CNE+

Policy Paper

Devising a Growth Strategy for Puerto Rico

June 2016

Policy Paper:
Devising a Growth Strategy for Puerto Rico

José Antonio Ocampo
Professor of Professional Practice in International and Public Affairs
at the School of International and Public Affairs
Co-President of the Initiative for Policy Dialogue
Columbia University

Deepak Lamba-Nieves
Research Director
Center for a New Economy
Postdoctoral Fellow, Watson Institute for International and Public Affairs
Brown University

Sergio M. Marxuach
Policy Director
Center for a New Economy

June 2016

The Puerto Rican economy has already experienced a "lost decade"—to use the term that the Economic Commission for Latin America and the Caribbean, ECLAC, coined in the 1980s for Latin America and that has been widely used at the international level since then—and, if no action is adopted soon, it will continue on a negative path for the foreseeable future. The contraction of the island's Gross National Product (GNP) has been one of the worst in the world over the past decade, and is intertwined with a deep fiscal and debt crisis that, if not arrested, will continue to push the economy in a downward spiral and the country into a deeper crisis.

Although the Puerto Rican authorities have adopted austerity measures for several years, including a reduction of government payroll, tax increases, pension reform, and changes to collective bargaining agreements, among others, the magnitude of the debt crisis was only fully recognized very late in this process, particularly when Governor Alejandro Garcia Padilla announced in June 2015 that the public sector debt was "unpayable". In turn, the Commonwealth was largely out of the radar of the U.S. Administration—and, more broadly, of the U.S. political system and public opinion—until that announcement was made. The Administration has made clear that the solution requires access to debt resolution procedures that the Commonwealth lacks at present, and that this requires action by the U.S. Congress. Despite the urgency of the matter, Congress has failed to take timely action.[1] This forced the Puerto Rican Legislature to authorize the Governor on April 6th to default on potentially all debts in order to use the increasingly scarce government revenues to finance essential government services.

The capacity of the Puerto Rican authorities to face the crisis is extremely limited due to the lack of the traditional instruments of macroeconomic policy. It lacks, first of all, autonomous monetary and exchange rate policies. This is the principal reason why the Commonwealth's crisis has been compared to that of Greece—"the Greece of the U.S." But, due to the deep deterioration of its public finances, it also lacks the space to undertake a counter-cyclical fiscal policy. Finally, its subordinate political status makes it dependent on decisions by U.S. Congress and Federal Courts without much of a voice on those decisions.

[1] On June 9, 2016, the U.S. House of Representatives approved H.R. 5278, also known as "PROMESA", which provides a mechanism for Puerto Rico to restructure its debts in conjunction with a strong oversight board and other provisions.

A solution to the fiscal and debt crisis needs more than short-term solutions: it requires the renewal of economic growth. Indeed, in the absence of growth, solutions to the debt crisis will not be sustainable. But renewing economic growth requires identifying and launching new dynamic production activities, as the model of development was already exhausted prior to the crisis, and was barely propped up by tax schemes that attracted foreign investment but did little to foment indigenous development opportunities.[2] Traditional structural reforms, by themselves, are unlikely to generate new dynamic sectors, which must therefore be encouraged by an active industrial policy, supported by some legal provisions and institutional transformations, notably exempting Puerto Rico from the Jones Act (P.L. 66-261; 46 U.S.C.A. §688).

This Policy Brief presents an integrated view of the short and long-term dimensions of the policy packages that must be implemented. The first section reviews basic facts about the economy of Puerto Rico. The second looks at the fiscal and debt crisis and proposals to solve them. The third analyzes the structural features of the economy and the general characteristics of the industrial policy that must be put in place.

1. Background

The economy of Puerto Rico started to contract in 2006, and has accumulated a reduction of GNP of 14%. This is one of the worst economic performances in the world over the past decade. Indeed, it is second[3] only to that of Greece, which has accumulated a fall in GDP of 28% during the 2007-15 period. The Baltic economies also experienced more severe GDP contractions in 2007-09—between 13 and 19%—but had recovered by 2015, with the exception of Latvia (which still shows a contraction of 5% relative to the 2007 level).

