

Policy Memorandum

Recommendations to the Governor of Puerto Rico

Center for a New Economy

San Juan | DC | Madrid

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INTRODUCTION

Puerto Rico is going through the most difficult situation it has faced in half a century. The island's economy has been stagnant, contracting or growing minimally, for 15 consecutive years. In 2015, then-Governor Alejandro García Padilla announced that Puerto Rico's debt could not be paid. In 2017, the government of Puerto Rico officially filed its bankruptcy petition under the terms and conditions of the federal PROMESA law. That year we were also hit by two powerful hurricanes. In addition, in early 2020 the southwestern part of the island was damaged by several earthquakes.

Finally, in the spring of 2020, we saw the first cases of COVID-19 in Puerto Rico. The SARS-CoV-2 virus has spread around the world, affecting more than 100 million people, and unfortunately causing the death of more than 2,000,000 human beings. The global pandemic has also adversely affected economic activity throughout the world, causing hundreds of billions in losses, and increasing unemployment and poverty in dozens of countries.

Puerto Rico, therefore, is facing several simultaneous crises, one superimposed on the other. This situation demands a robust response from the government of Puerto Rico precisely when its capacity to execute is limited by bankruptcy, the politicization of public employment, years of austerity policies, and corruption. This conjunction of an overwhelming agenda and a lack of human and financial resources requires that clear work priorities be established. In this memorandum, we present some suggestions on what those priorities should be and how to address them.

COVID-19 PANDEMIC

This is the most urgent and important issue facing your administration in the short term. Although several vaccines are already approved and in production, the pandemic is not over yet. It is important to continue educating citizens about the importance of wearing masks, maintaining social distance, and avoiding crowds in public places. At the same time, efforts must be redoubled to continue testing and contact tracing people who may have been exposed to the virus.

Second, Puerto Rico has made progress in the vaccination process, but some logistical problems are foreseeable in the short term. Currently, the limited availability of vaccines is the main obstacle to achieving the goal of vaccinating 70 to 75% of the population. However, once the pitfalls of vaccine production and distribution are overcome and the portion of the population that qualifies for the vaccination begins to increase, it is foreseeable that logistical problems will arise that will unnecessarily limit the rate of vaccination. We suggest, as has been done in some states, that multiple vaccination centers be set up at the local level, not only in hospitals, CDTs, and pharmacies, but also in community centers, school gyms, churches, shopping center parking lots, and other easily accessible facilities around the island. In addition, we recommend training and authorizing dentists, emergency technicians and paramedics, and other appropriately trained personnel, to vaccinate against COVID-19 (we understand that medical and nursing students are already authorized to vaccinate).

Finally, it is necessary to continue supporting small and medium-sized business owners, as well as people who have been unemployed due to the pandemic. Although President Biden has announced a comprehensive plan to help these groups, it is important to complement it with a local program. We understand that the Fiscal Oversight Board has proven receptive to reprogram emergency funds for these purposes. The important thing is to design these programs properly to help those most in need and populations that for a variety of reasons are not covered by the federal government plan.

RECONSTRUCTION

The delay in rebuilding the capital stock destroyed by the hurricanes of 2017 and the earthquakes of 2020 has been a drag on Puerto Rico's economy. The US Congress has appropriated more than \$67 billion for reconstruction work on the island. However, the disbursement process by federal agencies has been extremely slow, for two reasons. First, in our opinion, the federal Office of Management and Budget (“OMB”) has dragged out the process of apportioning congressional appropriations to allow their use. According to the Congressional Research Service:

When Congress passes appropriations bills and they are signed into law, “budget execution” begins. A group of statutory provisions that observers refer to collectively as the Antideficiency Act requires OMB to “apportion” appropriated funds—that is, make appropriations available to agencies in legally binding increments (e.g., quarterly). The statute’s express purpose is to prevent federal officials from obligating or expending funds at a rate that would prematurely exhaust the funds, such as before the end of a fiscal year.¹

We understand that this process is necessary to control and monitor spending by federal agencies. **However, it seems to us that during the Trump administration it was used in an arbitrary and capricious manner to discriminate against Puerto Rico.** We recommend that your administration take the necessary steps in Washington, D.C. to correct this situation.

Second, the Department of Housing and Urban Development (“HUD”) imposed on Puerto Rico a series of unnecessary conditions for the disbursement of CDBG-DR funds, through the grant agreements that govern the use of these funds. We recommend that those contracts, **which Puerto Rico should never have signed in the first place**, be amended to establish a reasonable and non-discriminatory control process.

Beyond accelerating the disbursement of funds for reconstruction, we recommend that the housing and energy sectors be given top priority.

