

Written Testimony of

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to the

United States Senate Committee on the Judiciary Hearing on

Puerto Rico's Fiscal Problems: Examining the Source and Exploring the Solution

**December 1, 2015
Washington, D.C.**

“I think as economists we should at least always suspect ourselves if we find that we are on the popular side.”

Friedrich A. Hayek, *On Being an Economist*, (1944)

Good morning, Chairman Grassley, Ranking Member Leahy, and members of the Committee. Thank you for the opportunity to appear here today to discuss Puerto Rico's fiscal and economic challenges. My name is Carlos A. Colón-De-Armas and I am a professor of finance at the Graduate School of Business at the University of Puerto Rico.

This document starts with an Executive Summary that highlights the key points of my written testimony. Given the time constraints, I will limit my initial remarks to the Executive Summary and I will leave the rest for the record, and to discuss with you during the Q&A portion of the hearing.

Executive Summary

- Puerto Rico faces two distinct challenges: a fiscal crisis and an economic crisis.
- Contrary to what most people are saying, the available evidence indicates that the fiscal crisis was not caused by a weakening economy. For one, the downward trend in the economy began almost three decades before the fiscal problems started. More importantly, public expenses started to get out of line at the same time that General Fund revenues were increasing at a healthy pace.

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- To finance its profligate ways, the Government of Puerto Rico sacrificed its limited borrowing capacity, that was supposed to be utilized only to finance public investments, and used it instead to finance spending. As a result, an already fragile economy experienced a significant loss of investments and deteriorated even more.
 - Fixing the economy of Puerto Rico, while necessary, will not repair the Island's fiscal crisis. To fix the fiscal crisis, the Government of Puerto Rico needs to cut spending. To fix the economic crisis, public and private investments on the Island must be increased and the business climate in Puerto Rico should be improved.
 - The starting point to fix the fiscal crisis should be to cut expenses in the General Fund by \$1.0 - \$1.5 billion annually.
 - To be most effective, this reduction should be achieved through a participatory process that must include all relevant interest groups including labor leaders.
 - The evidence shows that this level of reduction in expenses is feasible without the need to fire government employees and without affecting the quality of the public services required by the citizens.
 - The available evidence also demonstrates that the Government of Puerto Rico has the necessary resources to honor its debt commitments as originally contracted. In other words, the public debt of Puerto Rico can be paid.
 - Therefore, from the standpoint of what is best for Puerto Rico, default, bankruptcy, debt restructuring, or any kind of negotiation that involves not complying with debt commitments as originally contracted should be avoided at all costs.
 - In this regard, the key consideration should be how to restore access to financial markets to enhance investments on the Island.
 - It would be incorrect to frame this issue as a short-term budgetary matter.
 - To improve the quality of life on the Island, more investments are needed. For these investments to take place, financing is necessary. for which access to financial markets is essential.
 - As an example, look at the recent drought in the San Juan Metropolitan area, which left many residents without water for up to 5 days a week, while water was going to waste on the western side of the Island. This situation illustrates vividly the human costs of the government's inability to access financial markets to finance projects that are critical to everyday life in Puerto Rico.
 - It also is important to mention that the Government of Puerto Rico intends to force bondholders to suffer losses for problems caused, not by the bonds, but by unfunded loans issued by its own Government Development Bank. Such an outcome, if implemented, would be unreasonable.

- To address many of these issues, appointing a control board has been proposed. I have mixed feelings toward that proposal. On the one hand, I recognize that a control board may be very effective to put the financial house in order and restore credibility in Puerto Rico. On the other hand, we do not need people to make hard decisions. We need people to make smart decisions. Yet, these control boards have the tendency to enter troubled spots to cut indiscriminately. In Puerto Rico, this would not be the correct approach to follow. Perhaps, instead of creating such a board, it could make more sense to establish specific targets of what needs to be done and to contract with an independent CPA to certify whether it has been done. This approach would have the added benefit of keeping responsibility in the hands of the public officials whose job it is to fix these problems.
- The reality is that all the time that government officials are dedicating to measures like bankruptcy, debt restructuring, debt negotiations, and control boards diverts their attention from the important actions that they should be undertaking. It would be more productive if all that time and effort were dedicated instead to reducing public expenses and finding ways to pay the public debt.
- Finally, although most of the actions required to fix these problems are local in nature, there are some actions that Congress may take to help Puerto Rico face its current challenges. These include the following:
 - Provide Puerto Rico with parity in funds for all health-related programs.
 - Channel any additional resources available toward infrastructure investments.
 - Solve Puerto Rico's political status once and for all.

Once again, thank you Chairman Grassley, Ranking Member Leahy, and members of the Committee for holding a hearing on this important matter and for giving me the opportunity to participate in it. I now look forward to answering any questions that you may deem appropriate.

Puerto Rico: How Did We Get Here and How Do We Get Out?

The Government of Puerto Rico is suffering from chronic deficit spending, an excessive public debt burden, and retirement systems for public employees with acute actuarial and cash deficits that dangerously threaten their very existence (i.e., the fiscal crisis). At the same time, the economy of Puerto Rico has been experiencing, for various decades now, a long-term debilitating trend that one usually associates with a region that lost its productive capacity (i.e., the economic crisis). As we face these two crises, and as we look for ways to solve these problems and turn this situation around, a wide gap has become apparent between what many people are saying, and proposing, and what the data, and the available evidence, actually indicate.

In fact, I pose to you that, regarding the challenges that we face in Puerto Rico, much of what is being said is unsubstantiated. Even worse, most of what has been proposed is largely irrelevant and with far more adverse consequences than the problems that the proposals themselves aim to solve.

For the most part, government officials, analysts, and so called experts, assume a cause and effect relationship that moves from the economy to the government. As that narrative goes, Puerto Rico's economy weakened around the year 2006, allegedly as a result of the termination of Section 936 of the U.S. Internal Revenue Code. This debilitated economy, supposedly, brought about a reduction in government revenues which, in turn, triggered its fiscal crisis. Nothing could be further from the truth.¹ Let's look at the evidence.

According to the official statistics available from the Puerto Rico Planning Board, the deterioration of Puerto Rico's economy started in the 1970s, around when Section 936 started, and not when it ended. In fact, the economic strategy followed by Puerto Rico, centered on giving tax incentives to Multinational Corporations, created an ever increasing gap between the economic activity that took place on the Island (as measured by the Gross Domestic Product or GDP), and the economic activity generated by the local factors of production (as measured by the Gross National Product or GNP), without significantly benefitting the local economy.²

Puerto Rico's fiscal crisis started much later. The evidence from the annual audited financial statements of the Government of Puerto Rico between fiscal year 1970 and fiscal year 2013³ demonstrates that the budget of the General Fund of the Government of Puerto Rico was mostly balanced through fiscal year 2000. During those same years, even with the economy in its long-term downward trend, not only was the budget balanced, but Puerto Rico's public debt was well-rated⁴ and well-regarded in financial markets. The total public debt as a percent of GNP actually declined during that time indicating a proper usage of debt to finance investments that spearheaded economic development.⁵

General Fund expenses began to increase disproportionately with revenues, and chronic deficit spending by the Government of Puerto Rico started, in fiscal year 2001. In that year, the Island

¹ It is certainly true that in situations like Puerto Rico now faces causality usually goes from the economy to the government. Usually, a weak economy is what creates fiscal problems for the government. In this particular case, however, causality goes in the other direction. It was the government, and its profligate ways, that caused additional havoc on Puerto Rico's economy.

² For instance, between 1948 and 1979, Puerto Rico's Gross National Product (GNP) grew at an average annual real rate of +5.56% (surpassing the corresponding U.S. rate of +3.89%). From 1980 to 2014, however, that growth dwindled to +1.28% (below the corresponding U.S. rate of +2.65%). One way to ascertain that this downward trend is of a long-term nature and not due to recent events is to break down the growth of the GNP by decades. When you do so, you get the same relative result of higher growth in Puerto Rico in every decade before 1980, but higher growth in the states in every decade afterwards. (See pages 4-10 of the enclosed presentation.)

³ The audited financial statements for years 2014 and 2015 are not yet available.

⁴ For example, GOs were rated A/A- by Standard & Poor's and Baa1 by Moody's Investors Service.

⁵ See pages 12-13 of the enclosed presentation.

experienced a short recession and General Fund revenues were down by -1% (-\$79 million) compared to the year before, but the General Fund deficit was -\$464 million. In other words, the deficit for fiscal year 2001 was almost six times the revenue shortfall. The following years, while revenues steadily increased, deficit spending skyrocketed. In 2002, revenues increased by +7% (+\$492 million), but the deficit was -\$1,674 million. In 2003, revenues were up by +2% (+\$151 million), but the deficit reached -\$438 million. In 2004, revenues went up by +7% (+\$515 million), but the deficit ended up being -\$803 million. In 2005, revenues jumped by +11% (+\$916 million), but the deficit was -\$681 million. In other words, deficit spending by the Government of Puerto Rico started while revenues were increasing at a healthy pace. That is hardly the case of a fiscal crisis caused by a weakening economy. On the contrary, these data suggest that the fiscal problems of the Government of Puerto Rico resulted from deliberate over-spending by local politicians. Then recession hit again in 2006 and revenues decreased by -5%, but the damage was already done since the cost structure of the government was already out of control. As a result, the increasing trend in expenses continued unaltered.⁶ Instead of fixing this deficit spending, starting with the budget for fiscal year 2004, the government formalized the usage of debt to balance the budget at the time it was approved, and not just to cover the excess spending that accumulated during the year.

