The Need for Federal Action to Address Puerto Rico's Fiscal, Debt and Economic Crisis

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Committee on State and Federal Legislation
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Madame Chair and Members of the Committee on State and Federal Legislation, thank you for the opportunity to testify today. My name is James Parrott, Deputy Director and Chief Economist of the Fiscal Policy Institute (FPI), a nonpartisan nonprofit education and research organization focused on New York economic and fiscal policy issues.

The broad crisis and the need for a comprehensive strategy

The immediate crisis is that the Commonwealth of Puerto Rico cannot pay interest on its $72 billion in combined outstanding debt, which has grown more than twice as fast as the island's GNP over the past 15 years. Its debt was downgraded in early 2014 to below investment grade, the Government Development Bank (GDB) last borrowed at rates in the mid-teens, and its recent failure to make debt payments has virtually closed off credit market access. But the debt crisis is inseparable from a broader fiscal and economic crisis.

Among others, the June report from former IMF economist Anne Krueger and colleagues describes the inter-related dimensions of the crisis and notes that "the debt cannot be made sustainable without growth, nor can growth occur in the face of structural obstacles and doubts about debt sustainability."[1] The latest fiscal report from the Center for a New Economy (CNE) highlights the imperative for not only a credible fiscal adjustment plan but also the comprehensive restructuring of the three insolvent infrastructure public authorities[2] (including their debt), and the recapitalization of the Government Development Bank (GDB, the government's fiscal agent).[3]

As the CNE puts it: even were Puerto Rico to achieve sustainable budget stability (i.e., no operating deficits in the general fund or authority budgets), it cannot service its debt without robust economic growth that CNE pegs at 6.8% annually. Growth of that magnitude is a far cry from the average 1% nominal GNP growth of the past 3 years. In this context, it would be "rational" for Puerto Rico's debtors to accept a debt write-down because that will increase the

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[1] Anne O. Krueger, Ranjit Teja, and Andrew Wolfe, ***Puerto Rico—A Way forward***, June 29, 2015, p. 1.
[2] Puerto Rico Electric Power Authority (PREPA), Puerto Rico Aqueduct and Sewer Authority (PRASA), and Puerto Rico Highways and Transportation Authority (PRHTA).
[3] Sergio M. Marxuach, ***Analysis of the Governor's Budget Request for Fiscal Year 2016***, Center for a New Economy, June 2015, pp. 33-34.

likelihood of the investment and economic growth needed to come close to servicing the adjusted debt.

To return economic growth to the 5-7% range last achieved in the early 2000s, a new mix of economic and labor market policies is needed, along with restructuring and revitalizing key economic sectors, including electric generation, transportation, agriculture, health care, tourism and higher education. As the unsustainability of the debt became apparent in recent years, Puerto Rico has adopted dramatic fiscal and other changes including steep budget cuts and major tax reforms, and yet shrinking the structural budget deficit is not sufficient. Broad economic reforms are also essential. Budget austerity, the elimination of the Work Tax Credit and increased consumption taxation without a mechanism to lessen the burden on low-income communities are extracting a heavy toll from those least able to bear it, and will make sustained economic growth harder to achieve.

Puerto Rico's political status and the political-economic context

Puerto Rico's unique political status vis-à-vis the Federal government compounds its challenges in addressing the crisis. Puerto Rico is denied voting representation in either house of Congress even though more U.S. citizens (3.5 million) reside there than in two-fifths (21) of the states. Puerto Rico does not have an autonomous currency,[4] nor access to international financial authorities such as the IMF that could provide emergency lending assistance.[5] Puerto Ricans have uneven access to federal programs. They are covered by Social Security, Medicare, and Federal food stamps, and while Puerto Rico does participate in Medicaid, it receives a much lower Federal match than its relatively low per capita income would otherwise entitle it to if it were a state. While Puerto Ricans pay payroll taxes, most do not pay Federal income taxes.

One of the biggest obstacles at present is that Federal law does not authorize the Puerto Rican government to allow its distressed public authorities to file bankruptcy under Chapter 9 of the U.S. Bankruptcy Code, authority that would give Puerto Rico access to a well-structured process under Federal court supervision to re-negotiate certain categories of its debt.[6]

Without, in Nobel economist Joseph Stiglitz's words, the "privileges of a state or the powers of a sovereign," Puerto Rico leads a quasi-colonial existence too often treated mainly as an offshore tax haven by the United States.[7] Washington bears considerable responsibility for the economic decline that figures so prominently in Puerto Rico's current crisis. The passage of NAFTA in 1993 and the 1996 repeal of the federal possessions tax credit (with a 10-year phase-out) that was claimed by many of the U.S. corporations dominating Puerto Rican's manufacturing sector into the late 1990s resulted in a significant decline in manufacturing activity on the island.[8] Between

[4] For independent countries not part of currency unions such as the Euro, debt crises typically are addressed through currency devaluation.

[5] Joseph E. Stiglitz and Mark Medish, "What the United States Owes Puerto Rico," ***Wall Street Journal***, August 14, 2015. IMF involvement could provide emergency lending that could facilitate some form of debt restructuring.

