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Understanding the Largest Default in U.S. Municipal Finance History

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Until the end of 2017, Puerto Rico was stuck in a protracted recession that lasted a dozen years and left the island much poorer than it had been for several decades. The pace of economic activity contracted by at least one-fifth during this long period, greatly undermining the revenue side of public finances. The coup de grace was provided by hurricanes Irma and Maria when they struck Puerto Rico in September 2017, causing unprecedented humanitarian, economic, and infrastructure-related damages which have derailed, for better and for worse, prior trends in fiscal revenues and spending.

Natural disasters are destructive of private and public wealth, but they tend to be good for new economic activity, particularly construction, because thanks to insurance payouts and federal disaster-related transfers, reconstruction efforts usually put people to work and spending money in their pockets. And sure enough, most of the activity indicators have risen sharply in recent months. The latest figures for this past March show that electric power generation, though still lower than before the hurricanes, was up almost 13% year-on-year; auto sales were 16% higher; bankruptcies were down; non-farm payroll employment was about 2% higher; and general gross government revenues were up a whopping 25%, standing also 18% above their level two years ago. Therefore, the long recession is finally over in Puerto Rico and the government's coffers are no longer empty now that revenues exceed expenditures.

Indeed, the level of public and private disaster relief spending will be hugely significant for the island. The latest fiscal plan, as certified a week ago by the Financial Oversight and Management Board for Puerto Rico, projects that more than $80 billion of disaster relief funding will be received in total from federal and private sources – and that's equivalent to more than 100% of Puerto Rico's 2018 GNP. This stimulus will be disbursed throughout the next decade and come in multiple forms, such as construction companies hiring local workers who are unemployed or weren't

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looking for work, while also bringing in workers from the mainland who spend money for food and lodging and local taxes, to repair or replace all the infrastructure, roads, and buildings that were affected.

Now to what extent is the long economic contraction, which saw the island's employment rolls drop by about one-fifth through early 2018, responsible for Puerto Rico's slide into default? The answer is important and not just for history buffs. If a vicious downward economic spiral has now come to an end possibly for good, and perhaps a virtuous cycle has begun, then maybe we should be more optimistic about an earlier-than-otherwise improvement in Puerto Rico's creditworthiness.

But before you start sending out "Buy" recommendations on Puerto Rico bonds, let me clarify that, in my opinion, while the economic backdrop was decidedly unhelpful to the condition of public finances, it is not a main explanation for the largest default in the history of U.S. municipal finance. And looking forward, by the same token, I don't expect that all the reconstruction-related transfers and spending will bail out the government of Puerto Rico – never mind its creditors. In fact, I'm more concerned now than I was before the hurricanes struck that the very necessary shrinkage and reform of the island's public sector will be delayed – and delayed precisely by the heady rush of reconstruction activities.

Public opinion has blamed the phaseout of Section 936 of the Internal Revenue Code, or the Possessions Tax Credit, as a potential cause of Puerto Rico's economic decline after 2005 and thus indirectly the government's debt default, but I question that. The credit became effective in 1976 and it replaced a variety of other corporate tax benefits dating back to the 1920s. It was equal to the full amount of federal tax liability related to an eligible corporation's income from its operations in a possession like Puerto Rico, effectively making such income tax-free. It worked best for pharmaceutical and life-science companies that could transfer their "intangible assets" to Puerto Rico, and thereby shift most of their profits to the island.

The Section-936 companies claiming the credit grew to employ over 100,000 workers, initially equivalent to at least 15% of all nonfarm jobs on the island, but given its fiscal cost to the federal government, it was a hugely expensive subsidy to job creation. Its trickle-down effects in Puerto Rico were small because shareholders on the mainland reaped most of the tax benefit, so much so that some of the factories that opened could be regarded as window-dressing for the huge tax avoidance scheme involved. In 1996, the tax credit was repealed by the U.S. Congress, though companies were eligible to claim previously earned credits through 2005, and during that decade many of them did wind up or curtail their presence, shedding many manufacturing jobs.