¹ Congressional Research Service, *Office of Management and Budget: An Overview*, RS21665, November 12, 2020, p. 16; see also *OMB Circular No. A-11 (2017)*, sections 120.1 – 120.15.

HOUSING

Puerto Rico has faced a crisis in the housing sector for decades, marked by a lack of affordable housing. More than half of renters and nearly half of homeowners with mortgages spend more than a third of their income on housing costs, which means they are very vulnerable to losing their homes. In addition, the waiting list for public housing and Section 8 vouchers has reached 16,000 and 10,000 families, respectively. This situation requires making a larger number of housing units available at affordable prices or implementing measures to prevent the displacement of families.

The development of affordable housing must take location into consideration, as it is important these units be located in areas that concentrate the greatest number of economic opportunities, amenities, and services, or what we can call Geographies of Opportunity (“GO”). Therefore, investments using federal or private funds should prioritize providing affordable housing and avoiding displacement in GOs, while the most disadvantaged areas of Puerto Rico should be a priority for public and private investments aimed at improving the quality of public infrastructure, housing, and job development.

Hurricanes Irma and María and the 2020 earthquakes exacerbated the lack of affordable housing and significantly deteriorated the housing stock in Puerto Rico. According to data from the Individual Assistance program administered by the Federal Emergency Management Administration (“FEMA”), over 325,000 homes - approximately 21% of all housing units - suffered damage from these disasters.

As we detail in our housing initiative report, Blueprint, the long process of post-disaster reconstruction will be defined primarily by pressing housing needs. However, there is a deep fragmentation of different views and interests in connection with everything related to the issue of housing and land tenure. Given this situation, we need a comprehensive planning and public policy framework that is based, at a minimum, on the following principles: (1) providing decent, safe, and affordable housing for all, (2) developing inclusive, healthy communities with full opportunities for social mobility, and (3) encouraging community participation in all decision-making processes.

According to [recent reports from the Department of Housing](#) and the Central Office for Recovery, Reconstruction, and Resilience (“COR3”), dozens of reconstruction-related programs have already been launched. However, we are concerned that more than three years after the hurricanes, there are thousands of homes with blue roofs and, as of October 2020, only 146 home reconstructions or repairs had been completed under the Home Repair, Reconstruction or Relocation Program (“R3”) administered by the government of Puerto Rico. Faced with this crass slowness, it is essential to review and amend the design of the main housing reconstruction programs to, among other things: speed up the pace, ensure that local communities are fully included in all decision-making processes, and government investments benefit entire communities and not just a select group of households.

Certainly, the ravages of the pandemic have delayed reconstruction programs and worsened the residential vulnerability of hundreds of thousands of families in Puerto Rico. Therefore, it is essential that the government of Puerto Rico take advantage of and administer, quickly and effectively, the \$325 million that was earmarked for Puerto Rico under the “Emergency Rental

Assistance Program” created through the Coronavirus Relief Fund. We recently sent a memorandum to the Designated Secretary of Housing, William Rodríguez, with some figures and analysis on the possible scope of such a program.

ENERGY

There are currently four important processes running in parallel, each of which will affect the future of Puerto Rico's electrical system: the Integrated Resource Plan (“IRP”) of the Electric Power Authority (“PREPA”) has been approved by the Puerto Rico Energy Bureau (“PREB”) and its implementation is about to begin; PREPA has presented a plan to modernize and reconfigure Puerto Rico's electrical grid as part of a broader effort to rebuild the island's infrastructure; the terms of PREPA's debt with its bondholders and other creditors are being renegotiated under Title III of PROMESA; and the government of Puerto Rico has executed an agreement to transfer the administration and operation of the electricity transmission and distribution system to a private entity and has begun the process to do the same with the generation capacity.

It is imperative that the reconstruction of the electricity grid, the restructuring of PREPA's debt, and the privatization of the administration and operation of the system are executed in a manner that is consistent with the IRP, which is the long-term master plan for Puerto Rico's electricity system. We are concerned, however, that the implementation of these four processes is taking place with little or no coordination, which may result in duplicate, inconsistent, or non-compliant efforts with the laws and regulations of Puerto Rico and the United States, including the legal requirements to increase electricity generation capacity using renewable energy sources.

In terms of rebuilding the system, FEMA has already announced that it will be making more than \$10 billion available for the reconfiguration and modernization of Puerto Rico's electrical grid. At first glance, however, it appears that two different and not necessarily consistent plans are being developed for the use of the same funds. On the one hand, LUMA, a company contracted by PREPA to manage and operate the transmission and distribution system, is preparing a “System Remediation Plan” (“SRP”) for PREPA. On the other hand, PREPA and Burns & McDonnell, a private contractor, submitted a ten-year Infrastructure Modernization Plan (“IMP”) to FEMA in December 2020. It seems to us that there is a marked disconnect between the SRP and IMP, which are currently being executed as two projects in parallel and which will effectively result in a duplication of efforts and wasted funds.

