

TESTIMONY BEFORE THE UNITED STATES SENATE COMMITTEE ON ENERGY AND
NATURAL RESOURCES PUBLIC HEARING ON PUERTO RICO'S ECONOMY, DEBT, AND
OPTIONS FOR CONGRESS

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October 22, 2015
Washington, DC



Good morning, Chairman Murkowski, Ranking Member Cantwell, and Members of the United States Senate Committee on Energy and Natural Resources. I thank you for the opportunity to appear today before this Committee to discuss Puerto Rico's financial and economic challenges.

Puerto Rico currently faces two distinct, yet related, crises. The first, and most urgent, arises out of the government's weak financial situation. The second is the product of the chronic stagnation of its economy over the last ten years.

Decades of fiscal and economic mismanagement have engendered an economy characterized by: (1) chronic primary deficits; (2) high debt-to-GNP ratios; (3) low employment levels in the formal economy; (4) a large informal economy, encompassing both legal and illegal activities; (5) significant government corruption and predatory rent-seeking behavior in both the public and private sectors¹; (6) substantial tax evasion; (7) a hollow productive base; and (8) high levels of private consumption and indebtedness enabled by having access to a stronger currency than its economic fundamentals would warrant. In our opinion, the parallels with Greece are quite evident for all to see and none to misunderstand.

Notwithstanding this dismal economic situation, the island managed to *triple* its public debt from \$24 billion in 2000 to \$72 billion in 2015. Indeed, during this period Puerto Rico's public indebtedness grew at a compound annual rate of 7.6%, while its income (GNP) grew at a nominal rate of only 3.6%.²

Given that Puerto Rico's indebtedness grew at an average annual rate two times faster than the growth rate of its GNP during the past fifteen years, it should not be surprising that Puerto Rico's public debt currently exceeds its GNP. To be fair, however, for decades the borrowed money was put to good use to finance the construction of public schools, hospitals, highways, and other essential infrastructure. The problem is that during the last twenty years or so, a large portion of the money borrowed by issuing long-term debt was used to finance budget deficits, operating expenses, and classic pork-barrel spending.

In February 2014, the three principal rating agencies downgraded the Commonwealth's debt, as well as debt issued by several of its agencies and instrumentalities, to speculative or non-investment grade.

The rating downgrades had a material adverse effect on the Commonwealth's finances because they essentially shutdown its access to the capital markets, at least at reasonable rates. This, at a time when the central government is still running a sizeable budget deficit, several of the Commonwealth's agencies and instrumentalities face significant maturities in the near term, the economy is contracting at an estimated annual

¹ "Rent-seeking" can be defined as the pursuit of uncompensated value from other economic agents; in contrast with profit seeking, where economic agents seek to create value through mutually beneficial economic activity.

² In Puerto Rico, GNP, which measures income earned by residents or by locally-owned production factors, is a more accurate measure of economic activity than GDP due to distortions induced by the transfer pricing practices of multinational companies operating in the island. For a technical analysis of the GNP/GDP gap in Puerto Rico see "Economic Growth" by Barry P. Bosworth and Susan M. Collins in *The Economy of Puerto Rico: Restoring Growth*, (Brookings Institution Press: Washington, DC, 2006), p. 17-81.

rate of 1.2%, liquidity is running extremely tight, and net outmigration has increased to levels not seen since the 1960s.

Given the magnitude and multiplicity of challenges faced by Puerto Rico it should be obvious that there are no quick fixes to solve the island's fiscal and economic problems. Congress needs to implement a comprehensive program, remove some of the disadvantages imposed on Puerto Rico under the current political arrangement, and eliminate some long-standing inequitable and discriminatory policies. The current situation simply does not allow for piecemeal action by Washington, a wide-ranging plan is needed.

In the short-term the most pressing issue is Puerto Rico's deteriorating liquidity situation. If the cash flow projections made by Conway MacKenzie are accurate, then Puerto Rico will not have enough cash on hand to meet all its obligations as soon as December of this year.³

In that event, in the absence of either (1) access to an emergency liquidity facility or (2) forbearance from bondholders, the probability of a disorderly default is quite high, because the current administration has already stated its firm intention to keep essential government operations running and Puerto Rico cannot avail itself of relief under Chapter 9 of the U.S. Bankruptcy Code.

Given the short time window, the policy options at the federal level boil down to (1) providing short-term financing to Puerto Rico to avoid a default or (2) enacting legislation extending the application of Chapter 9 to Puerto Rico.

With respect to Chapter 9, the first thing to notice is that Puerto Rico's 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.

In game theory terms, Puerto Rico faces a game in which there are multiple players, which sometimes have common and sometimes-opposing interests, and not making a deal leaves everyone worse off. In this type of game the final outcome could be one of any number of possible "Nash equilibria", which would generate sub-optimal results for all parties involved.

Congress could help Puerto Rico figure a way out of this conundrum by approving legislation to authorize the Puerto Rican government to allow its distressed agencies, instrumentalities, and municipalities to file for bankruptcy under Chapter 9 of the U.S. Bankruptcy Code.

However, while we support allowing Puerto Rico to avail itself of Chapter 9 procedures to adjust its debt and believe it would provide a helpful framework for addressing existing coordination and information failures, we also stress that it is by no means a complete or perfect solution to all of Puerto Rico's troubles.

