



ROUNDTABLE DISCUSSION ON THE FUTURE OF PUERTO RICO'S ECONOMY

STATEMENT FOR THE RECORD
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Introduction

Good afternoon, Ranking Member Velázquez, Members of the United States House of Representatives, and distinguished guests. I thank you for the opportunity to appear today before this Roundtable to Discuss the Future of Puerto Rico's Economy. My remarks today will cover three topics. First, I will briefly discuss the impact of the enactment of the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA"). Second, I will stress the need for policy initiatives at the Federal level to help Puerto Rico end its current downward economic spiral and jumpstart economic growth in the short-term. Finally, I will outline the work of the Growth Commission convened by the Center for the New Economy to develop a long-term economic growth strategy for Puerto Rico.

PROMESA: A Game Changer

The enactment of the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA") in June 2016 opened a new chapter in U.S.-Puerto Rico relations. After decades of benign neglect, Congress recognized in 2016 that it has a moral obligation under the U.S. Constitution to foster the welfare of the U.S. citizens that live in Puerto Rico. This means, first and foremost, that it is in Congress's own interest to see through that Puerto Rico is successful in addressing its current fiscal and economic crisis.

Unfortunately, some of the policy tools set forth in PROMESA are not working as expected and may actually hinder the island's ability to escape its current economic death spiral.

First, the imposition of a Fiscal Oversight Board over the duly elected government of Puerto Rico—with broad powers over the island's fiscal and economic policies, authority to command the implementation of its recommendations, and the capacity to prevent the enforcement or execution of otherwise valid contracts, executive orders, laws or regulations—has seriously undermined the island's political institutions, already extremely compromised by clientelism, partisan politics and corruption.

In addition, the Fiscal Oversight Board has added a new layer of opacity to fiscal policymaking in Puerto Rico. The discussions among Board members have been carried out mostly behind closed doors, while interactions between the Board and the Government of Puerto Rico tend to be summarized *ex post*, usually through succinct letters written in rather cryptic language. It is quite ironic that the Fiscal Oversight Board, which, among other things, was given the task of increasing the transparency of Puerto Rico's finances, has actually contributed to worsening that problem.

Second, the benefits of PROMESA's complicated territorial debt restructuring process, which combines principles drawn from both the U.S. Bankruptcy Code and from the realm of sovereign debt restructuring, remain fairly uncertain and contingent on the

successful implementation of a completely new and untested legal framework for territorial bankruptcy. The risk that such an experimental framework fails to adequately address Puerto Rico's debt restructuring needs are magnified by the fragile state of the Puerto Rican economy, which has undergone a protracted decade-long contraction.

Finally, both the fiscal plan and the budget for fiscal year 2018 that have been certified by the Fiscal Oversight Board impose significant austerity measures in the short-term. The most likely result of the implementation of these measures will be a further contraction of the Puerto Rican economy; increased unemployment, poverty and inequality; thus generating further migration to the mainland and lower tax revenues in the island as the tax base shrinks; which will lead to calls for more cuts in government services; less government services, in turn, will lead to a general decrease in quality of life and living standards, which will result in yet more "push" migration to the mainland.

Jumpstarting the Economy – The Federal Component

Given the extreme weakness of the Puerto Rican economy it should be obvious that economic growth opportunities will not materialize spontaneously, even after significant debt restructuring. In our view, Puerto Rico needs to devise and execute a complex, two-prong strategy to restore growth. First, there is a need to jumpstart economic growth in the short-term. Second, the island needs to formulate an economic development plan to sustain that growth over the long-term, something it has failed to do for quite some time.

Again, it is important to highlight that this already difficult task is further complicated by the austerity policies the Fiscal Oversight Board has required Puerto Rico to implement. The certified fiscal plan for Puerto Rico orders the island's government to implement large expenditure cuts, significant tax increases, and deep structural reforms *without access to any short-term financing*.

The implication of the Fiscal Oversight Board's policy posture is that—unless Congress is otherwise willing to address a full-scale social crisis in Puerto Rico—Federal assistance will be necessary to jumpstart economic growth in the short-term. Congress needs to implement a comprehensive economic 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.

A short-term economic program for Puerto Rico at the Federal level should, at a minimum, focus on the following issues:

- *PROMESA Implementation* – The Fiscal Oversight Board will be probably be in place for at least five or six years. *Congress has a moral obligation to ensure it works in the best interests of the people of Puerto Rico and not for the benefit of*

other extraneous and opportunistic stakeholders. The guiding principle here should be: first do no harm. That is why it is particularly important for Congress to (1) supervise the development of fiscal plans and annual budgets; (2) follow closely the developments regarding the restructuring of Puerto Rico's debt and all Title III and Title VI proceedings under PROMESA; (3) propose alternatives to the counterproductive austerity policies imposed by the Fiscal Oversight Board; (4) follow-up on the recommendations made by the Congressional Task Force in December 2016; and (5) ensure that the U.S. government provides much needed technical assistance to the Puerto Rico Office of Management and Budget and the Puerto Rico Treasury Department.

