The Puerto Rican Government’s Fiscal Plan: The Need for a New Start

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*Purpose of this document: The Roselló Government must create its own Fiscal Plan and tear up entirely the October 14, 2016 submission of the previous government. The Roselló plan must aim at job creation and growth in the context of the reality of recent economic performance and the implementation capacity of the government.*

The Puerto Rican government presented its Fiscal Plan, called for under PROMESA, on October 14. The PROMESA Oversight Board, however, rejected the Plan and called upon the government to make various changes, including revisions of the “baseline projections.” On December 14, the government submitted “Revised Baseline Projections” to the Board.

*The October Plan and the Revised Projections are failing in several respects, and they do not do the job of setting a path for the Puerto Rican economy to move forward.* Most generally, these documents neither address how the severe debt crisis would be dealt with nor how a foundation for economic growth would be established. *The new government should abandon the October 14 Plan and prepare a new plan* to meet the conditions of PROMESA. Serious deficiencies in the Plan and Revised Projections include:

* In the Revised Projections, there is a 16.24% decline in real GNP in FY2018, the first year of the 10 year projection. This remarkable decline, greater than the severe decline over the entire period of the current recession, is not adequately explained and its impacts—which would certainly be substantial—are not taken into account.
* The essential relationship between government action and the private sector is not effectively examined in the Plan. No convincing program for igniting economic growth is presented. In order for the private sector to play its necessary role in Puerto Rico, the government must initiate and maintain a period of significant growth.
* The Plan has no serious analysis of why the Puerto Rican economy and the government’s fiscal situation are in such terrible condition. Relying on the inaccurate “conventional wisdom” that the termination of Section of 936 is largely responsible for Puerto Rico’s economic woes, the Plan then sets out misleading policy proposals—that is, tax gimmicks designed to recreate the alleged positive impact of 936.
* The Plan gives woefully inadequate consideration to what would need to be done by the federal government to overcome Puerto Rico’s economic difficulties, in terms of dealing with the current government debt and supporting growth-directed actions in the coming years. Because it does not take account of the magnitude of the support that would be needed in terms of debt restructuring and other federal government actions, the Plan’s growth projections for the coming decade are unrealistically optimistic.
* The Plan presents the claim that it is not a program for austerity, but features of the Plan would continue on the path of austerity that has been followed for the past several years with disastrous results. In particular the Plan calls for continued reductions in government expenditures and further reductions in the government workforce. Moreover, the huge GNP decline in the Revised Projections for FY2018 would seem to both reflect and generate substantial austerity.
* There is no recognition in the Plan of the time it would take to implement its many proposals, particularly the organizational changes in the government operations. The proposals are presented and their impact incorporated into the projections of future economic activity as though they could be implemented virtually immediately, and, in addition, as though they are costless. Thus, again, the Plan’s projections are unrealistically optimistic.

**The Huge Decline Projected for FY2018**

 In the Revised Baseline Projection, real GNP falls by 16.24% in FY2018. This is an extreme decline, a one year decline greater than the decline in GNP of 14.1% that took place over the entire 2006-2015 period. This extreme drop begs for explanation, but such explanation is not apparent in the document. Moreover, there seems to be no discussion of the impacts of the drop. What, for example, would it do to investment? What would it do to out-migration? What would it do to social services? A disruption of this magnitude to economic and social life—to say nothing of politics—requires elaboration.

**Government Action and Private Action**

 Economic growth in Puerto Rico will depend on a new era of private sector investment and production. The Fiscal Plan might appear to recognize this reality, providing several proposals for changes that would seem to support renewed private sector activity. Yet, there is no reason to believe that improvements in government operations—e.g., reforming the business permitting process—or more of the tried-and-failed tax incentive approach would have significant effect on private firms’ decisions under the present circumstances. Significant private investment will not take place in a seriously depressed economy, as is the case with Puerto Rico. Even when costs are reduced by the types of proposals in the Plan, if there is minimal prospect of demand growth and the economy remains stagnant or declining, firms will not invest.

 Private sector investment is essential, but government action is needed to show private actors that growth has begun and will continue. One essential step is resolving the debt crisis (about which more below). In addition, government must undertake public infrastructure investments that will start the growth process. While the Plan does include proposals for infrastructure investment, it does so on a seriously insufficient scale. The government needs to “jump start” the economy. The expenditures and employment expansion will ignite the private sector response. (See below for elaboration.)

