

Testimony of Anne O. Krueger before the House Subcommittee on Oversight and Investigations of the Committee on Financial Services. February 26, 2016.

Chairman Duffy, Members of the Committee, Ladies and Gentlemen:

I am pleased to be here and have a chance to discuss Puerto Rico's economic plight.

My name is Anne Krueger, and I am currently Senior Research Professor of International Economics at the School for Advanced International Studies at Johns Hopkins University. I was formerly Chief Economist of the World Bank from 1982 to 1986, Ritch Professor of Economics at Stanford University and First Deputy Managing Director at the International Monetary Fund from 2001 to 2006.

I am an economist, and not a lawyer. The issues being considered today have both economic and legal aspects. However, I shall confine my remarks to the economics of the situation and the implications for some of the legal questions.

In January 2015, I was approached by the Government Development Bank (GDB), (Roberto Sanchez Vilella Government Center, De Diego Avenue, San Juan, Puerto Rico) to lead a study into Puerto Rico's economic situation and prospects. I invited two former IMF officials to join me in this work, and we presented a report to the GDB at the end of June. We also made presentations of our findings, sponsored by the GDB, at that time, to the Governor and to the public. The report can be found on the GDB's website. There have been some minor revisions to the numbers since that time, but to the best of my knowledge, the outlook has not changed materially since.

Puerto Rico ought to be the jewel of the Caribbean. With its beautiful climate, scenery and beaches, the use of both English and Spanish, its location between the Spanish speaking Latin American countries and English speaking north, and the U.S. dollar and legal framework, it should be an attractive site for headquarters for companies doing business in both North and South America, as well as a major tourist attraction.

But it is not. It has had a stagnant economy for about 20 years. People, especially those of working age, can easily catch a plane and move to the mainland, and they do. In a recent article about the causes of Japan's slow growth, much blame was placed on the decline in population, which is falling at a rate of about one half percent a year. Puerto Rico's loss has been well over 1 percent a year for most of this decade and is thought to have reached 2 percent last year. Puerto Rico has only about the same number of tourist beds as it had in 1980, while tourism has boomed throughout the rest of the Caribbean.

But population loss and failure of tourism to boom are only symptoms of stagnation. They are the result of factors that have led to stagnation, rather than the cause.

The best way to address the needed policy changes that could reverse this decline is to look at what has gone wrong and resulted in such low growth.

The factors are numerous. Until 1996, the federal government extended tax exempt status to mainland companies that operated in Puerto Rico, and the pharmaceutical industry on the island had become a leading industry in response. It was then decided that the tax exempt status was to be phased out over the next ten years.

Some companies began leaving, and that was a negative for growth over the next decade. Successive Puerto Rican governments used traditional Keynesian remedies in an effort to

offset the decline, borrowing to finance not only planned budget deficits but unplanned expenditure and unanticipated shortfalls in revenues (due to the downturn in economic activity and overly optimistic forecasting).

At first, borrowing was easy, as Puerto Rico had little debt and bonds of the commonwealth held triple tax exempt status. But, over time as the economy failed to recover, debt accumulated. The diagnosis that Puerto Rico was in recession, and that Keynesian remedies would solve the problem, was wrong.

But as the economy shrank and borrowing continued, debt servicing and borrowing costs rose. Successive governments took measures that were intended to balance the budget. However, a lack of effective expenditure controls and the failure to anticipate the extent to which the downturn would persist, meant that net debt and borrowing increased every year over the past decade.

When the economy shrinks, tax revenues fall and expenditures (especially on social safety nets) rise. This was a major reason underlying the buildup of debt. By 2014, borrowing could take place only at very high costs and the market is now virtually closed for any new issues, while outstanding debt is selling at a sizeable discount.

While the absence of growth, and failure to find ways for its resumption, has been the main factor leading to continuing deficits and borrowing, an additional factor has handicapped policy makers as they have struggled with the issue. That is, the state of statistical reporting in Puerto Rico is unsatisfactory. Books are not closed until well after the end of reporting periods. The authorities, as a result, do not have good feedback as to the behavior of the economy. Moreover, the lack of effective and efficient expenditure controls resulted in the buildup of arrears by government agencies that were then cleared at the beginning of the next fiscal year.

The fiscal imbalances that resulted from efforts to reverse the economic decline were themselves a contributor to future difficulties, as debt servicing costs and uncertainty have increased.