The depression has been speeded up by an even stronger contraction of investment and commercial bank assets—over 30% (if the current fiscal year is included) and 40%, respectively. In turn, it had generated a massive 22% fall in employment. This has been accompanied by a dramatic reduction of labor market participation, which fell from 48.6% in 2007—an already very low level by

[2] This is reflected in the fact that the Puerto Rican economy started to contract prior to the subprime crisis in the summer of 2007 that marks the beginning of the 2007-09 U.S. financial crisis.

[3] We refer to countries not facing domestic conflicts. Syria, Libya, the Central African Republic and Ukraine have experienced contractions of between 20% and 40%, ranked by the severity of the depression.

international and, particularly, U.S. standards—to 39.9% in 2015. The low level of labor market participation—and, particularly, the unusually low male labor participation—has structural determinants, including demographic ones, particularly high levels of outward migration and the high levels of labor market informality.[4]

The search for employment opportunities has led to massive migration to the mainland –the largest since the 1950s. Per capita GNP has fallen, therefore, less than total GNP, by 6.7% between FY2006 and FY2014[5], implying a reduction of the population of 6.8%, according to the official national accounts, but according to other analysts it may be higher (more than 300,000 people, or 8% of the population since 2006). This implies a major loss of growth opportunities, as it is represented to a large extent today in skilled and semi-skilled labor that does not find opportunities at home.

The contraction of economic activity worsened the fiscal situation. In turn, the austerity measures adopted, even if insufficient to correct the fiscal imbalance, have fed into the contraction of demand and economic activity. The net result was an explosion of the debt ratio, to over 100% of GNP. Since 2013 the Commonwealth lost normal access to capital markets, and in 2015 even access to high cost financing, generating a severe liquidity constraint that is reflected in an increasing number of defaults on different debt instruments—including a default on Government Development Bank debt on May 1st, and the announcement that the same may occur with some general obligation payments due in July.

2. The fiscal and debt crisis

There is agreement that fiscal mismanagement has been a major problem in Puerto Rico, and that it predates the current crisis. The Commonwealth ran sizable deficits prior to 2006, and as a result of that the public sector debt to GNP ratio, which had fluctuated around 60% during the 1980s and 1990s, started to increase in the early 2000s and had already reached 76% in 2006.

---

[4] Certainly, lack of opportunities are contributing to the reduction of participation rates, which were increasing at a slow rate prior to the crisis, and can experience a new upward trend if growth is renewed.
[5] We have re-estimated the fall in per capita GNP to make the data consistent with the evolution of population according the national accounts.

After some initial but very moderate expansionary policies, which can be understood as part of the expansionary packages put in place by the U.S. and most industrial countries after the outbreak of the global financial crisis, austerity policies have been in place since 2009. They have generated an 11% reduction in nominal primary (non-debt) general funds expenses between FY2010 and FY2015, equivalent to 21% in real terms using the GNP deflator[6]. Several taxes have been raised, including the sales and petroleum taxes, and a controversial excise tax on sales by certain American and foreign corporations operating in Puerto Rico was enacted in December 2010, which has become the source of about one-fifth of tax revenues[7]. As a result, the deficit has substantially declined in recent years, despite the contraction of economic activity.

The fiscal situation has affected the capacity to access financial markets. The Commonwealth has been shut out of the municipal bond market since 2013, and has relied since then on high-cost bonds placed with nontraditional lenders and the sale of (very scarce) pension assets to meet obligations. Loss of access to the municipal bond market was partly the result of external events—the restructuring of Detroit's general obligation debt in 2013—but also of the downgrade of Puerto Rico's debt, including the general obligation bonds that have a Constitutional protection, to non-investment grade in February 2014 by all major rating agencies.

With a series of defaults by several government agencies and the use for general expenses of tax revenues that guaranteed certain bond issues, access even to high cost financing was totally interrupted in 2015. This situation has also affected the Government Development Bank, the provider of short-term liquidity to the government. As a result, liquidity has run out and the Commonwealth has already defaulted on selected obligations, generating numerous legal debt disputes that are likely to become increasingly chaotic. The rising costs of new debt obligations—which have increased over 70% during the past five years—has also partly defeated the austerity

[6] Data for fiscal year 2015 is from the Commonwealth of Puerto Rico Financial Information and Operating Data Report, dated November 6, 2015.

