investment are the most damaging effects of the budget deficits facing state and local governments. Cuts in these areas not only deepen the recession and make recovery more difficult, but they undercut long term economic growth.

State and local government expenditures serve three main social goals: public safety, safety net programs (including health care assistance for poor residents) and investment for the future (especially in education and infrastructure). There are several reasons why these expenditures should rise in 2002.

Public safety spending requirements are increasing as a result of the events of September 11th. State and local governments share in the nation's drive to increase homeland security. Without federal aid, state and local governments will not have the resources to maintain, much less significantly raise, security spending or the money will come from education, health care, and other state/local responsibilities. Moreover, recent changes in the federal tax code have already affected state and local fiscal capacity, and these measures need to be reconsidered or offset in order to prevent even deeper cuts as states rise to face their new responsibilities.

In a recession, safety net spending should rise. Unemployment rises, the number of people without health insurance rises and it is likely that the downward trend in welfare caseloads may reverse. Maintaining and increasing these expenditures as needed is an important part of the nation's safety net and state and local governments have a role in offsetting these impacts of recession. For example, California's first round of proposed announced budget cuts included cuts of $200 million from delaying the expansion of health care coverage for poor families and $50 million in cuts from the Low Income Energy Assistance Program. These cuts fall precisely on those Californians who are most likely to be hurt in the recession.

Cuts in education and infrastructure investment are the most damaging effects of the budget deficits facing state and local governments. Cuts in these areas not only deepen the recession and make recovery more difficult, but they undercut long term economic growth.

In the first $2.2 billion of proposed cuts in California's state budget, nearly $850 million comes from education programs. This does not include the future cuts from the $12.4 billion in forecast deficit in the anticipated California State budget.

The basic case is simple. Without federal assistance, many vital programs will be cut. With federal assistance, spending to meet security needs can be increased while providing full funding for safety net and investment programs for state and local governments, all while contributing to fighting the recession and boosting the pace of recovery.

3. Why Assistance for Infrastructure Should be in the Assistance Package

Federal assistance for infrastructure spending allows the nation to have an insurance policy against a weak recovery while not changing basic underlying tax or spending priorities.

Federal aid for infrastructure meets all of the economic criteria for anti-recession policies. Infrastructure assistance can be 1) temporary, 2) immediate, 3) consistent with long-term economic growth and new security goals and 4) not subject to the ideological stalemate of recent stimulus debates.

The strongest advantage of infrastructure assistance is that it combines fighting recession with building a foundation for long-term growth. Infrastructure investment, along with education investment, are the major ways that state and local government spending directly contributes to improving the foundations for long-term economic growth. There is compelling evidence that a trained workforce combined with world-class airport, port and other infrastructure facilities are required to attract and maintain high growth industries.

All states have existing priorities for infrastructure. For example, California has at least $100 billion in identified infrastructure needs. Federal assistance for infrastructure investment builds on existing priorities and well-established plans. Infrastructure investment does not face the criticism of trying to develop brand new programs under the guise of fighting recession.

State and local governments are beginning to cut their spending on infrastructure now. They will continue to do so if assistance does not arise. Infrastructure spending is an immediate and major casualty of current state revenue declines. For example, Colorado canceled bids for $173 million in highway projects this year and a $409-million highway bond issue. Thus federal assistance will have an immediate positive effect on activity levels, even if states and localities are not able actually to go beyond their plans already in place.

States are under pressure to increase infrastructure spending even more than previously planned to take account of new security needs. They will not be able to meet this need, in the face of serious budget and credit problems, without new forms of federal assistance.

Federal assistance for infrastructure spending allows the nation to have an insurance policy against a weak recovery while not changing basic underlying tax or spending priorities. It can be temporary and sized to meet the need for stimulus. It is immediate in the sense that many existing state projects can be started as funding becomes assured for projects previously approved but simply waiting for funding.

Federal assistance for infrastructure provides an important insurance policy against a too-weak recovery, while promoting established priorities for stimulating long-term economic growth and not retracing the contentious issues of the recent federal stimulus debate.

1. New Capital Investment to Meet the Nation's Critical Infrastructure and Economic Development Needs

A. Federal Block Grants to Support State and Local Capital Financing

Issue:

In every state, there are billions of dollars in critical, but unmet infrastructure needs. New schools must be built and existing schools need to be repaired and wired for the high-tech age. Transit networks, roads and bridges need to be improved and water systems need to be modernized and made secure against terrorists.