In light of this evidence, it does not make sense, as many are proposing nowadays, to prescribe economic growth to cure the fiscal crisis that ails the Government of Puerto Rico.⁷ As much as I am in favor of strengthening economic growth in Puerto Rico, the truth of the matter is that no economic growth in the world is able to mitigate the effects of a political class bent on excess spending.

To finance this excess spending, the Government of Puerto Rico sacrificed its limited borrowing capacity, which was supposed to be utilized to finance public investments, and used it instead to finance spending. As a result, investments on the Island suffered, decreasing in real terms at an average annual rate of -2.80% over the last 11 years, while consumption spending and disposable income increased, albeit weakly.⁸ Thus, it becomes evident that, in the case of the fiscal and economic crises that ail Puerto Rico, causality goes in the opposite direction. It was not a weak economy that caused the fiscal crisis, but rather a government bent on overspending took resources away from investments, used them instead to finance its profligate ways, thereby

⁶ See page 14 of the enclosed presentation.

⁷ Two of the proposals geared toward economic development revolve around exempting Puerto Rico, totally or partially, from the maritime Jones Act and the federal minimum wage. Neither of these two proposals is likely to have any impact towards addressing the many challenges facing Puerto Rico.

- The maritime Jones Act was enacted in 1920. That enactment occurred more than 50 years before the economy of Puerto Rico started its deterioration process in the 1970s, and 81 years before the fiscal crisis began in 2001. Thus, any discussion regarding cabotage laws in relation to the solution to the crises in Puerto Rico, while entertaining, is utterly irrelevant.
- The federal minimum wage was implemented in Puerto Rico in 1983, almost a decade after the economic deterioration started and 18 years before the fiscal crisis began. Therefore, it is unlikely that it had anything to do with either of these two problems. More importantly, the scientific evidence regarding the impact of the minimum wage on the economy of Puerto Rico is not clear. (See pages 20-22 of the enclosed presentation.)

⁸ See page 16 of the enclosed presentation.

causing an already weakening economy to accelerate its deterioration process.

Surprisingly, in light of the above evidence, the Government of Puerto Rico has concentrated its efforts on reneging on its commitments to bondholders and to reduce the debt burden through a process of restructuring, negotiation, or bankruptcy.⁹ The Governor even went as far as to say that Puerto Rico is unable to pay its public debt as contracted. This approach is not only wrong, but it is extremely dangerous for the well-being of the Island. Specifically, this approach is not justified by the budget numbers, it fails to distinguish between bonds and loans issued by the Government Development Bank for Puerto Rico (GDB), which are the culprit of the overwhelming debt burden facing the government, and it would close access to financial markets for an indeterminate number of years to the detriment of all Puerto Ricans. Besides, this approach is what created the liquidity crisis that has become one of the most urgent matters that the government now faces.

- According to the official budget approved by the Legislature of Puerto Rico and signed by the Governor, the total debt service on the entire public debt, for the current fiscal year 2016, represents 16.8% of the consolidated budget of the Government of Puerto Rico. If we limit the analysis to the General Fund, the corresponding debt service burden represents only 15.8% of the budget.¹⁰ Contrary to what the Governor said, these numbers indicate that the Government of Puerto Rico is able to pay its debt service.¹¹

⁹ For the most part, the Government of Puerto Rico is basing its strategy on the report by Krueger, Anne O., Ranjit Teja, and Andrew Wolfe, *Puerto Rico - A Way Forward*, June 29, 2015 (updated on July 13, 2015), the so called “Krueger Report”. That report is too limited in scope, concentrating on the period since the year 2000. This limitation biases the analysis and produces recommendations that are equally distorted. Although there is no fixed rule regarding the number of years that a study of this kind should analyze, it is not sound practice to cover only “bad” years, like this report did, and neglecting to consider “good” years. In the case of Puerto Rico, it also is important to analyze the situation before, during, and after Section 936 was enacted, and later eliminated. Of course, the report was “prepared at the request of legal counsel”. As such, it may serve well to support a legal theory or strategy. It does not have, however, the depth necessary to serve as the basis upon which to establish sound public policy. The *Puerto Rico Fiscal and Economic Growth Plan* prepared by the Working Group for the Fiscal and Economic Recovery of Puerto Rico pursuant to Puerto Rico Executive Order 2015-022, dated September 9, 2015, follows closely along the same lines of the “Krueger Report” and, accordingly, is equally defective in that regard.

¹⁰ See pages 17-18 of the enclosed presentation.

¹¹ These figures are part of the official budget for the Government of Puerto Rico as approved by the Legislature and signed by the Governor. In that regard, it is important to consider the following chronology:

May 20, 2015: The Governor of Puerto Rico proposed to the Legislature a General Fund budget for fiscal year 2016 for a total of \$9,800 million.

June 28, 2015: The Governor declared, through *The New York Times*, that Puerto Rico’s public debt is “not payable”.

June 29, 2015: The “Krueger Report” is published.

June 29, 2015: The Legislature approved, and the Governor signed, a General Fund budget for the same total as originally proposed, \$9,800 million. That budget is part of a consolidated budget for the entire government that adds approximately \$28,800 million.

If the Government of Puerto Rico were to pay the debt service included as part of its approved budget, it would have honored all its commitments to bondholders and we would not be discussing the possibility of default. If new information would have emerged between the time that the budget was proposed and when it was finally approved,

- Bond contracts in Puerto Rico contain appropriate “additional bonds tests.” When those tests prevented the issuance of more bonds, the GDB simply loaned money to government agencies knowing full well that they had no reliable sources of payment, thereby making the overspending possible. Those GDB loans, and not the bonds, caused the problems. In its approach, however, the Government of Puerto Rico fails to distinguish between bonds and GDB loans. Thus, it intends to penalize bondholders by forcing them to absorb a reduction in the value of their bonds for problems caused, not by the bonds, but by these unfunded loans issued by the very same government entity that was supposed to control government finances and to make sure that these problems would never happen. Such an outcome, if implemented, would not be reasonable. In the case of Puerto Rico, the only debt holder who should suffer a “hair loss” is the GDB.
- Any kind of default, bankruptcy proceedings, restructuring, or negotiation that results in the Government of Puerto Rico not honoring its debt commitments as originally contracted would disrupt access to financial markets for an uncertain number of years. As a result, investments on the Island would be severely curtailed. Thus, the economic development of Puerto Rico, and the quality of life of the residents of the Island, would be adversely affected.
- The liquidity crisis that the Government of Puerto Rico is currently facing, and that government officials are using as the latest excuse to renege on its commitments, is not part of the fiscal and economic crises discussed above. This liquidity shortfall is nothing more than the normal annual situation faced by the government due to the fact that its “tax revenues are received during the second half of the fiscal year (January through June) while operational expenditures are spent evenly throughout the fiscal year.”¹² The government normally handled this situation by issuing “tax and revenue anticipation notes (TRANS).”¹³ The government, however, “has been unable to obtain TRANS financing this fiscal year from commercial banks or capital market sources.”¹⁴ This inability to issue TRANS is due to the fact that the Government of Puerto Rico has been denied access to financial markets because of the way in which it has improperly managed its fiscal crisis.

In summary, Puerto Rico is facing two severe, and distinct, crises, each with its own origin and causes. Next, I will outline some of the actions that I deem necessary to address each of these two crises.

either through the “Krueger Report” or by any other source, that the debt was actually not payable, the budget should have been amended to reflect a lower figure for debt service. The fact that the budget was finally approved for the same amount as originally proposed demonstrates that the debt is payable. Alternatively, one would have to conclude that the budget was not correctly approved.

¹² See Commonwealth of Puerto Rico, “Financial Information and Operating Data Report,” November 6, 2015, p. 34.

¹³ *Ibid*

¹⁴ *Ibid*

To solve the fiscal crisis, since the problem resulted from excess spending and not from a reduction in revenues, the solutions have to revolve around spending reductions and a wiser usage of public resources. Some ideas along those lines are presented below.

- Reduce expenses in the General Fund by \$1.0 - \$1.5 billion annually.¹⁵
 - To do so, labor leaders should be actively involved in the process. After all, government employees know better than anybody else how public resources are wasted.¹⁶
 - As part of that process, there should be an evaluation of the possibility of eliminating some government agencies.
 - The possible elimination of subsidies to cities, towns, and related agencies should also be considered.
 - Because it is not necessary, and to show good faith and to elicit the right collaboration by labor leaders, there should be a firm commitment to not fire government employees. Besides, firing government employees would exacerbate the financial problems facing the retirement system, which is another reason why this option should be avoided.
 - But, there should be no recruiting of new government employees either.
- The resources liberated from cutting expenses should be redirected toward investments.
- The possibility of liquidating the GDB should be carefully studied. This liquidation may help to strengthen government controls, by eliminating the entity that made possible the deficit spending. Also, it may help to reduce a portion of the public debt.
- Do not use public-private partnerships (PPPs) as financing tools. PPPs increase the cost of financing and, therefore, reduce the feasibility of many projects that otherwise would be worthwhile to undertake.
- Reduce income taxes and replace them with consumption-based taxes, **ON A REVENUE NEUTRAL BASIS!**

¹⁵ According to the audited financial statements of the Government of Puerto Rico, between fiscal year 2001 and fiscal year 2013, General Fund revenues averaged approximately \$8,100 million, expenses averaged \$9,700 million, and the deficit averaged -\$1,600 million. Since then, new revenue sources have been added and, according to the Puerto Rico Department of Treasury, revenues in fiscal year 2014 and 2015 averaged approximately \$9,000 million. Therefore, reducing expenses in the General Fund by \$1,000 - \$1,500 million annually should be enough to eliminate the deficit, pay debt service, and free resources for investment purposes.

