

The Wages of Debt

By Sergio M. Marxuach

Puerto Rico's public finances are on an unsustainable path. As shown on Table 1 below, during fiscal year 2009 Puerto Rico's total public sector debt, for the first time in recent memory, was equal to the island's Gross National Product (GNP).

Table 1	
Puerto Rico Public Sector Debt	
	(in millions of \$)
Direct full faith and credit obligations	\$ 10,894
TRANs line of credit	\$ 612
Sales Tax debt	\$ 7,615
Municipal debt	\$ 2,838
Puerto Rico guaranteed debt	\$ 4,106
Debt supported by Puerto Rico appropriations or taxes	\$ 1,412
Public corporations and agencies	\$ 22,490
Limited obligation/non-recourse debt	\$ 6,489
Total debt as of December 31, 2008	\$ 56,456
COFINA bond offering June 2009	\$ 5,340
Total debt as of June 30, 2009 (estimate)	\$ 61,796
GNP as of June 30, 2009*	\$ 61,701
Debt/GNP ratio	100.15%

* Official Planning Board estimate

Sources: GDB and PRPB

Economists consider this an important benchmark because if the ratio of debt-to-GNP continues to rise at a rapid pace, lenders may question the financial solvency of the government and demand higher interest rates for holding government debt. Eventually, if the debt-to-GNP ratio keeps increasing uncontrollably lenders may not provide enough funding for the government to meet its obligations. By then, whether the government resolves the crisis by raising taxes, cutting spending, or going into default, economic growth will be seriously disrupted.

Some analysts of Puerto Rico's public finances argue that the debt-to-GNP ratio should be calculated by excluding all public debt that does not constitute a direct claim on the full faith and credit of the government of Puerto Rico. The rationale for this argument is that debt issued by municipalities or by public corporations, for example, is payable from sources other than the general fund, namely, municipal taxes in the case of municipal debt and income from operations in the case of public corporations. While this argument is technically accurate, we respectfully disagree for two reasons. First, with the exception of the Tobacco Settlement Bonds, funding for Puerto Rico's public debt comes from

Puerto Rico sources. Municipalities and public corporations do not derive income from international or offshore operations. Therefore, Puerto Rico's GNP, which is roughly equal to the income generated by locally-owned factors of production, is in our opinion the appropriate benchmark for measuring the island's capacity to service all its debt.

Second, and perhaps more important, bond markets have come to expect that all Puerto Rico debt is offered with an implicit guarantee by the central government because the GDB has a strong incentive to intervene and protect Puerto Rico's credit whenever there is a threat of default. Indeed, this is exactly what happened in the 1990s when the Puerto Rico Aqueduct and Sewer Authority could not service its debt and the GDB assumed the financial obligation in order to avoid a default, even though it was not legally obligated to do so.

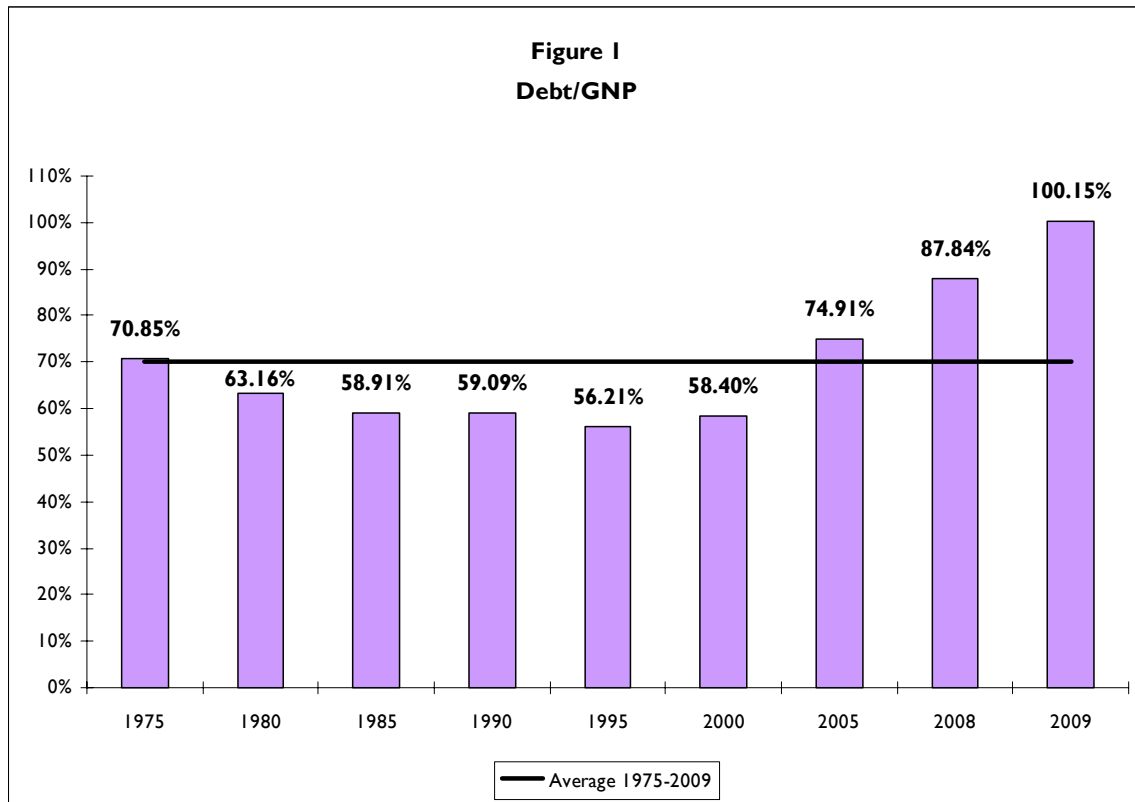
Also, there is an illuminating, analogous debate taking place in the United States. According to the U.S Treasury the total debt owed by the government of the United States amounts to \$11.66 trillion, of which \$7.33 trillion is debt held by the public, while \$4.33 trillion is held by other government entities (mostly trust funds for Social Security and Medicare). <http://www.treasurydirect.gov/NP/BPDLogin?application=np>

