US Infrastructure: High Hopes, Hard Realities

- **There is yet-again renewed enthusiasm for infrastructure on Capitol Hill following last month's apparent bipartisan support for a USD 2 tn package, but its chances of passing are next to nil.**
- **A partial deal in the order of USD 200 bn could provide a catalyst for a broader funding and debt ceiling deal well ahead of crunch time at the end of the fiscal year when the Feds run out of flexibility.**
- **Such a deal would have only a marginal and transitory impact on growth at best, but could provide a political boost to a President increasingly desperate to get things done.**

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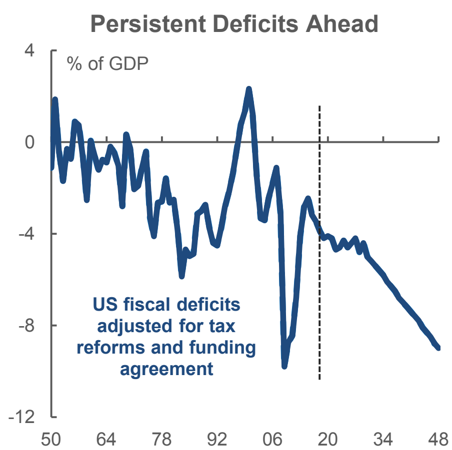
TAKE CENTER STAGE

Infrastructure is back in vogue in Washington D.C. Late last month, media reported a bipartisan agreement of USD 2 tn for infrastructure investment following a closed-door meeting among President Trump, House Speaker Pelosi, and Minority Leader Schumer. There was scant detail beyond broad references to roads, bridges, mass transit, and high-speed communications.

Recall President Trump campaigned on a USD 1 tn infrastructure spending pledge. This was based on an assumption that USD 200 bn federal spending would leverage USD 800 bn in private investment. After assuming office, this ballooned to a USD 1.5 tn infrastructure plan, which quickly lost steam when it was unveiled that state and local governments, along with the private sector, were expected to shoulder USD 1.3 tn under this new plan. The USD 200 bn figure appeared again in March without much fanfare in the President's Budget FY2020 request as a single line item '*Support major investment in infrastructure*'.

Chart 1



Sources: Scotiabank Economics, CBO.

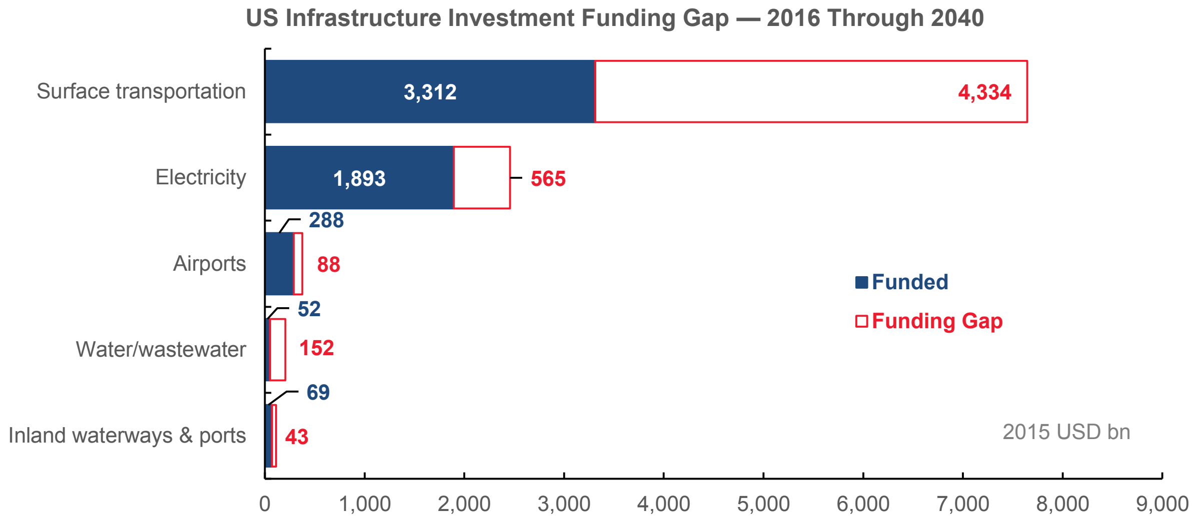
IT'S JUST POLITICS

A deal is still a long way off. The recent informal bipartisan agreement simply acknowledges the mutual importance placed on infrastructure. President Trump is expected to share details on how to pay for it as a next step in the negotiations. One can expect the Republicans to push for a plan that will '*pay for itself*' over time with a number of questionable assumptions around its impact on growth and ability to leverage additional financing.

Democrats have signalled that they expect the President to offer up some '*pay-fors*' in return for support. They have even suggested a roll-back of the 2017 tax cuts—no doubt a non-starter for the Republicans. With tax increases off the table a year out of elections and expenditure restraint elusive, a more likely outcome would be a modest, deficit-financed package, along with some token offsets. This would be consistent with the government's penchant for deficit-spending (chart 1).