As an example, the Federal Highway Administration (FHWA) estimates that the annual investment required just to maintain the nation's transit systems is $10.8 billion. Traffic congestion costs Americans an estimated $72 billion annually – in wasted fuel and lost time. As another example, $127 billion is needed to repair and improve the nation's public schools. In California alone, over $16 billion is needed over the next five years to fund the State's share of public school construction and renovation and over $1.5 billion is needed immediately to bring student-to-computer ratios to an acceptable level.

The challenges of inadequate infrastructure are squarely in front of the nation as we enter a period of economic uncertainty. However, the ability of state and local governments to finance critical infrastructure and economic development projects is outstripped by the substantial needs that currently exist. State and local governments face budgetary limitations, particularly acute at the present time, which constrain their abilities to finance capital projects needed for long-term economic growth. In addition, some valuable infrastructure projects cannot move forward in the traditional capital markets, absent additional assistance or credit support.

A program of federal support for state and local government infrastructure and economic development financing can expand the capacity of states and localities to finance needed projects. In addition, it can draw new investment into this sector from sources such as public pension funds – which currently have approximately $2 trillion in assets – by providing the credit support which would enable those funds, on a voluntary basis, to make equity and debt investments in infrastructure and economic development projects which achieve risk adjusted returns and meet fiduciary standards.

A federally supported capital investment program can meet well documented infrastructure needs and contribute to long-term economic growth, while providing an economic stimulus if the recession is deeper and longer than predicted by some. Studies have shown that every $1 in investment in public works creates $2.50 in economic activity and the FHWA has estimated that every $1 billion in transportation improvements creates 42,000 jobs.

Proposal:

- Provide five years of federal block grant appropriations to state and local governments to support infrastructure and economic development projects and programs that are sponsored by state, local, or regional governments. The proposed federal appropriation of $10 billion annually in each of the five years would be distributed based on an appropriate formula. Using a leverage ratio of 5:1, this amount would leverage over $250 billion in state and local projects.

- States and localities would allocate the block grant funds for:

  - State, local, and regional public works and infrastructure projects;
  - Public-private partnerships, including economic development projects sponsored by local or state governments;
  - State and local pension fund investments in infrastructure and economic development projects.

- These grants could be used to support, among other items:

  - Credit enhancement of tax-exempt bonds;
  - Credit enhancement of taxable bonds, including those purchased by pension funds;
  - Equity investments in real estate or other development projects; and
  - Private equity partnerships suitable for public pension fund investments.

- With respect to pension funds, the grants would be used to provide the credit enhancement and/or risk mitigation necessary to facilitate pension fund debt and equity investment in infrastructure and economic development projects. For example, the federal funds could be used to guarantee (partially or in whole) taxable debt issued for projects. As another example, such funds could change the project risk profile to enable pension fund equity investments to achieve the required risk adjusted returns.

- The various forms of support, cited above, would carry different leverage ratios. Credit enhancement on tax-exempt or taxable bonds, for example, might have a leverage ratio ranging between 5:1 and 10:1, while equity investments would require a case by case evaluation. Application of the funds would be at the discretion of the state and localities, subject to broad federal statutory guidelines, through a competitive allocation process.

- Assistance would be given only to projects or programs that cannot get traditional financing without assistance; it shall not be used to replace existing public funding or private-sector forms of credit enhancement. Criteria for receiving an allocation would include:

  - The economic benefits of the project;
  - The level of economic need of the community served; and
  - The degree of leverage.

B. Accelerating Infrastructure Projects Through Pledges of Future Planned Federal Expenditures

Issue:

The federal government provides significant revenues for state and local infrastructure development, but this investment occurs over many years. Capital spending for environmental projects or military base cleanup, for example, often extends beyond 20 years. Up-front financing for such projects could minimize the costs of inflation, accelerate development and ensure a more rapid delivery of project benefits to the affected communities.

Proposal:

- Stimulate state and local infrastructure developments by providing a federal revenue pledge for multi-year projects. With a strong pledge of revenues, state and local governments could issue bonds and receive funds at the outset of a project, thereby accelerating its completion and the attendant benefits. The federal government could strengthen this pledge through various means, including:

  - Pledging revenues through a statutory formula: Transportation funding (TEA-21, for example) is based on a formula in statute, which has permitted state governments to bond against the revenue stream (GARVEE bonds);

  - Lengthening the authorization period: A period of five years or longer, if feasible under federal budget processes, would expand the ability to issue debt against future revenue streams.