³ Conway MacKenzie, *Commonwealth of Puerto Rico Liquidity Update*, August 25, 2015.

Another significant problem on the fiscal side is the cost of the Government Health Plan, which is one of the principal drivers of Puerto Rico's non-interest expenditures.⁴ Providing Puerto Rico equal treatment under federal healthcare programs, such as Medicare, Medicaid, and the Affordable Care Act would provide the Commonwealth with some much-needed fiscal space and address a long-standing injustice inflicted on Puerto Ricans. For the truth of the matter is that Puerto Rican workers and employers pay the same payroll taxes as workers and employers in the mainland, yet benefits to Puerto Rico are unfairly rationed by federal legislation.⁵

On the economic growth side of the equation, we recommend extending the federal Earned Income Tax Credit ("EITC") program to Puerto Rico. The federal EITC is the most effective anti-poverty program in the United States. Recent research also shows that it encourages work, promotes savings, helps poor families smooth out the effect of unexpected financial shocks, and builds a strong sense of future orientation among recipients.⁶ Extending this program to Puerto Rico, which would provide a significant wage supplement to low-income Puerto Rican working families, could be expected to stimulate aggregate demand in the short-run.

Sustaining economic growth over the long-term, however, is a more complicated issue, involving the interplay of many factors and variables, including: the capability to accumulate and increase capital in all its forms—financial, physical and human; the efficiency with which inputs are utilized in the production process, what economists refer to as total factor productivity; the degree of openness to the world, which has become increasingly important as knowledge flows across national borders and foreign trade and investment influence the incentives to innovate, imitate, and use new technologies; and finally, adaptable institutional structures that provide the right incentives to innovate and develop new technologies, reorganize production in order to exploit new opportunities, and accumulate physical and human capital.

In this context we strongly recommend that any savings derived from a reduction in debt service be dedicated *exclusively* to develop and implement a new industrial policy for Puerto Rico based on (1) a set of coherent horizontal policies such as reforming an unnecessarily complicated permitting and licensing system that stifles innovation, lowering energy and other costs of doing business in the island, and substantially improving educational standards; (2) discovering new sectorial opportunities through a process of dialogue and consultation with key stakeholders in the private and civic spheres; and (3)

⁴ *Commonwealth of Puerto Rico Quarterly Report*, dated May 7, 2015, p. 20-21 and 37-40.

⁵ See United States Government Accountability Office, *U.S. Insular Areas: Multiple Factors Affect Federal Health Care Funding*, GAO-06-75, (October 2005), and *Puerto Rico: Information on How Statehood Would Potentially Affect Selected Federal Programs and Revenue Sources*, GAO-14-31, (March 2014).

⁶ See Bruce D. Meyer, "The Effects of the Earned Income Tax Credit and Recent Reforms" in *Tax Policy and the Economy*, Volume 24, Jeffrey R. Brown, ed., (University of Chicago Press, 2010); Sara Sternberg Greene, *The Broken Safety Net: A Study of Earned Income Tax Credit Recipients and a Proposal for Repair*, New York University Law Review, Vol. 88, No. 2, May 2013; V. Joseph Hotz, Charles H. Mullin, and John Karl Scholz, *Examining the Effect of the Earned Income Tax Credit on the Labor Market Participation of Families on Welfare*, NBER Working Paper 11968, (National Bureau of Economic Research: Cambridge, MA, 2006); and Chuck Marr, Chye-Ching Huang, and Arloc Sherman, *Earned Income Tax Credit Promotes Work, Encourages Children at School, Research Finds*, (Center on Budget and Policy Priorities: Washington, DC, 2014), among others.

“identifying spillovers, externalities, and other areas where [Puerto Rican] society could learn more.”⁷

This new learning, in turn, would lead to: new investment in R & D, increased productivity, identifying new areas of comparative advantage for Puerto Rican firms, higher economic growth and the creation of high-quality jobs, which is what will categorically end Puerto Rico’s economic stagnation. We at the Center for a New Economy are currently working with experts from Columbia, Brown, MIT, and Brookings, among other institutions, to develop this medium to long-term industrial policy.

Finally, any new economic strategy for Puerto Rico, no matter how nuanced, sophisticated, or brilliantly conceived, is bound to fail if it ignores the fact that Puerto Rico has reached the limits of its development within the constraints imposed by its subordinate political status, which is both humiliating to Puerto Ricans and unworthy of the United States.⁸

In conclusion, Chairman Murkowski, I thank you and the Committee once again for the opportunity to participate in this important public policy debate and look forward to answering any questions that you or Committee Members may deem appropriate to ask.

⁷ Joseph E. Stiglitz and Bruce C. Greenwald, *Creating a Learning Society: A New Approach to Growth, Development, and Social Progress*, (Columbia University Press: New York, 2014), p. 489.

⁸ Neither a sovereign country nor a state of the union, Puerto Rico has no authority to negotiate international treaties, no access to emergency financing from multilateral institutions, no monetary policy instruments, limited fiscal policy tools, nominal representation in Congress, and the U.S. Supreme Court has determined it is constitutionally permissible for Congress to discriminate against Puerto Rico in the application of federal programs as long as there exists a “rational basis” for doing so.