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Puerto Rico Needs Economic Freedom, Not Bailouts

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Puerto Rico is in a debt crisis, and Governor Alejandro García Padilla (D) has announced that “the debt is not payable” given the commonwealth’s large deficits and collapsing economy.¹ Presenting a government-commissioned report, economist Anne Krueger explained that the origin of Puerto Rico’s debt is decades of stimulus spending and economic stagnation:

Since 1996, there has been virtually no economic growth in Puerto Rico. At first, people thought there was a recession, but it was not. It has been two decades of stagnation with falling population and no measurable increase in real per capita incomes. Attempts to “offset the recession” with expansionary fiscal policy financed by borrowing have been made for the past two decades.... Solving Puerto Rico’s problems through fiscal expansion has not worked, and will not work.²

In the current crisis, policymakers will be tempted to focus on only the short-term consequences of debt resolution, but any step toward debt resolution should be coupled with reforms that will give Puerto Rico the potential for future growth. Otherwise, Puerto Rico will follow the same path as Greece, which defaulted on its debt in 2011,³ again in 2012,⁴ and is poised on the brink of a third default in 2015.

Congress should free Puerto Rico from the punitive Jones Act and the federal minimum wage and give Puerto Rico’s legislature flexibility in administering welfare programs. However, Puerto Rico’s own lawmakers have the final responsibility to ease the restrictions on work and trade that they have enacted over the years.

How Puerto Rico Got Here

Puerto Rico’s convergence to mainland income levels was interrupted by the imposition of federal rules that curtailed growth. Most notably, Alida Castillo-Freeman and Richard Freeman found that a 1970s minimum wage increase destroyed almost one-tenth of the island’s jobs.⁵

The economic slowdown became stagnation when two economic crutches were removed. First, in the early 1990s, “the U.S. began closing military bases on the island.”⁶ Then, corporate tax preferences were removed,⁷ although Puerto Rican residents retained their immunity from the individual federal income tax. These twin losses led to the emigration of hundreds of thousands of job-seeking Puerto Ricans, a housing price collapse, reduced investment, and a sharp reduction in banking system assets that produced a credit crunch. Economic competitiveness was further damaged by high oil prices, the 2008 financial crisis, and the Great Recession.

The response of the government—expanding government and government-owned enterprise payrolls by borrowing more than \$70 billion using its privileged access to the tax-free U.S. municipal bond and other capital markets—compounded the island’s economic problems.⁸ The government made things even worse with weak controls on public expenditures, nontransparent management of public debt, and toleration of rampant tax evasion.

This paper, in its entirety, can be found at
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Dealing with Bad Debt

Governor García Padilla has requested that Congress extend Chapter 9 bankruptcy to Puerto Rico so that the commonwealth can continue to borrow despite its inability to repay its creditors.⁹ Chapter 9 bankruptcy is available to municipalities, but not to U.S. states. The municipal bankruptcy process allows municipalities to stiff-arm current bondholders while borrowing from new bondholders. Investors purchased Puerto Rican debt at very low interest rates precisely because federal law forbade Puerto Rico and its public enterprises from using Chapter 9. If Chapter 9 had been available to Puerto Rico, the commonwealth would have found itself in a debt crisis much sooner.

Instead of changing the rules at the point of crisis, Puerto Rico and its creditors need to negotiate a partial default under existing terms. Congress should not use its authority to protect investors who made bad investments or government agencies that made

bad loans. Puerto Rico should focus on restructuring its existing debts and enacting economic reforms that will put its economy on a sustainable path.

Structural Reforms

The report on Puerto Rico's economy co-authored by Krueger is a brutal indictment of the commonwealth's laws and government practices.¹⁰ Despite the large share of employment in the public sector, the economists found that the Puerto Rican government fails to budget properly and lacks transparency and accuracy.¹¹

Puerto Rico should reform its labor laws so that they are less restrictive than laws on the mainland rather than more restrictive. Public employees in Puerto Rico receive twice as much vacation time as mainland public employees. Even in the private sector, layoffs are "onerous," which of course means that businesses are more reluctant to hire unproven workers.¹² Rather than imitating the so-called