¹⁶ In addition to examining the audited financial statements, I also examined the General Fund and the Consolidated budget of the Government of Puerto Rico. From that examination, I can reasonably conclude that the above suggested budget reduction is not only feasible, but it can be accomplished without affecting the quality of the services that the government needs to provide to its citizens. Also, I obtained a good sense of the line items that I would cut, if it were up to me, to accomplish the task. In the end, however, as the saying goes, "there is more than one way to skin a cat". In other words, there are multiple ways to accomplish the objective of reducing expenses by \$1,000 - \$1,500 million annually. More importantly, it is better to let a consensus process dictate the way instead of trying to force my ideas upon others. That is why I did not to include in my written testimony the detailed list of line items that I would prefer to cut.

- Create a trust fund to preserve the funds to be received from government asset sales, to avoid spending the value of capital assets in the short term.
- In the different retirement systems, benefits should be linked to contributions while preserving, as much as possible, the defined-benefits structure.
- Discuss with private sector entities like, for example, the Puerto Rico Chamber of Commerce and the Puerto Rico Manufacturers Association, the possibility for them to provide services that in Puerto Rico, contrary to other jurisdictions, are carried out by government agencies (e.g., Tourism Company, Puerto Rico Industrial Development Corporation).

Even though the economic crisis is not the main culprit in terms of the fiscal crisis, the economy needs strengthening. Below are some brief ideas to address that as well.

- Establish, as the top priority, the discussion and implementation of initiatives that would promote economic growth and wealth creation, as opposed to wealth distribution, which tends to dominate policy discussions.
- Advance public policies that encourage exporting by local firms.
- Reduce the cost of doing business in Puerto Rico (e.g., eliminate bureaucratic permitting requirements, and improve water, energy, and transportation infrastructure).
- To be really effective, all of these recommended initiatives should be advanced by consensus, and with the principal political parties sitting at the table.

As you see, most of the above actions are local initiatives, to be undertaken by officials in Puerto Rico.¹⁷ In addition to these actions, there is a lot that Congress can do to help Puerto Rico face its current challenges. A few of those actions are outlined next.

- Make it clear that Congress will not approve any initiative that can be considered a substitute for the local actions necessary to lower expenses, stop deficit spending, and put the fiscal side of the Government of Puerto Rico in order. In fact, these local actions

¹⁷ Shortly after he took office, the Governor of Puerto Rico proposed a budget for fiscal year 2014 that increased expenses by \$750 million. In his address to the Legislature defending that budget (available at <http://www2.pr.gov/presupuestos/Presupuesto2013-2014/Mensaje%20del%20Gobernador/Mensaje%20de%20Estado%20del%20Gobernador.pdf>), delivered on April 23, 2013, the Governor itemized how that increase would be allocated. A complete itemized description of that proposed increase can be found on page 2.63 of the *Síntesis General de Presupuesto Consolidado* (available at <http://www2.pr.gov/presupuestos/Presupuesto2013-2014/Informacin%20de%20Referencia/S%C3%ADntesis%20Presupuesto%20Consolidado.pdf>). Before fiscal year 2014 was over, in February 2014, Moody's Investors Service, Standard & Poor's, and Fitch Ratings downgraded the General Obligation bonds and other credits of the Government of Puerto Rico below investment grade ("junk") and the ratings of the public debt of Puerto Rico have been going down the rating charts ever since. In subsequent budgets, the Governor reduced expenses but, for the most part, those reductions have been too timid and have largely come from the initial increase he himself brought about. Naturally, we will only be able to corroborate this information when the audited financial statements for fiscal years 2014 and 2015 are published.

should be considered to be the first line of attack in solving the fiscal crisis of the Island's government.

- To address many of these issues, appointing a control board has been proposed. I have mixed feelings toward that proposal. On the one hand, I recognize that a control board may be very effective to put the financial house in order and restore credibility in Puerto Rico. On the other hand, we do not need people to make hard decisions. We need people to make smart decisions. Yet, these control boards tend to be dominated by IMF types who usually enter troubled spots to cut indiscriminately. In Puerto Rico, this would not be the correct approach to follow. Perhaps, instead of creating such a board, it could make more sense to establish specific targets of what needs to be done and to contract with an independent CPA, under the basis of "agreed-upon procedures", to certify whether it has been done. This approach would have the added benefit of keeping responsibility in the hands of the public officials whose job it is to fix these problems.
- Provide Puerto Rico with parity in funds for health-related programs such as medicare, medicaid, and the tricare plus program for military personnel. After all, if Puerto Rico pays the same social security and medicare-related federal taxes, it is only fair that we receive the same benefits as well.
- Since Puerto Rico's most urgent economic needs revolve around increasing investments and improving the business climate on the Island, any additional resources available from the Federal Government should be channeled toward infrastructure investments. In that regard, the primary objectives should be to (1) improve the water storage and distribution infrastructure in Puerto Rico; (2) modernize the technology for energy generation; and (3) complete the strategic highway network around the Island.
- Solve Puerto Rico's political status once and for all. Following in the best human rights traditions of our country, it is the right thing to do and it is Congress's responsibility to do so. In addition, solving the political status of Puerto Rico would put a stop to the confusion brought about by political arguments, camouflaged as economic arguments, that contaminate the process and distract us from properly concentrating on meeting the fiscal and economic challenges ahead.

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Enclosure: Presentation - "How Do We Get Out of This?"

Puerto Rico: How Do We Get Out of This?

By

Carlos A. Colón De Armas, Ph.D.

December 1, 2015

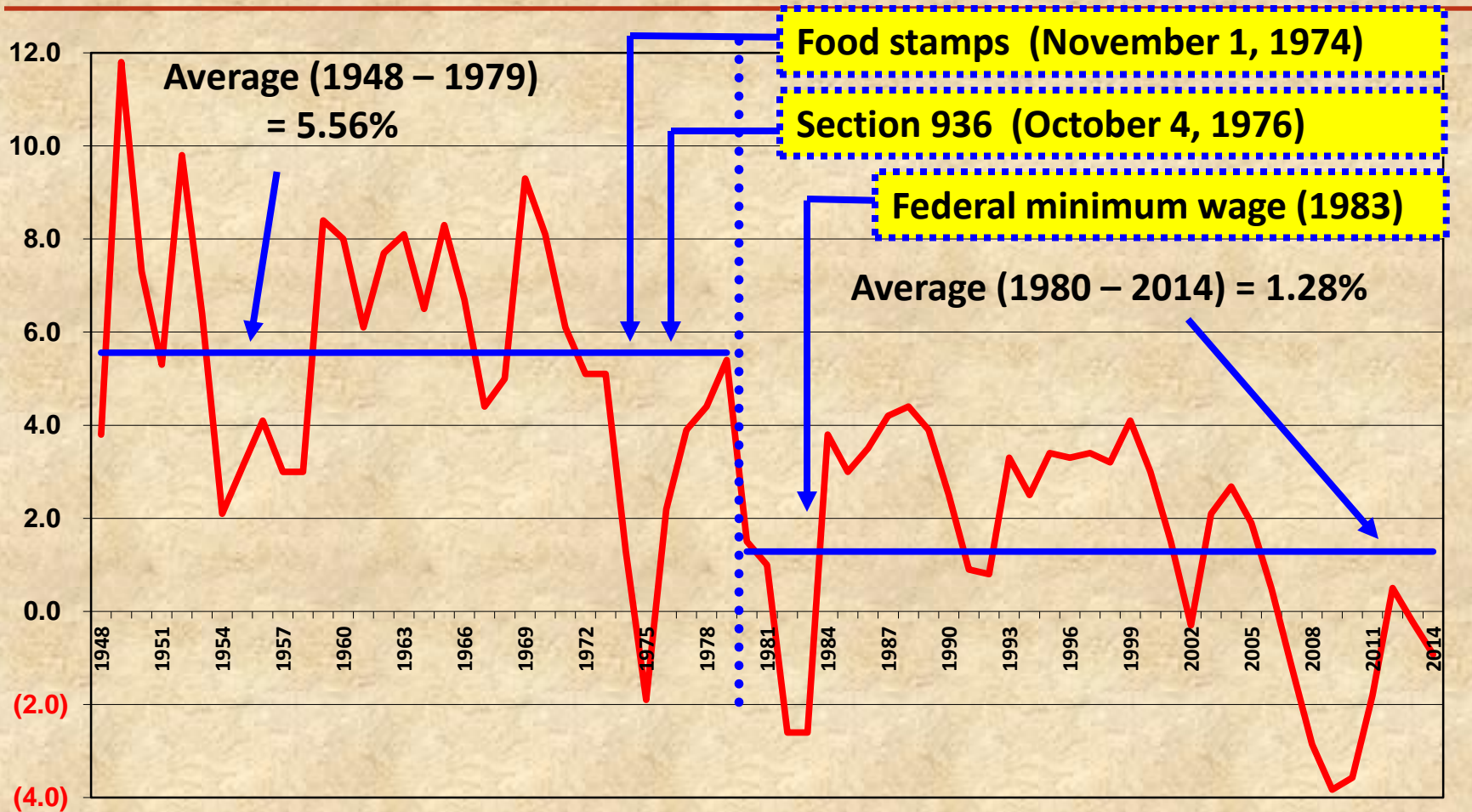
Presentation Outline

- ➔ Economic Crisis
- ➔ Fiscal Crisis
- ➔ Additional Facts
- ➔ The Impact of the Federal Minimum Wage on Employment in Puerto Rico
- ➔ Conclusions and Recommendations