[7] The 2010 reform changed the source of income rules applicable in Puerto Rico and imposed a temporary excise tax on certain offshore purchases by manufacturing firms active in the island. Since the excise tax can be credited against U.S. taxes, it can be understood, in terms of its economic substance, as a transfer from the U.S. Treasury to the Puerto Rican government. The excise tax is set to expire in December 2017.

policies[8] and contributed to the dire liquidity situation, which has forced fiscal authorities to keep funding current expenses at the cost of suspending debt payments.

In the absence of access to Chapter 9 of the U.S. Bankruptcy Code, the Puerto Rican Legislative Assembly enacted in June 2014 the "Public Corporations Debt Enforcement and Recovery Act" to grant certain public corporations the ability to restructure their indebtedness in an orderly process. But in February 2015 a judge from the District Court of Puerto Rico struck down the Act, a decision later ratified in July by the Court of Appeals for the First Circuit. On June 13, 2016 the Supreme Court of the United States issued an opinion (5-2) affirming the judgment of the First Court of Appeals, which found the Puerto Rico Recovery Act to be pre-empted by federal law and therefore unconstitutional.

The enactment of the Act, however, ratified the view among market agents that the debt situation was not sustainable and accelerated the loss of access even to the most expensive forms of financing. Furthermore, lack of action by U.S. Congress to provide the Commonwealth access to bankruptcy procedures led to the enactment of an emergency debt moratorium bill in April 2016 that provides broad powers to the Governor, including an authorization to default on potentially all debt obligations.

The government of Puerto Rico was very late in recognizing the need for strong and broader action on debt restructuring. It was not until the publication of the Commonwealth's May 2015 *Quarterly Report*, that the recognition of difficulties was finally made open: "The Commonwealth may need to implement administrative and emergency measures in fiscal year 2016 and thereafter, which could include a moratorium on the payment of debt service or debt adjustment" (p. 12). This was followed by the Governor's statement that the debt was unpayable, and by a series of reports on the fiscal, debt and economic situation commissioned by the Commonwealth's government: a broad report led by Anne Kruger presented in June 2015, a liquidity report by Conway MacKenzie in August, and a "Fiscal and Economic Growth Plan" presented in September and updated in January 2016 by the Working Group for the Fiscal and Economic Recovery of Puerto Rico created by the Governor.

[8] Overall expenses have fallen 6% between FY2010 and FY2015 despite the already mentioned contraction of 11% of primary expenditures.

U.S. authorities ignored the buildup of the debt crisis, but attention increased substantially in the second semester of 2015, including the release of a U.S. Treasury *Roadmap for Congressional Action*, a study of the fiscal situation by the Congressional Research Service, and several legislative initiatives to support the Commonwealth.[9]

Given the dire state of public sector finances, major fiscal reforms are inevitable. This includes some cuts in spending as well as a comprehensive tax reform. The effects of tax reform would be limited by the ongoing recession and by interrelated dependence on a few corporate taxpayers and on the controversial excise tax enacted in 2010[10], which must also be replaced after 2017.

Correcting the fiscal crisis would help restore a sense of macroeconomic stability of the Puerto Rican economy but that, by itself, is *not* going to renew economic growth. In the words of the U.S. Treasury *Roadmap* for Puerto Rico: "Austerity alone is not a path to recovery" (p. 1). Rather, the tax and spending measures adopted to face the fiscal crisis will further weaken aggregate demand. The only exception are expenses backed by possible additional transfers from the U.S. Treasury in the area of health that would guarantee equal treatment under Federal health programs—Medicaid, Medicare and the Affordable Care Act—to Puerto Ricans, an obvious equity issue given their character as American citizens. The reform of health programs should, therefore, be part of any policy package.