- *Healthcare* – The cost of the Government Health Plan is one of the principal drivers of Puerto Rico's budget deficit and healthcare funding is the number one policy issue for Puerto Rico in Washington right now. 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. In addition, Federal funding for Medicaid in Puerto Rico is unfairly capped, and the island is subject to unequal reimbursement treatment regarding key Medicare programs. Moreover, the island faces the consequences of the possible repeal and replacement of the Affordable Care Act, as well as proposed changes to the funding for the CHIP, Medicaid, and Medicare programs. Over half a million beneficiaries could lose their access to Puerto Rico's public health insurance program. Providing Puerto Rico equal treatment in these Federal programs would grant the Commonwealth much-needed fiscal space and address a long-standing injustice inflicted on Puerto Ricans.
- *Safety Net Programs* – Puerto Rico is an extremely poor territory of the United States. Therefore, maintaining key safety net programs such as the Nutritional Assistance Program, Social Security Disability Insurance, and the WIC program; as well as extending to Puerto Rico the Child Tax Credit and the Earned Income Tax Credit, among other federal programs, is crucial for the wellbeing of thousands of low-income Puerto Ricans.
- *Jumpstarting Economic Growth* – The short-term growth program from Washington should also include treating Puerto Rico fairly and equitably in any tax reform and infrastructure proposals made by the Trump administration; increasing federal procurement spending, augmenting the SBA's presence and activity in Puerto Rico, and providing additional NIH/CDC research funding; maintaining or increasing K-12 and university Federal education funding; providing Department of Energy technical assistance to the Puerto Rico Electric Power Authority ("PREPA"); actively promoting the effective use of Workforce Development Programs; and seeking a partial exemption from the Jones Act.

The CNE Growth Commission – The Local Component

In addition to those initiatives at the Federal level, Puerto Rico needs to craft a local long-term economic development strategy and strengthen its execution capabilities.

Achieving long-term, sustainable economic growth and development is a complex endeavor that requires a new set of strategies and the rebuilding of institutions; thus, there are no quick fixes or silver bullets.¹ In other words, economic growth is not simply a function of exiguous regulation, low wages, or preferential tax treatment. Rather, the process of growth is quite complicated, involving the interplay of many variables and factors that must be present if a country is to succeed.

As a first step in charting the road towards sustainable economic development, the Center for a New Economy (CNE)—Puerto Rico’s premier and only independent, non-profit think tank—has undertaken the task of empaneling the CNE Growth Commission for Puerto Rico (the “CNE GC”).

The CNE GC will identify opportunities and innovative strategies that can disrupt the pernicious pattern of economic decline, weak governance, deficient policymaking and flawed assessments of results, and embark on a new path to foster long-term growth.

CNE’s vision is based on the premise that long-term sustained economic growth is a result of a country’s capability to progressively move into higher value-added activities. This is achieved by improving the types and quality of the goods and services produced and by finding innovative and more efficient ways of producing them. This is especially true in the 21st century, which is characterized by ever-deeper inroads into a knowledge-based economy and by heightened global competition. Therefore, any new economic strategy for long-term growth ought to be focused on:

- (1) Speeding up the process of economic structural change by advancing the economy’s insertion in high-value niches, investing in innovation, and adopting new knowledge and technologies;
- (2) Creating the institutional framework to promote this structural change; that is, *revamping* the institutions whose mission is to promote this transformation; and
- (3) Devising public policies that help raise the wellbeing of society in an inclusive manner, so that most of its members can benefit from the gains of improved economic performance.

¹ Indeed, past efforts have been unsuccessful mainly due to the failure to understand the complexity of the growth process. It requires, for example, setting realistic goals for and building adequate execution capabilities in economic development institutions; the revamping of competition policy and its enforcement; providing structural access to credit; improving the fiscal toolkit of exemptions, credits and deductions; updating and modernizing obsolete regulations; and strengthening the research and innovation ecosystem.

An important factor to keep in mind is that the capability of the government to implement its development strategies, policies, and programs, as well as to provide continuity to these, is a key constraint. Therefore, developing the capabilities for private actors and the government to work together towards these objectives is a key component of any proposed growth and development agenda.

Objectives

The CNE Growth Commission will identify and produce relevant analyses, policy designs and, in certain instances, demonstration projects to improve economic and social policy decision-making in Puerto Rico. These initiatives should advance the creation and institutionalization of *learning cycles* via sustained collaborations between government policy-makers, practitioners, and key stakeholders in academia, the NGO community, and the private sector.