Economic Crisis

Puerto Rico: GNP Annual Growth

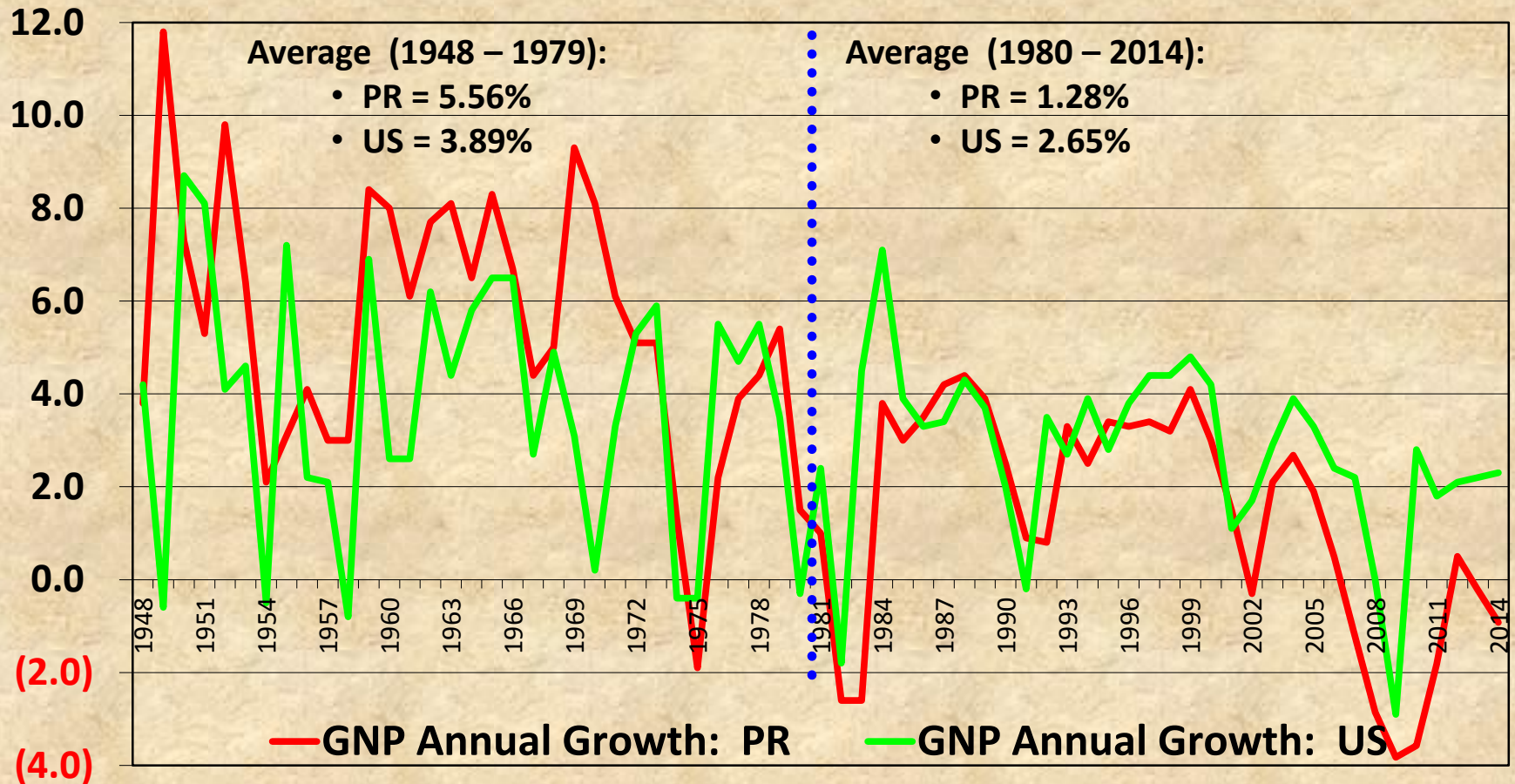
(In real terms and in %.)



Source: Puerto Rico Planning Board and author's computations.

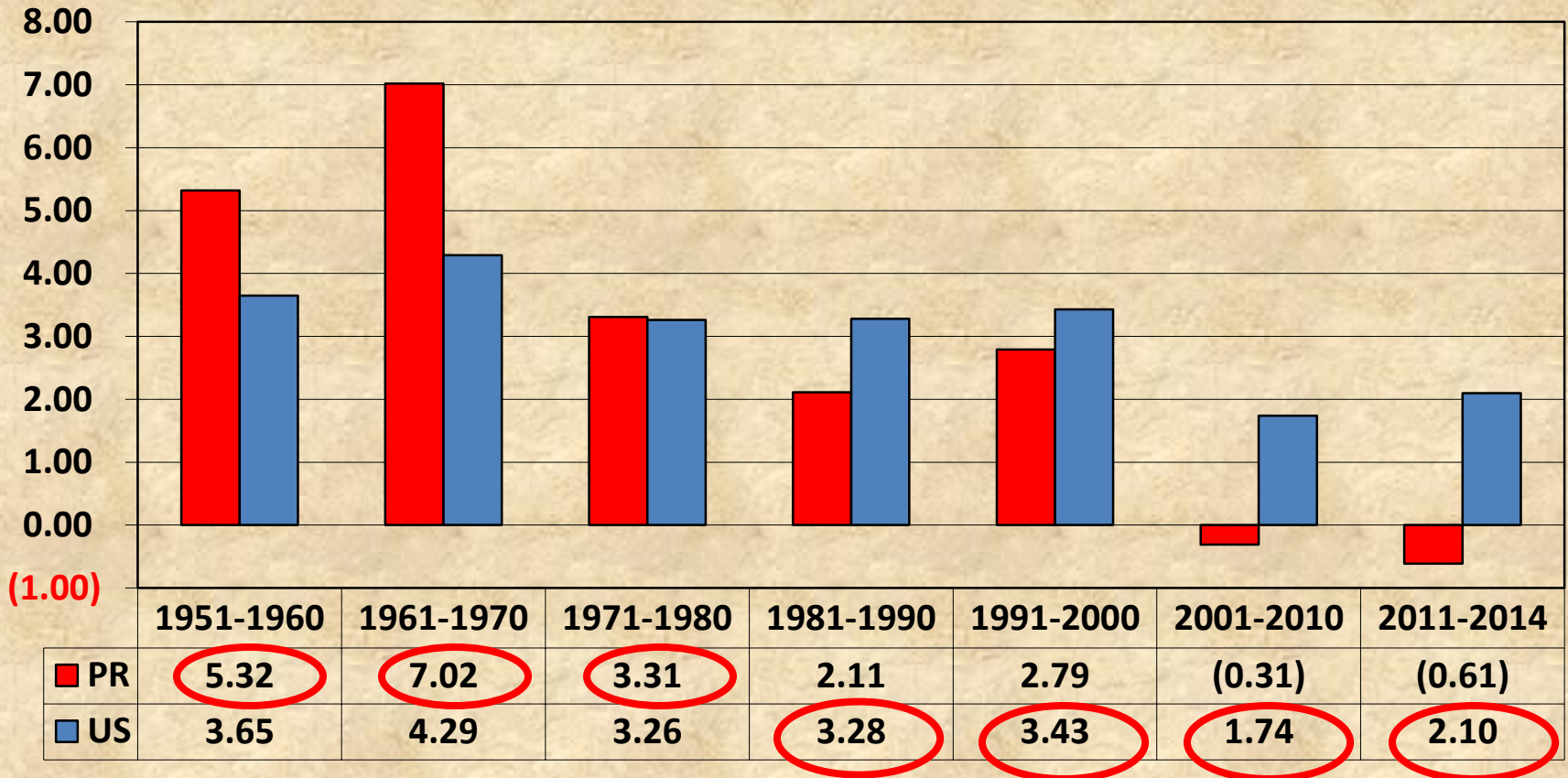
GNP annual Growth: PR vs. US

(In real terms and in %.)



