Insight

The Do's and Don'ts of the Puerto Rican Debt Challenge

GORDON GRAY | JULY 8, 2015

The governor of Puerto Rico has publicly stated that the Commonwealth's debt portfolio is unsustainable, diverting attention from a debt crisis confronting Greeks to one threatening Americans – and necessarily drawing responses from 2016 candidates. These responses run from the silent to the laughable, and offer an important lesson in what to do and what not to do when confronting debt crises.

Puerto Rico's Challenge is a Textbook Example of a Debt Crisis

Puerto Rico has been running large deficits to finance general government operations, and has seen its debt increase from over 63 percent of its Gross National Product (GNP) in 2000 to a projected 100 percent of GNP in 2015. This reflects persistent structural deficits during periods of economic growth and contraction. Importantly, this measure includes public sector entities – including the Commonwealth's major utilities, highway funding agency, and retirement programs – that are not visible in the central government finances but are heavily indebted.

While Puerto Rico's structural deficits may have been feasible, at least for a time, during periods of higher growth, the accumulated debt increases interest costs, which adds additional fiscal pressure to budgets during times of weak economic growth— constraining the Commonwealth financial flexibility during economic contraction. In recent years, the growing indebtedness of Puerto Rico's public sector combined with weak economic growth, has produced deficits of 5 percent of Puerto's economy, which in nominal terms is only growing at 1 percent. This is the classic death spiral of higher debt, interest, met with lower growth and tax receipts.

How *Not* to Fix a Death Spiral – A Bailout By a Different Name

If the key to fixing a debt spiral is the inclusion of a growth-strategy, then the key to guaranteeing a continued spiral is the inclusion of an anti-growth strategy. Among the 2016 candidates, Secretary Clinton's plan for the Puerto Rican debt challenge reflects the latter approach.

Clinton would allow Puerto Rico to seek chapter 9 bankruptcy protection that municipalities, like Detroit, can use to restructure debts. It would be a more orderly process than default for Puerto Rico to work out payments on its existing obligations to a highly diverse set of creditors. Governor Bush has also called for extending this provision to Puerto Rico.

There is nothing wrong necessarily with Puerto Rico seeking Chapter 9 protection, but it alone won't solve Puerto Rico's financial problems.

There are two key problems with the approach. First, it does not address the Commonwealth's persistent structural challenges.

Second, Clinton's proposal is a bailout by a different name. While it avoids the technicality of being called a bailout since it doesn't require specific federal funding, the proposal calls for increased federal spending with taxpayers on the hook.

How? By increasing federal Medicaid spending in Puerto Rico, funneling federal funds back through their health system.

An anti-growth strategy like that is exactly the wrong direction for Puerto Rico curing their financial woes.