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**The San Juan Star**
P.O. Box 364187
San Juan, PR 00936-4187
c/o Viewpoint

Or send us a fax:
(787) 782-0310

Or e-mail us at:
viewpoint@sjstar.net

# Puerto Rico's Keynesian paradox

Sergio Marxuach
Commentary

John Maynard Keynes, the most influential economist of the first half of the 20th century, wrote in his seminal "General Theory of Employment, Interest, and Money" (1936) that "practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist." An assertion ironically validated by President Richard Nixon, an eminently practical man himself, who famously said in 1971 that "we are all Keynesians now." So we are. Or at least we were until 1980, when F.A. Hayek and Milton Friedman replaced Keynes as the economists *du jour* in the capitalist West, but that is a story for another time.

Economic policymakers in the Puerto Rican government, themselves usually quite exempt from pesky intellectual influences, appear, however, to remain suspiciously in thrall to the theories of the long-defunct Mr. Keynes. This is perhaps to be expected, given that Keynes advocated in favor of pervasive government intervention in the economy, especially in times of recession, in order to stimulate demand, jump-start investment and increase employment. The essence of his policy prescription was simple: governments should run deficits during recessionary times, in order to increase economy activity; and they should do the opposite during the good times, when governments should produce surpluses to compensate for the deficits incurred during the bad years. That way, the government's budget would be roughly in balance throughout the whole economic cycle.

However, during the past five or six years the validity of Keynes' recipes for economic growth appears to be under question in Puerto Rico. The gospel according to Keynes is that if the economy is idle then the government should step in and stimulate aggregate demand by increasing government expenditures. The problem is that the fiscal faucet in Puerto Rico has been wide open during the past five years and yet our economy is in a state of languorous stagnation.

Puerto Rico has closed each of the last five fiscal years with an average general fund deficit of $450 million, or roughly 5 percent of general fund revenues for each of those years. In addition, between June 30, 2002 and May 31, 2007, Puerto Rico's total public sector debt, which includes debt issued by the central government, public corporations, and municipalities, increased from $27.98 billion to $43.57 billion, an increase of $15.59 billion, or 55.68 percent, which is equivalent to a compound annual growth rate of 9.26 percent. Meanwhile, GNP at current prices grew at a compound rate of 5.90 percent between 2002 and 2006. In other words, our public sector indebtedness increased at a rate 1.56 times faster than our national income during this period.

Alas, all this public spending has not yielded the expected results. According to Keynes, a dollar spent by the government should increase economic activity by more than a dollar. However, the economy has been in a torpid stupor since 2002 and in a recession since March 2006, which means that despite all that spending, economic activity is actually shrinking instead of growing. Simply put, traditional Keynesian stimulus is not working.

There appear to be two plausible explanations for this Keynesian paradox. First, as has been pointed by James Dietz in his "Economic History of Puerto Rico" (Princeton, 1986), "state expenditures in Puerto Rico, whether by the Federal or the Commonwealth government, are not typical Keynesian-type outlays that stimulate the economy, increase GNP, and drive production to the full employment level. Given the openness of the economy and the small domestic multiplier, spending has a greater impact on production in the United States than in Puerto Rico." In other words, most government spending is for imports. Therefore, the multiplier effect in Puerto Rico is smaller than what would be predicted by Keynesian analysis.

Second, increased government spending stimulates aggregate demand only to the extent that this additional spending complements, rather than substitutes, private investment spending. The problem is that Puerto Rico government debt is so attractive as a financial investment that it diverts funds from otherwise productive uses. Economists call this the "crowding out" effect.

To see how this works assume you have $1 million available for investment. You can choose between (i) buying relatively risk-free Puerto Rico government bonds, which have never defaulted and pay tax-free interest of, say, 4.75 percent per year (equal to a 7.09 percent tax equivalent yield if you are in 33 percent tax bracket); or (ii) starting a new business venture and running all the risks associated with Puerto Rico's Byzantine permitting process. Most rational investors will choose the bonds without even thinking about it.

For all the foregoing reasons, therefore, we believe that implementing a big infrastructure spending program, as has been suggested by some economists, will not lift the Puerto Rican economy from its current recession. If Puerto Rico's economy were not as open as it is and if our government were not as large as it is, then this prescription would make perfect sense — a page straight out of the old Keynesian playbook. Unfortunately, however, we operate under quite different conditions and the empirical data of the last five fiscal years leads us to question the effectiveness of standard Keynesian remedies in Puerto Rico.

That is why we favor significant tax cuts, for both corporations and individuals, in order to jump-start the economy. We are better off in the long run leaving money in people's pockets rather than putting it in the clammy hands of government bureaucrats.

*Sergio Marxuach is director for policy development at the Center for the New Economy, a Puerto Rico-based think tank ( www.grupocne.org).*