PUERTO RICO’S GROWTH AND MACROECONOMIC SITUATION AND PROSPECTS

Anne O. Krueger
Senior Research Professor of International Economics
School for Advanced International Studies
Johns Hopkins University
Emeritus Professor of Economics, Stanford University
Senior Fellow, Stanford Center for International Development
First Managing Director, International Monetary Fund, 2001-2006
Introduction

- This is a report done by myself, Ranjit Teja, and Andrew Wolfe.
- We were asked to present a report, analyzing Puerto Rico’s current macroeconomic situation and prospects, with suggestions as to how to improve the outlook.
- The report finds that the current situation is unsustainable, and that a coherent set of policies must be adopted if the outlook and prospects are to improve: there must be significant fiscal adjustments; policies must be adopted that are more conducive to economic growth; there must be institutional reforms to assure that policy changes will be sustained; and the current high level of debt must be addressed.
Introduction (Continued)

- After some background, the need for all three policy actions as a coherent package is addressed. Then fiscal, growth, and debt policies are discussed in turn. They form the basis for a diagnosis of the current situation. That, in turn, brings us to a possible agenda of policy reforms.
Puerto Rico has wonderful potential. Its tourism possibilities are enormous; as a bilingual island in the Caribbean (with well above average educational attainments) it could greatly increase its role as a link between South America and the rest of North America. And it has great potential for expanding economic activity in many other dimensions.

Its status as a territory of the United States brings both advantages and disadvantages.

Advantages include its legal framework and the predictability that this brings in many regards, the fact that its residents are U.S. citizens, and some transfers from the U.S. government. Resident Puerto Ricans who do not work for the U.S. government are not subject to U.S. income tax.
Disadvantages include that it is subject to the U.S. minimum wage (but not to Chapter 9 of the U.S. bankruptcy code), and subject to a number of other Congressionally-mandated requirements (such as the Jones Act and environmental regulations).

There are also mixed blessings. For example, Puerto Rico is tied to the U.S. dollar which provides certainty but means that neither devaluation nor monetary policy is a potential policy tool. Puerto Ricans are beneficiaries of much U.S. welfare legislation and that supports many Puerto Ricans but also raises business and fiscal costs. Membership in the FDIC helped buffer the effects of the banking difficulties of the past decade.
Puerto Rico’s economy has reflected this. Special tax exemptions from the U.S. tax code attracted businesses to Puerto Rico for a number of years, and a boom followed. But they were removed starting in 1996 and some businesses left the island.

Since 1996, there has been virtually no economic growth in Puerto Rico. At first, people thought there was a recession, but it was not. It has been two decades of stagnation with falling population and no measurable increase in real per capita incomes.

Attempts to “offset the recession” with expansionary fiscal policy financed by borrowing have been made for the past two decades. Since Puerto Rican bonds were triple tax exempt, the Commonwealth was able to borrow at favorable terms for a long period of time.
But fiscal expansion failed to renew growth, and debt mounted. Solving Puerto Rico’s problems through fiscal expansion has not worked, and will not work.
The Current Situation

- At the current time, the situation is dire: debt is high, the fiscal position is unsustainable, population is falling, and there is no growth. All four issues are interrelated and must be addressed.

- Without restoring growth, there is no possibility of a turnaround in the fiscal situation. And without a turnaround in the fiscal situation, there is little possibility for growth. And the outlook for both of these cannot improve without addressing the high, and prospectively higher, burden of debt the Commonwealth is carrying. Outmigration will persist if economic growth is not restored.

- A symptom of all this is that the government’s cash balances are critically low; delays will reduce the room for manoeuvre and intensify the crisis.
Factors Retarding Growth

- Factors external to Puerto Rico have contributed. The removal of tax breaks triggered the start of the decline. The financial crisis and recession that started in 2008, and the accompanying credit crunch certainly affected Puerto Rico. So did the climb in oil prices in the last decade.

- But internal factors and policies on the supply side have also hurt. Labor policies are particularly detrimental.

- Employers are reluctant to hire because the federal minimum wage is high relative to skill levels and competitors. This makes some industries (such as tourism and activities using unskilled labor) less competitive with other Caribbean islands and globally than they otherwise would be.
Factors Retarding Growth (continued)

- But, in addition Puerto Rican legislation and practices have added significantly to labor costs. These include length of paid vacations and sick leaves, very short probationary periods, year-end bonuses, requiring overtime on anything more than 8 hours daily, and more.
- The welfare system makes employment unattractive for workers whose productivity is not much above the minimum wage.
- Energy costs are very high relative to the U.S. mainland.
- Transport costs are high, due both to the Jones Act and domestic regulations.
- Local laws and regulations restrict domestic competition and raise the costs of doing business and uncertainty. Puerto Rico’s rankings in the Doing Business index are poor for many aspects.
Factors Retarding Growth (continued)

- The results of all these factors have been outmigration, loss of tourism share in the Caribbean, and manufacturing restricted to high value/low weight/capital intensive industries. The government has used firm-specific tax breaks to try to attract more industries, but this is detrimental to a long-run growth strategy and has cost tax revenue.
Fiscal Problems