Some analysts, including the prestigious Congressional Budget Office (CBO www.cbo.gov/), argue that debt held by the government should not be included in the calculation of the U.S. debt-to-GNP ratio. According to the CBO, "the debt issued to those accounts is intra-governmental, [and] it has no direct, immediate impact on the economy. Instead, it simply represents credits to various government accounts that can be redeemed as necessary to authorize payments for benefits or other expenses."

However, other analysts, such as Dave Walker, former Comptroller General of the United States and current president of the Peter Peterson Foundation (www.pgpf.org), disagree. After all, they claim, "it is real money owed that will have to be paid back" and the amount is enormous. The fact that it is owed by one pocket of the government to another is irrelevant.

Similarly, CNE believes that debt is debt. Whether the proximate source of repayment comes from income taxes, sales taxes, municipal taxes, or monthly payments for public utilities, the underlying source of the income available for debt service ultimately is the economy of Puerto Rico. Therefore, we believe the appropriate analysis is to compare all of Puerto Rico debt against Puerto Rico's GNP.

As shown on Figure 1 below, the explosion in Puerto Rico's debt-to-GNP ratio is a relatively recent phenomenon.



From 1975 to 2009, the average debt-to-GNP ratio for Puerto Rico is 69.95%. Remarkably, during the period between 1980 and 2000, the ratio fluctuated in a narrow range between 58% and 63%. The ratio, however, increased substantially to 74.91% in 2005 and to 100.15% in 2009. In contrast, in the United States the current ratio of debt held by the public to GDP is around 60% and approximately 82% if we take into account debt held by other government entities.

At the international level among developed countries, the CBO found that Belgium and Italy carried debt amounting to more than 100% of their GDP in the 1990s. Net public debt averaged about 103% of GDP in Italy and 110% in Belgium during the second half of the 1990s. However, those two countries' experience involved debt that, relative to GDP, later fell modestly in the case of Italy (to 89% in 2008) and dropped significantly in the case of Belgium (73% in 2008). The OECD estimates the debt to GDP ratio for member countries to be currently around 52%. It is only among less developed economies that we find countries with a debt ratio approaching or exceeding 100% of GDP.

As shown in Table 2 below, most of the increase in Puerto Rico is due to increases in limited obligation debt and in the extra-constitutional debt, financial instruments that were seldom used in Puerto Rico before 2000.

Table 2
Total Public Debt and GNP
(\$MM)

June 30,	Const. Debt	Municipal Debt	Public Corps	Extracon. Debt	LO/NR Debt	Total Debt	%Δ	GNP	%Δ	Debt/ GNP
2009*	\$11,506.0	\$2,838.0	\$31,936.0	\$9,027.0	\$6,489.0	\$61,796.0	15.74%	\$ 61,701.0	1.50%	100.15%
2008	\$8,758.7	\$2,819.4	\$26,342.4	\$9,011.7	\$6,460.7	\$53,392.9	15.61%	\$60,787.2	3.80%	87.84%
2007	\$8,167.2	\$2,463.0	\$24,159.4	\$8,028.7	\$3,365.0	\$46,183.3	7.06%	\$58,563.1	3.23%	78.86%
2006	\$7,276.3	\$2,330.3	\$20,449.5	\$9,557.5	\$3,522.7	\$43,136.3	7.12%	\$56,732.3	5.54%	76.03%
2005	\$7,307.1	\$2,181.4	\$19,234.2	\$7,980.3	\$3,565.3	\$40,268.3	7.57%	\$53,752.4	6.00%	74.91%
2004	\$6,878.7	\$2,046.0	\$18,040.6	\$6,977.3	\$3,491.0	\$37,433.6	-	\$50,708.7	-	73.82%
CAGR	10.84%	6.76%	12.10%	5.29%	13.20%	10.55%		4.00%		

* estimate

Looking at the data on Table 2, we find, first, that GNP growth, even in nominal terms, has slowed down significantly since 2000. Everything else being equal, this would have led to an increase in the debt-to-GNP ratio, even if Puerto Rico's debt had increased at its normal rate. However, as we have shown on Table 2 above, Puerto Rico's debt increased at a very fast pace during recent years.