However, a variety of statistics indicate that most of the decline involving companies that had taken advantage of the credit was offset by expansion in other existing or new ventures mostly outside manufacturing, such that overall the economy was not affected that much. For example, the number of nonfarm jobs kept expanding after 1996 and peaked in 2005, with the economy continuing to grow through the phaseout's 9th year, taking a serious tumble only in the wake of the national financial crisis of 2008.

Another economic phenomenon blamed for undermining public finances and thus paving the road to default is emigration, because when confronted with limited job prospects and low pay, many of Puerto Rico's better-educated and more capable workers have left the island for work opportunities elsewhere. This too is a contested hypothesis. Puerto Ricans have been leaving the island for decades, initially mainly to New York and lately mainly to Florida. Until 2005, however, the departures were more than offset by the continued growth of the island's remaining population, such that the number of inhabitants increased by more than 70% from 1950 until 2000, from 2.2 million to 3.8 million.

The population subsequently stabilized and began to shrink during the latest decade, to the point where the 2020 census could well register a headcount of only 3 million. That would confirm a 10-year population drop of about one-fifth of total. Still, that's not so uncommon a challenge considering the shrinkage that several major cities in our mainland have had to contend with. In the decade of the 1970s, St. Louis lost nearly 30% of its residents, and so far, relative to 1950, the city has lost two-thirds of its population. Cleveland lost nearly one-fourth of its inhabitants during the 1980s, and so far, 60% of total since 1950. Pittsburgh lost one-fifth of its inhabitants in the 1980s, and 55% of total since 1950. And yet, none of those cities ended up defaulting on their municipal debts, because they took measures to cut spending consistent with the reduction in their revenue base. The problem is, the authorities in Puerto Rico did not make that adjustment.

And so this leads me to address the factors that truly explain the veritable explosion of public indebtedness that took place in Puerto Rico during the past several decades – both when the local economy was performing relatively well, prior to 2006, and when the economy started to shrink, and then kept on contracting, after that date.

First, some cold hard facts. The sum-total of Commonwealth, plus state corporation, plus municipal debt of Puerto Rico reached $1 billion in 1967. A decade later it was up to $6 billion. Two decades later, in 1987, it totaled $10 billion. Three decades later, in 1997, it was $20 billion. Four decades later, by 2007, it had soared to $46 billion. And a mere 7 years after that, by 2014, it exceeded $72 billion.

Thus, in the span of 47 years, the public debt increased 72 times, and in absolute terms Puerto Rico became the 2nd-largest sub-sovereign debtor in the entire United States, only behind the state of California with a tax-supported debt in the vicinity of $84 billion. The big difference is that California has a population of almost 40 million, whereas Puerto Rico has 3 million – a 13-times-smaller base. The other big difference is that per capita income in California is around $33,000/year, whereas in Puerto Rico it averages $12,000/year – a nearly two-thirds smaller base.

These figures come alive when restated as follows. Whereas California's state debt represents a burden of 6½% of annual per capita income, by 2010, Puerto Rico's public debt represented a burden of 160% of annual per capita income, one which went on to max out in 2017 at 190% of per capita income.

For additional perspective, note that the state with the highest such ratio is Connecticut, where the state debt represents 16% of its annual per capita income (of $41,000). In other words, by 2010 Puerto Rico was already ten times more indebted than Connecticut relative to income and population.

Now Connecticut is ranked single-A by all three of the leading credit-rating agencies, so one figures that Puerto Rico would have been rated much lower. And yet, back in 2010 Moody's rated the Commonwealth of Puerto Rico's an A3 credit, Fitch thought it was a BBB+ credit, and only S&P had serious doubts and rated it a barely investment-grade BBB-. With the benefit of hindsight, Puerto Rico should have been deemed a single-B credit with a negative outlook.

As to the factors that truly explain the veritable explosion of public indebtedness that took place in Puerto Rico during the past several decades, there are a number of demand-side factors – as in demand for debt financing, I mean – and one major supply-side factor, as in supply of debt financing.