- Public sector debt has risen every year since 2000, reaching 100 percent of GNP by 2014.
- These increases reflect a number of institutional weaknesses as well as the weak economy.
- Projections of revenue and budget formulation have been overly optimistic.
- There is a lack of expenditure control; part of excess expenditures has been financed by delaying payments until the next fiscal year. Verification of payrolls has also been lax.
- As cash has become tight, there has been bargaining with individual companies, settling for lower tax obligations in return for early payment. That, in turn, has encouraged delays in payments.
Fiscal Problems (Continued)

- There are numerous tax credits that reduce tax revenues.
- Statistical and accounting practices do not permit reliable monitoring of fiscal trends. The latest fiscal accounts are for FY2013.
Focus on Central Government

- The General Fund is used as the measure of fiscal balance, but it understates the true deficit and the nature of challenges; the Commonwealth’s credit status is not independent of other debt outstanding by government agencies. Moreover, the fiscal deficit should be measured as the sum of net debt issued to the private sector plus the accumulation of payables plus the rundown of cash balances plus other financing through rundown of assets. That is the generally accepted measure of fiscal performance.

- Our measure of central government includes all parts of the public sector except municipalities, the retirement funds, the state insurance fund, and the three large enterprises.
Size of Deficits

- The primary and overall deficits so measured are larger and more serious than generally recognized.
- This last year’s budget was intended to run a surplus of revenue over non-debt expenditure large enough to pay interest and amortization of the debt. In fact there was an alarming decline in cash balances as the surplus of revenue over non-debt expenditure was $850 million and interest and amortization costs were $2.8 billion.
- The 3 big state enterprises and the employee and teacher retirement funds are also running large deficits. The liquid assets of the government employee retirement fund have been drained and those of the teacher retirement fund are at low levels.
- These are shortfalls that will grow in coming years and ultimately fall on the central government.
Overall Deficits

- These deficits combined yielded an overall deficit averaging around 5 percent of GNP in FY2013-2014. Since nominal growth is just 1 percent, they imply rising debt ratios and explain the growing concern in financial markets about debt sustainability.

- Near-term prospects are very poor and things must change – either now or when they are forced to – and being forced to would be even worse.
Prospects

- We do not use a forced crisis as our base line, but instead posit that real GDP growth remains very low – at about minus 1 percent. This is NOT a pessimistic base line. We also assume 2 percent inflation, which may be high, but is the target rate of the Federal Reserve.

- We use those assumptions to assess the minimum financing needs over the next five years, with policies in effect in May 2015 and latest expenditure projections (but before the sales tax reform and renewal of Law 66) continuing.

- The result is a deficit of about 3 1/2 percent of GDP per year. If pay downs of arrears, amortizations, and downside risks (such as loss of ACA funding) are taken into account, the total financing gap ranges from $3.5 to $8.2 billion per year through FY2025. If the Commonwealth could borrow to finance that, government debt would more than double in that time.
Prospects (Continued)

- The gap must be closed through wide-ranging policy actions that reduce the fiscal deficit AND restore growth.
Need for Actions on Both Fronts

- Growth and fiscal adjustment must go hand in hand. If fiscal adjustment alone were used, the resultant austerity would yield stagnation, if not decline, and the budget would not balance.

- Growth cannot be restored without fiscal adjustment, as the uncertainty resulting from fiscal imbalances would seriously weigh on economic activity. And even if structural measures did raise growth rates somewhat, it is inconceivable that that could happen sufficiently to outweigh rising fiscal and debt pressures.

- The fact that partial solutions have been tried and failed in the past also points to the urgency of a new, comprehensive approach to the problem.
Need for Actions on Both Fronts (Continued)

- Getting a sufficiently bold approach will not be easy. The needed measures may face political resistance, but failure to address the issues will harm all groups in Puerto Rico even more.
- New institutions to establish budget discipline and adequate data provision are needed. So, too, are changes in labor laws. Fiscal deficits must be cut. Federal inertia needs to be challenged.
Needed Structural Reforms for Growth

- What economic activities would grow most rapidly after reforms is always unpredictable – there have been surprises everywhere far-reaching reforms have been undertaken. But it is likely that tourism, financial/services activities, and more labor-using activities would be among those taking off depending on the reform package adopted.

