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Testimony Before the United States Senate Committee on Finance Public Hearing on Financial and Economic Challenges in Puerto Rico

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> The paths of progress in history have proved to be more devious and unpredictable than the putative managers of history could understand.
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> —Reinhold Niebuhr, *The Irony of American History*, (1952)

Good morning, Chairman Hatch, Ranking Member Wyden, and Members of the United States Senate Committee on Finance. For the record, my name is Sergio Marxuach and I am the Policy Director at the Center for a New Economy, Puerto Rico's only, not-for-profit, independent, and non-partisan think tank. I thank you for the opportunity to appear today before this Committee to discuss Puerto Rico's financial and economic challenges.

Puerto Rico, usually invisible to the U.S. media, has been in the news recently, especially since the governor announced that the island's public debt of $72 billion, equivalent to 103% of its GNP, was "unpayable" and needs to be restructured.[1]

The island, a U.S. territory since 1898, has experienced severe economic problems for several years now. Its economy has been contracting or stagnant at least since 2006, and unemployment, poverty, and inequality levels are extremely high, especially in comparison with the fifty states in the mainland.[2]

Furthermore, decades of fiscal and economic mismanagement have engendered an economy characterized by: (1) chronic primary deficits; (2) high debt-to-GNP ratios; (3) low employment levels in the formal economy; (4) a large informal economy, encompassing both legal and illegal activities; (5) significant government corruption and predatory rent-seeking behavior in both the public and private sectors[3]; (6) substantial tax evasion; (7) a hollow productive base; and (8) high levels of private consumption and indebtedness enabled by having access to a stronger currency than its economic fundamentals would warrant. In our opinion, the parallels with Greece are quite evident for all to see and none to misunderstand.

Notwithstanding this dismal economic situation, the island managed to *triple* its public debt from $24 billion in 2000 to $72 billion in 2015. Indeed, during this period Puerto Rico's public indebtedness grew at a compound annual rate of 7.6%, while its income (GNP) grew at a nominal rate of only 3.6%.

Given that Puerto Rico's indebtedness grew at an average annual rate two times faster than the growth rate of its GNP during the past fifteen years, it should not be surprising that Puerto Rico's public debt currently exceeds its GNP. To be fair, however, for decades the

[1] In Puerto Rico, GNP, which measures income earned by residents or by locally-owned production factors, is a

[2] To put the situation in perspective, consider that Puerto Rico's per capita income is one third of United States' and close to one half of the poorest state, Mississippi; its poverty rate is 46% in comparison with 15% in the United States as a whole; and 38% of its population receives nutritional assistance, while only 13% of the population in the fifty states receives such assistance.

[3] "Rent-seeking" can be defined as the pursuit of uncompensated value from other economic agents; in contrast with profit-seeking, where economic agents seek to create value through mutually beneficial economic activity

borrowed money was put to good use to finance the construction of public schools, hospitals, highways, and other essential infrastructure. The problem is that during the last twenty years or so, a large portion of the money borrowed by issuing long-term debt was used to finance budget deficits, operating expenses, and classic pork-barrel spending.

We at CNE had warned for years that Puerto Rico's levels and rates of indebtedness were not sustainable.[4] In February 2014, the three principal rating agencies ratified our analysis by downgrading the Commonwealth's debt, as well as debt issued by several of its agencies and instrumentalities, to speculative or non-investment grade. Since then, the Commonwealth and its agencies and instrumentalities have been downgraded further by the three main rating agencies.

The rating downgrades had a material adverse effect on the Commonwealth's finances because they essentially shutdown its access to the capital markets, at least at reasonable rates. This, at a time when the central government is still running a sizeable budget deficit, several of the Commonwealth's agencies and instrumentalities face significant maturities in the near term, the economy is contracting at an estimated annual rate of 1.2%, liquidity is running extremely tight, and net outmigration has increased to levels not seen since the 1960s.

Given the magnitude and multiplicity of challenges faced by Puerto Rico it should be obvious that there are no quick fixes to solve the island's fiscal and economic problems.

In our opinion, what is needed in the *short-term* is a two-prong action program, both at the federal level and in Puerto Rico. In Washington, Congress needs to implement a comprehensive program, remove some of the disadvantages imposed on Puerto Rico under the current political arrangement, and eliminate some long-standing discriminatory policies. The current situation simply does not allow for piecemeal action by Washington, a wide-ranging plan is needed.