But other factors have contributed to the economy's poor performance. These have included global events (the oil price increase of the last decade and the financial crisis of 2007-8), federal policy, and policies adopted by the Puerto Ricans themselves.

However, even when global events have been favorable (as during the years 2002 to 2007 and 2011 to 2014 with the upswing on the mainland and global economies); the Puerto Rican economy remained in stagnation.

At the federal level, there have been several contributing factors, including the funding formula for Medicaid, the Jones Act, which requires Puerto Rico's shipping (including especially oil, all of which is imported and which is the major energy source for electricity) to be on U.S. built and manned ships; minimum wage legislation, and a number of federally mandated environmental and other regulations. While all of these have been detrimental to Puerto Rico's fiscal and economic situation (especially because of competition with other Caribbean islands), Puerto Rico has been exempt from some mainland policies which could have helped. Chief among these are Puerto Rican ineligibility for the earned income tax credit and for Chapter 9 of the U.S. bankruptcy code. I will say more about these later as they, and especially Chapter 9, are the focus of this hearing.

Still at the federal level, there are a number of welfare measures which have effects on the island. Puerto Ricans are eligible for food stamps and other federal welfare programs including subsidies for housing, electricity, and more. One calculation that was made indicated that a wage earner in a household of three would have take home pay of about \$1100 a month if working at

the minimum wage (and it is estimated that a large percentage of Puerto Rican jobs are paid at rates close to it) and \$1700 if on welfare. A serious result has been that Puerto Rico's labor force participation rate is only 40 percent, compared to 62 percent in the United States. Of course, many Puerto Ricans go on welfare and work in the informal economy. This means that their earnings are not subject to tax as well as that their productivity is lower than it would be in the informal sector. That is detrimental to growth and to the fiscal situation.

At the level of the commonwealth, there is also much that needs to be done to improve growth prospects. In rankings of "ease of doing business", Puerto Rico ranks 47th of 189 (the U.S. ranking is 7th). There are many rules and regulations which require permits and other approvals, and they are slow in coming. Labor market regulations are in some ways more restrictive than those on the mainland. For example, employers are required to pay a 13th month bonus in December, each year. That makes the effective minimum wage on the island 8.3 percent above that on the mainland. Commonwealth employees have been entitled to 30 days annual leave, 18 days sick leave (which can be taken as leave if not used), and there are more holidays on the island than on the mainland. There are also significant obstacles to laying off workers.

There are many more practices that impede growth prospects and that need to be altered, but I will mention only two. First, the commonwealth faces large future pension and other liabilities that cannot be met under present policies and prospects. Second, there has been a tendency to deal with businesses on a one-off discretionary basis, with negative results for the economy as a whole (and there has been almost no credible research as to the effects or usefulness of many of these incentives. This has resulted in significant delays (especially in property registration and obtaining construction permits), as well as differential tax treatments of different firms.

The above considerations provide a broad overview of the factors underlying Puerto Rico's current crisis. Addressing unsustainable debt, correction of fiscal policies, and altering a set of policies inimical to growth are all essential if the island's prospects are to improve significantly. Experience of the International Monetary Fund in countries confronting extreme financial difficulties has shown that there needs to be "ownership" of reforms by the authorities. The authorities would surely need to buy in to these reforms if they are to succeed in laying the foundation for resumption of growth and higher living standards.

A first point I would make is that addressing any one or two of these issues can perhaps provide some relief and some breathing space for a year or two, but all three issues must be confronted meaningfully if Puerto Rico's prospects are to improve significantly.

In the remainder of my testimony, I will focus on why each of these issues must necessarily be addressed, but of course I will pay more attention to the debt issue, which is the subject of this hearing, than the other two.

Turning first to growth, it is obvious that a resumption of economic growth is desirable for its own sake. Most Puerto Ricans want to remain at home, and they move to the mainland for lack of economic opportunity on the island. But in addition to the inherent desirability of growth, establishing a set of policies that will offer greatly improved growth prospects is essential if there is to be any hope of achieving a debt burden that is sustainable going forward. If an economy is destined to shrink into the indefinite future, it cannot borrow for the longer term – investors would know that the tax base would be shrinking while expenditure demands would be increasing. The only sustainable fiscal policy would be one of reducing expenditures each year in line with reductions in tax revenues.

Measures needed for growth are many and most of them will take several years before their full beneficial effects are felt.