1. Michael Corkery and Mary Williams Walsh, "Puerto Rico's Governor Says Island's Debts Are 'Not Payable,'" *The New York Times*, June 28, 2015, <http://www.nytimes.com/2015/06/29/business/dealbook/puerto-ricos-governor-says-islands-debts-are-not-payable.html> (accessed June 29, 2015).
2. Anne O. Krueger, "Puerto Rico's Growth and Macroeconomic Situation and Prospects," Government Development Bank for Puerto Rico, June 29, 2015, <http://www.gdb-pur.com/documents/PRGROWTHANDMACROECONOMICSSITUATION.pdf> (accessed June 29, 2015).
3. David Gow, "Eurozone Crisis: Banks Agree 50% Reduction on Greece's Debt," *The Guardian*, October 27, 2011, <http://www.theguardian.com/world/2011/oct/27/eurozone-crisis-banks-50-greece> (accessed June 29, 2015).
4. "The Wait Is Over," *The Economist*, March 17, 2012, <http://www.economist.com/node/21550271> (accessed June 29, 2015).
5. Alida Castillo-Freeman and Richard Freeman, "When the Minimum Wage Really Bites: The Effect of the U.S.-Level Minimum on Puerto Rico," in George J. Borjas and Richard B. Freeman, eds., *Immigration and the Workforce: Economic Consequences for the United States and Source Areas* (Chicago: University of Chicago Press, 1992), pp. 177-212, <http://www.nber.org/chapters/c6909.pdf> (accessed June 30, 2015).
6. Aaron Kuriloff, "Puerto Rico Urges Concessions from Creditors," *The Wall Street Journal*, June 29, 2015, <http://www.wsj.com/articles/puerto-rico-releases-report-calling-for-concessions-from-creditors-1435588154> (accessed June 30, 2015).
7. Anne O. Krueger, Ranjit Teja, and Andrew Wolfe, "Puerto Rico: A Way Forward," Government Development Bank for Puerto Rico, pp. 3-4, June 29, 2015, <http://www.gdbpr.com/documents/PuertoRicoAWayForward.pdf> (accessed June 30, 2015).
8. Norbert Michel, "Changing U.S. Bankruptcy Law Will Not Help Puerto Rico," *Forbes*, June 1, 2015, <http://www.forbes.com/sites/norbertmichel/2015/06/01/changing-u-s-bankruptcy-law-will-not-help-puerto-rico/> (accessed June 30, 2015).
9. Suzanne Gamboa, "Puerto Rico Governor: We Can't Let Our Debt Bring Us to Our Knees," NBC News, June 29, 2015, <http://www.nbcnews.com/news/latino/puerto-rico-governor-we-cant-let-our-debt-bring-us-n384121> (accessed June 29, 2015). Congress enacted Chapter 9 of title 11 of the United States Code, on "Adjustment of Debts of a Municipality," pursuant to its power under Article I of the U.S. Constitution to "establish...uniform Laws on the subject of Bankruptcies throughout the United States...." Chapter 9 allows the municipalities of the 50 states, with the permission of their respective state governments, to obtain adjustments of municipal debts. 11 U.S.C. 101(52) and 109(c). The states themselves, and territories of the U.S., including the Commonwealth of Puerto Rico, are not eligible to obtain adjustment of debt under Chapter 9. 11 U.S.C. 109(c). In June 2014, Puerto Rico enacted a territorial bankruptcy act of its own, the "Puerto Rico Public Corporation Debt Enforcement and Recovery Act," which the U.S. District Court in Puerto Rico held unconstitutional in a case currently on appeal. *Franklin California Tax Free Trust v. Commonwealth of Puerto Rico*, 2015 WL 522183 (D. Puerto Rico, February 6, 2015) ("Because the Recovery Act is preempted by the federal Bankruptcy Code, it is void pursuant to the Supremacy Clause of the United States Constitution."), *appeal pending*, Nos. 15-1218 and 15-1221 (1st Circuit, argued May 6, 2015).
10. It is a credit to the government of Puerto Rico that the commissioned economists were given the freedom to sharply criticize the existing administration. Krueger et al., "Puerto Rico."
11. *Ibid.*, p. 22.
12. *Ibid.*, pp. 17-18.

acquis sociaux (workers' collective "social rights") of Europe, Puerto Rico needs to keep good workers and compete in U.S. product markets by being cost-effective.