  - Entering contractual obligations. If the federal government obligates itself for completion of a project over a designated number of years and a designated amount of money, bonds can be issued even with the uncertainty of specific budget appropriations.

The scope of currently projected federal investments is quite significant. Over the next five years, the federal government is expected to spend over $180 billion for infrastructure projects, and over $160 billion on education. If only 20 percent of that revenue stream were pledged for bonds, state and local governments could issue close to $100 billion in bonds for infrastructure projects and over $75 billion in bonds for education capital projects.

State and local bonds have been issued, using this model, to finance transportation and public housing projects. This proposal would extend this technique to other areas of federal spending, including but not limited to:

- Military base conversion (Department of Defense)
- Superfund cleanup (Environmental Protection Agency)
- School modernization (Department of Education)
- Rail/Amtrak expansion, airport security modernization (Department of Transportation)

2. Increased Financing for Private Sector Projects of Public Benefit such as Affordable Housing and Pollution Clean-up

Issue:

State and local governments have broad authority to issue tax-exempt bonds for public projects. Federal law limits the amount of tax-exempt bonds that can be issued for private sector projects of public benefit. These "private activity" bonds can be issued for purposes that include single family home mortgages, affordable multi-family housing, industrial development projects (manufacturing), environmental clean-up projects, and student lending. These bonds have been an important tool in stimulating state economies, contributing to homeownership and affordable rental housing, and meeting other critical public needs.

Federal law places a limit – known as the bond volume cap – on the amount of such bonds that may be issued, based on a per capita formula applied in each state. Although the volume cap was increased in January 2001 and again in January 2002, demand for these bonds continues to outstrip supply. For example, in California, demand for private activity bonds in 2000 exceeded supply by a 2 to 1 ratio, in Pennsylvania, by a 3 to 1 ratio, and in 2001, Texas and Illinois were oversubscribed by approximately three times.

The law also currently prohibits users of industrial development bonds (IDBs) from having capital expenditures of over $10 million in a municipality where the project is located for the three years prior to and subsequent to their issuance. This limitation has existed for 23 years, during which time the value of $10 million has been effectively cut in half because of inflation. IDBs often are not used because of this limitation.

The use of private activity bonds for brownfield assessment and remediation – critical pieces of economic development and community revitalization efforts – is not currently permitted.

Proposal:

- Amend federal law to increase, for a three-year period (2002 through 2004), the private activity bond volume cap by 20 percent – from $75 to $90 per state resident (and for small states, from $225 million to $270 million). This would result in approximately $5 billion in additional bonding authority across the nation in each of the next three years. In addition, the law should be amended to allow recycling of mortgage revenue bonds to expand funding available for homeownership.

- Amend the law to increase the dollar limitation on users of industrial development bonds from $10 million to $20 million.

- Expand permissible uses of private activity bonds to include brownfield assessment and remediation.

3. Temporary and Immediate Fiscal Assistance to States and Localities to Stabilize Capital and Operating Budgets

Issue:

State and local governments face a budget crisis in 2002. Preliminary estimates already show budget gaps of $50 billion at the state level alone and a demand for $5 billion in increased spending on homeland security. When local governments are added, the total state and local budget shortfall could easily reach $75 - $100 billion, the size of the recently debated federal stimulus package.

This crisis will continue even if the larger economy begins to recover; it will get much worse if the economy does not rebound. Moreover, as budgets and credit conditions deteriorate, states and localities will cut needed infrastructure projects, with adverse effects on local and regional economies immediately and into the future. Further, as required by constitutional balanced budget provisions, states and localities will react by cutting spending and raising taxes – creating a drag on economic recovery at a critical time.

Some cuts are already being made in state and local spending, but most of these cuts will occur in the near future. Thus, unlike the cuts in business capital investment and consumer spending, impacts of state and local budget actions have not yet been felt in the economy. They are a land mine squarely in the path of economic recovery.

Critical infrastructure investment and essential spending can be stabilized, to the benefit to the national economy, by an urgent program of temporary federal assistance to state and local capital and operating budgets.

Proposal:

- Immediately enact a $100 billion program of one-year fiscal assistance to states and local governments.
  - Base the allocation formula on population, modified to some extent by factors such as per capita income and by urgency of need measured by unemployment.
  - Designate the funds as outright grants to state and local governments.
  - Provide the funds for states and localities to allocate as they see fit.
  - Review the program after one year, with the possibility of renewal, depending on economic conditions.

