Input for Bipartisan Congressional Task Force on Economic Growth in Puerto Rico

Puerto Rico’s economic growth challenge

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Introduction

It would be a gross understatement to say that the Puerto Rico faces daunting economic challenges. The island is in the midst of a secular economic slump that has lasted for more than 10 years and that has seen its population decline by around 10 percent. At the same time, the island is now saddled with an extraordinarily high level of government debt and pension obligations that it cannot honor. It is also stuck in a monetary union with the United States that precludes the use of independent monetary and exchange rate policies to jumpstart its languishing economy.

Puerto Rico’s difficult challenges pose a clear choice to US policymakers. They can either come up with a comprehensive and far-reaching economic support package for the island that gives the island a chance to reverse its economic decline. Alternatively, they should brace themselves either for Puerto Rico opting for independence from the United States to afford it greater room for policy maneuver or for Puerto Rico going the way of West Virginia and Alabama. Those latter states have seen their economies in permanent economic decline and have seen large parts of their economically active population seeking better economic opportunities elsewhere in the Union. If the US is to avoid either such outcome, Congress will need to take aggressive measures soon that go considerably beyond the recently passed PROMESA Act.

The remainder of this report is divided into two sections. The first discusses the reasons for the extremely difficult economic situation in which Puerto Rico now finds itself. The second discusses what might comprise the minimum elements of a comprehensive economic program that might get the Puerto Rican economy to grow again on a sustainable basis.

Daunting challenges to economic growth

Puerto Rico faces a constellation of economic challenges that underline the need for a bold and comprehensive economic program to put the island’s economy back onto its feet. Among those challenges are the following:
1. The island is mired in a 10 year secular economic slump. That slump started with the termination some ten years ago of US congressional tax breaks for companies located in the island and was exacerbated by years of domestic economic mismanagement, especially in the area of budget policy. As a result, while the mainland’s economy has grown by roughly 10 percent over the past decade, the island’s economy has contracted by some 10 percent.

2. The island is experiencing a population outflow that appears to be gaining momentum. Over the past decade, the island has lost 10 percent of its population with the outflow in 2015 having picked up to as much as 2 percent in a single year. Meanwhile, labor participation rates on the island have fallen to as low as 44 percent as high social benefit payments in relation to wages have discouraged Puerto Rican residents from seeking employment.

3. Years of poor budget management and low economic growth have resulted in an extraordinary growth in the island’s public debt and in its public pension obligations. At present, the island’s public debt amounts to around 100 percent of the island’s gross national product while its unfunded pension obligations amount to another 55 percent of GNP.

4. As part of a monetary union with the United States, Puerto Rico lacks an independent monetary and exchange rate policy that might be used as an offset to the impact of fiscal policy tightening on aggregate demand. This highly limits the amount of fiscal policy tightening that the island may reasonably be expected to do without further exacerbating its economic slump.

5. Beyond gross domestic economic mismanagement, a major reason for Puerto Rico’s slump has been the fact that the island has been hit by a number of supply side economic shocks. These have included the final phasing out in 2005 of a variety of tax subsidies for US corporations operating out of Puerto Rico as well as the winding down of a US naval base on the island. Sadly, it seems that Puerto Rico’s all important tourist industry could now be being hit by a Zika shock, which is the last thing that the battered island’s economy needs.
A Comprehensive Economic Revitalization Plan

The many challenges to the Puerto Rican economy listed above would suggest that the island needs **the boldest of economic programs** to get its economy moving again. The recently passed PROMESA Act provides a good start by imposing on the island an Oversight Board to improve budget management and by providing Puerto Rico with a temporary stay on creditor litigation to forestall a legal free for all over debt payments. However, those measures in themselves fall far short of what is needed to revive long-run sustainable economic growth. Rather, it would seem that what is required is a multi-faceted and aggressive economic support program that would include the following elements:

1. It needs to be recognized that as part of a comprehensive economic adjustment program Puerto Rico needs **immediate and substantial debt relief** amounting to at least 33 percent that might reduce its total debt and pension obligations to below 100 percent of GNP. Recent experience with countries like Greece highlight the dangers of economic policy denial with respect to very high debt burdens. Delaying debt relief all too often is counterproductive in that it requires excessive budget adjustment and it prolongs investor uncertainty as to the potential for the economy to recover.

2. Puerto Rico’s newly established Oversight Board must impose **budget discipline on the island and improve budget transparency**. However, it is of the essence that the Oversight Board is realistic in the amount and the pace of fiscal adjustment that it requires of the island. The recent Greek experience would underline the risk that excessive budget adjustment in a monetary union can be counterproductive. Indeed, since Puerto Rico does not have an independent monetary or exchange rate policy to cushion the impact of budget policy tightening, such tightening could very well deepen the economic slump that the island is already experiencing. That in turn can lead to lower tax collections and to higher debt to GNP ratios.

3. Breaking a long term secular economic slump, particularly at a time that the island is forced to pursue austere budgetary policies, all too likely requires a **positive external shock** to break the downward economic spiral in which the island seems to be mired. For this reason, serious thought should be given to
restoring the sort of US Congressional tax preferences that the island enjoyed before 2005 and that might once again encourage corporate investment from the mainland.

4. The US Congress must remove those impediments to Puerto Rican economic growth that originate from the mainland and that are presently unfairly putting the island’s economy at a disadvantage. Repeal of the Jones Act that unduly increases the island’s transport costs should be undertaken without delay. Restoring equity to the way Medicare funds are distributed to the island should also be undertaken with a view to relieving budget pressure on the island.

5. Every effort should be made to improve the island’s dismally low labor participation rate. To that end, Puerto Rico needs to engage in serious labor market reform that might increase the flexibility and efficiency of its labor force. In addition, serious consideration should be given to the use of Income Tax Credits. Those credits would seem to be a preferable way to improve labor market participation than further reductions to Puerto Rican minimum wages, which could have the unintended effect of further compressing aggregate demand in the midst of an economic slump.