Puerto Rico: A Growing Economy or A Basket Case

November 2018

*A surge of public infrastructure investment, valuable in terms of immediate growth and employment effects, is essential because of the impetus it will create for private sector development.* *Lack of economic growth or very slow growth—a program of austerity—would not only fail to meet the needs of the populace, but would also undermine Puerto Rico’s ability to make debt payments.*

Puerto Rico needs to have a growing economy to provide for the well-being of its people. Also, economic growth is needed to provide the resources to repay *to some extent* the government’s outstanding debt. Debt servicing, however, cannot be allowed to stand in the way of providing for the well-being of the Puerto Rican people. Lack of economic growth or very slow growth—a program of austerity—would not only fail to meet the needs of the populace, but would also undermine Puerto Rico’s ability to make debt payments.

The “New Fiscal Plan for Puerto Rico: Restoring Growth and Prosperity,” put in place on April 19, 2018, by the Financial Oversight and Management Board (FOMB), is not the answer**.** It is a program for austerity. It would have Puerto Rico limp along for a decade, with the economy standing only 1.5% above its level of Fiscal Year 2017 in 2027, ten years after the hurricanes’ devastation.[[1]](#footnote-1) Moreover, the FOMB plan projects real GNP growth at less than 1% a year into the late 2050s.[[2]](#footnote-2) This projected outcome, as bad as it is, is only possible because the FOMB makes unrealistically optimistic assumptions about the impact of the structural changes it demands.[[3]](#footnote-3) This FOMB plan is unacceptable, all the more so as 2017 followed a decade of economic decline in Puerto Rico.

The FOMB’s plan, if followed, would make Puerto Rico into an economic basket case. The economy would slide further and further behind that of even the poorest U.S. states. Aside from the possibility of another recession in the states (which would, of course, damage Puerto Rican growth as much as that of the states), the U.S. economy is likely to grow by 25% between 2017 and 2029,[[4]](#footnote-4) while the FOMB plan would have Puerto Rico only 3% above its 2017 level in 2029. And this would come after the 2006 to 2017 period, when the Puerto Rican economy declined by 18% and the U.S. economy (in spite of the Great Recession) rose by 17%. (All figures are inflation adjusted.) With Puerto Rico falling further and further behind the states, it is likely that population decline would continue, even the weak economic growth figures of the FOMB’s plan would not be achieved, and the Puerto Rican economy would continue on a downward spiral—*if Puerto Rico adheres to the FOMB plan.*

**An Alternative Proposal**

There is, however, an alternative. The alternative would be based largely on public infrastructure investments, going well beyond the repair of the hurricane-related destruction. It has been well-recognized that before the hurricanes the state of Puerto Rico’s infrastructure was in need of substantial investment; so this public infrastructure investment would be in response to a pressing need.[[5]](#footnote-5) This public investment in new and improved infrastructure would raise the growth rate of the economy in the period 2022 through 2029 well above the rates projected in the FOMB plan.[[6]](#footnote-6)

The alternative proposal presented here calls for $25 billion of new, public infrastructure investment spread over the 2020 to 2029 decades. (The sources of the $25 billion will be addressed below.) While the alternative would have the economy growing by 21% between 2020 and 2029, the FOMB plan would have the economy grow by 10% in this period. As compared to the 2017 level of the economy, the alternative would place the economy 13% higher, while the FOMB projects the economy as only 3% higher. This comparison and the details on which the alternative projections are based are explained in the Appendix.[[7]](#footnote-7)

 The alternative’s large decade-long program of public spending on new infrastructure, beyond the repair of old infrastructure damaged or destroyed by the hurricanes, could both create growth directly and provide the foundation for continuing growth into the future. Twenty-five billion is an amount that is necessary to generate a substantial upsurge in the Puerto Rican economy, sharply raising output and employment, and slowing, if not halting and reversing, the exodus from the island. C*rucially, this $25 billion would provide a catalyst to a resurgence of private investment*. At the same time, when spread over a decade, $25 billion is a feasible amount, an amount that could be raised as explained below.

Beyond the alternative’s results within the 2020 to 2029 period, it would raise lasting output capacity by over $8 billion and increase lasting jobs by over 100,000. (See the Appendix for details and explanation.) *Yet, these estimates of output and employment impacts are conservative because they do not include the extent and impact of new private investment, which would surely be substantial. Indeed, the surge of public infrastructure investment, valuable in terms of immediate growth and employment effects, is essential because of the impetus it will create for private sector development.*

*Especially important, this surge of new activity, by significantly altering the economic climate in Puerto Rico, would give rise early-on to new private activity, bringing gains well beyond those attributable to the public investment alone. While private activity resulting from the multiplier process generated by the investment spending is included in the impact estimates, the rise in private activity resulting from the improved investment climate is not included. Therefore, the expansion estimates noted here should be viewed as conservative.*

Questions might exist as to whether or not Puerto Rico would be able to absorb the high rate of investment called for in the alternative program. That is, it might not be able to effectively invest funds in new infrastructure at such a high rate. Yet, given the starved condition of the economy, the large amounts of investment seem both necessary and reasonable. The roles of the Revitalization Coordinator, working under the Oversight Board, in exercising oversight of the choice and operation of projects, would reduce the likelihood of ineffective investments. Nonetheless, if this “big push” is rejected as unrealistic, more moderate approaches to rehabilitation of the Puerto Rican economy could be undertaken, which would have the same general effect, though smaller.