PARTICIPANTS IN DECEMBER 5, 2001 AND JANUARY 28, 2002 ROUNDTABLE DISCUSSIONS *

NAME	**ORGANIZATION**
Chris Ailman	California State Teachers' Retirement System
The Honorable Philip Angelides	California State Treasurer
David Blitzstein	United Food and Commercial Workers
Michelle Cunningham	California State Teachers' Retirement System
The Honorable Randall Edwards	Oregon State Treasurer
Michael Flaherman	California Public Employees' Retirement System
James Galbraith	LBJ School of Public Affairs, University of Texas, Austin
Dan Gallagher	Los Angeles City Employees' Retirement System
David Gatton	U. S. Conference of Mayors
Bob Georgine	Union Labor Life Insurance Co.
Rick Hayes	California Public Employees' Retirement System
Stephen Levy	Center for Continuing Study of the California Economy
The Honorable H. Carl McCall	New York State Comptroller
The Honorable Dale McCormick	Maine State Treasurer
The Honorable Richard Moore	North Carolina State Treasurer
Elizabeth Mozley	Florida State Board of Administration
The Honorable Shannon O'Brien	Massachusetts State Treasurer
Peg O'Hara	Council of Institutional Investors
James Parrot	Fiscal Policy Institute
Martha Peyton	TIAA-CREF
George M. Philip	New York State Teachers' Retirement System
Howard Rifkin	State of Connecticut Treasurer's Office
The Honorable Felix Rohatyn	
Dave Smith	AFL – CIO
Wayne Smith	Massachusetts Pension Reserves Investment Management Board
The Honorable Bill Thompson	New York City Comptroller
Mike Travaglini	State of Massachusetts Treasurer's Office

* Partial list. In addition to the December 5th Roundtable Discussion, there was a subsequent meeting on January 28th to review the contents of this report. Organizational affiliation listed for identification purposes only. This listing does not imply endorsement by the individual or organization of the contents of this report.

THE WALL STREET JOURNAL.
Tuesday, September 25, 2001

Rebuilding Can Revive the Economy

By Felix G. Rohatyn

Congress has approved, and President George W. Bush signed, legislation that offers New York roughly $20 billion to help rebuild from the tragedy of Sept. 11. Another $15 billion will go to help the faltering airline industry. Only time will tell whether this will be sufficient to deal with the serious economic downturn facing the city and the nation. But it is likely that the ripple effect of the attacks on New York and Washington, coming on top of a weakening economy, will require broader action on both the local and national levels.

The immediate reaction to the terrorist attack by the president and Congress indicates that we are breaking out of the intellectual straitjacket of budgetary "lock boxes" and not "squandering" the Social Security "surplus." It is high time that we came back to the reality that we have the lowest debt-to- gross-domestic-product ratio of any developed country, that we have a fundamentally strong economy, and that our only objective must be to regain economic growth. That must be done, on a national scale, by a combination of private and public investment.

Rebuilding New York's infrastructure is important. Rebuilding the national infrastructure and, at the same time, fueling economic growth and productivity, is equally important. President Bush should take a page from of one of his predecessors, Dwight Eisenhower.

In 1956, trying to prevent a recession after the Korean War and to deal with nuclear threats to urban areas, Eisenhower signed the Federal-Aid Highway Act of 1956. Over the next 30 years, 43,000 miles of highway were built at a cost of $128 billion (over $250 billion in present value and averaging, in the early years, over 3% of GDP). That generated enormous economic activity and helped secure our cities. President Bush should consider a similar piece of landmark national legislation.

Our national economy is likely to enter a significant downturn due to its weakness in the past year and the impact of the recent events. The dramatic downturn in the airline industry is just one aspect of this downturn, which will inevitably result in still more lost jobs, lost confidence, and a significant slowdown in consumer spending. A large-scale public-investment program would have an important long-term economic impact and is badly needed by urban as well as rural America. It would also provide a great psychological lift to Americans worried about the future.

A recent report by the American Society of Civil Engineers indicated that America's infrastructure needs over the next five years total $1.3 trillion simply to reach acceptable standards. Our schools are in the worst shape of any category, worse even than our sewers. It would take $127 billion to bring our schools into good overall physical condition, according to the Department of Education, and over $300 billion to meet the costs of rising enrollment and installing modern technological infrastructure. If education is indeed a priority, as President Bush rightly claims it to be, the physical condition of our schools and their safety is as important as their curriculum.

