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Vision

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Where Is The World Going? How Do We Get There First?

Editor | James Hoge

Will CEOs Step into the Breach?

Debt and Dysfunction Impair Economic Progress

A Motivated Private Sector Can Open the Door to New Solutions

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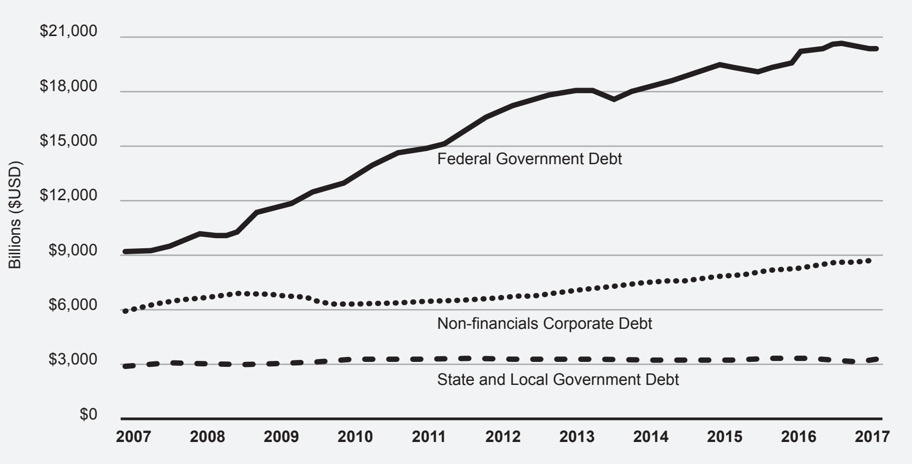
Ten years on from the catastrophic meltdown in financial markets, the global economy is in generally good shape with pockets of actual growth. Europe is doing better, including France, Germany, Italy, and Spain, where growth for the first quarter of 2017 was generally above expectations. Canada and other developed markets are accelerating and, importantly, China has not come off the rails, which has helped emerging market and other commodities-driven economies recover.

As for the US economy, the unspectacular growth that has characterized the recovery – less than half of what we might have expected – seems to be gaining momentum; the second quarter of 2017 repeated the recent pattern of making up for a weak first quarter. And, after years of extraordinary accommodation by global central banks, inflation might finally be picking up – the Bank of England is set to raise interest rates to temper accelerating inflation and in the US, inflation indicators in the month of August were the highest since January, a development that, if it holds, will clear the way for the Federal Reserve to move forward with rate increases and begin to unwind its massive balance sheet of securities.

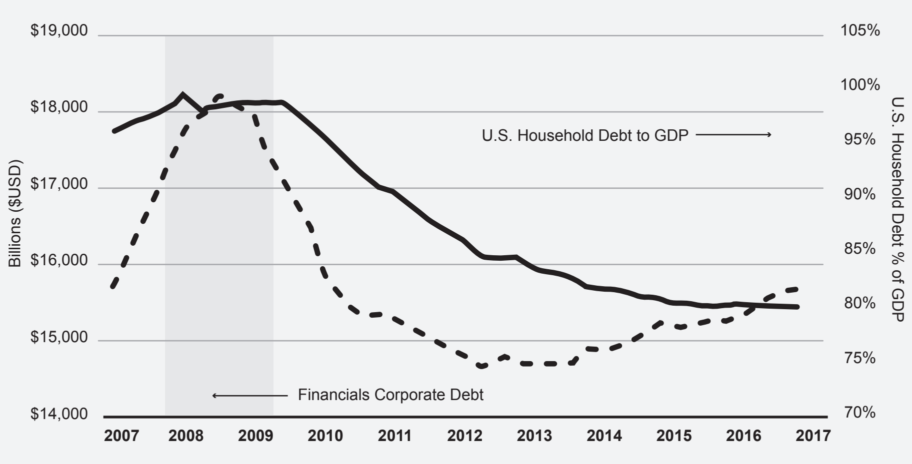
The recovery has come with enormous cost. The contagious effect of the 2008 crisis was driven in large part by a collapse in the US housing market that caught out a highly-leveraged global bank and “shadow banking” system that was unable to unwind its exposure without government intervention. That intervention – the bailout of U.S. and European banks, AIG and other lenders, as well as the rescue of Freddie Mac and Fannie Mae, the government sponsored enterprises at the center of the crisis with $5.2 trillion in US home mortgage debt held or guaranteed – essentially shifted the financial burden of the debt cleanup from the commercial lenders and the GSEs (Government Sponsored Enterprise) to the U.S. taxpayer. The Fed also essentially printed $4 trillion to fund the addition of bonds and mortgage backed securities to its balance sheet to suppress interest rates and to encourage private investment and consumer spending.

