Biden’s once-in-a-generation infrastructure plan puts IITs in spotlight

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There is no shortage of capital for infrastructure, but rather a lack of suitable investment vehicles and political will. Another way forward is necessary.

A mammoth investment step-up to modernize the country’s infrastructure, creating millions of jobs in the process – this was how the Biden administration billed its American Jobs Plan, after weeks of negotiations led to an agreement among a bipartisan group of US senators in late June. The president sees the infrastructure deal as a catalyst for a clean energy future.

This deal is a huge step towards addressing the nation’s ageing infrastructure, but much remains to get done over the long term, as highlighted by the latest American Society of Civil Engineers (ASCE) 2021 infrastructure report card.

The ASCE report reveals that for the first time in 20 years the USA made progress restoring the country’s infrastructure, taking US infrastructure out of the ‘D’ range to ‘C-‘. The country is moving in the right direction in sectors like drinking water, inland waterways and airports – the private sector has invested in the electric grid, freight rail and more.

The development of an IIT structure, tax-efficient for both governments and investors, would aim to create a financing tool for essential but costly long-term generation-to-generation infrastructure.

Figure 1: Cumulative investment needs by system, based on current trends 2020 to 2029 ($bn)

Infrastructure System	Total needed	Funded	Funding Gap	2021ASCE Grade
Transportation	$2,834	$1,619	$1,215	Rail (B), Roads (D), Bridges (C), Transit (D-)
Water	$1,045	$611	$434	Drinking (C-), Storm (D), Waste (D+)
Energy	$637	$440	$197	C-
Airports	$237	$126	$111	D+
Waterways & Ports	$42	$17	$25	Inland (D+), Ports (B-)
Dams	$94	$13	$81	D
Waste	$21	$14	$7	Hazardous (D+), Solid C+)
Levees	$80	$10	$70	D
Parks & Recreation	$78	$10	$68	D+
Schools	$870	$490	$380	D+
Totals	**$5,937**	**$3,350**	**$2,588**	**C-**

Source: 2021 Infrastructure Report Card, ASCE

"A purpose-built Infrastructure Investment Trust (IIT) structure could act as a liquid investment vehicle for essential infrastructure, particularly in emerging markets where foreign investment in listed equity is now common amongst many investors."
G20/OECD Report on the Collaboration with Institutional Investors and Asset Managers on Infrastructure: Investor Proposals
Extract from OCED Report, July 2020

However, the ASCE's analysis reveals that the US long-term investment gap continues to grow. Figure 1. shows that the total investment required over the next ten years has increased to $2.59tn, up from $2.1tn in 2017 – the USA is currently paying about half of its infrastructure bill.

What is needed now is increased, long-term and consistent investment from government and the private sector, equivalent to 3.5% of GDP by 2025. Continued underinvestment at current rates will have serious economic consequences, the ASCE argues, costing an estimated:

- $10tn in GDP
- More than 3 million jobs
- $2.4tn in exports over the next 20 years

In Issue 7 (page 8) of the *GLIO Journal*, we wrote about the benefits of introducing a clearly defined Infrastructure Investment Trust (IIT). The development of an IIT structure, tax-efficient for both governments and investors, would aim to create a financing tool for essential but costly long-term generation-to-generation infrastructure. The proposal, coming at a time when the funding of public projects is under extreme pressure, offers a potentially harmonious social outcome:

- Citizens get quality infrastructure assets and services
- Politicians get happier voters, job creation and an economic boost
- A wider range of willing investors get access to infrastructure assets

A G20/OECD report[1] published in July 2020 presents multiple proposals from the private sector on mobilizing investment in infrastructure, including a proposal on a clearly-defined financial vehicle[2] for infrastructure – an infrastructure investment trust (IIT) – for which GLIO provided the OECD with comments and feedback.

The IIT structure could emulate the legal and financial blueprint set by Real Estate Investment Trusts (REITs).[3] It is worth reminding ourselves that in the USA, where REITs were born, there are six vehicles backed by infrastructure assets which are predominantly telecom towers.[4] Today about 25% to 30% of all commercial real estate is in the hands of private investors through the $1tn market capitalization REIT market.[5] NAREIT estimates that 80 million Americans own REITs through retirement savings and other investment funds.