The original sinner was not a Puerto Rican big spender, but rather an Ivy League New Yorker named Rexford Tugwell, who was a professor of economics at Columbia University and became part of Franklin Roosevelt's first "Brain Trust" – the group that helped develop policy recommendations leading up to the New Deal. He had visited the Soviet Union in 1927 and was impressed with the Soviet state's ability to command the production of goods and to distribute them to the needy. Therefore, he preached the benefits that central planning could deliver in Depression-era America, and he got to run some experiments involving U.S. agriculture and housing. Tugwell served in FDR's administration until he was forced out in 1936, denounced by conservatives for violating the values of American individualism and accused falsely of being a Communist.

Roosevelt was undaunted by this controversial advisor, and a few years later he appointed Tugwell as Governor of Puerto Rico for the duration of World War II. Far from the headlights trained on Washington, that's where Tugwell finally got to implement some of his state-led, top-down ideas of how to spur economic development. Tugwell bought up, with newly minted debt, private utilities and he merged them to create state monopolies, while also expanding existing public corporations – likewise monopolies – with authority to issue debt without limit.

These Tugwell creations became the forerunners of the electric power authority (PREPA), the water-and-sewer authority (PRASA), the highway and transportation authority (PRHTA), and the one-of-a-kind Government Development Bank (GDB). And issue debt these creations did again and again – right up to the day, a few years ago, when they came to owe $22 billion and nobody else would buy their bonds. Their fate reminds me of the quote attributed to Margaret Thatcher, to the effect that "The trouble with Socialism is that eventually you run out of other people's money."

While the beginning of debt accumulation coincided with greater local control after Tugwell stepped down, it occurred despite Puerto Rico having institutional structures in place to constrain borrowing. Unfortunately, these structures—a balanced budget clause in the 1952 constitution and a historic limit on government debt at 7% of assessed property valuations—failed to restrain the ambitions of successive administrations in San Juan.

The legal framework for a balanced budget dates to the 1917 Jones-Shafroth Act, and it was incorporated into Puerto Rico's Constitution as approved in 1952. It read: "The appropriations made for any fiscal year shall not exceed the total revenues, including available surplus, estimated for said fiscal year unless the imposition of taxes sufficient to cover said appropriations is provided by law." However, a 1974 ruling by Puerto Rico's then attorney general, a gubernatorial appointee, clarified the legal meaning of "revenues" to mean resources available to the government including the proceeds of bond issuances. Therefore, in the decades that followed, successive administrations used bonds to balance Puerto Rico's budget, gutting the restraining intent of the balanced-budget clause.

As concerns the statutory ceiling on public debt, in 1961 Puerto Rico amended its constitution to replace the 7% cap based on property valuations with a limit on debt-service payments at 15% of average annual revenue from income, property, and excise taxes. This meant that the Commonwealth could borrow more so long as tax revenues increased, say, by hiking tax rates – an option that previously did not exist. Moreover, this borrowing limit only applied to "bonds or notes for the payment of which the full-faith credit and taxing power of the Commonwealth shall be pledged." The constitutional language thus did not apply to bonds backed by a single tax. In 2006, an administration availed itself of this loophole by creating COFINA, an entity that would issue bonds backed exclusively by Commonwealth sales-tax revenues. The practical result is that COFINA obligations, which grew from zero to $18 billion in the span of one decade, were excluded from the calculation of debt for the purpose of ensuring compliance with the constitutional debt-service limit.

None of these limits applied to Tugwell public-corporation debt, which is theoretically backed by revenues from user fees. But to the extent that their chronic operating losses were offset by subsidies from Puerto Rico's general fund, their obligations were partially serviced by tax revenues, thereby defeating the purpose of the original borrowing limit.

To be sure, there are states, municipalities and territories that manage their fiscal affairs quite well even in the absence of balanced-budget rules and debt or debt-service ceilings. But, to put it bluntly, prudent fiscal behavior has been absent in Puerto Rico for a very long time, as the debt trajectory mentioned earlier makes crystal clear.