Second, so-called limited obligation/non-recourse debt has increased at a compound annual growth rate of 13.2% during the period between 2004 and 2009, which is equal to 3.3 times the nominal GNP growth rate during that period. Furthermore, in absolute terms this type of indebtedness, which consists of debt issued by a medley of assorted special funding vehicles, has increased from \$367 million in 2000 to over \$6.4 billion in 2009.

Third, extra-constitutional debt has also increased significantly in recent years. In absolute terms, the extra-constitutional debt has increased from \$3.6 billion in 2000 to slightly over \$9 billion in 2009. During some of the early years of the current decade, the extra-constitutional debt increased by more than 20%, and while growth has moderated in recent years, it is still growing at a rate that is 1.3 times the nominal GNP growth rate between 2004 and 2009.

In sum, Puerto Rico's total debt has increased at a compound annual growth rate of 10.55% during the period between 2004 and 2009, a rate that is 2.64 times the 4.00% nominal GNP growth rate during the same period. However, we should bear in mind that public debt can grow faster than GNP for a limited time only, and it cannot do so indefinitely. Simply put, this is not sustainable over the long term and over-borrowing always ends badly, whether it is an individual, a corporation, or a country.

We should worry about Puerto Rico's increasing public indebtedness for various reasons. First, deficits and increasing public indebtedness to finance them depletes saving for our future. National saving provides capital for private and public investment and is necessary for economic growth and rising living standards. National saving is made up of private saving plus public saving by the state and local governments. Private saving

equals business saving, from profits, plus personal saving from income not spent on consumption. Public savings, in turn, equals surpluses minus deficits; therefore, surpluses add to public saving and deficits subtract from it. In Puerto Rico both government saving, due to recurring deficits, and personal savings, due to excess consumption, currently are negative; while business saving has remained fairly constant over the last decade. So, everything else being equal, by accumulating deficits and devoting ever greater amounts to payments on the public debt we are crowding out investment on other things. In other words, instead of supplementing private investment, government debt offerings actually substitute for other capital investments.

Second, the reduction in national saving will raise domestic interest rates. Most economists agree that greater government borrowing would raise interest rates and lead to greater private saving, at least in the short term. But the offset would be far from complete, so national saving would decline. That decline would in turn reduce investment in Puerto Rico but not on a one-for-one basis (at least initially), because higher interest rates would attract foreign capital to Puerto Rico and perhaps induce local investors to keep more of their money at home. However, as real investment is displaced by government debt, GNP would grow more slowly and eventually decline. In the longer run, as the debt continued to grow and unless the interest premium was very large, capital would probably flee Puerto Rico, further reducing investment.

Third, beyond reduced national savings, increased interest rates, reduced investment, and reduced economic growth, sustained indebtedness has other pernicious effects. Economically and morally, long-term debt issued today represents a claim on the earnings of future generations. In some cases this is not necessarily bad. For example, if we issue long-term debt today to finance the construction of a toll bridge with a useful life of forty or fifty years, then it makes sense for the financial burden to be shared with future users because they will also benefit from using the bridge over the next half-century or so.

The problem arises when we issue long term debt to finance current or past consumption. That is the equivalent of going on a shopping spree with a credit card today and telling a two-year old toddler that he will have to foot the bill twenty years from now. Unfortunately, that is precisely what we are doing today by issuing all that long-term extra-constitutional debt, "limited recourse debt" and sales tax debt. Most of the proceeds from those bond offerings have been used to settle old debts or to finance current operational expenses but not to fund long-term assets. However, it should be clear for all to see and none to misunderstand that borrowing only serves to postpone the time when taxes will have to be paid. Therefore, we should be mindful of the moral consequences of what we are doing: we are reducing our children's and grandchildren's future living standards by pledging a significant part of their future income to pay for the recklessness and spendthrift ways of previous government administrators. Those are the wages of debt.

It would be unfair to single out any one government or administration and blame it for this mess. The simple truth is that the current state of affairs is the result of decades of

bad, irresponsible decision making. However, that fact is not sufficient to collectively exonerate us from guilt, because in the end, if, as Dietrich Bonhoeffer has said, the ultimate test of a moral society is the kind of world it leaves to its children, then all of us in Puerto Rico have failed that test miserably.