In any case, in the absence of renewed growth, confidence in the long-term stability and prospects of the economy has waned. From the point of view of reestablishing confidence, the critical issue is a debt renegotiation that must sharply reduce the debt burden, delay debt payments to allow the economy to grow again, and create some room for additional public investment to restore economic growth. Debt restructuring must, therefore, meet two essential criteria: *it should be comprehensive and should allow for a "fresh start" of the Puerto Rican economy –i.e., renewal of economic growth*. Indeed, the best interest of creditors is served by a stable debt situation that can only be guaranteed by renewed growth. Delaying a necessary restructuring of Puerto Rico's debt

[9] The Federal Reserve Bank of New York had also published a report in July 2014, which despite its title (on the competitiveness of Puerto Rico), largely dealt with the fiscal crisis.

[10] These issues are interrelated as only eight companies represent 85% of the excise tax payments, according to the Commonwealth May 2015 *Quarterly Report* (p. 20).

will only lead to the destruction of bondholder value and lower recovery levels through additional unsustainable borrowings, high interest rates, and restrictive fiscal policies that would amplify the current economic contraction.

The problem is that Puerto Rico's public debt is spread across a variety of debtors (18 issuers in total) representing a complex web of claims in an uncertain regulatory and legal framework. This situation makes it very difficult for creditors to work as a class because one set of creditors will worry that any relief they provide the island will simply make it easier for a different set of creditors to recover a larger amount of their claims.

Therefore, in our view, it is quite clear that *any comprehensive solution to the debt crisis would require restructuring Puerto Rico's general obligation bonds, and breaking the link between specific debt obligations and specific tax revenue streams*, which cover 70% of total debt.

In this scenario, an orderly court-supervised process would help ensure fair treatment to all parties, including small, retail investors currently not "at the table". The alternative—an untested and potentially disorderly process with numerous creditor lawsuits and years of scorched-earth litigation—would further depress the local economy, increase restructuring costs, and make long-term recovery harder to achieve.

The new legal framework should also include typical additional provisions: a stay on litigation processes to allow Puerto Rico to run their current budgets without liquidity constraints, and creditor seniority in the restructuring process for whoever lends to Puerto Rico while renegotiations are in place.

H.R. 5278 achieves most of these objectives but the restructuring process is very cumbersome and is untested.

Any restructuring would require an autochthonous independent monitoring body that would guarantee the adoption of the agreed tax reforms—which must include closing loopholes—fiscal discipline, and improving budget design (notably tax estimates) and fiscal reporting. The agreed restraints should also prohibit issuing bonds guaranteed by specific tax revenue streams.

Beyond the current crisis, finding a solution to the insolvent pension system is also a priority, as it is likely to run out of assets in a few years. This process should include a dialogue with the labor unions to reach agreement on the best possible solution for current and future pensioners, given the fact that large part of pension payments would depend on current budgets that will be subject to severe constraints. Therefore, labor unions should participate and have a voice in the debt restructuring process, given the large unfunded liabilities that the Puerto Rican government owes them.

3. The need for a new development strategy

Puerto Rico's post-war economic history can be divided into three basic periods. The first was a boom from the late-1940s to the mid-1970s, with a rapid increase of per capita income that matched the rate of productivity growth (about 5% a year). This was followed by a significant slowdown since the mid-1970s, which lasted until the mid-2000s, when productivity growth fell to just over 1% a year and Gross National Income (GNI) per capita started to decline vis-à-vis the U.S. Both of these phases were characterized by large tax incentives, notably exemption from U.S. income taxes for profits made in Puerto Rico, an incentive that was gradually phased-out in the decade that ended in 2006. This incentive served to attract the new industries that propelled growth, including in the second phase a sizable pharmaceutical industry, which constitutes the core of the island's manufacturing and export sector.

Despite the convergence with the per capita income of the U.S. during the first phase, the per capita income of Puerto Rico remained significantly below that of the U.S. and, indeed, it is currently about a third of the U.S. level and half of that of the poorest state of the Union. (Mississippi). As a result, poverty levels remained high (46% vs. 15% in the mainland), reflecting also a more skewed income distribution than that of the U.S. This lack of convergence of per capita income, despite a customs and currency union with the mainland, high levels of U.S. and foreign investment and labor mobility, contradicts the view that those conditions should guarantee income convergence –as, in fact, the renewed divergence of per capita incomes in the European Union also do, in a region where convergence had been stronger than that between Puerto Rico and the U.S. In turn, the slower growth during the second phase may indicate that Puerto Rico was starting to face what in the recent literature has come to be called the "middle-income trap", associated with the difficulties in moving to the higher technology and, more generally, the higher knowledge-intensive sectors.