A crucial assumption of the alternative is that the court will resolve Puerto Rico’s bankruptcy case in a reasonable manner, allowing a level of debt servicing consistent with a level of government spending that maintains the well-being of the populace. This would mean the annual amount of debt servicing in the coming decade must be about $1.5 billion annually. The FOMB Plan calls for annual debt servicing of about $2.5 billion for the first five years of its projections.[[8]](#footnote-8) This amount of debt servicing is one of the factors that leads the FOMB to project low growth rates—its austerity program.

**The Availability of Funds**

In November 2018, it appears that, at best, new external funds coming to Puerto Rico connected to hurricane recovery will be about $65 billion, the majority from federal sources but also some from private insurance. The alternative presented here posits that, in addition to this $65 billion, $25 billion can be available as public funds over the 2020-2029 decade from the following: reduction in debt service payments, increase in federal funds from Puerto Rico being treated the same as the states in federal programs, improvements in tax collection, and increased borrowing (perhaps guaranteed by the U.S. Treasury).

Table 1 shows the breakdown of the $25 billion on an annual basis—i.e., $2.5 billion per year—and an explanation follows the table.

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**Table 1: Sources of $2.5 Billion Annually for New Public Infrastructure Investment**

Reduction of Debt Service Payments

(one-half of reduction in debt service

of public enterprises and municipalities)………………………$1,500 million

Revenue from Equal Treatment in

Federal Programs (share that accrues

to the government)……………………………………………..…..$300 million

Increased Effectiveness of Tax Collection

(3.2% increase in collection of total taxes) ………………..;…$300 million

New Annual Borrowing

(RTF bonds at 5%)……...………………………………………$421.05 million

First Year’s Interest on New Debt\*..………………..…… —$21.05 million

 Total…….………....$2,500 million

\* This set of sources of funds does not include funds to pay the interest on the new debt beyond the initial year of that debt. It seems reasonable to assume, however, that, as the economy begins to grow and creates an impetus for private investment, the increased economic activity will generate sufficient government revenue to pay the interest on the new debt in subsequent years.

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*Reduction of Debt Service Payments*. A reasonable resolution of Puerto Rico’s debt crisis would result in a halving of the debt service payments of public enterprises and municipalities through some form of restructuring. In FY2016 (i.e., before any default or restructuring), total annual debt servicing payments on Puerto Rico’s public debt were about $4 billion. About one-quarter of the public debt was “General Obligation, Guaranteed and Publicly Issued Appropriation Debt.” The assumption here is that only the remaining debt service (on debt of public enterprises and municipalities) would be halved. Also, it is assumed that, although the savings of $1,500 million will directly accrue to public enterprises and municipalities, it will be available for general government use.

*Revenue from Equal Treatment in Federal Programs*. Economic growth will depend on the federal government in its programs treating Puerto Rico and the Puerto Rican people in the same manner as the states and people living in the states. Were such action immediately implemented it would provide about $3.8 billion annually to Puerto Rico. (See Table 2.) It is assumed here that during the coming decade, only half this amount would come to Puerto Rico annually. Much of this (e.g., the federal Earned Income Tax Credit, the Child Tax Credit, and Supplemental Nutritional Assistance) would go directly to families. Also, Medicare and Medicaid would pay more for medical care, though some of these payments would offset Puerto Rican government obligations. Injection of these funds would yield tax income for the government and would induce a higher level of economic activity, which would also raise tax revenue. All in all, it is reasonable to estimate that equal treatment would result in a $300 million increase in government revenue.[[9]](#footnote-9)

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**Table 2: If Puerto Rico Were Treated in the Same Manner as the States with Regard to Federal Programs, Additional Funds for Puerto Rico Annually Would Be Roughly (in millions of dollars):**