We recommend, therefore, (1) that you appoint a coordinator who reports directly to your Chief of Staff and who has the authority to coordinate these four processes so that they are carried out in an orderly, efficient and rational manner; (2) that the PREB hold public hearings for PREPA to explain how the SRP and the 10-year IMP will be coordinated, and how it will avoid the duplication of efforts and the waste of funds; and (3) that your administration does not approve the new construction of storage infrastructure for or electricity generation with natural gas, unless it is consistent with the requirements of the IRP.

DEBT RESTRUCTURING

The Fiscal Oversight and Management Board (“FOMB”) is negotiating a restructuring of the General Obligation Bonds (“GOB”) and other debt whose source of repayment ultimately depends on the general fund (approximately \$35 billion). In October 2020, the FOMB revised its offer to creditors to reduce this debt to approximately \$11.9 billion, consisting of (1) \$6 billion in cash; (2) \$4.9 billion in new GOB; and (3) \$1 billion in the form of a Contingent Value Instrument (“CVI”).

The CVI consists of an additional \$1 billion of GOB payable solely for any excess income (“superior performance”) generated by 5.5% of the SUT in relation to the base established in the May 2020 Fiscal Plan. Under the proposed plan, the amount resulting from any superior performance would be apportioned 60% to local government and 40% to bondholders and its distribution to creditors would be subject to an annual limit of \$50 million. Unused amounts are not “carried forward” and the face value of the CVI would be amortized by \$50 million per year, regardless of whether a cash payment is made. The term of the CVI is 20 years. Under the revised plan, the combined recovery rate for all creditors would range from 31.3% (not including CVI payments) to 34.1% (including all CVI payments).

The introduction of a CVI is a novel and welcome development, as it offers an alternative to mitigate the high level of uncertainty. It is very difficult to make reliable medium and long-term economic and financial projections in the best of times. However, the current COVID-19 pandemic; the amount of economic “scarring” (in the words of the International Monetary Fund) that can persist after the pandemic is under control; the ambiguity surrounding the disbursement of federal reconstruction aid funds; and the potential inability of the government of Puerto Rico to carry out much-needed governance reforms makes it nearly impossible. There are too many moving parts and the level of uncertainty is unprecedented.

Given the lack of reliable economic and financial projections, it is not feasible for Puerto Rico to present a Plan of Adjustment in good faith that will be binding for the island's government for thirty years. However, PROMESA requires Puerto Rico to submit a viable Plan of Adjustment (“POA”) to successfully exit the Title III process and Judge Taylor Swain has given the parties until February 10, 2021 to agree on the basic terms of a POA. The CVI helps the parties overcome this dilemma and mitigate part of the uncertainty surrounding the Fiscal Plan, offering investors a greater recovery, should the economy perform better, while protecting the government and residents of Puerto Rico in case government revenues are below expectations.

Our main objection with the proposed POA is that, according to the FOMB's own analysis, the government's cash balance as of June 30, 2021, after the payment of the POA obligations, is estimated slightly below the minimum capital level of the \$2.5 billion required (which includes the capital needs of the Commonwealth, FEMA advances, and the initial liquidity of PREPA's transmission and distribution project). **In fact, under the current proposal, liquidity is significantly reduced by 2026, and by 2030 the initial cash balance is negative at the beginning of that fiscal year.**

Perhaps one way to address this problem would be to increase the CVI component, while reducing the consideration paid in the form of new GOBs. The exact amount would be subject to

negotiation, of course, but the idea is to allow the government to submit a viable POA; successfully exit Title III proceedings; and reduce the likelihood of a liquidity crisis by the end of the decade. In the final analysis, it is a win-win proposition, since investors participate in any potential upside economic scenario; Puerto Rico is left with a sustainable debt load; and both parties mitigate the risk of a new default in the short-term.

WASHINGTON, D.C. AGENDA

While there is much work to be done at the local level, it is equally important to keep an eye on the federal sphere and foster relationships with key players in federal government agencies. With a new Administration and a new Congress in D.C., CNE remains [committed to advocating for and promoting](#) good federal public policy for the island. This time focused on promoting a better public understanding of how federal reconstruction funds work and seeking simplified access to allocated funds, in addition to guaranteeing equal treatment for Puerto Rico in various federal social safety net programs.

Government officials must also recommit to ensuring equitable access to all federal programs for Puerto Rico, especially with regard to Medicaid funds, the extension of an Earned Income Tax Credit ("EITC"), improved access to Supplemental Security Income ("SSI"), and a thoughtful transition to the Supplemental Nutrition Assistance Program ("SNAP"). It is important that, in parallel, local officials help eliminate public stigma and negative discourse around populations participating in social safety net programs.