Priorities are another point of contention. So far, President Trump's various pitches have largely been financing plans, not funding priorities. There is still a vast gulf between President Trump's proclivity for private interests (read, property developers), along with a roll-back of regulation at the expense of environmentalists, and the emerging Democratic ideology around the Green New Deal. That said, with major investment gaps across almost all infrastructure classes, a middle ground could likely be found in sectors such as roads, bridges, transit, electrical grids, and communications infrastructure (chart 2).

Chart 2

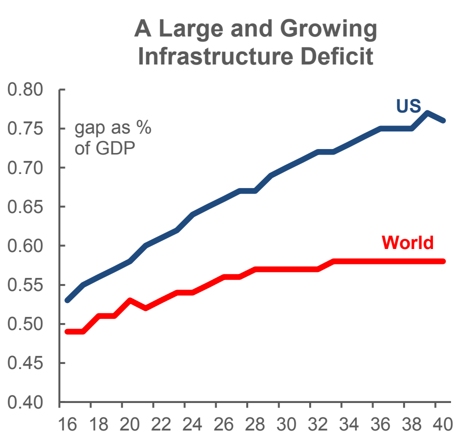


Sources: Scotiabank Economics, American Society of Civil Engineers.

MOTIVATED PARTIES

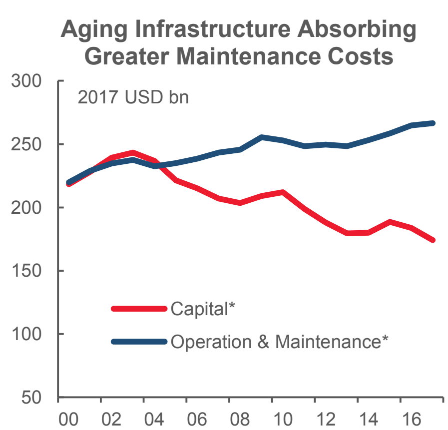
There is full agreement on both sides that US infrastructure investment needs resuscitation. Its growing investment gap exceeds and outpaces global trends, measured as a difference between today's policy trends versus best-peer performance (chart 3). There has been a persistent erosion of public investment from a peak of 4.2% of GDP (federal, state and local combined) in the late 1930s to about 1.4% today. Already-stretched subnational levels of government increasingly shoulder the bulk of infrastructure financing, with almost three-quarters dedicated to operations and maintenance alone (charts 4 and 5). The potential losses to the US economy will only continue to grow (chart 6).

Chart 3



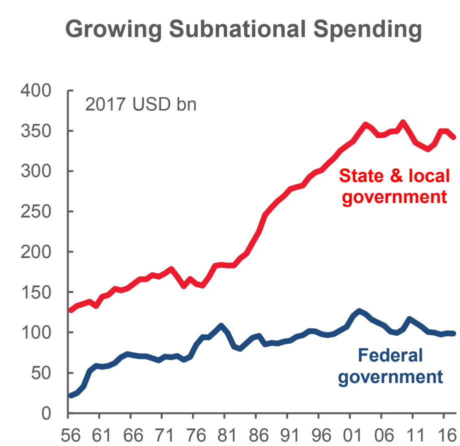
Sources: Scotiabank Economics, Global Infrastructure Hub.

Chart 4



Sources: Scotiabank Economics, CBO.
* Transportation and water infrastructure. Adjusted for inflrastructure-specific inflation.

Chart 5



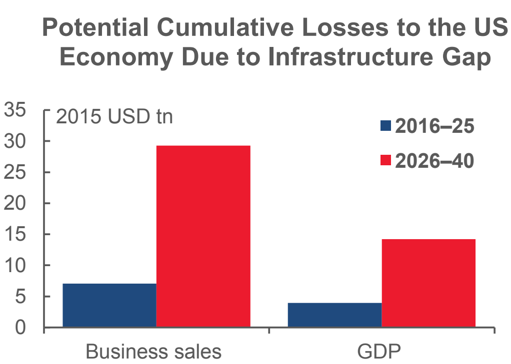
Sources: Scotiabank Economics, CBO.
Transportation and water infrasctructure.

With skin in the game for both parties, the recent improvement in bipartisan rhetoric around infrastructure could modestly improve the chances of President Trump's budget ask receiving broad support later this summer as a sort of down-payment. A partial deal could be a catalyst that helps clear the way for a broader funding and debt ceiling deal well ahead of when the US Treasury runs out of flexibility toward the end of this fiscal year. It also leaves the door open for the next government to deliver—and claim credit for — a second, larger infrastructure deal.