Earned Income Tax Credit $1,100

Child Tax Credit 280

Medicaid 150

Medicare 1,000

Nutritional Assistance 500

Procurement 445

All Other Programs 325

**Total $3,800**

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Sources: EITC and CTC, private professional scoring; Medicaid and Nutritional Assistance, calculated from data in the *Congressional Task Force on Economic Growth in Puerto Rico: Report to the House and Senate*, pages 102 and 95, respectively. Jones Act and Procurement from text; Medicare, rough estimate from information in U.S. Senate working paper “Addressing Puerto Rico’s Medicare Crisis And Implementing an Urgent Path to Recovery,” Working Paper as of November 30, 2015 (v8), [https://www.finance.senate.gov/imo/media/doc/Puerto%20Rico%20Healthcare%20Community%20(Attachment%201).pdf](https://www.finance.senate.gov/imo/media/doc/Puerto%20Rico%20Healthcare%20Community%20%28Attachment%201%29.pdf), and Puerto Rico Medicare, Coalition for Fairness, “Action Needed for Health Care in PR,” February 13, 2015. <http://nebula.wsimg.com/1bd5367a289dc65699c178818d0739a7?AccessKeyId=C2485EFE08948AE5AAE0&disposition=0&alloworigin=1>; All Other Programs, rough estimate from information in *Task Force*.

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*Increased Effectiveness of Tax Collection.* Any program to alleviate the current debt crisis will require steps by the Puerto Rican government to increase the effectiveness of its economic policies, most importantly its tax collection policies. Without tax collection reform, total taxes would amount to about $9.5 billion annually. If reform can raise collections by slightly more than 3%, this would add $300 million annually to government revenue.

*New Annual Borrowing.* While these three sources of funds totaling $2.1 billion annually would go a long way, they would not bring the decade total to $25 billion. New borrowing will be needed. With the existing debt burden greatly reduced and with the role of the Fiscal Oversight and Management Board and Revitalization Coordinator (created by PROMESA) well established, bond investors should have a level of confidence that would make new borrowing possible at reasonable interest rates. Moreover, repairing the Puerto Rican economy would be most effective if the U.S. Treasury would guarantee payment on the new bonds. (The possibility of federal guarantees is suggested in PROMESA, Title V, Sec. 505, Paragraph b.) Assuming the Puerto Rican government could borrow under these circumstances at 5%, it could borrow $400 million each year as well as $21.05 million each year to cover the 5% payment on this new debt (see note to Table 2). The net addition to funds would be $400 million and would bring the total available for new public infrastructure investment to $2.5 billion each year.

**Economic Well-Being**

 The alternative program for economic growth presented here can enhance the economic well-being of the Puerto Rican populace. With growth, people will have the jobs and income that will allow them to provide for their material needs. Moreover, with growth, the exodus from the island can be abated, slowing, if not halting, the decline in the workforce.

 The implementation of the program will depend on a significant reduction of Puerto Rico’s public debt, through restructuring or other possible means. This reduction will depend very much on the outcome of matters currently before the court. Reductions of the sort assumed here are essential for the growth of the economy and for the well-being of the Puerto Rican people, but in addition, over the long-run, the growth is essential for payment of the debt.

 Ironically, then, both the Puerto Rican people and the creditors have a common long-run interest in reduction of debt service, which will allow growth, improvement of the well-being of the populace, and fulfillment of debt obligations.

Appendix

Constructing the Alternative and Detailed Projections

The essence of the alternative proposal presented here is the $25 billion of new, public infrastructure investment. The impact of this investment (not including the impetus, beyond the multiplier effect, on private investment) is calculated from information in the FOMB’s plan and from an earlier (pre-hurricanes) similar calculation set out in J. Tomas Hexner and Arthur MacEwan’s “Reviving the Puerto Rican Economy Requires A Big Push of Public Infrastructure Investment,” a paper submitted to the Congressional Task Force on Economic Growth in Puerto Rico, August 2016, [https://www.finance.senate.gov/imo/media/doc/Arthur%20MacEwan%20and%20J.%20Tomas%20Hexner%20(Submission%205).pdf](https://www.finance.senate.gov/imo/media/doc/Arthur%20MacEwan%20and%20J.%20Tomas%20Hexner%20%28Submission%205%29.pdf).

The alternative starts by accepting the FOMB’s estimate of the stimulatory impact of expenditures for reconstruction and repair from the hurricanes’ damage. Thus, the growth estimates for 2020 and 2021 (and for years before the alternative is put in place) are the same as those in the FOMB plan. However, for 2022 onward, the FOMB plan’s growth estimates include the impact of the structural reforms contained in the plan. These estimates, as stated above, are unrealistically optimistic (to say nothing of the fact that some of the reforms are undesirable). Thus, for the years 2022 onward, an adjusted set of FOMB growth rates is used; these adjusted rates—which are only rough approximations—include the stimulatory impact of the reconstruction and repair expenditures but not the supposed impact of the structural reforms.