Addressing fiscal policy next, a first observation is that growth is necessary if fiscal balance is to be attained. As long as the economy is in decline, it is doubtful whether a long-term fiscal solution can be found. But, even if growth is resumed, fiscal balance is essential for continued growth for the obvious reason that without it, borrowing might start but would quickly be perceived as unsustainable. When growth prospects are good, governments can afford to borrow to finance productive public investments. But when growth prospects are dismal, there will not be many productive investments and there will be little prospect that debt servicing could be sustained.

Turning then to debt, the current level of debt is so high that Puerto Rico has virtually no market access. That, in turn, means that without addressing the debt problem, not only is Puerto Rico almost certainly unable to continue debt servicing indefinitely, but the commonwealth would have immediately to cut its public expenditures sharply in line with its dwindling tax revenues. While there are cuts that can and should be made, these would not have full effect instantaneously. There is a very good case, for example, for finding ways to reduce the number of teachers: there are about 30 percent more teachers than there were several decades ago while there are about 40 per cent FEWER students! But no one would advocate instantaneous reductions; clearly, this would need to be done over several years. Moreover, if the commonwealth had funding to offer reasonable retirement or retraining packages to teachers, the process would be less painful (and less depressive of economic activity). There are many other examples where some funds now could mean a better fiscal situation later. But in Puerto Rico's current situation, the debt overhang makes that infeasible.

If the commonwealth had to reduce its expenditures tomorrow to a level consistent with tax receipts, economic activity would surely be further depressed significantly (and that would continue as cuts had to be made in future liabilities such as pension payments). That, in turn, would induce more outmigration, and more job losses on the island. Tax revenues would fall while the need for expenditures on welfare would rise, thus worsening the fiscal situation still further. The vicious circle in which Puerto Rico finds itself would only be worsened.

However, it is almost unimaginable that the authorities would choose to maintain debt service given the order of magnitude that would have to be made immediately in public services in order to do so. Large and instantaneous cuts in payroll, and in expenditures such as those for lighting, policing and other public services would almost surely be largely avoided. In that case, the choice is between an orderly process for debt restructuring soon and a disorderly cessation of debt service payments spread out over the future.

Uncertainty about how the situation would be managed is already depressing economic activity. The longer the situation persists, the deeper will be the drop in economic activity, the longer the period of stagnation, and the greater will be the ultimate cost to creditors and Puerto Ricans alike.

For creditors, the choice is between accepting restructuring to enable growth to resume (as other policy measures are undertaken as well) or to resist now, fight restructuring, and be confronted with an even loss of net present value.

Hence, fiscal issues cannot be satisfactorily addressed and growth is highly unlikely to resume until the debt overhang issue is resolved. And Puerto Rico's debt is unusually complex. A number of government entities (the power company, the water and sewer company and the highway authority are the biggest

ones) have issued their own bonds. There are a variety of pledges, including of future revenue streams, and of assets.

With no protection under U.S. bankruptcy law, any group of creditors can take the case for their priority to courts. It seems inevitable that such a scenario, once started, would take years to resolve the issues. But, as I indicated above, the likelihood that growth could resume while the litigation process was underway is very small. As such, the period during which the court proceedings were continuing would be a further period of declining real incomes and continued outmigration. When the court battles were finally resolved, Puerto Rico's economic recovery would start from an even worse position than the one it is now in. Providing a legal framework which would enable a comprehensive restructuring of Puerto Rico's debt is therefore a crucial and desirable first step on the path to recovery.

A restructuring which provided creditors with reasonable certainty as to future payments while giving the commonwealth a bit of room for financing necessary investments in reforming the economy is therefore, in my judgment, highly desirable. By itself, it would not be enough. But without it, it is doubtful if Puerto Rico's downward spiral can be reversed without much more financial support and assistance from the federal government than seems possible.

With the parameters of debt service for the foreseeable future understood, the Commonwealth could address the fiscal challenge. The choice as to which expenditures to cut and what tax reforms to undertake should be the Commonwealth's, although the scope for raising tax rates is limited (as the attraction of outmigration or movement to the informal sector would increase). With needed economic reforms to spur economic growth also undertaken by the Commonwealth, and support by the federal government (including the EITC and other measures), it is likely that Puerto Rico's downward spiral could be quickly

arrested and that growth could resume and acquire some momentum over a 2-3 year period. The alternative, of a continued shrinkage of Puerto Rico's population and real income, is one too unpleasant to contemplate.