Specifically, this Committee could introduce legislation on two issues that could have a positive and significant short-term impact on both the fiscal and economic growth parts of the problem.

On the fiscal side, the cost of the Government Health Plan is one of the principal drivers of Puerto Rico's budget deficit.[5] Providing Puerto Rico equal treatment under federal health programs, such as Medicare, Medicaid, and the Affordable Care Act would provide the Commonwealth with some much-needed fiscal space and address a long-standing injustice inflicted on Puerto Ricans. For the truth of the matter is that Puerto Rican workers and

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[4] See, for example, CNE's Policy Brief—Municipal Fiscal Crises in the United States: Lessons and Policy Recommendations for Puerto Rico, published in April 2006.
[5] *Commonwealth of Puerto Rico Quarterly Report,* dated May 7, 2015, p. 20-21 and 37-40.

employers pay the same payroll taxes as workers and employers in the mainland, yet benefits to Puerto Rico are unfairly rationed by federal legislation.[6]

On the economic growth side of the equation, we recommend extending the federal Earned Income Tax Credit (EITC) program to Puerto Rico. The federal EITC is the most effective anti-poverty program in the United States. Recent research also shows that it encourages work, promotes savings, helps poor families smooth out the effect of unexpected financial shocks, and builds a strong sense of future orientation among recipients.[7] Extending this program to Puerto Rico, which would provide a significant wage supplement to Puerto Rican working families, could be expected to stimulate aggregate demand in the short-run.

Outside the scope of this Committee's jurisdiction a federal comprehensive policy package could include approving legislation to authorize the Puerto Rican government to allow its distressed agencies and municipalities to file for bankruptcy under Chapter 9 of the U.S. Bankruptcy Code; exempting Puerto Rico from coastwise shipping laws (Jones Act), which require the use of relatively expensive U.S. vessels for trade between Puerto Rico and the U.S. and approving legislation to relax the overly binding income and asset limits that apply to recipients of certain social assistance programs.

This federal assistance would be conditioned on Puerto Rico agreeing to (1) increase tax revenues by improving enforcement efforts, closing down ineffective tax loopholes, and modernizing its property tax system; (2) crackdown on government corruption; (3) significantly improve its Byzantine and unduly opaque financial reporting; (4) reform an unnecessarily complicated permitting and licensing system that stifles innovation; (5) undertake affirmative actions to materially lower energy and other costs of doing business in the island; and (6) substantially improve educational standards.

In addition to all of the above, Puerto Rico also needs to obtain some debt relief. After years of relying on accounting gimmicks, forward refundings; back-loaded "scoop and toss" refinancings, capitalized interest payments, and other short-term, expensive liquidity fixes, the Commonwealth has finally admitted that its debt is unsustainable.

While it is true that Puerto Rico's capacity to repay its debt ultimately depends on restoring economic growth in the island, there can be no economic recovery without debt

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[6] See United States Government Accountability Office, *U.S. Insular Areas: Multiple Factors Affect Federal Health Care Funding,* GAO-06-75, (October 2005), and *Puerto Rico: Information on How Statehood Would Potentially Affect Selected Federal Programs and Revenue Sources,* GAO-14-31, (March 2014).

[7] See Bruce D. Meyer, "The Effects of the Earned Income Tax Credit and Recent Reforms" in *Tax Policy and the Economy*, Volume 24, Jeffrey R. Brown, ed., (University of Chicago Press, 2010); Sara Sternberg Greene, *The Broken Safety Net: A Study of Earned Income Tax Credit Recipients and a Proposal for Repair*, New York University Law Review, Vol. 88, No. 2, May 2013; V. Joseph Hotz, Charles H. Mullin, and John Karl Scholz, *Examining the Effect of the Earned Income Tax Credit on the Labor Market Participation of Families on Welfare*, NBER Working Paper 11968, (National Bureau of Economic Research: Cambridge, MA, 2006); and Chuck Marr, Chye-Ching Huang, and Arloc Sherman, *Earned Income Tax Credit Promotes Work, Encourages Children at School, Research Finds*, (Center on Budget and Policy Priorities: Washington, DC, 2014), among others.

sustainability and that, in turn, is not possible without significantly restructuring at least some of the debt.