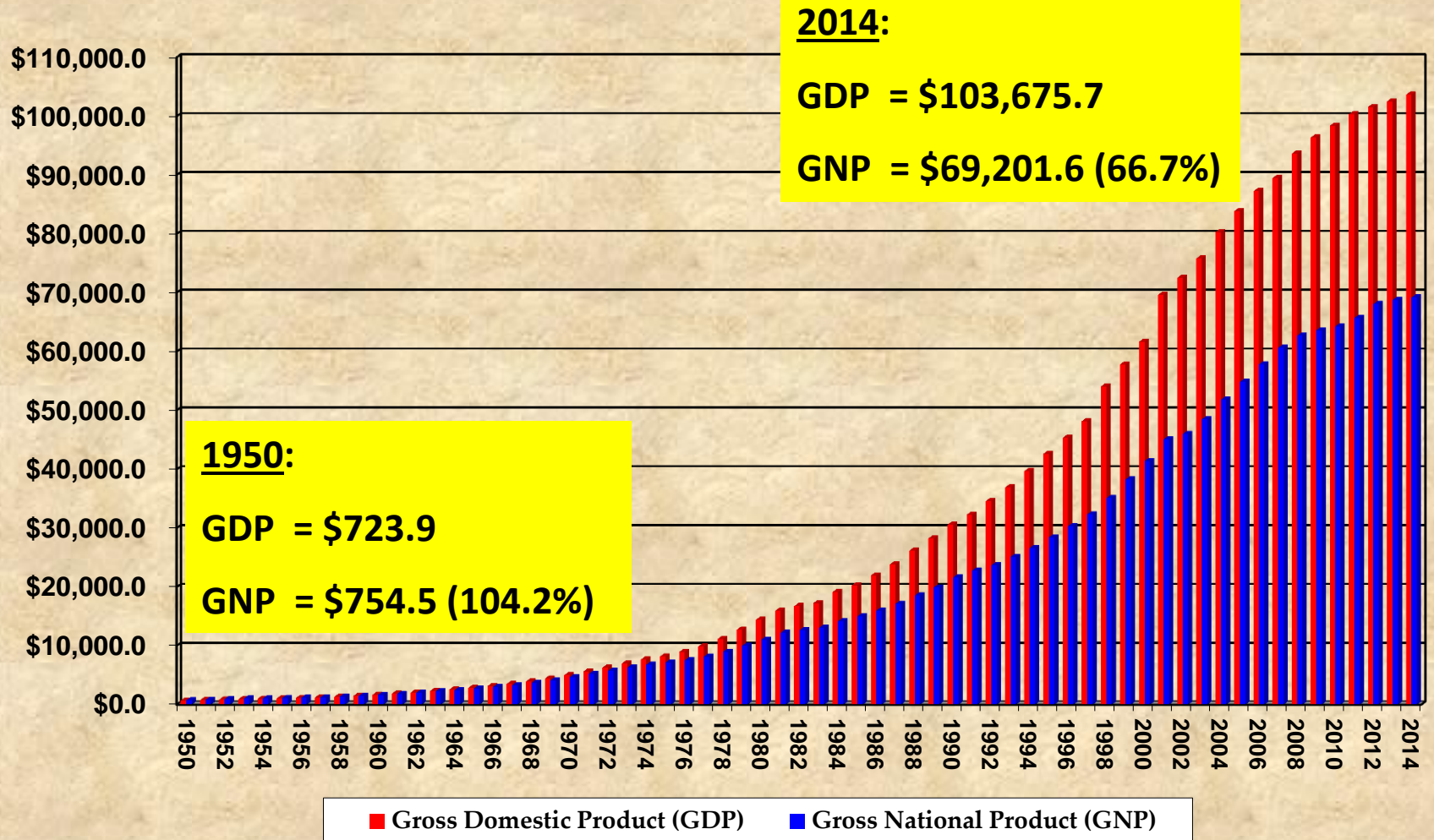
GNP Average Annual Growth: PR vs. US

(In real terms and in %.)



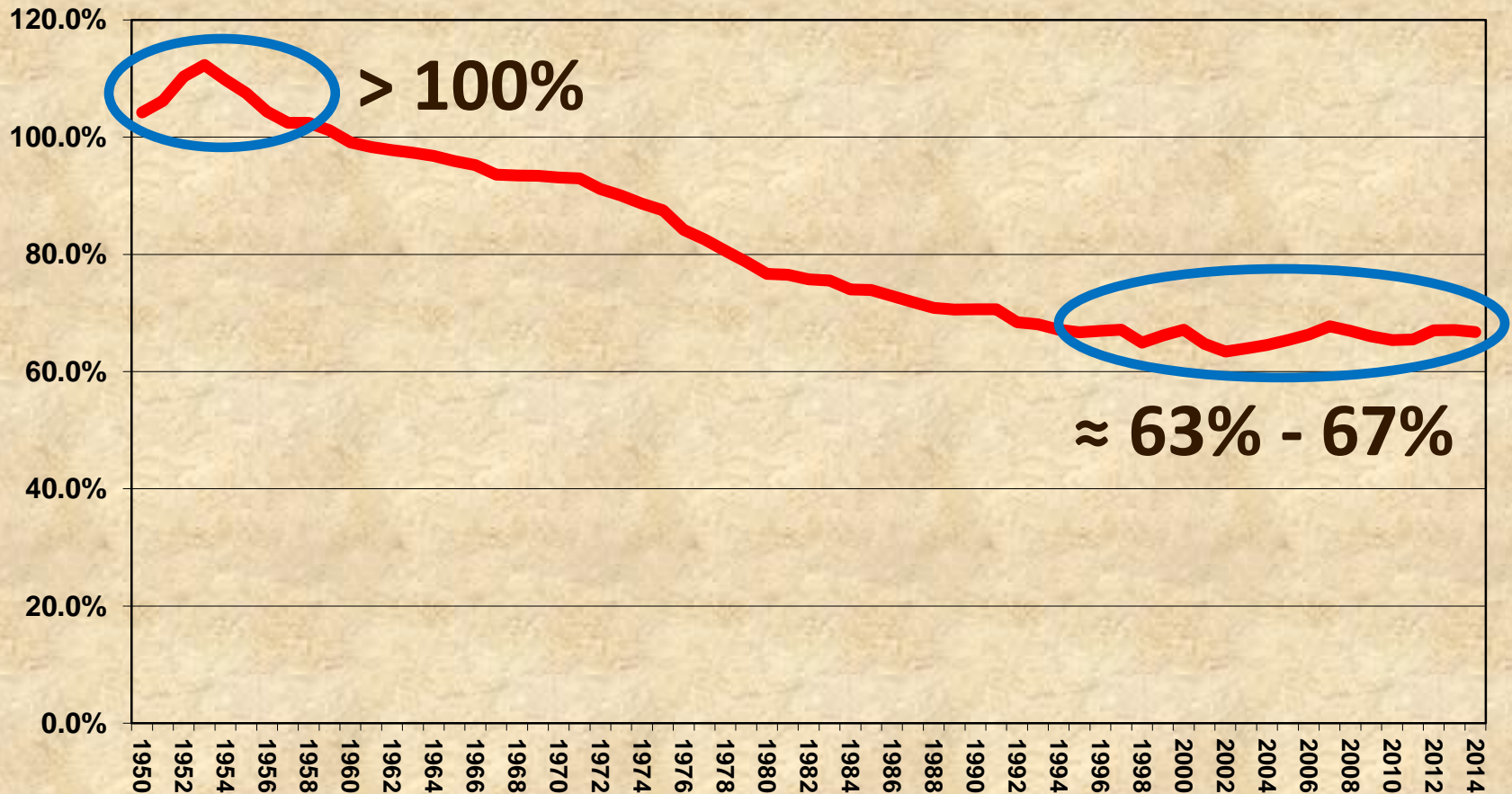
Puerto Rico: GDP vs. GNP

(Current prices. In millions.)



Source: Puerto Rico Planning Board and author's computations.

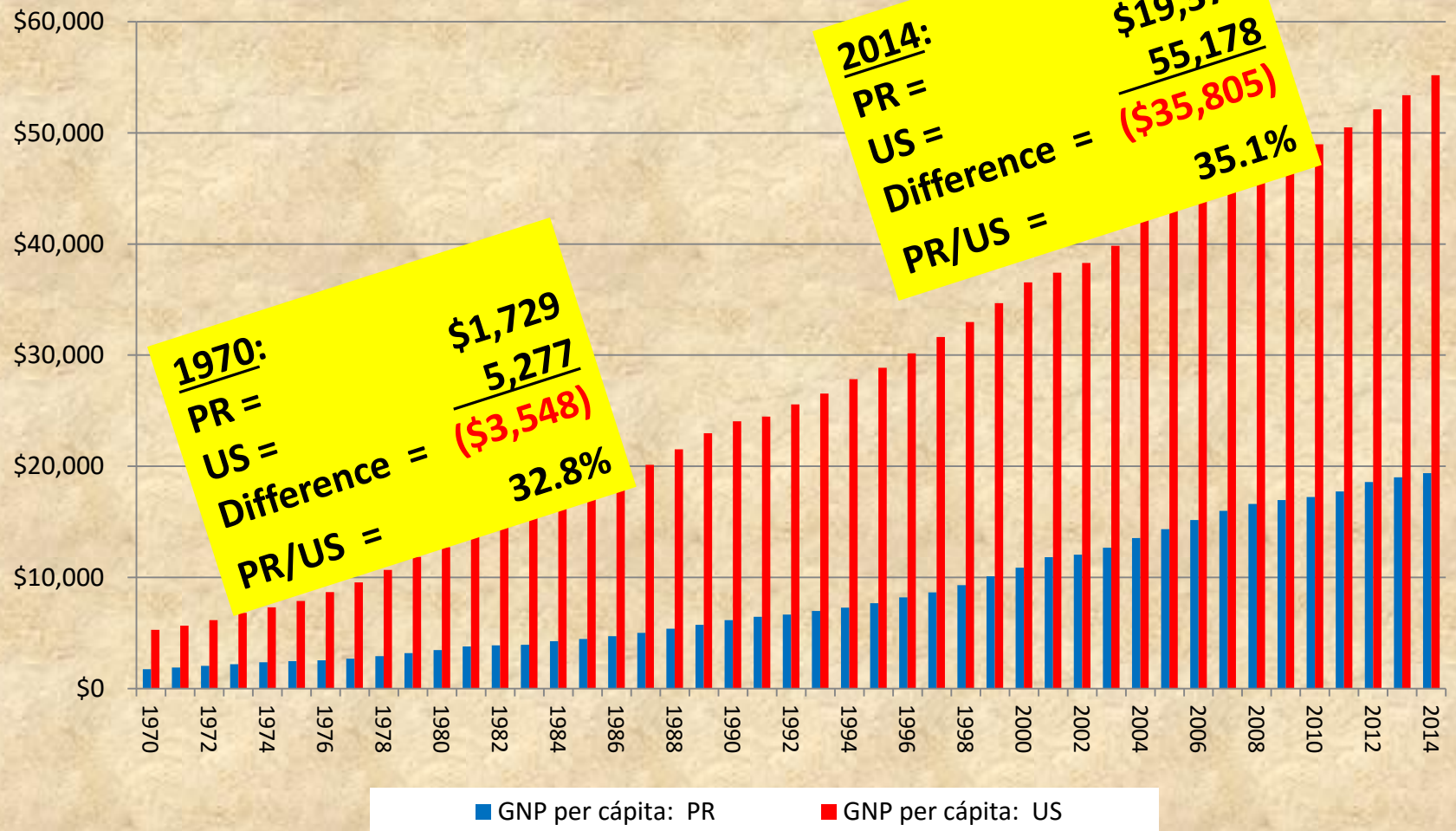
Puerto Rico: GNP / GDP



Source: Puerto Rico Planning Board and author's computations.