Before the terrorist attack, our airports were estimated to need $40 billion to $60 billion worth of investment to handle increased traffic. They will now need more to meet greater security requirements. Mass transit systems will require $39 billion to maintain current conditions, and $72 billion to improve significantly. Roads will require $350 billion, and bridges $80 billion.

The list goes on and on for waste disposal, drains, water systems, etc. For the country, that list is both a need and an opportunity.

A $250 billion five-year infrastructure program should be the objective of an initial Bush plan. Its financing could be done in a variety of ways, and should offset the fiscal pressure on state budgets that will be caused by the coming downturn. The country's strong fiscal condition suggests direct federal financing as the cheapest and most practical way to accomplish this.

The increase in the national debt of $50 billion per year as a result of this program would be less than 0.5% of GDP, and the benefits to growth, employment and national productivity would more than offset this. If necessary, it would also be possible to mobilize financing from state employee pension funds, which have hundreds of billions of dollars in assets, by creating local bonds with federal guarantees.

The Federal-Aid Highway program of 1956 was financed by federal gasoline taxes, but any tax increase at this time would be counterproductive. As a matter of fact, the administration might consider restructuring the current version of the Bush tax cut in order to bring the rate reductions forward and provide stronger near-term stimulus.

Some will argue that these policies would raise fears of future inflation and raise long-term interest rates. But what we have to fear is near-term deflation and contraction, not future inflation.

President Bush could call on business and labor, Democrats as well as Republicans, to support such a program. Tens of thousands of Americans will be laid off in the near future. A national infrastructure program of this type could generate up to one million new jobs, depending on the investment mix, and maintain these jobs over time. It would well serve the nation in this time of need.

The San Diego Union-Tribune.
Wednesday, January 16, 2002

Investments as an economic stimulus

By Philip Angelides

The economic slide that was accelerated by the terrorist attacks of Sept. 11 generated a sharp and divisive debate in Washington over the measures needed to ensure a recovery. The stalemate that resulted, however, has provided a fresh opportunity to pursue an economic strategy to create wealth for future generations.

In December, financier Felix Rohatyn, New York Comptroller Carl McCall, and I convened a meeting of pension fund managers, local and state investment officers, and labor leaders to discuss measures to respond to the nation's economic challenges. From that meeting emerged a broad outline of a strategy that calls for new capital investment to rebuild and modernize our crumbling infrastructure -- schools, transit, parks, high-tech networks and other systems so necessary for long-term economic growth.

The case for such a strategy is straightforward.

In every state, there are billions of dollars in critical, but unmet, infrastructure needs. Over $127 billion is needed to repair the nation's public schools. In California alone, $16 billion is needed over the next five years to fund the state's share of public school construction and renovation, and more than $1.5 billion is needed immediately to bring student-to-computer ratios to an acceptable level.

The Federal Highway Administration (FHWA) estimates that the annual investment required just to maintain the nation's transit systems is over $10 billion. Airports, bridges, and water systems need to be updated and made secure against terrorists.

An initiative that mobilizes the credit and financial strength of the federal government to support state, local government and pension fund investments in critical infrastructure and economic development projects would begin to repair these tatters in our public fabric and lay the foundation for enduring economic strength. Such an approach is particularly critical at this moment, given the fiscal straits of many state and local governments as revenues plummet.

The National Conference of State Legislatures has reported that 44 states show lower-than-expected revenues while at least 19 face higher-than-expected costs due to the economic slowdown. States may cut upward of $50 billion from their budgets, wiping out any positive effects of the currently contemplated federal stimulus efforts and threatening vital capital outlay projects.

Here are some specific steps which can be taken to boost infrastructure investment and assist economic recovery.

While state and local governments can issue bonds for economic development and infrastructure projects, their ability to do so is limited by their budgetary constraints. A federal program to provide credit support for state and local bonds would be a powerful fiscal tool for two reasons: it would lay the foundation for future growth and stimulate the economy if the recession is deeper and more enduring than some are projecting. Studies have shown that every dollar invested in public works creates $2.50 in economic activity. The FHWA says that more than 42,000 jobs are generated for each $1 billion spent on transportation improvements.

Public pension funds -- which now have over $2 trillion in assets -- could play a major role in an infrastructure building program by purchasing federally guaranteed bonds for projects that could not be financed absent those guarantees. These bonds could pay for regional projects such as inter-city high-speed rail lines, while representing a prudent investment for pension systems. Temporarily increasing federal limits on the ability of state and local governments to finance affordable housing, pollution clean-up and job creation with tax exempt bonds also should be considered. These projects can generate economic benefits in the near term, as they contribute to critical community revitalization efforts.
These are only a few of the ways that Washington could help rebuild our infrastructure and enhance economic opportunity. These measures would serve as a blueprint for tomorrow's growth, providing far more benefits than a temporary stimulus.