According to a recent paper by Carmen Reinhart and Christoph Trebesch "'kicking the can down the road' via cash flow relief and debt rescheduling does not facilitate economic recovery in debtor countries. In protracted crises, growth only picks up after deeper debt relief, such as after the Brady plan."[8]

Analyzing 35 debt relief episodes in 30 middle and high-income countries during period between 1978 and 2010, these researchers found (1) that "sovereign debt relief averaged…16% of GDP and 36% of external debt in the middle- high-income emerging markets [crises]" during that period and (2) emerging market countries that received significant debt relief reported, on average, an 11% increase in per capita income during the five years following "decisive debt relief".

They conclude that "softer forms of crisis resolution, such as debt rescheduling, temporary payment standstills, and bridge lending operations were not generally followed by higher growth and better ratings. [And] These crisis resolution tools were ineffective in solving debt crises that had been dragging on for several years."[9] Therefore, obtaining significant debt relief for Puerto Rico appears to be a necessary condition to restore economic growth in the island.

On the other hand, it should be obvious that obtaining debt relief is not sufficient, in and by itself, to jumpstart economic growth. The important point in the case of Puerto Rico, is that any savings derived from a reduction in debt service be used exclusively to advance and implement a renewed industrial policy, broadly defined, based on horizontal policies such as the ones described above, discovering new sectorial opportunities through a process of dialogue and consultations with key stakeholders in the private and civic spheres, and "identifying spillovers, externalities, and other areas where society could learn more."[10]

This new learning, in turn, would lead to: new investment in R & D, increased productivity, identifying new areas of comparative advantage for Puerto Rican firms, higher economic growth and the creation of high-quality jobs, which at the end of the day is what will categorically end Puerto Rico's economic stagnation. We at the Center for a New Economy are currently working with experts from Columbia, Brown, MIT, and Brookings, among other institutions, to develop this medium to long-term industrial policy for Puerto Rico.

Finally, I would be negligent if I did not raise the question of whether Puerto Rico has reached the limits of what it can do to improve the quality of life of its people within the

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[8] Carmen M. Reinhart and Christoph Trebesch, *Sovereign Debt Relief and Its Aftermath*, Faculty Research Working Paper Series, John F. Kennedy School of Government, RWP 15-028 (June 2015), p. 33.
[9] Id. at p. 34.
[10] Joseph E. Stiglitz and Bruce C. Greenwald, *Creating a Learning Society: A New Approach to Growth, Development, and Social Progress*, (Columbia University Press: New York, 2014), p. 489.

constraints imposed by its subordinate political status. Neither a sovereign country nor a state of the union, Puerto Rico has no authority to negotiate international treaties, no access to emergency financing from multilateral institutions, no monetary policy instruments, limited fiscal policy tools, nominal representation in Congress, and the U.S. Supreme Court has determined it is constitutionally permissible for Congress to discriminate against Puerto Rico in the application of federal programs as long as there exists a "rational basis" for doing so.

Thus, Puerto Rico lives in a state of permanent limbo, a status that is both humiliating to Puerto Ricans and unworthy of the United States. Simply stating that it is up to Puerto Ricans to decide their political status, while true, is insufficient because the United States' Congress has long-standing legal and moral obligations with respect to Puerto Rico that it has failed to honor. Congressional failure to act not only highlights a shameful lack of political will, it also weakens the United States' moral standing and its ability to effectively utilize its "soft power" in the international arena, when it argues for better treatment for Hong Kong by China, for the Palestinians by Israel, or for Greece by members of the Eurozone.[11]

In this context I would like to quote from the remarks made just a few days ago by an extraordinary man who came to this magnificent building to address a rare joint session of Congress. Drawing from a deep well of wisdom that has accumulated for over twenty centuries, he stated:

> "Your own responsibility as members of Congress is to enable this country, by your legislative activity, to grow as a nation. You are the face of its people, their representatives. You are called to defend and preserve the dignity of your fellow citizens in the tireless and demanding pursuit of the common good, for this is the chief aim of all politics. A political society endures when it seeks, as a vocation, to satisfy common needs by stimulating the growth of all its members, especially those in situations of greater vulnerability or risk. Legislative activity is always based on care for the people. To this you have been invited, called and convened by those who elected you."[12]

In conclusion, Mr. Chairman, I thank you and the Committee once again for the opportunity to participate in this important public policy debate and look forward to answering any questions that you or Committee Members may deem appropriate.

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[11] See Joseph S. Nye, Jr., *Soft Power: The Means to Success in World Politics*, (Public Affairs: New York, 2005)

[12] Pope Francis, *Remarks Before the Congress of the United States of America*, 24 September 2015.