When the island's successive governments developed their annual budget, they frequently overestimated the amount of revenues that would be collected in the next fiscal year. In the period from 2002 to 2014, Puerto Rico overestimated its genuine revenues in eight out of thirteen years, or 62% of the time. And Puerto Rico's agencies have regularly spent more than the amounts the legislature appropriated for a given fiscal year. In the same period 2002-2014, government spending exceeded appropriated amounts in nine of the thirteen years, or 69% of the time. No wonder new debt continued to be piled on top of previously contracted debt, year in and year out.

Unprofessional management of politicized governmental agencies and corporations has also been behind Puerto Rico's fiscal woes. The case of the electricity monopoly PREPA is relatively well known, but the problem is endemic throughout the corporations. PREPA failed to invest in its electric generation and transmission systems, hampering their performance and leading to increased production costs. PREPA did not fully pass on cost increases to consumers because political interference prevented it from adjusting its base charge for the last three decades, even though it is designed to cover operating expenses and debt service. To cope with cost increases and other managerial failures, PREPA issued a great deal of debt -- $9 billion – to finance its operations.

Many public services provided are too costly because of overmanning and a lack of cost controls, adding to the government's borrowing requirements. Here are two examples. Largely due to emigration, the number of school-age children dropped 30%

from 2006 to 2017, and the number of children under 5 years old fell 42% in the same period. Only recently have empty or near-empty public schools been shuttered around the island, but most teachers are still on the payroll because there is little political tolerance for the necessary layoffs.

Puerto Rico's Department of Health runs six different healthcare agencies and many redundant facilities, and the procurement of medical goods and services is fragmented and thus inefficient. The government has been excessively generous in its Medicaid program, opting to insure some categories of individuals that it is not required to cover under federal law. Almost half of the island's population now avails itself of Medicaid. Meantime, federal funding for Puerto Rico's Medicaid program is one-half to two-thirds lower than it would be if the island were a state, such that Medicaid weighs heavily on the government's budget.

The aforementioned are a some of the leading demand-side factors that have driven budget deficits and debt accumulation, and they illustrate a generalized absence of prudence and responsibility on the part of the branches of government in Puerto Rico – regardless of the party holding the governorship or a majority in the legislature. Unless and until a new, courageous leadership wins popular support to do what should have been done – to shrink and modernize the public sector, and to adopt new and binding rules of fiscal behavior – we should remain skeptical that the current debt crisis has succeeded in changing for the better the hearts and minds of the people of Puerto Rico and their elected representatives.

But there is one major supply-side factor that has been instrumental in the large-scale provision of debt financing for the island, and that is of course the smooth, toll-free, five-lane highway into the mainland's municipal bond market that the triple-tax exemption provides for bonds issued by U.S. territories. It is a temptation that the territories have largely resisted, with the one eye-popping exception being Puerto Rico. This island's capacity to issue debt at favorable rates and with exaggerated credit ratings surely postponed the implementation of fiscal reforms and controls necessary to balance Puerto Rico's government budget on an enduring basis.

Therefore, the exemption is part of the overall incentive problem that needs fixing. Congressional removal of the triple tax exemption for Puerto Rico's municipal securities is probably too drastic a penalty, so perhaps retaining the exemption but only for bonds funding clearly identified capital outlays generating specific revenues, rather than for deficit financing or unspecified purposes, should be considered.

A related measure is having Congress finally authorize the SEC to establish requirements for municipal issuers on the timing, frequency, and content of initial and continuing disclosure materials. Puerto Rico governments routinely issued audited financial statements in an untimely manner, failing to meet contractual obligations to provide continuing disclosures for its securities. At present, the SEC cannot directly impose any penalties on an issuer like Puerto Rico for failing to adhere to the terms of its continuing disclosure agreements, so I favor extending its policing role into the municipal securities market, which is less regulated and transparent than others.