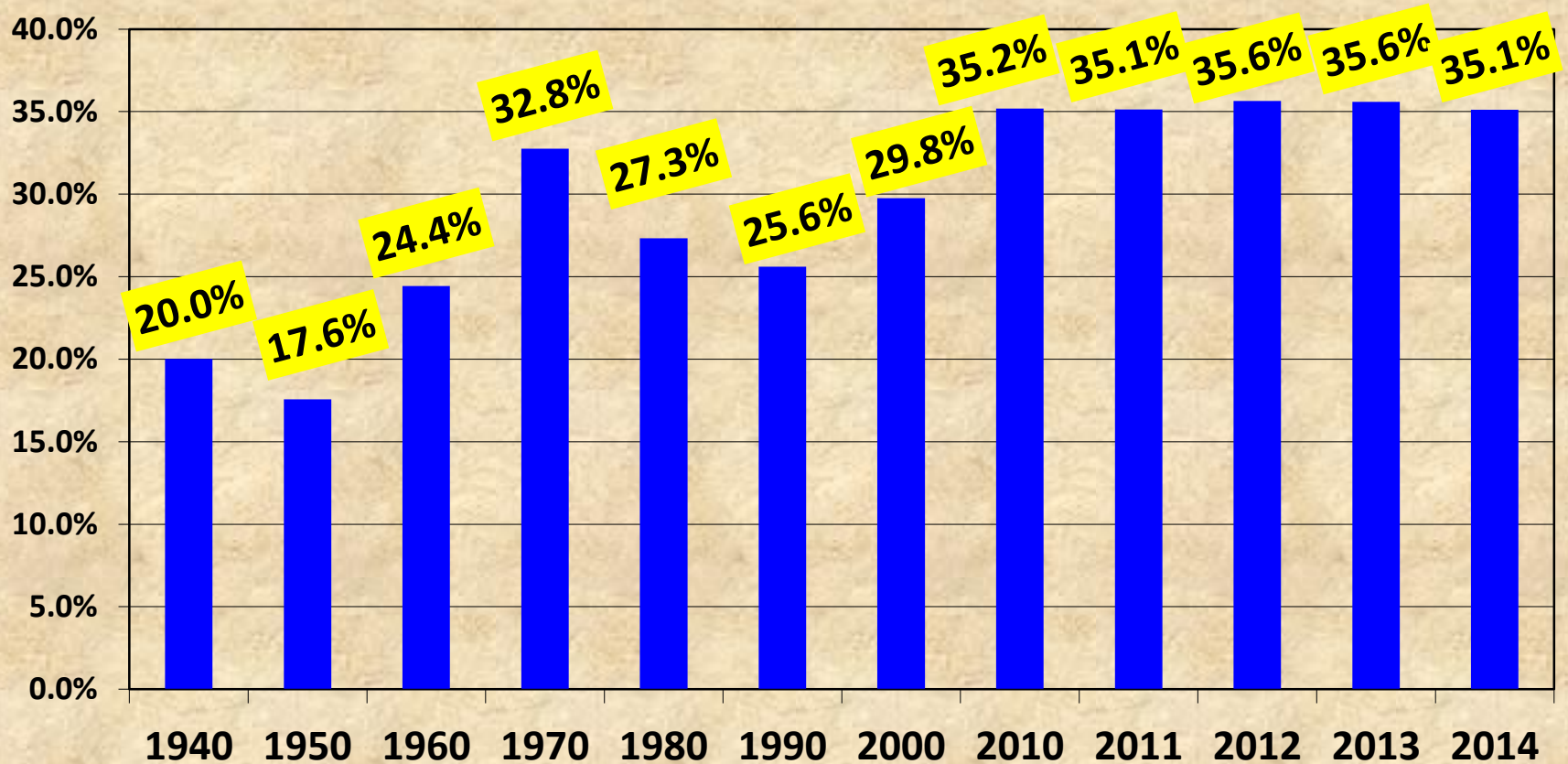
GNP per Cápita: PR vs. US

(Current prices.)



GNP per Cápita: PR / US

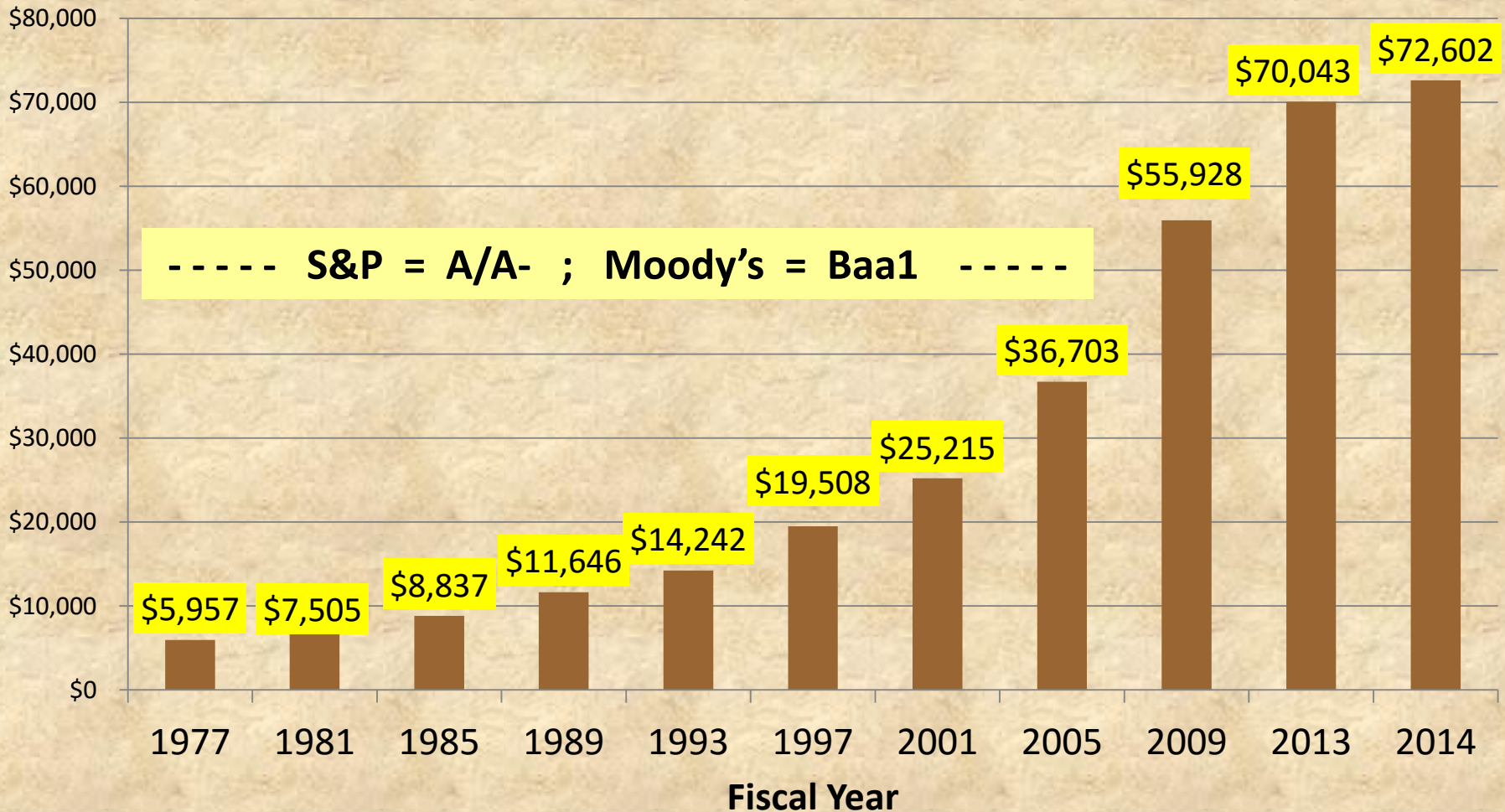
(Current prices.)