Driven by regulatory requirements and common sense, financial institutions and households have cleaned up their balance sheets during the ten years since the meltdown. This helps explain why the recovery has been so shallow; banks have been unable to take on as much risk as they otherwise would and consumers have been wary of digging themselves another hole.

But while a more stable financial system and less-extended consumer is positive for long-term growth, there is work to do if we want to improve the breadth and depth of economic expansion. Many state governments have been unable to reduce their unfunded pension and other liabilities or invest in infrastructure to grow their economies because of a collapse in tax revenues due to a spike in business failures and unemployment from the crisis. And non-financial US corporations have meaningfully increased their debt loads, in part to finance stock buybacks to offset mediocre topline growth and increase earnings per share. Nothing would fund those state pension obligations or mitigate the risk of that leverage more effectively than real economic growth. As Elizabeth Taylor said, “there is no deodorant like success.”



Source: Teneo; Economic Research, Federal Reserve Bank of St. Louis, 2017



In response to the events of 2008 and the Great Recession that was triggered, US policymakers were determined, and rightly so, not to repeat the mistakes of their predecessors who were judged to have mishandled monetary policy in the 1930s. But in economics anyway, there is no free lunch. While we may have averted another Great Depression with difficult but far less acute unemployment, social unrest and violent conflict than that which occurred in the 1930s and 1940s, in doing so we doubled the debt burden of the US economy, which perhaps guaranteed a decade of slow growth and fragile confidence.

Political and Policy Paralysis
Missing from the arsenal of policy solutions to slow growth and wage stagnation has been tax reform and infrastructure investment. Obviously, a deeply divided political environment has been a challenge, but the massive growth in government debt and the unrelenting pressure on state governments has had an even greater impact. In the US, even with a President who ran on a clear commitment to reforming the tax code to make US businesses more competitive and a plan to fund massive infrastructure investments, we have yet to see progress on either front. The Republican party, in charge of both houses and seemingly in agreement on President Trump's priorities, has its own divisions with those focused on tax cuts and spending reductions squaring off against those who want fundamental tax reform and infrastructure investment. As always, we can't have it all.

Ten years after the global financial crisis devastated employment and markets, the US political class remains stymied – our infrastructure is a decade older and while employment is deemed "full", the American middle class continues to shrink as the jobs they are capable of don't pay as much as we need them to for real economic progress. The US corporate tax rate, highest among developed economies, distorts the capital allocation and investment decisions of American companies with significant overseas earnings and strands massive amounts of capital outside the US economy – untaxed by and less productive in the US than it would be if it were repatriated.

As this is being written, it is not clear whether the administration's attempts at "tax reform" will yield only a tax cut, or that any such package will include a major new stimulus program to drive infrastructure investment. In the Spring of 2017, President Trump issued a Fact Sheet on infrastructure initiatives for 2018 budget. While certainly a broad set of principles, it does recognize the fact that federal spending alone won't solve the problem and hints at transferring responsibilities to the states with a scheme to "leverage" $200 billion in federal outlays into $1 trillion in total investment. While the paper is not clear on how to achieve that 5X multiplier, it does mention partnership grants to sidestep the fact that the Federal government cannot make loans to private entities to improve assets that will remain Federal. Such grants would allow the Federal government to provide funding to private partners for projects to improve federal assets in return for access to revenue sources.

A New Order
Meanwhile there has been spectacular growth in revenues and market value among the small group of US-based technology companies such as Apple, Facebook, Amazon and Google. The stocks of these four companies has accounted for 30 percent of the growth in the S&P in the past year and they reportedly account for 20 percent of profits held outside the US. The growth and ability to disrupt entire commercial sectors of some of these companies has also redistributed competitive power and, if history is any indication, means they will attract increasing attention from regulators.