Getting IIT done – hurdles and possible solutions

A Cohen & Steers paper in 2020[6] examined the weight of investment dry powder awaiting suitable infrastructure assets. It concluded that while governments struggle to raise capital to maintain or develop essential infrastructure, $220bn[7] in potential investment is seeking a home.

Clearly the shortage is not of capital, but governments' willingness to work with the private sector and create suitable asset vehicles.

North America, for example, has rather limited track-record so far in transportation infrastructure.[8] Toronto's Highway 407 is a positive precedent that has supported $16bn in economic benefits for the area since it was sold 20 years ago, but the privatization of transportation assets remains rare. (More about Highway 407 on p22). Passenger railroads (D-) and airports (D+) tell a similar story of underinvestment and limited private investment involvement, both scoring poorly (scores in brackets) in the ASCE report.

We believe that innovative and case-supported privatization programs can provide the mechanism to address the mismatch between capital poised to invest and public assets in dire need of upgrade. >

1. *The G20/OECD Report on the Collaboration with Institutional Investors and Asset Managers on Infrastructure: Investor Proposals, released in July 2020 at the G20 Finance Ministers and Central Bank Governors meeting.*
2. *IIT has the potential for tax efficiency for both governments and investors.*
3. *We first raised this idea in issue 2 of the GLIO Journal. Also see in Issue 3: 'IITs to help solve the US infrastructure funding gap'.*
4. *REIT.com*
5. *Source: UBS Global Real Estate Analyzer, 2017*
6. *www.cohenandsteers.com/insights/read/let-private-capital-heal-what-ails-public-infrastructure*
7. *Preqin. See 'Mind the Gap' article in this issue 7 of the GLIO Journal.*
8. *Much of the US utility, telecom infrastructure and energy transportation sectors are listed and boast broad ownership.*

We believe that innovative and case-supported privatization programs can bridge the gap between investment-ripe capital and upgrade-starved public assets.

The biggest hurdle, however, is politics. Getting state and local lawmakers to release ownership and control of critical assets to private companies remains a challenge. Moreover, voters – the users of the assets – may need convincing that the aim of the privatization is not profiteering but funding the building and management of costly yet essential transport and communications infrastructure.[9]

Another issue lies in the provision of assets in less densely populated areas. The need for infrastructure maintenance may be acute, but expected user fees may not provide a feasible investment case.

The advantages to those with greater infrastructure awareness are nevertheless clear:

- Citizens get to use higher-quality, better-funded assets and services than they would otherwise. This is particularly pertinent post-COVID, in a world where global government finances are already stretched by the attempt to reboot the economy.
- Updated infrastructure fuels an economy's long-run potential growth rate and competitiveness.
- A broader range of investors access the infrastructure assets they crave in a coherent, transparent and regulated vehicle. Put simply, the population can own a stake in the essential assets they use on a day-to-day basis.
- Factoring ESG considerations into the development and maintenance of assets is critical to receive funding from private markets; investors must be convinced those managing the assets are doing the right thing. There is a clear opportunity to ring-fence essential new clean energy development.

For those who doubt the imperative, the cost of doing nothing could be huge as illustrated earlier. The risk of continued inaction is clear.

Privatization of public assets presents a clear path forward and the rarest of social outcomes: a potential triple win – quality assets & services, an economic boost and essential investment

Creating an IIT structure against a backdrop of pent-up global demand for targeted infrastructure investment could open the floodgates to private capital. Conditions would be set to attract investment to mission-critical transportation and utility infrastructure assets, many of which are in dire need of improvement.

For investors, the steady cash flow characteristics of infrastructure projects would also mean that the IIT could be used as part of a stable, lower-volatility, high yield-oriented investment allocation. This type of asset class is in high demand by investors.

"A vehicle encouraging capital formation and deployment for infrastructure assets is becoming increasingly critical. REITs have been transformational across the globe for real estate investment and a new IIT could do the same for infrastructure. An IIT would increase the tax base, improve infrastructure quality and performance, plus user experience. Moreover, the vehicle enables both international and domestic investors to participate in building out infrastructure fit for the 21st century."

David Stanford, Enterprise Managing Consultant, Real Foundations

9. *In 2008, the Pennsylvania Turnpike lease to Abertis was to get a proposed 27% toll increase. The bid was withdrawn due to widespread legislative opposition.*

Creating an IIT structure, coupled with the pent-up global demand for targeted infrastructure investment, could open the floodgates to private capital.