The third phase is the ongoing lost decade. The development model, which was already showing increasing strains since the mid-1970s, has now entirely collapsed The fact that the economic contraction was preceded by a period of slow economic growth, that it started before that of the U.S. and it has continued (with only a mild and aborted recovery in 2012-13) despite the recovery of the American economy, indicate that the economy faces difficulties beyond the effects of negative external shocks. It is possible that the loss of privileged access to the U.S. market generated by a sequence of free trade agreements (FTAs), starting with NAFTA in 1994, may have contributed to this result. But, again, the slowdown in the mid-1970s happened much earlier than the sequence of FTAs, and the lost decade much after the launch of NAFTA.

Renewing growth requires, therefore, a combination of efforts. Short and medium term efforts are essential to spark economic activity and begin reversing the effects of a protracted slowdown. *These efforts should part of a comprehensive long-term growth strategy –a new development model— capable of inducing investment in new economic activities, notably knowledge-intensive sectors, designed through a dialogue between key stakeholders in the public and private spheres. An active industrial policy is the main instrument to achieve this strategic goal*.

To jumpstart the Puerto Rican economy it will be necessary to devise and deploy a combination of effective programs, policies and investments. A *Growth Commission* could spearhead a process that diagnoses, designs and helps implement feasible solutions. Significantly different from a fiscal control board, its mandate will be centered on defining a comprehensive development framework for the island, one that includes both short-term measures and medium-term strategies aimed at what its name indicates: renewing and sustaining a new phase of economic growth.

Near-term efforts should be centered on interrupting the pernicious cycle of divestment, decline and departure, and stabilizing the fiscal and economic situation. The *Growth Commission* could study and suggest incentive programs that are "locally accountable"—where better estimations of costs and benefits are defined, strict performance standards are established, and beneficiaries are liable to brokered benchmarks. In other words, programs that depart from the traditional tax schemes employed in Puerto Rico, which have granted a myriad of tax benefits that have significantly eroded the tax base but offered limited development outcomes. The *Commission* could also assist in targeting inefficient incentives and tax loopholes to be dismantled, in order to generate the needed government revenues to increase public investment to boost local economic activity, examining ways of increasing institutional capacity and identifying innovations in public management.

Medium-term strategies devised by the *Commission* should be focused on planning strategic investments in specific sectors of the Puerto Rican economy. A series of empirical diagnoses that examine the prospects for public and private investment, growth and job creation in existing and promising sectors could serve as the basis for a comprehensive action plan.

Because the ultimate goal is the creation of a new development model, some "structural reforms", understood as market-based and institutional reforms, may be necessary but are an unclear way forward. Puerto Rico has some of the features that are usually recommended under the banner of structural conditions that facilitate growth. The Commonwealth is a very open economy with full access to the U.S. market, even in sectors in which other countries have restricted access (the defense-related industries).

In institutional terms, although the local political system shows significant weakness –and, in recent years, a persistent gridlock— the country also has the U.S. legal and judicial system. It also has, relative to most emerging countries, high educational levels, access (albeit limited) to the U.S. welfare system, a relatively good physical infrastructure and is part of the U.S. financial system.

In structural terms, two key labor markets reforms are important. The first is the adoption of the *Earning Income Tax Credit (EITC)*, which, aside from being the most effective anti-poverty program of the U.S., creates incentives to formalize labor relations and provides significant relief from regressive consumption taxes. Its adoption would also initially increase the income of working families, facilitating the recovery of aggregate demand. This should be combined with giving Puerto Ricans access to the federal Child Tax Credit.

The second involves transforming the design of social assistance programs in order to incentivize work in the formal sector and promote self-sufficiency. In the same vein as the Canadian Self Sufficiency Project, efforts should aim to experiment and test the impacts of providing earning supplements and targeted job training to long-term welfare recipients in the Temporary Assistance for Needy Families and Nutritional Assistance Programs who find stable employment in the formal sector. These kinds of program overhauls should be performed after conducting rigorous trials that evaluate the costs and benefits of program changes.