Fiscal Crisis

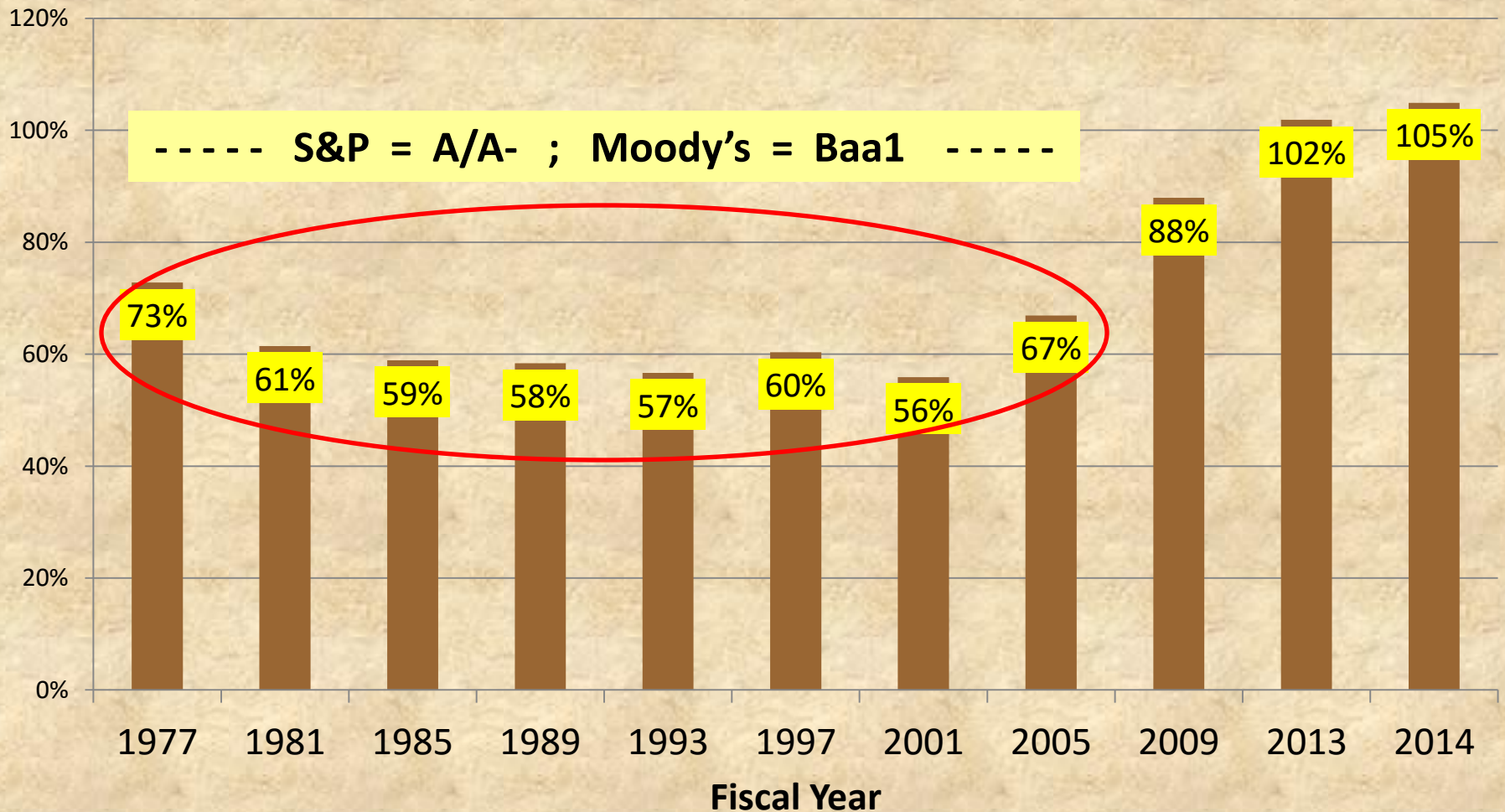
Puerto Rico's Public Debt

(In millions.)



Source: Government Development Bank for Puerto Rico.

Public Debt as a % of GNP

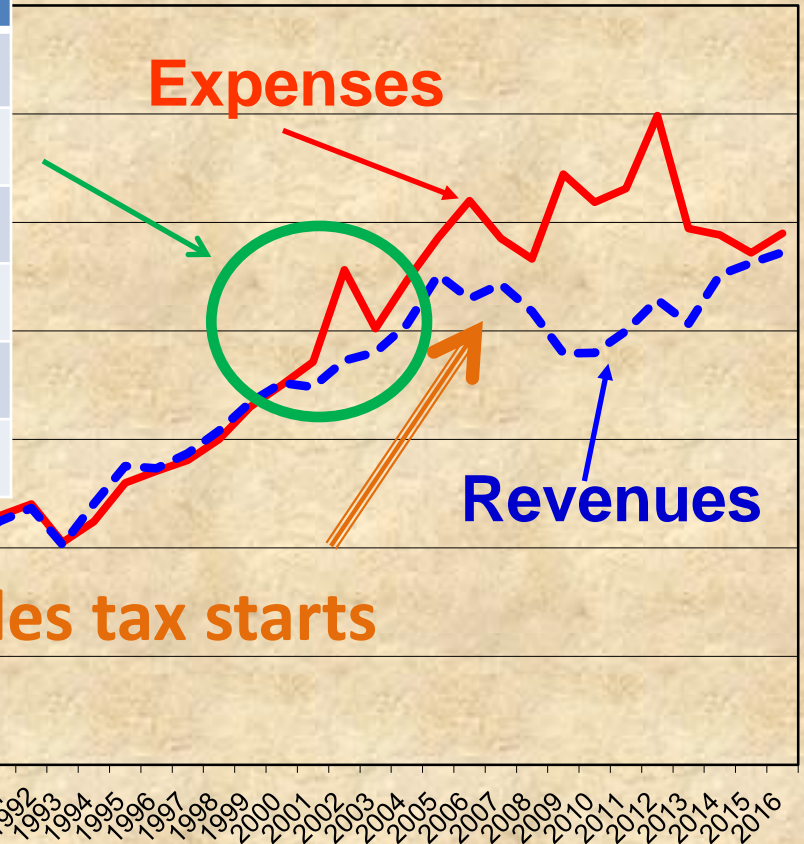


Source: Government Development Bank for Puerto Rico.

General Fund: Revenues vs. Expenses

(In \$ thousands.)

| | Revenues | Revenues | Rev. – Exp. |
|------|----------|-----------|-------------|
| 2001 | -1% | (78,718) | (464,032) |
| 2002 | +7% | +492,078 | (1,674,106) |
| 2003 | +2% | +150,531 | (438,299) |
| 2004 | +7% | +515,004 | (802,849) |
| 2005 | +11% | +915,817 | (681,467) |
| 2006 | -5% | (444,326) | (1,806,138) |



Sources:

1970-2013: *Comprehensive Annual Financial Report (CAFR)* of the Government of Puerto Rico.
 2014-2016: Puerto Rico Office of Management and Budget.

Additional Facts

Income, Expenses, and Investment in PR

(In millions.)

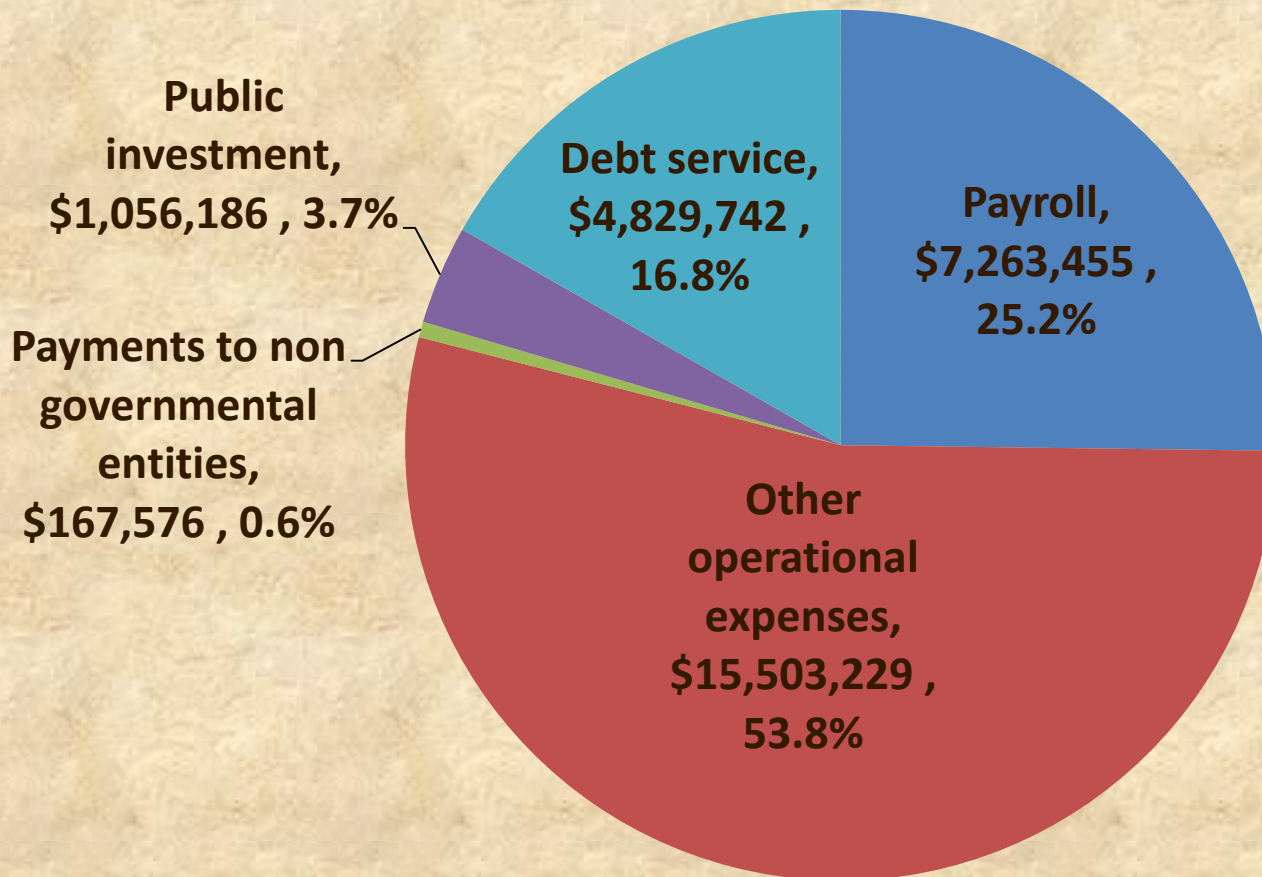
| | 2003 | 2014 | Average annual change |
|-----------------------------------|------------|------------|-----------------------|
| Disposable personal income | | | |
| At current dollars | \$42,132.6 | \$61,444.2 | +3.49% |
| At constant dollars | \$8,723.3 | \$9,659.3 | +0.93% |
| Personal consumption expenditures | | | |
| At current dollars | \$41,970.4 | \$62,324.4 | +3.66% |
| At constant dollars | \$8,832.2 | \$9,797.7 | +0.95% |
| Gross domestic investment | | | |
| At current dollars | \$11,619.1 | \$9,065.7 | -2.23% |
| At constant dollars | \$1,871.9 | \$1,369.4 | -2.80% |

Source: Puerto Rico Planning Board, Statistical Appendix.