Proposed Agenda

The Commission will work towards (1) identifying and suggesting ways to relax local and external constraints that inhibit the territory from speeding up the process of economic structural change towards higher productivity activities; and (2) generating opportunities to diversify the portfolio of high productivity activities in the economy. Specifically, the Commission will focus on the following areas with the potential for high impact:

- **Area 1: Identifying Sectorial Opportunities**

The strategy to move Puerto Rico into higher value-added activities and improve productivity across sectors of the economy will require a rigorous diagnostic analysis. This analysis will help determine an *ex ante* optimal research portfolio to be developed for purposes of industrial promotion activities. This, in turn, will require setting realistic goals and adequately assessing the management execution capabilities of the territory's economic development institutions.²

Identification of New Sectorial Ventures – A cutting-edge methodology in productive development diagnostics, *product space analysis* will help the Commission to identify new products and services that could augment aggregate value through the use of existing productive capabilities embedded in the island's current production structure. The methodology operationalizes the idea that it is generally easier for countries to move from products and services that they already produce to others higher in the value chain that are similar in terms of capital requirements, knowledge, and skills. Because not all

² Caveat: At present, key public institutions such as the Puerto Rico Industrial Development Company, the Puerto Rico Science and Technology Trust, the Government Development Bank, and the Economic Development Bank, have depleted their assets and funding independence; while the fiscal and market competition policy components are controlled by institutions outside the economic development arena (i.e., the Department of the Treasury on the tax regime for multinationals, emerging and existing businesses; and the Department of Justice on competition policy).

feasible new products contribute in the same way to value added and growth, a key challenge along the diversification process is the identification of those goods/services that are feasible and have a higher potential to sustain economic development.

- **Area 2: Horizontal Reforms to Enhance Competitiveness**

At the same time, the Commission will identify opportunities for effective policy reform in areas with the potential to enhance the competitiveness of local and multinational producers across multiple sectors, such as: tax and competition policy, human capital and workforce development, energy production, and communications, information, and technology infrastructure, among others.

- **Area 3: Macro-Fiscal Policy**

A Working Group of the Commission will develop feasible proposals for tax policy reform with the aim of (i) enhancing the territory's competitiveness and (ii) reducing tax distortions that may inhibit productivity growth in the private sector. This Group will work on evaluating the potential for a *disciplined* fiscal reform to enhance the territory's competitiveness, given its inclusion in the US monetary union.

In addition, Puerto Rico's deep and prolonged recession has made the Commonwealth's debt position unsustainable. In such a recessionary (demand-constrained) regime, as demonstrated by the significant sub-utilization of available factors of production (i.e., labor, capital), an austerity-based internal devaluation would be suboptimal—both unfair and inefficient. Instead, the deep fiscal imbalance, population contraction, and lack of government access to credit, demand a rigorous assessment of the debt restructuring requirements that are a necessary condition for restoring economic growth.

Conclusion

In sum, Puerto Rico has been under severe economic, fiscal, and financial stress during the past decade. During that period the Commonwealth has enacted a series of austerity and fiscal consolidation measures. Yet, in contrast with other jurisdictions that could complement those policies with either (1) a currency devaluation to boost exports or (2) loans from emergency liquidity facilities negotiated with international multilateral institutions, Puerto Rico, due to its institutional constraints, cannot devalue its currency nor does it have access to such emergency liquidity facilities.

Furthermore, the Fiscal Oversight Board has ordered Puerto Rico to put on the equivalent of an IMF policy straitjacket without providing access to the few benefits that usually accompany IMF conditionality programs. In our view, this policy posture simply does not make sense and implementing these policies will, in a perverse way, *decrease* Puerto Rico's short and medium-term capacity to pay its debts and obligations by amplifying an already prolonged economic contraction.

Second, in the short-term, a firm Federal commitment to jumpstarting economic growth in the island is crucial to help Puerto Rico turn its economy around. Congress needs to implement a comprehensive economic program, remove some of the disadvantages imposed on Puerto Rico under the current political arrangement, and eliminate some long-standing inequitable and discriminatory policies.

Third, in addition to initiatives at the Federal level, Puerto Rico needs to craft a long-term local economic development strategy. This strategy should consist of sectorial, horizontal and institutional policies to promote Puerto Rico's capability to progressively move into higher value-added activities.

Fourth, we note that any new economic strategy for Puerto Rico, no matter how nuanced, sophisticated, or brilliantly conceived, is bound to eventually fail if it ignores the fact that Puerto Rico has reached the limits of its development within the multiple constraints imposed by its subordinate political status, which is both humiliating to Puerto Ricans and unworthy of the United States.³

In conclusion, Congresswoman Velázquez, 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.

³ 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.