- Reducing and, to the extent possible, removing disincentives to hire workers is certainly a key issue. Puerto Rico should push to the extent possible for a relaxation of the federal minimum wage – it could be through tying it to the differential between mainland and island wages, to setting it at a stated fraction of the mainland wage, or other means.
Needed Structural Reforms for Growth (Continued)

- But there are things Puerto Rico itself can do, including removal of the requirements for higher labor compensation and regulation than is required under U.S. law. There could also be arrangements for apprenticeships or training periods especially for young people during which the minimum wage might need not to apply.
Other Supply Side Issues

- Federal welfare payments are generous relative to the low incomes in Puerto Rico and Puerto Rico should seek more latitude in adjusting welfare requirements and benefits.
- Exemption from the Jones Act could also significantly benefit Puerto Rico and enable it to compete on a more level playing field with its Caribbean neighbors.
- Cutting high energy costs can also contribute significantly to growth.
- Improving the business climate could contribute significantly to growth prospects. Bringing down input costs, as discussed above is important. But the weakest areas identified by the World Bank, such as the difficulty in registering property, in paying taxes, and in obtaining construction permits should be top priority and would have little budgetary cost.
Fiscal Adjustment and Debt

- Eliminating the deficit will take substantial measures. We tried to identify some measures that would not be overly inimical to growth prospects. The overall aim should be to focus changes on the policies that are most detrimental to growth, reducing expenditures where significant excesses and inequities appear, and to move toward more uniform across-the-board treatment of businesses (replacing the ad hoc nature of incentives now given).

- The recommended changes were identified relying largely on the experience of other countries. They would need to be adjusted to Puerto Rico’s individual situation and to be phased in over time, or be introduced with existing beneficiaries grandfathered.
Revenues

- The measures we identified would, in our judgment, achieve fiscal balance by 2020 if accompanied by structural measures. There would be additional tax revenues as employment rose, if property taxes (which are now based on 1954 valuations) were revamped, tax amnesties and closings were eliminated, and with the sales tax measures. This should be stopped immediately. What will take time is eliminating tax exemptions.

- Overall, these measures (or others similar to them) could raise receipts by $1 billion in FY2016, $3 billion annually by FY2020 and $4 billion by 2025.

- If opportunities in the formal sector of the economy grew more rapidly, there is almost surely additional scope for tax collections from those currently in the informal economy.
Expenditures

- There is scope for reductions of up to $2 billion annually by FY2020 and more by FY2025.
- Renewing Law 66 and freezing remaining spending in real terms saves $1 billion by FY2020.
- The teacher-student ratio in Puerto Rico is uneconomically low and lower than education experts advise. There are 40 percent fewer students and 10 percent more teachers than a decade ago.
- The subsidy to the University of Puerto Rico could be reduced, with higher tuition and provision of more needs-based scholarships, with savings of an estimated $500 million per year.
Expenditures (Continued)

- Cuts in benefits in Medicaid in excess of minimum standards on the US mainland could save an estimated $150 million per year.
- A higher growth path could yield another $1 billion per year by FY 2020.
- There is, of course, a great deal of uncertainty surrounding these, and other, estimates. There are unknowns, such as the size of declines in Law 154 receipts, and needed reform in retirement system funding. There is also uncertainty as to the timing of the impact of newly adopted measures.
Need for Debt Relief

- While there may be a little more scope for fiscal adjustment, we believe that a significantly larger adjustment would result in reduced growth and therefore not achieve the desired outcomes. So even with some additional measures, a large residual financing gap remains for the next decade. Debt relief is needed.
- A voluntary exchange with creditors with a later/lower debt service profile could be obtained.
- To achieve this, bondholders would need to be convinced that relief would support reforms that would result in a larger return than continuing on the present path.
- Any discussion with creditors would need to be coordinated between general obligation debt and the public enterprise discussions. It would facilitate discussions were Puerto Rico included in Chapter 9 of the US Bankruptcy code.
Strengthening Institutions

- To be successful, reforms will have to entail strengthening important institutions and credibility.

- A first step would be a long-term fiscal plan for all 5 years of the adjustment period. Rules, such as Gramm-Rudman or other rules, that enforce spending cuts and tax increases when there are shortfalls would help. So too would a fiscal oversight board.

- Equally important, the transparency of fiscal data and their timely provision would enable a better informed public discussion and policy decision making.

- Moreover, statistics for the wider economy need urgently to be strengthened.
Conclusions

• Puerto Rico is in tough times. There are two choices. A first is to recognize that the problems have been long of the making and can be remedied only with a comprehensive approach, entailing expenditure and revenue measures and structural and institutional reforms. Even with all that, the burden of the debt will have to be addressed.

• The second is to wait until the inevitable happens. A few piecemeal fixes can be tried and could even postpone the day of reckoning a bit. But unless the comprehensive approach is undertaken in full recognition of its urgency the inevitable will happen and be even more damaging to the people of Puerto Rico than a comprehensive action program.
Conclusion (continued)

• Such a program must include sizable fiscal adjustment, structural measures, institutional reforms, and debt restructuring. While there can be choices as to precisely which taxes or expenditures to raise or cut, there can be little or no choice as to the magnitude of the needed changes. Likewise, structural measures will need to be sufficiently far reaching to put business on notice that a business-friendly Puerto Rico is open for business. And institutional reforms, to enforce budgetary discipline, to provide good and timely feedback to policy makers on fiscal and economic performance, will be needed.

• Even with reforms, it will be several years before the full benefits are realized, especially since people will not see the abyss they could have been in. But once the reforms take hold, Puerto Rico could begin to realize much of its great potential, reversing the decline of the past two decades and attaining new heights.