Government Budget: 2015-2016

(In thousands.)

Consolidated Budget = \$28,820,188

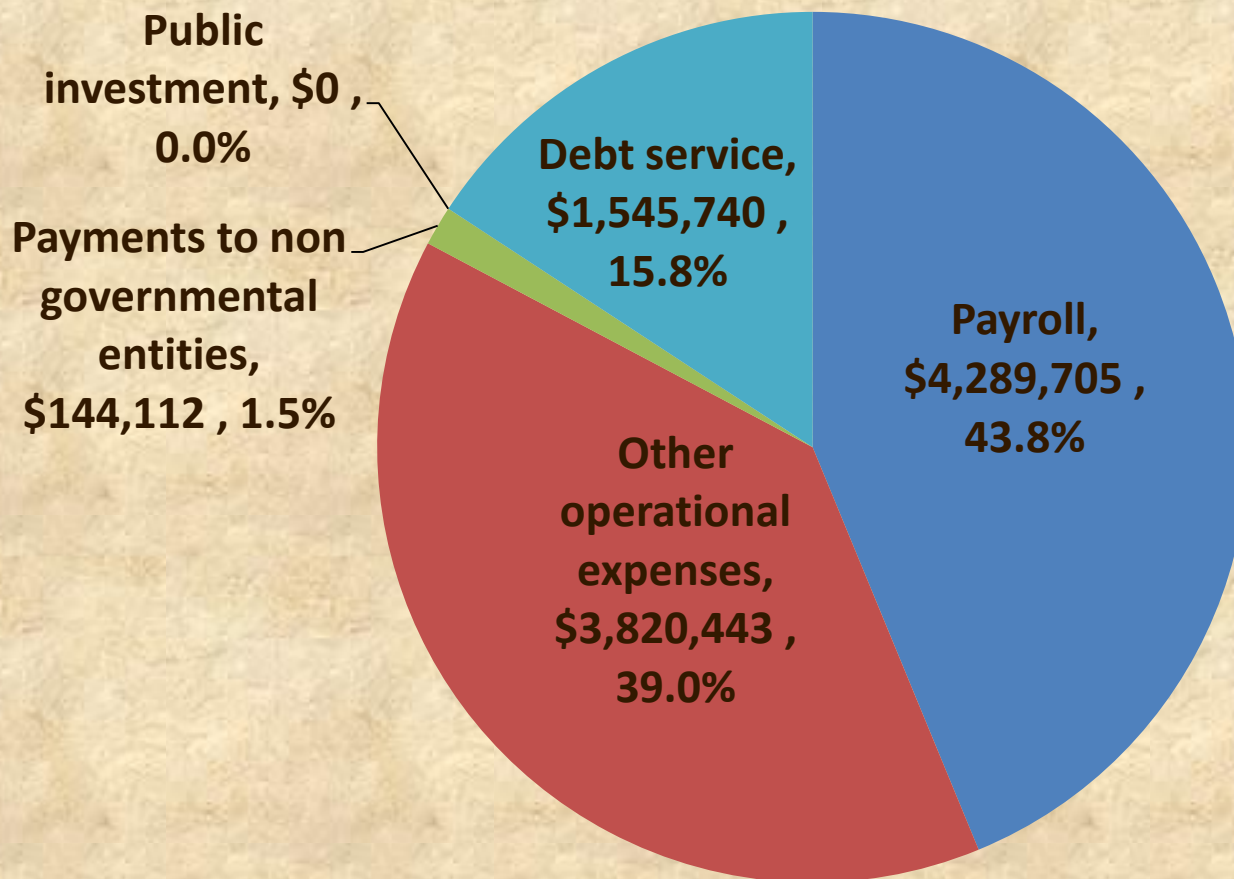


Source: Puerto Rico Office of Management and Budget

Government Budget: 2015-2016

(In thousands.)

General Fund Budget = \$9,800,000



Source: Puerto Rico Office of Management and Budget

The Impact of the Federal Minimum Wage on Employment in Puerto Rico

Negative? ...

- ⇒ “Imposing the U.S.-level minimum **reduced total island employment by 8-10 percent** compared to the level that would have prevailed had the minimum been the same proportion of average wages as in the United States.”

Castillo-Freeman, Alida J. and Richard B. Freeman. (January 1992, p. 178). “When the Minimum Wage Really Bites: The Effect of the U.S.-Level Minimum on Puerto Rico.” Chapter 6, pp. 177-212, in Borjas, George J. and Richard B. Freeman, editors, *Immigration and the Workforce: Economic Consequences for the United States and Source Areas*, University of Chicago Press.

... or maybe not?

- ➔ “... the cross-industry panel analysis of Castillo-Freeman and Freeman is found to be extremely sensitive to plausible, minor changes in specification. Indeed, just estimating Castillo-Freeman and Freeman's specification by weighted least squares (WLS), instead of ordinary least squares (OLS), changes the sign of the minimum wage variable. The basic conclusion of this paper is that **the evidence on minimum wage effects stemming from Puerto Rico is quite fragile.**”

Krueger, Alan B. (June 1994, p. 4). “The Effect of the Minimum Wage When It Really Bites: A Reexamination of the Evidence from Puerto Rico.” NBER Working Paper No. 4757.

Impact on Current Crises?

- ➔ **“The timing of their problems does not have to do with the minimum wage,”** Richard Freeman, the Herbert Ascherman Chair in Economics at Harvard University, told ThinkProgress. “I don’t believe it’s done much positive but it certainly didn’t cause any of the current problems.” ... “I thought that was going to be the great cause of massive job loss,” he said. Instead, they found that it reduced total employment on the island by 8 to 10 percent, mainly in low-wage jobs. **That wasn’t as much as he had expected, and the losses were also concentrated in some industries that were already on the decline.** “It’s dubious it would cause the problems today,” he said ... “If I were looking for solutions for getting the economy out of its trouble, **I wouldn’t be pushing the minimum wage,**” he said.

Covert, Bryce. (July 8, 2015). “What Really Caused the Puerto Rican crisis.” *ThinkProgress*.

(<http://thinkprogress.org/economy/2015/07/08/3677565/puerto-rico-crisis-minimum-wage/>)

Conclusions and Recommendations

Fiscal Crisis and Economic Crisis

- ➔ The fiscal crisis and the economic crisis that afflict Puerto Rico are two separate problems, with very distinct causes and origins.
- ➔ Fiscal crisis:
 - Origin:
 - Spending in excess of revenues: 2001 budget
 - Balancing the budget with debt: 2005 budget
 - Cause: Excess public spending
- ➔ Economic crisis:
 - Origin: Mid 1970s
 - Cause: Economic policies divorced from globalization trends.

Fiscal Crisis: What needs to be done?

- ➔ Reduce expenses in the General Fund by \$1,000 - \$1,500 million annually
 - Actively involve labor leaders.
 - Evaluate the possibility of eliminating some government agencies.
 - Eliminate subsidies to cities, towns, and related agencies.
 - No firings of government employees.
 - No recruiting of new government employees.
- ➔ Redirect resources toward investments.
- ➔ Study the possibility of liquidating the GDB.
- ➔ Do not use PPPs as financing tools.
- ➔ Reduce income taxes and replace them with consumption-based taxes, **ON A REVENUE NEUTRAL BASIS!**
- ➔ Create the General Fund Trust to preserve the funds to be received from asset sales.
- ➔ In the different retirement systems, link benefits to contributions while preserving, as much as possible, the defined-benefits structure.
- ➔ Private sector entities like, for example, the Chamber of Commerce and the Manufacturers Association, should explore the possibility of providing services that in Puerto Rico, contrary to other jurisdictions, are carried out by government agencies (e.g., Tourism Company, PRIDCO).

“Competitiveness is a meaningless word when applied to national economies. And the obsession with competitiveness is both wrong and dangerous”.

Krugman, Paul. (March/April 1994).
“Competitiveness: A Dangerous
Obsession.” *Foreign Affairs*, 73(2), p. 44.

Economic Crisis:

What needs to be done?

- ➔ Top priority: Growth and wealth creation.
- ➔ Public policy that encourages exporting by local firms.
- ➔ Reduce the cost of doing business in Puerto Rico.
- ➔ To be really effective, all of this should be done by consensus, and with the principal political parties sitting at the table.

End