BANG FOR THE BUCK

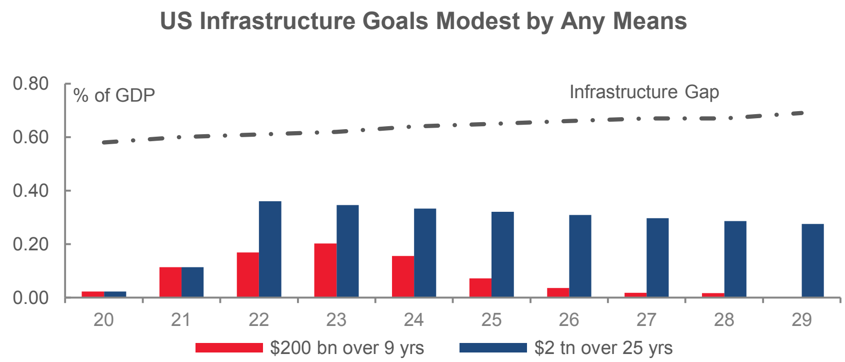
But the numbers are not big under any scenario. Two trillion sounds impressive—at almost 10% of GDP—until it is spread over 25 years and deflated relative to broad GDP. It would translate into roughly USD 85 bn annually assuming a multi-year ramp-up. While this is bigger than the President's budget ask, which peaks at USD 50 bn in 2023 before quickly dropping off, it would be a stretch to call it a game changer at less than half a percent of GDP (chart 7).

Chart 6



Sources: Scotiabank Economics, American Society of Civil Engineers.

Chart 7



Sources: Scotiabank Economics, Global Infrastructure Hub, CBO.

There are many reasons to apply additional negative judgement against any significant boost to output (box 1). Even in an ideal scenario (i.e., a debt-financed investment in a low-growth, low-debt environment), the most optimistic estimates of fiscal multipliers are just north of one. With tight labour markets and a construction sector at capacity in the US, any near-term boost should be heavily discounted, particularly if there is a dampening response from the Fed. Any medium-term impact would quickly fade, absent exponential growth in the investment profile, given steeper infrastructure-specific deflators.

Ultimately, a deficit-financed infrastructure package in an economy operating above potential like the US, at best, could maintain the public debt-to-GDP ratio at level. It runs the risk of actually steepening its current assent.

TOO LITTLE, TOO LATE…OR TOO EARLY

Infrastructure investment is sorely needed in the US over the medium term. Chronic underinvestment over the past decades has contributed to waning growth potential. But at this stage in the economic cycle, the impact of such a new spending package would be significantly eroded, its magnitude marginal, and its financing controversial. A small deal today that paves the way for a larger deal tomorrow may not be a terrible outcome.

BOX 1

PANACEA OR PIPEDREAM?

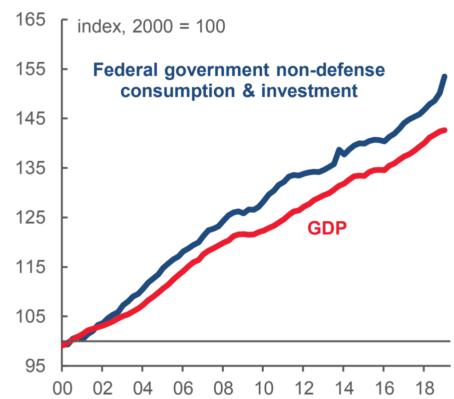
It is easy to make a compelling case for infrastructure investment, in theory at least. It can provide a short term boost to the economy when shovels hit the ground, while also enhancing growth potential through productivity-enhancing investments. Though estimates vary widely across literature, the IMF suggests a 1% of GDP increase in investment spending can lift output levels by 0.4 % in the first year and 1.5% after four. With interest rates lower than nominal growth in most major economies—a trend expected to continue for the foreseeable future—financing is cheap.

But will it pay for itself? The answer is, it depends. Investments in core infrastructure—defined as roads, railways, airports, and utilities—produce larger gains in output than investments in broader infrastructure such as hospitals and schools. The US Congressional Research Service estimates a 1% increase in public capital stock drives a long term level increase of 0.12% in private-sector output for broad infrastructure versus a 0.17% level impact for targeted infrastructure.

The stage of the economic cycle is also important. A 1% of GDP investment shock in a period of slack can boost medium term output levels by as much as 3%, according to the IMF, but would be negligible in periods of high growth. Its impact over time should be further discounted, given steeper infrastructure-specific deflators relative to the GDP deflator (chart 8).

Financing will also impact outcomes. A deficit-neutral plan financed through tax increases or spending cuts would offset any growth impact in the short term. While a deficit-financed plan could have a stronger stimulative effect in the short run, it could crowd out private investment over the long run. The US Congressional Budget Office estimates that every dollar increase in the deficit reduces investment by 33 cents over the medium term as it pushes up interest rates and crowds out more efficient private sector investment.

Chart 8 **Government Spending Deflators Higher**



Sources: Scotiabank Economics, BEA.