In institutional terms, significant reforms are also necessary. These include those of fiscal institutions already mentioned as well as simplifying the byzantine licensing and permitting system for the creation of new firms, and significantly improving the management of the state-owned firms, particularly in the energy sector, to reduce costs and increase efficiency. Moreover, institutional reforms should also aim to improve educational standards at the K-12 level, and modernize outdated labor regulations.

The basic goal of industrial policy should be to identify, *in close interaction with the private sector and civil society*, opportunities for new production activities in the island, particularly knowledge-intensive activities. These include the higher value-added segments and functions of the value chain in which Puerto Rico is already active –notably, pharmaceuticals—, both upstream and downstream –and, in the first case, particularly in research and development. But industrial policy is not limited to traditional industrial activities: it should aim at stimulating the economy and advancing structural change by bolstering and supporting key sectors.

Moreover, industrial policies also aim to correct imbalances between market and social outcomes. In the case of Puerto Rico, this would essentially involve developing a new process of dialogue and consultation between private actors and the public sector, including labor unions, and potential investors from the U.S. (but also from other countries), that would help to identify capabilities and opportunities in leading sectors and explore new opportunities in bio-agriculture, aerospace, professional and financial services, information technologies and specialized tourism, among others. This is precisely the kind of dialogue and consultation process that the Center for a New Economy, in collaboration with Espacios Abiertos, the Initiative for Policy Dialogue of Columbia

University, and the Watson Institute for International and Public Affairs at Brown University is devising.

The public sector—including local governments—would participate in this process to help create the synergies that lead to complementary private investments, as well as support the learning processes characteristic of new activities. This would imply:

- A major redesign of the policies in place to facilitate private investment, which have so far failed to generate a dynamic set of new activities, and often facilitated opportunities for rent seeking.

- Reinforcing public sector support for basic and applied research, including improving the use of federal programs and initiatives that promote research and development, establishing a sound migration and development policy framework that helps building knowledge and investment networks between island and Diaspora stakeholders, and revamping educational standards at all levels.

- The creation of a true Development Bank that promotes new private sector activities, including with partial risk capital, rather than playing the role of the bank of the public sector.

- A deep analysis of the generous tax incentives in place to promote new investments in services, including those that were designed in 2012 (Laws 20, 22 and 273) as well as preexisting benefits (such as Law 399 for insurance companies). Given the revealed ineffectiveness of these incentives, and the need to rationalize major tax loopholes, there should be clear criteria for tax incentives, notably the knowledge intensity of the promoted activities and the opportunities for learning, knowledge spillovers and developing forward and backward linkages with local firms.

Since one of the likely candidates for new activities could be the transformation of the island into a major maritime transportation and logistical hub, it is essential to exempt Puerto Rico from the U.S. coastwise shipping laws (the Jones Act of 1920), which governs trade between Puerto Rico and the mainland U.S. In addition, closer interaction with the Caribbean and Latin American countries, using the clear advantage of having a bilingual skilled labor force and being a U.S. territory in terms of access to the legal and financial system of the U.S., offers promising opportunities for Puerto Rico. Furthermore, the ongoing opening of U.S.-Cuba relations may present particular opportunities for Puerto Rico, considering that many Puerto Rican firms have vast experience navigating the legal and regulatory requirements established by the U.S. government.

These considerations, as well as those related to the legal system for debt restructuring, raise a final set of questions about Puerto Rico-U.S. relations that must be included in the agenda going forward. This may imply full statehood or independence, based on democratic decisions by Puerto Rican citizens, but it must eliminate the subordinate political status under which the island currently operates.

Center for a New Economy
San Juan, PR

The Center for a New Economy (CNE) is an independent, non-partisan think-tank that advocates for the development of a new economy for Puerto Rico. Founded in 1998, CNE produces rigorous public policy research and analysis, and is one of the most credible and influential voices on Puerto Rico's economy. CNE is organized as a 501(c)(3) non-profit entity that does not solicit nor accepts government funding. It relies solely on funding by individuals, private institutions and philanthropic foundations.

www.grupocne.org www.facebook.com/grupocne www.twitter.com/grupocne