The CEOs of these companies (along with many of their peers at non-technology firms) are taking more direct and provocative stands on social and political issues, with some funding entrepreneurial policy and political groups. While the wealthy and powerful of the business world have always engaged in politics (from the Koch brothers to George Soros), sitting CEOs of public companies are taking more risk to make their political views known and engaging in policy debates outside their specific industry scope.

Beyond the growth of technology companies, the US could be on the verge of a long cycle of growth in the so-called “real economy” – with small business owners gaining the confidence to invest and manufacturers and other large energy consumers advantaged by a more reliable and less volatile supply of domestic energy. As they grow, the manufacturers and technology companies looking to expand in the US are attracted to states and cities with the space and zoning flexibility, as well as more up-to-date infrastructure (airports, ports, highways) to make expansion practical and affordable. In practice, unfortunately, that means from a regional perspective, the rich get richer – states with such attractions and the financial wherewithal to offer tax incentives get the new investment and job growth, while other parts of the country miss their chance to grow.

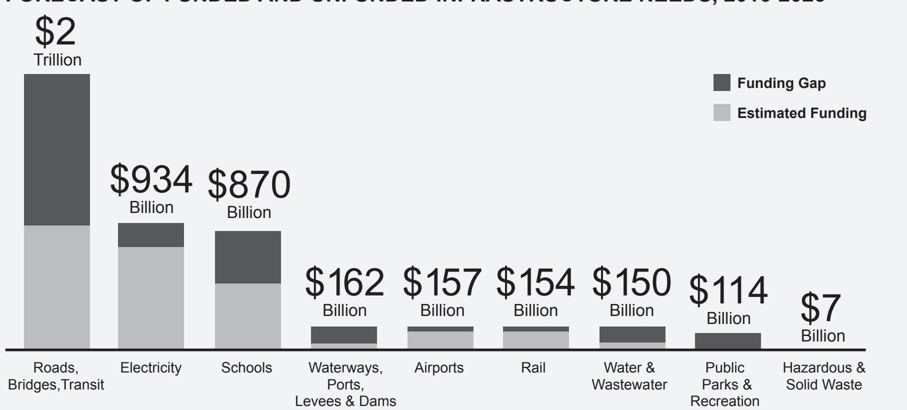
States that continue to lose jobs and fall into deeper fiscal peril obviously must reassess their competitive strategy and stop looking at private companies mainly as something to tax and regulate to fund the activities of the government. Connecticut, for one, has in the past 10 years allowed its state budget to grow 50 percent while managing to grow its population and GDP only 1.7 and -0.3 percent respectively; that is a losing proposition.

“First See that We are Benefitting Ourselves…”

Would it be possible to incentivize the private sector, particularly the large growth companies and manufacturers, to spread their investment around the country, and in some cases, provide the financing necessary to build the infrastructure they need but the state and local governments (where most infrastructure investment has to come from) cannot afford?

When New York City began its phenomenal economic climb in the mid-1800s, it depended on the ambitions of a small cluster of fabulously wealthy and immensely powerful business titans to build the city.

FORECAST OF FUNDED AND UNFUNDED INFRASTRUCTURE NEEDS, 2016-2025



Source: American Society of Civil Engineers 2017 Infrastructure Report Card and Failure to Act series, published 2011-2017

Cornelis Vanderbilt built a steamship and later a railroad empire as a ruthless competitor and shrewd financier. He took enormous risk, but shunned debt and government interference. Yet when Vanderbilt wanted to run his tracks through New York City, he bought the land and laid the tracks. Then he built Grand Central Depot out of his own pocket in 1871. Some thirty years later, after a fatal train collision in the Depot, the Board of Directors of the New York Central and Hudson River Railroad, which included Cornelius Vanderbilt's grandsons Cornelius Vanderbilt II and William K. Vanderbilt (whose father is quoted in the title of this section), as well as William Rockefeller and JP Morgan, approved the replacement of the depot with the current Grand Central Terminal. The design of the new terminal required the company to fully convert its fleet of trains to electricity. The company paid for it all – Grand Central Terminal and the cost of covering what would become Park Avenue was $2 billion in today's dollars, but the company gained the lucrative air rights to the land along Park Avenue. After 136 years, the Terminal, magisterial and perhaps the most crucial element of infrastructure in the Northeast, if not in the US, still stands – bringing New York City's office buildings, restaurants, bars and hotels nearly 800,000 commuters a day.