[6] Center for a New Economy, ***Chapter 9 for Puerto Rico: Necessary but not Sufficient***, July 29, 2015.

[7] Stiglitz and Medish.

[8] U.S. Government Accountability Office, ***Fiscal Relations with the Federal Government and Economic Trends during the Phase out of the Possessions Tax Credit***, May 2006. See, also, Juan Gonzalez, "Puerto Rico's economic 'death spiral' can be helped if Washington allows the island to declare bankruptcy," ***The New York Daily News,*** August 4, 2015.

1996 and 2014, manufacturing employment dropped by nearly half. [9] Washington has failed to work with Puerto Rico to craft a viable alternative economic strategy in the wake of NAFTA and the possessions tax credit repeal.

Over the past decade, the size of Puerto Rico's economy has declined by roughly 20 percent, and the accelerating out-migration of Puerto Ricans to the mainland has reduced the island's total population by nearly 7 percent.[10]

Addressing the fiscal-debt-economic crisis

The fiscal-debt-economic crisis facing Puerto Rico is monumental and a path forward requires far-reaching actions on many fronts. Debt restructuring and relief is in the interests of bondholders as much as those living on the island. No level of debt is sustainable without economic growth, and economic growth is unlikely as long as the debt is unsustainable. But there is little chance for such debt restructuring without comprehensive and difficult fiscal and economic changes. A far-reaching and credible fiscal plan with convincing expenditure, revenue and budget management changes is essential. Severe fiscal austerity, however, will impede any economic rebound.

There is merit in the suggestion for an independent fiscal oversight board to advise on the budget and oversee its implementation as one component of a comprehensive strategy. A state-authorized financial control board that brought together the major elected leaders and private sector representation played a key role in New York City's recovery from its mid-1970s fiscal crisis by establishing a structure for budget discipline and transparency that provided some measure of reassurance to bondholders and credit rating agencies without usurping accountability to the electorate. It is essential that any such independent financial board include representation from low- and moderate-income Puerto Ricans.

Puerto Rico's tax structure, riddled as it is with a large number of individual and business tax breaks, is in need of a complete overhaul. KPMG concluded its in-depth examination of the island's tax system by calling for aggressive measures to curb a deep-seated culture of tax evasion.[11]

The Federal government needs to take several urgent steps to redress the third-class treatment of the health care needs of the 60 percent of the island's population that depends on Medicare or Medicaid. Puerto Rico's Medicare reimbursement rates are 40 percent lower compared to the mainland and the Medicaid program receives 70 percent less than any state and is capped. Further drastic cuts in Medicare and Medicaid payments, including for the Medicare Advantage program are scheduled for 2016. Without Federal changes, the viability of Puerto Rico's vital health care system is in jeopardy. The health care sector accounts for about a fifth of the island's

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[9] James Surowiecki, "The Puerto Rican Problem," ***The New Yorker***, April 6, 2015.

[10] ***Puerto Rico Fiscal and Economic Growth Plan***, Prepared by the Working Group for the fiscal and Economic Recovery of Puerto Rico Pursuant to Executive Order 2015-022, September 9, 2015, pp. 8-9. According to the 2014 American Community Survey, Puerto Rico's total population fell by 67,000 in 2014.

[11] KPMG, Commonwealth of Puerto Rico Tax Reform Assessment Project, ***Unified Tax Code of Puerto Rico: Tax Policy Implementation Options Executive Summary***, October 31, 2014.

economy, and it has already suffered a substantial exodus of doctors to the mainland in recent years.[12]

New York City Council Resolutions Urging Federal Action

The three resolutions[13] before this Committee speak to essential actions needed by the U.S. Congress and the President. The resolutions address the need to extend to Puerto Rico the authority to use bankruptcy as a vehicle to orderly restructure the debt of its major authorities, to improve Puerto Rico's treatment under the Medicare and Medicaid programs, and to exempt the island from the Merchant Marine Act of 1920 (aka the "Jones Act") that significantly increases shipping costs to and from the island and that has hampered Puerto Rico's economic performance.

I support these resolutions and applaud the Council for raising these important issues that bear so heavily on Puerto Rico's economic and political viability.

Thank you for the opportunity to testify today.

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[12] Lizette Alvarez and Abby Goodnough, "Puerto Ricans Brace for Crisis in Health Care," ***The New York Times***, August 2, 2015; Puerto Rico Healthcare Crisis Coalition, "The Issue," http://puertoricohealthcarecrisis.com/the-issue/

[13] New York City Council ***Res. No. 767***, Resolution calling upon the United States Congress to pass and the President to sign H.R. 870, also known as, the Puerto Rico Chapter 9 Uniformity Act of 2015; ***Res. No 818***, Resolution calling upon the United States Congress to pass and the President to sign the Improving the Treatment of the U.S. Territories under Federal Health Programs Act of 2015 (H.R. 2635), which would make improvements to the treatment of the United States territories under the Medicare and Medicaid programs; and ***Res. No. 836***, Resolution calling upon the United States Congress to pass and the President to sign legislation allowing an economic hardship exemption for Puerto Rico from the Merchant Marine Act of 1920, commonly known as the "Jones Act."