Boosting the tax base with IITs

The introduction of an IIT should, ideally in our view, act to increase the tax base. Currently, publicly owned infrastructure competes with private business but is not part of the tax pool (i.e. private airlines vs. government-owned rail).

If owned privately, these assets could then contribute to the tax base – for example, in the case of an airport, states and municipalities could benefit from an increase in property taxes, while dividend payments and capital gains could also be taxable. The creation of an infrastructure investment vehicle could be a net addition to the existing tax base and rather than a tax burden.

A purpose-built IIT could leverage much of the success offered by other tax-efficient structures like REITs and provide a clearly defined path for inward bound infrastructure investment.

The IIT could be specifically tailored to the characteristics of infrastructure assets, including how assets and income qualify for inclusion. For example, looking at the ASCE breakdown of infrastructure types, some sectors naturally lean towards private investment like transportation, energy and communications, while social infrastructure like schools, public parks and recreation lean towards government funding.

Figure 2: GLIO's proposed IIT – basic elements

	IIT – Basic Structure
Purpose	Allow broad access to income-producing infrastructure and development
Legislative formation	De novo structure via an infrastructure bill
Distribution	No distribution requirements to allow incentivized investment
Qualifying Assets	Transportation, utilities, energy distribution, communications infrastructure assets[13]
Qualifying Income (existing)	-NA-
Qualifying Income (proposed)	90% of gross income derived from qualifying income from transportation, utilities, energy distribution and communications infrastructure
Ownership	Widely held base among domestic and international institutional and retail shareholders
Taxation	Dividend paid deduction means up to 100% of earnings not taxed at corporate level, distributions include pass-through of depreciation; up-front infrastructure development can be offset against ordinary income

Source: GLIO

An IIT with a built-in ability to pass through tax losses to offset an investor's ordinary income would create a powerful investment incentive from a broad base of long-term global investors.

Looking at the funding gap, imagine how private finance could help develop transportation ($1,619bn gap to 2029) while the government redirects resources to the $490bn gap for US schools. This is public and private capital working together for the greater good.

Figure 2. outlines the basic elements of a purpose-built IIT. This definition would cover the ownership of electric, gas and water utilities, energy transportation and storage, telecommunications/data physical architecture, freight and passenger railways, airports, seaports, bridges and toll roads.[10]

Much of global infrastructure investment requires new construction projects – both developed and emerging economies. This involves a period of no income and, in fact, losses from up-front investment.

An IIT would need to capture the tax loss pass-through benefits of a private partnership structure, unlike the current REIT rules,[11] providing a powerful investment incentive from a broad base of long-term global investors. The 1980s construction boom in commercial real estate had just such a stimulating measure behind it.[12]

IITs a tonic for the economy

State-of-the-art, well-maintained infrastructure is essential for countries to keep their competitive edge. Telecommunications infrastructure is ever more important to business and in our private lives, and this sector will form the spine of the transition from 4G to 5G.

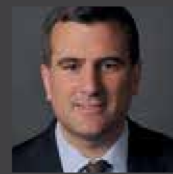
While the USA, for example, leads the world in innovation, business sophistication, financial markets and higher education, it lags in the basic economic structural pillars, of which transportation infrastructure is one – and this needs to be addressed. >

10. These types of assets are covered by the classification governing the GLIO Index: EDHECinfra's TICCS.
11. Up-front tax losses cannot be captured in current REIT regulations.
12. The 1981 Economic Recovery Tax Act, which dispensed additional incentives. Individuals who invested in real estate could quickly write off expenses and losses against income earned from other sources, while a lower capital gains tax rate meant that subsequent profits would be taxed at a lower rate, helping fuel the creation of much of today's real estate.
13. Transportation/distribution of energy, power, data, vehicles (air, sea, road), including the ownership of: 1) electric, gas and water utilities; 2) Communications infrastructure; 3) Freight and passenger railways, airports, seaports, bridges and toll roads.

GLOBAL LISTED INFRASTRUCTURE ORGANISATION

The challenges of funding and operating infrastructure in today's economy require an enlightened approach to attracting private capital through the widest possible global investor base. A listed infrastructure vehicle, through a de novo clearly defined Infrastructure Investment Trust, can provide global investors with a familiar, easily understandable and liquid exposure to infrastructure that can inject economies with fresh, essential capital.

The moment is right for governments to join forces with the private sector to build out the proposals found in the G20/OECD Report.



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