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The Puerto Rican Saga

Two years ago, Andrew Wolfe, Ranjit Teja and I prepared a report on the economic situation and outlook for the Puerto Rican economy. The picture was bleak: economic stagnation (if not retrogression), fiscal crisis and unpayable debt-servicing obligations. We presented evidence that without serious policy actions on three fronts – measures to improve growth prospects, address fiscal imbalances and deal with the debt – the outlook was dismal.

Since then, some action has been taken. There is currently a stay on debt-servicing obligations, which prevents creditors from individually going to court and getting legal authority to seize assets. A control board was established by the U.S. Congress as a precondition for the stay. It rejected the initial budget proposed by the governor but has since approved a revised one. Nonetheless, the actions to date are almost certainly insufficient to reverse Puerto Rico's economic fortunes. The hurricane damage in September worsens the picture further still.

Puerto Rico is legally a territory of the United States, which entails both benefits and costs. Among the benefits, Puerto Ricans are U.S. citizens with U.S. passports and can move freely between the mainland and the island. The Commonwealth can offer the assurances of U.S. law and the U.S. dollar to foreign investors. Per capita income is only about $17,000, which is about a third of the U.S. average and half of that of the poorest mainland state (Mississippi). Puerto Rican residents are not subject to U.S. federal income taxes but are eligible for food stamps and some other benefits, including the mandated medical payments under the Affordable Care Act. However, the Commonwealth is expected to begin shouldering that fiscal burden this fiscal year, a burden projected to reach more than $1.5 billion in 2019 and $2-3 billion annually during the next decade.

That fiscal burden is among the costs of Puerto Rico's status. Puerto Rico is also subject to the federal minimum wage law, which is currently $7.50/hour. This makes it difficult to compete for tourism with other Caribbean islands, where the wages are less than a third of those in Puerto Rico.

Puerto Rico grew relatively slowly after World War II until the enactment of a federal law exempting mainland-based industrial companies from taxes on corporate profits if they manufactured on the island. This led to a growth spurt, and the companies that responded most enthusiastically were generally highly capital-intensive, and chiefly pharmaceuticals. The boom lasted until 1996, when Congress voted to phase out the exemption over the following ten years. Thereafter, growth began to taper, and real GNP has declined in virtually every year since 2002 (although some of the pharmaceutical companies have remained). Real GNP is now estimated to be ten percent lower than in 2002.

Accompanying this downturn, out-migration to the mainland has accelerated. While data are subject to considerable error, the current population is estimated to be 3.4 million, about half of what it was several decades ago. Estimates for 2016 indicate that 1.7 percent of the population emigrated (consisting primarily of those in the labor force) and that real GNP fell two percent. Over the years of stagnant or decreasing output, Puerto Ricans viewed their economy as in a temporary recession, when it was in fact shrinking. Successive governments proposed budgets in deficit, anticipating that the "stimulus" would turn things around. But the economy continued to shrink, and borrowing was necessary to cover the larger than anticipated deficits. When government debt was high enough to raise alarm bells, proposed budgets were balanced, but inevitably expenditures were larger and revenues smaller than anticipated as the economy shrank more than had been forecasted.

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All the while, there was an unrecognized and growing problem: over time, legislation and regulations had mounted that provided disincentives for economic activity on the island. These ranged from long waits and tedious processes for building permits to labor laws that clearly reduced labor productivity, all in an environment where the high minimum wage had already limited the growth in tourist activity (it is estimated that there were no more tourist beds in Puerto Rico in 2016 than there were in 1970, despite the boom in tourism throughout the Caribbean and in Florida). It was virtually illegal to fire a worker (which, counterintuitively, discourages the employment of labor, and especially unskilled labor), there were no provisions for apprenticeships, annual leave and sick leave mandated by law were generous by mainland standards, and so on. A government agency was empowered to grant incentive packages to firms entering the island market on an ad hoc basis. To make matters worse, government records and processes were incredibly lax. These and other similarly misguided policies had constituted a major drag on the economy, but they had been ignored, as the focus was on combatting the “recession”.

In the initial years after 2002, borrowing was still easy, because the U.S. Congress had granted Puerto Rican bonds triple exemption from federal, state and local taxes. This made the bonds very attractive to investors, and it had also long been assumed that Puerto Rico, like other U. S. government entities, could not and would not fail to honor its debt-servicing obligations. But by 2015, creditors had grown concerned about the high level of island debt and the continuing size of budget deficits. By 2016, Puerto Rico could no longer access the bond markets. Puerto Rico’s GNP is about $70 billion, and as of May 2017 its estimated debt (including unpaid pension obligations) is about $127.3 billion.

As the seriousness of the situation became increasingly evident, Congress responded in 2016 by passing the so-called PROMESA legislation, which established the control board and enabled it to oversee Puerto Rico’s program and progress in righting the situation. Some measures ameliorating the anti-growth climate have also been taken, but many questions remain. Even before the hurricanes, it was questionable whether a positive fiscal balance could be achieved. The outlook for negotiations with creditors is cloudy, especially for the very important electric power company, PREPA. Accelerated growth in the world economy will of course help, although as jobs become more plentiful on the mainland, more out-migration may be induced.

It is interesting to contrast the Puerto Rican experience with that of Greece. In both instances, a large entity (the EU and the U.S. government) had considerable influence over economic policies in the debt-ridden jurisdiction. Both could borrow at unrealistically low interest rates but were unable to reverse course when debt levels became high and prospectively unsustainable. Both were members of currency unions, preventing them from undertaking a devaluation. Both had policies that were inimical to growth. Under pressure (from the troika and the control board), both have taken actions to reduce/eliminate prospective fiscal deficits and reduce government debt to levels thought to be sustainable. But in both cases, measures that most economists would deem desirable to enable the resumption of growth have been undertaken half-heartedly, if at all, and have not – at least to date – been sufficient to bring about the needed increase in private economic activity and restore growth (although Greece may show modest growth in 2017).

There are, however, significant differences. Increased Greek borrowing was spurred by the low interest rates available after entry into the eurozone, whereas Puerto Rico’s debt built up in a misguided effort to offset what was thought to be a temporary recession. Greece’s prospective fiscal deficit was more than 12 percent of GDP in 2010, and Puerto Rico’s was around three percent. Puerto Rico has received little new money, whereas Greece was the recipient of new money from the troika and possibly significant debt forgiveness. The U.S. Congress has considerable ability to mandate expenditures (such as the Affordable Care Act) directly, which is not true of the EU’s power in Greece.

If there is a lesson, it is that resumption of growth is essential if a path out of economic crisis is to be found. When economic policies are antithetical to growth, any measures to right the budget or forgive the debt will be merely short-term palliatives.