This approach has ample precedent. Indeed, the successful American economic model has blended intelligent public sector investment with private sector dynamism. In the midst of the Civil War, Abraham Lincoln had the foresight to charter a transcontinental railroad, which created a national economy, and to establish a system of land grant colleges, which educated a modern work force.

In the dark days of the Great Depression, Franklin Roosevelt embarked on a program of public works to boost the nation's spirit and strength. To combat recession and to bolster national security, Dwight Eisenhower signed the Federal-Aid Highway Act of 1956, creating the interstate highway system.

Our response to our current challenges should be no less visionary. We should craft new capital investment initiatives that would signal to the people of our nation and the rest of the world that America is still capable of the kind of action during times of crisis that has made it great throughout its history.

Angelides is California State Treasurer.

The Sacramento Bee

Saturday, December 15, 2001

Editorial

Diet for recovery

Economy needs states to keep building

The biggest temptation for policy-makers in an economic downturn is to stop thinking about tomorrow. When revenues fall and budgets get tight, the easiest way to respond is to lop out capital projects and stop building for the future. But as a group of state investment and pension-fund investments pointed out in a meeting last week in New York, that's the wrong response, both for today and tomorrow. Is Congress, still mired in political infighting on an economic stimulus bill, listening?

The meeting, called by state Treasurer Phil Angelides, New York state Comptroller Carl McCall and Felix Rohatyn, long a leading investment banker on Wall Street, was the first step in putting together a state-local-federal strategy for responding to recession and terrorist attack by building up the country's public capital.

No one doubts the need. Around the country, and here in California in particular, there are hundreds of billions in unmet infrastructure needs: for new schools, better roads, commuter rail, airports and water and sewer systems. And this is a good time to build. Capital is cheap; interest rates are at a 40-year low. There are workers who need jobs.

But without a plan and federal assistance, public investment could easily shrink instead of grow. States are looking at estimated cuts of $30 billion in the next year. The nation's mayors project $11 billion in revenue shortfalls for cities. Many of the cutbacks will come in funding for capital projects, which are the easiest to suspend. Less building means fewer jobs and an even deeper and longer recession.

The best help Congress could give the economy would be to prevent that from happening. A temporary program of federal aid to state and local governments would bolster budgets and prevent cuts in services and capital projects. If the aid is aimed at sustaining infrastructure investment in particular, the federal government would sustain economic demand and employment today, while building the facilities that will bolster the economy for the future.

The investment officers are aiming in the next few days to put together a package of infrastructure-supporting measures for Congress to consider. Given what stimulus lawmakers have so far produced -- handouts for the rich and corporations in the House, stalemate in the Senate -- Congress needs to be paying attention.

San Francisco Chronicle
Thursday, December 6, 2001

Investing in the future

DESPITE the congressional debate over how to rescue the U.S. economy, lawmakers have ignored a crucial problem: No matter how the $100 billion or so in tax cuts and new spending is allocated, the stimulus will be all but negated by the estimated $75 billion in spending cutbacks planned by state and local governments that, like California's, are drowning in recession-spawned red ink.

But there's a hidden pot of money that could be accessed -- pension funds, which hold $2 trillion in assets.

California state Treasurer Philip Angelides is leading a coalition of pension fund and state officials from eight states that has come up with a laudable plan to harness these funds.

Because of strict fiduciary limits on pension-fund investments, funds cannot invest in most state and local bond issues because they are deemed too risky.

The solution, say Angelides and co-organizers New York Comptroller Carl McCall and investment banker Felix Rohatyn, would be a federal guarantee on state and local governments' bond issues. This would enable pension funds to buy billions of dollars of those bonds. As a result, governments could address their huge backlog of infrastructure projects, thus benefiting communities and creating much-needed jobs. Even more visionary projects, such as high-speed rail in California, could become feasible.

The concept was germinated by California's two huge public pension funds, CalPERS and CalSTRS, and the state Treasurer's Office, which during the past two years have channeled billions of dollars into investments in inner-city and impoverished rural areas in the state.

Yesterday, the coalition met in New York and agreed on a plan that they will present to Congress next month. It's a far-sighted initiative that deserves support.