MEDIUM AND LONG-TERM ECONOMIC GROWTH

Even if we set aside the economic damage caused by the 2017 hurricanes, the recent earthquakes, and the COVID-19 pandemic, it is clear that the Puerto Rican economy has suffered from secular stagnation for at least a decade and a half. This is not to say that rebuilding the capital stock damaged or destroyed by natural disasters, or providing assistance to both businesses and households adversely affected by the COVID-19 pandemic, are not important issues. However, these are necessary but insufficient actions to revive Puerto Rico's economic growth. We have to work to improve our anemic capacity to produce endogenous growth and to reform our institutions.

It is important, therefore, to start thinking [about a 21st-century industrial policy](#) for Puerto Rico. It is necessary to clarify, first, that the meaning of the term "industrial policy" has expanded since the early post-war era. Now it generally refers loosely to a group of public and private institutions, programs, and organizations working together to achieve economic transformation in a given country or region.

Furthermore, the objectives of a modern industrial policy are not limited to promoting the transition from a traditional agricultural economy to a modern manufacturing-based industrial economy, but seeks to identify economic sectors, for example, high-tech agriculture, advanced or

specialized services, or sophisticated manufacturing, in which a country has the opportunity to create greater added value and thus generate economic growth, as well as new and better jobs.

According to Robert Devlin, effective industrial policies have at least three elements in common. First, it is necessary to establish a national strategic vision for the medium and long term. Second, effective collaboration with the private sector, generally speaking, is essential. And third, consistency in the implementation of industrial policy over time is essential for success.

The first component, the strategic vision, in turn requires a deep and intellectually honest analysis of the country's economic situation, its advantages and disadvantages, areas of opportunity, and the capacity of its institutions and organizations to learn, collaborate and evolve.

After conducting this introspection exercise, the objective is to determine the strategic orientation of industrial policy in the medium and long term. Devlin has identified four strategic directions, which are not mutually exclusive: (1) attracting direct foreign investment; (2) the internationalization of small and medium-sized national companies; (3) the promotion of exports; and (4) innovation. The capabilities identified in the first part of the analysis, in turn, determine the strategic orientation of industrial policy.

The second element - collaboration with the private sector - is extremely complex since it requires the capacity of the state to coordinate initiatives and programs, first, among the different government agencies in charge of industrial policy and, second, among these agencies and the private sector.

In Ireland, for example, the office of the Taoiseach, or Prime Minister, coordinates this work, with the help of a permanent secretariat, the National Economic and Social Council, the National Economic and Social Forum, the Department for Enterprise, Trade and Employment, the organization Enterprise Ireland, the Irish Development Agency, Forfás, a kind of governmental think tank, and the Advisory Committee on Science, Technology and Innovation, among other agencies. Each of these agencies implements a part of a socioeconomic development plan that is updated every three years.

The state must also have the ability to establish a productive collaborative relationship with employers, academics, union leaders, and other organizations. The participation of private sector organizations is very important because, although the state retains the power to implement public policy, it is the private sector that has the knowledge and information about the potential for new economic development opportunities.

And precisely, the third element is the execution of industrial policy. According to Devlin, it is at this stage that many governments fail catastrophically. A country can design the best economic strategy in the world, but if its state institutions and the private sector cannot execute it, then the effort will have no significant impact on the economy.

The importance of institutions at this stage cannot be underestimated. In fact, some scholars argue that it is essential that institutions “be effective” before thinking about specific economic policies. According to Dani Rodrik, an optimal policy in the wrong institutional setting will be considerably less beneficial than a “second-best” policy in an appropriate institutional setting.

In short, it is necessary to think of industrial policy as an interactive process of strategic cooperation between the private sector and the government, that, on the one hand, serves to obtain information on business opportunities and limitations and, on the other, generates public policy initiatives in response. The challenge is to find a middle ground for government bureaucrats between full autonomy and integration with the private sector. Too much autonomy for bureaucrats minimizes corruption, but does not provide what the private sector really needs. But if bureaucrats get too involved in the private sector, they can end up in the pocket of business interests.



The Center for a New Economy (CNE) is Puerto Rico's first and foremost policy think tank, an independent, nonpartisan group that advocates for the development of a new economy for Puerto Rico. For more than 20 years, CNE has championed the cause of a more productive and stable Puerto Rico through its offices in San Juan, Puerto Rico, and Washington, D.C. We seek to inform current policy debates and find solutions to today's most pressing and complex economic development problems by rigorously analyzing hard data and producing robust empirical research. CNE is organized as a 501(c)(3) nonprofit that does not solicit or accept government funding. It relies solely on funding by individuals, private institutions, and philanthropic organizations.