 Private action will be the basis for lasting economic growth in Puerto Rico, but government action is essential in providing a context for that private action.

**No Serious Analysis of the Current Economic Debacle**

The Plan’s analysis of the origins of the economic crisis is largely confined to the following sentence at the beginning of the Introduction in the Executive Summary (p. 4):

“Puerto Rico’s GDP has contracted for nine of the last ten years in real terms, driven by the expiration of incentives provided under Section 936 of the U.S. tax code and the U.S. financial crisis, and exacerbated by outmigration and extraordinary austerity measures taken by the Commonwealth.”

Viewing the expiration of 936 as the principal and dominating cause of the long-lasting recession has become the “conventional wisdom,” but this view is not justified by the facts. The myth that the era of 936 was one of strong economic growth is simply wrong. From the mid-1970s to 2000, the Puerto Rican economy lagged further and further behind the U.S. economy. Although, as the Plan reports (p. 75) manufacturing employment dropped substantially from the initiation of the phase-out of 936, the decline did not take place in those sectors of manufacturing where 936 activity was concentrated—though employment decline in those sectors did take place after 2006 as the recession developed. Moreover, the decline of manufacturing employment in Puerto Rico was accompanied by a similar, but somewhat less severe decline in the United States, suggesting that something much more was involved than the termination of 936. While some production facilities of 936 firms have closed in recent years, the causes of these closures cannot generally be attributed to the termination of 936. Other causes—for example, the ending of important patents—appear to have been more significant.[[1]](#endnote-1)

The Plan’s superficial and thus inaccurate analysis of the causes of the economic decline leads to bad policy proposals. In particular, the Plan calls for the federal government to “Provide Puerto Rico with a tax treatment that encourages investment and job creation, such as modifications to Section 245a of the U.S. Internal Revenue Tax Code and extension of Section 1031.” (p.78) This proposal is intended to restore the alleged positive impact of Section 936. Yet, as noted, the 936 era was not an especially good period for economic growth. Growth was weak, and the 936-based program favored U.S. firms over Puerto Rican firms, undermining the basis for the emergence of a strong indigenous private sector. Section 936 led to a bloated manufacturing sector that pre-empted a focus on other areas of the economy where Puerto Rico would have real advantages.[[2]](#endnote-2)

**An Inadequate Specification of What is Needed**

The plan says nothing about the amount of debt restructuring that is needed to move Puerto Rico out of crisis and create the possibility for implementation of an economic growth program. It justifies this approach by saying, “…a specific debt restructuring proposal as part of the Fiscal Plan would be premature at this time...” (p. 72). Yet, it has little meaning to set out a plan for the economy without clarifying, at least roughly, the amount that the government’s debt obligations would be altered. It is inadequate and misleading to pretend that the Puerto Rican economy could establish a basis for renewed private investment and significant economic growth without stressing that debt obligations must be substantially reduced. In addition to federal support for substantial debt restructuring, other federal support will be needed for Puerto Rico to re-enter the bond market.

The most favorable projection offered in the Plan for economic growth over the next decade shows GDP rising by more than 13% “with U.S. government action.” However, this projection is presented without explanation of a proposal for debt restructuring, though it does include unspecified assumptions regarding other federal support. Yet, U.S. government support in debt restructuring would be essential to any program yielding significant growth.

An alternative projection for the economy over the next decade that is based on much more favorable assumptions—including a 50% reduction in debt servicing and a much larger amount of infrastructure investment—yields an increase in output of 7% over the decade. (See paper accompanying this document.) This is less than half as great as the Plan’s projection, which is based on some federal action but with neither of these crucial assumptions, suggesting the high and misleading optimism embodied in the Plan’s projections.[[3]](#endnote-3) However, the alternative projection does not include the impact on private activity that would be catalyzed by the large infrastructure investments; if the Plan projections do include this indirect impact on private sector activity (i.e., beyond the traditional multiplier effect), it offers no reference to this impact or any explanation of how it is estimated.

**An End to Austerity?**

The Plan describes the austerity program that has been implemented by successive governments during the past decade and correctly points out (as noted above) that the severe downturn has been “exacerbated by … extraordinary austerity measures taken by the Commonwealth.” The Plan is then presented as abjuring austerity. Yet, proposals in the Plan certainly suggest more austerity.