In particular, for 2022 and 2023 the FOMB’s growth estimates are adjusted downward—from 2.2% to 1.5% in 2021 and from 1.9% to1.5% in 2022. For the remaining six years of the decade, the FOMB’s projections drop to an average of 0.75% growth per year.[[10]](#footnote-10) However, this rate, too, is based on the FOMB’s unwarranted assumptions, and here this rate is reduced to 0.5%.

From the earlier Hexner and MacEwan paper referred above, it is possible to determine that the $25 billion of the alternative would raise growth rates by an average of 1.5% a year over what they would have been without the $25 billion. What “they would have been without the $25 billion” are the adjusted FOMB rates. The results are shown in Table A1.

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**Table A1: Annual Projected Percentage Growth Rates of GNP**

 FOMB Plan

 FOMB Plan adjusted Alternative

2018 -13.2 -13.2 -13.2

2019 5.9 5.9 5.9

2020 1.6 1.6 1.6

2021 1.4 1.4 1.4

2022 2.2 1.5 3.0

2023 1.9 1.5 3.0

2024 0.75 0.5 2.0

2025 0.75 0.5 2.0

2026 0.75 0.5 2.0

2027 0.75 0.5 2.0

2028 0.75 0.5 2.0

2029 0.75 0.5 2.0

2020-29 10.4 7.6 21.1

2017-29 3.1 0.5 13.1

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 That growth rates of the alternative then yield the outcomes that are noted in the text and set out in Table A2. (Again, the figures are based on the paper by Hexner and MacEwan, referred to above.)

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**Table A2: Investment and Outcomes Directly Attributable to the $25 Billion of Public Infrastructure in Boosting the Puerto Rican Economy Over the FY2020 to FY2029 Decade\***

 The Investment and Outcomes

Public Infrastructure Investment $25 billion

New Lasting Output Capacity $8.34 billion

New Lasting Jobs Created 115 thousand

Total Addition to Output During the Decade $75 billion

Job-Years of Employment Created During the Decade 1 million

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\* The full impact on production capacity will be attained only by 2031 because of time lags between investment and when the capacity becomes online.

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1. See “The New Fiscal Plan for Puerto Rico,” issued by the Financial Oversight and Management Board on April 19, 2018, pages 9 and 26. September 2017, when the hurricane devastation took place, was in Fiscal Year 2018. Unless otherwise indicated, all references to years here are to fiscal years. [↑](#footnote-ref-1)
2. The FOMB plan does project real annual growth of per capita GNP as between 1% and 1.4% in the 2030s, 2040s, and 2050s. This is because the plan also projects a steadily declining Puerto Rican population. Slow growth and its concomitant of poor living conditions are, of course, what would drive people to leave the island (and would also affect birth and death rates in ways that would contribute to the population decline). A plan with such implications is indefensible. [↑](#footnote-ref-2)
3. For an explanation of why important assumptions of the FOMB plan are unrealistically optimistic, see, “The ‘New Fiscal Plan for Puerto Rico’ (April 19, 2018): An Unrealistic and Misleading Path to Nowhere,” May 2018, https://ideas.repec.org/p/qed/dpaper/408.html. [↑](#footnote-ref-3)
4. Congressional Budget Office of the United States, “An Update to the Economic Outlook: 2018 to 2028,” August 2018, <https://www.cbo.gov/system/files?file=2018-08/54318-EconomicOutlook-Aug2018-update.pdf>. [↑](#footnote-ref-4)
5. The Puerto Rican government’s plan of April 4, 2018 called for substantial investment beyond what was needed to simply build back after the hurricanes. Its slogan was “Build Back Better,” and the plan called for strengthening the island’s critical infrastructure spurring economic revitalization. [↑](#footnote-ref-5)
6. Even though the investment called for in the alternative would begin in 2020, it would have its impact on growth only after a two-year time lag—that is, in 2022. The alternative also implies a growth rate higher than that projected by the FOMB for the years after 2029, but that is beyond the scope of the projections here. [↑](#footnote-ref-6)
7. The FOMB growth figures are as high as they are only because they ae based on unrealistically optimistic assumptions about the impact of structural changes in the economy. In the Appendix, the growth estimated in the alternative are compared not only to the FOMB Plan, but also to a more realistic, adjusted set of FOMB growth figures. This added comparison makes the alternative even more attractive. [↑](#footnote-ref-7)
8. The FOMB Plan of April 19, as cited above, Exhibit 80, page 125. [↑](#footnote-ref-8)
9. In the growth estimates of the alternative, no account is taken of the stimulatory impact of funds that go directly to the families, except to the extent that those funds and the spending of those funds affects tax revenues. This contributes to the conservative character of the alternative’s growth estimates. [↑](#footnote-ref-9)
10. The FOMB plan does not explicitly project yearly growth rates after 2023. However, its annual GNP growth rate average for the 2023 to 2030 period can be calculated from data in Exhibit 20 on page 26 of the plan. [↑](#footnote-ref-10)