Can we do anything so great again? Can we upgrade our air and sea ports, our highways and commuter train service, and local roads and water systems? Can we equip a new workforce with the technology skills employers need and can't find? Can we capitalize on the growth that can come from such trends like artificial intelligence, robotics and energy self-sufficiency to create a more balanced and fair economy by commissioning a renaissance in American infrastructure that would create higher wage jobs, reinvigorate local economies and improve the quality of life for millions of citizens?

Amazon founder Jeff Bezos is looking for a location in "North America" for a second company headquarters, which the company says would cost $5 billion to build, stretch across 8 million square feet and provide 50,000 high paying jobs. The company's list of requirements includes a major university and an international airport – in other words, infrastructure – which might eliminate a large number of aspiring cities that need such an opportunity more than those that would top the list.

Apple, Google and Amazon, among others, have committed to procuring or building for themselves the capacity to provide 100 percent renewable energy to power their massive server farms, distribution centers and other needs – for the most part funding it themselves. Major manufacturers such as Dow Chemical are building new capacity across the country. As an example, in the past 4 years Dow has invested $6 billion in manufacturing projects that created over 10,000 direct and in-direct US jobs. To help close the skills gap that is an impediment to economic growth, Dow and other employers have partnered with local colleges and vocational institutions to create an Apprenticeship Program to give formal and on-the-job training to thousands of young and displaced workers.

Governments Pushing the Envelope

There is also innovation among the states, some of which have begun to explore the flexibility that Public-Private Partnerships (PPPs) can provide. Recently, Colorado, Texas, and California have welcomed large private investors to improve rail ways, wind turbines and airports, respectively. Despite these select success stories, the U.S. is just scratching the surface in utilizing PPPs at a state level.

What became Infrastructure Australia (IA), a federal entity focused on infrastructure needs around the country, was originally conceived by the states. While IA has no decision-making authority in the establishment of specific programs, it does mandate that any public project that is estimated to cost more than $A50 million must consider PPP alternatives. The federal body is also a promoter and resource for standards and best practices for engaging in PPPs in Australia. Canada has established an effective national PPP system, again building on a system first tried by the provinces. PPP Canada has a mandate to identify and recommend federal PPP projects and review projects submitted for funding; it also has a multi-billion funding arm, the P3 Canada Fund – all established as part of a greater Build Canada plan for public infrastructure investment.

Closing the Gap

Narrow-gauge politics, funding gaps, muted tax revenue and gridlock in Congress have blocked the progress necessary for the infrastructure enhancements needed across the country. This needs to change. The CEOs of U.S. companies large and small can invest more time and energy into lobbying in Washington and the state capitols, but they ought to think bigger about how they can turn talk into action and investment.

On tax reform, for example, policymakers are eager to include a component that would encourage corporations to repatriate overseas profits. But when George W. Bush tried to do so in 2004 with what seemed an attractive 5.25 percent tax rate, the actual amount repatriated was underwhelming and most of it went to dividends and share buybacks rather than investment. This time around, the program should be designed not only to encourage a greater amount of repatriation, but also to dedicate a significant portion of the resulting tax revenues to a national infrastructure fund, governed by representatives from the public and private sector with a mandate to direct investment to projects which benefit state and local economies and make building and running businesses cheaper and easier. Business interest groups and CEOs should support such a program.

There are other solutions, such as a national infrastructure banks and tinkering with tax credits and incentives; hopefully there will be an opportunity in the next several months as the Trump Administration and Congress begin to debate the policy options. As business leaders consider their public policy and lobbying strategies for the upcoming debate, they should give serious thought to putting their weight behind private/public solutions that involve not only a commitment of time and talent but also capital.

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