A prime example is the proposal for further reduction in the government work force. The Plan points out that the government workforce has been reduced by 24% over the past decade and that now the workforce as a percentage of the population, at 6%, is in line with the figures for the states. (p. 15) The Plan then goes on to propose further reductions (which appear quite substantial, though the data presented are not clear) in the government workforce. In particular: “The Fiscal Plan calls for the Commonwealth to reduce its payroll costs, but does so through a 2% annual payroll attrition target that relies on the Commonwealth replacing departing workers only when necessary.” (p. 38) Reducing the government expenditures by workforce by attrition rather than layoffs can be more humane, but it remains as much a program of austerity.

Moreover, the government workforce reduction, both already undertaken and proposed, is based on the assumption that government productivity will not be harmed. Yet, it stretches credulity to claim that numerous government activities will be improved—e.g., shorter time for consideration of various business permits—with a smaller workforce. No explanation is offered regarding how this productivity improvement will be accomplished (let alone how long it will take or how decisions will be made regarding when it is “necessary” to replace departing workers).

Thus, the reduction in the government workforce and payroll would involve both a reduction in the government’s contribution to aggregate demand (the usual measure of austerity) and a potential for undermining changes in government operations that the Plan puts forth as supporting private sector advances—to say nothing of how social services would be undermined. Perhaps it is possible to implement the changes without ill effect, but this cannot simply be assumed. The Plan, if it is to be taken seriously, must support this assumption with data and explanation.

Perhaps the authors of the Plan would argue that the austerity impact of their proposals would be offset by spending proposals that are also part of the Plan. The difficulty is that, while various spending increases are proposed, there is no discussion of where the funds for this spending would come from. (The failure to explain where the funds would come from is connected to the failure to discuss debt service reduction and other support needed from the federal government.)

**It Takes Time**

While the plan proposes numerous changes in government operations, there appears to be no consideration of the time it would take to implement these proposals or of the costs (in terms of effectiveness) that implementation would involve.

For example, the Plan proposes a reduction in the number of government agencies from the 114 that existed in 2015 to 66 in 2018 and states that considerable cost saving will be achieved in rent (office space) and utilities. Such consolidations, however, can be complicated processes, requiring planning time and effective reorganization of functions, and, even when fully justified, can yield short-run and costly inefficiencies.

Another, and quite important, example is how the Plan would improve the tax system. The Plan recognizes that “The Commonwealth Must Increase Revenue Collections by Boosting its Capture Rate and Reducing Tax Evasion.” (p. 41) It proposes several steps to accomplish this goal, including upgrading technology, reorganizing tax collection systems, and improving tax enforcement. The problems with tax collection, however, are deep rooted and long standing. Moreover, they have an important political component. Significant change in the system would take years, and even then would require a degree of political will that has not been present in past efforts. It is necessary to improve tax collection, but it will take time and continuing positive political pressure.

The failure of the Plan to consider the time it would take to implement its many proposals means that its projections of economic growth, dependent on many of these proposals, cannot be taken seriously. To meet those projections, given the realities of the time it would take to implement the proposals, would require substantial support from the federal government. It would be desirable to face up to this need at the outset.

**Start Afresh**

The Roselló Government has articulated a clear mission statement, *focusing on jobs and growth*, and it should start afresh from that mission statement in developing a new fiscal plan to revive the economy and lay the foundation for growth. Its new fiscal plan must specify realistic goals and a realistic process-time for achieving these goals. The Oversight Board’s role will be a facilitator in reviving the economy. The burden for executing the plan, however, rests on the Roselló Government. And the ultimate prime movers will be the people of Puerto Rico, through their hard work and entrepreneurial acumen.

1. For elaboration of this critique of the “conventional wisdom” regarding Section 936, see Arthur MacEwan, “The Effect of 936,” paper submitted to the PROMESA Task Force. [↑](#endnote-ref-1)
2. See, for example, Juan Carlos Puig, “Tourism: An Opportunity Waiting for Action,” paper submitted to the PROMESA Task Force.

 [↑](#endnote-ref-2)
3. This alternative projection of the economy is contained in the paper accompanying this document: J. Tomas Hexner and Arthur MacEwan, “Reviving the Puerto Rican Economy Requires a Big Push of Public Infrastructure Investment.” This paper was submitted to the PROMESA Task Force. [↑](#endnote-ref-3)