Employment in Puerto Rico is further discouraged by welfare benefits that are calibrated to wages on the mainland, but are completely out of proportion on the island. As the Krueger report notes, "one estimate shows that a household of three eligible for food stamps, AFDC, Medicaid and utilities subsidies could receive \$1,743 per month—as compared to a minimum wage earner's take-home earnings of \$1,159."¹³ Since the median wage in Puerto Rico is just \$9.42,¹⁴ the median wage earner's earnings would be no more than \$1,505—still less than welfare offers.

Like workers, businesses face a discouraging mix of government penalties and rewards. Puerto Rico has a long history of relying on special tax deals to attract businesses while leaving unfavored companies to deal with red tape and an unresponsive bureaucracy. Where possible, regulations should be repealed altogether and regulatory agencies dismantled. In other areas, Governor García Padilla should push administrators to streamline the processes for starting a business and dismiss civil servants who are unwilling to be responsive.

A Role for Congress

Puerto Rico is responsible for most of the policy changes that the island needs to grow and prosper, but in a few cases Congress needs to act to free Puerto Rico from laws that were written without Puerto Rico's needs in mind.

The Jones Act, which has helped destroy the American shipbuilding industry by protecting it from competitive pressure,¹⁵ is especially damaging to Puerto Rico:

[The Jones Act requires] that all shipping between U.S. ports be performed by a tiny, aging, overpriced fleet of U.S.-flagged ships. The Government Accountability Office reported in 2013 that just 17 vessels belonging to four companies connect Puerto Rico's 3.5 million inhabitants to the mainland U.S. All but four of those vessels were more than 31 years old. With government prohibiting free-market competition among shippers, these four firms can charge higher prices for freight to and from the island. The result: higher consumer prices for islanders. The shipping restriction also puts Puerto Rican products at a cost disadvantage in mainland markets.¹⁶

Congress should:

- **Permanently exempt Puerto Rico from the Jones Act.** Relief from the Jones Act would allow the cost of living on Puerto Rico to decline, effectively giving everyone on the island a raise. The Jones Act also makes doing business in Puerto Rico riskier because it makes supply lines to and from the U.S. mainland more brittle.
- **Exempt Puerto Rico from the federal minimum wage.** The minimum is much higher relative to Puerto Rican wages than mainland wages. As the Krueger report made clear, "The U.S. federal minimum wage is very high relative to the local average (full-time employment at the minimum wage is equivalent to 77% of per capita income, versus 28% on the mainland) and a more binding constraint on employment (28% of hourly workers in Puerto Rico earn \$8.50 or less versus only 3% on the mainland)."¹⁷ Eliminating the federally mandated minimum wage for Puerto Rico would encourage economic growth and help the market create much-needed jobs.

13. *Ibid.*, p. 7.

14. U.S. Department of Labor, Bureau of Labor Statistics, "May 2014 State Occupational Employment and Wage Estimates: Puerto Rico," March 25, 2015, http://www.bls.gov/oes/current/oes_pr.htm (accessed June 30, 2015).

15. Brian Slattery, Bryan Riley, and Nicolas D. Loris, "Sink the Jones Act: Restoring America's Competitive Advantage in Maritime-Related Industries," Heritage Foundation *Backgrounder* No. 2886, May 22, 2014, <http://www.heritage.org/research/reports/2014/05/sink-the-jones-act-restoring-americas-competitive-advantage-in-maritime-related-industries>.

16. Salim Furth, "Two Ways That Washington Could Help Puerto Rico Without a Bailout," *The Wall Street Journal*, June 29, 2015, <http://blogs.wsj.com/washwire/2015/06/29/2-ways-that-washington-could-help-puerto-rico-without-a-bailout/> (accessed June 30, 2015). See also U.S. Government Accountability Office, "Puerto Rico: Characteristics of the Island's Maritime Trade and Potential Effects of Modifying the Jones Act," March 2013, <http://www.gao.gov/assets/660/653046.pdf> (accessed June 30, 2015).

17. Krueger et al., "Puerto Rico," p. 6.

- **Give Puerto Rico more flexibility to administer federal grants for welfare.** Reforms of the welfare state are badly needed, but require the cooperation of commonwealth and federal policymakers.

Conclusion

Puerto Rico has been a “paradise” of progressive economic policies, but high minimum wages, strict overtime rules, generous employment and welfare benefits, high energy costs, and protective business regulations have harmed the very people the policies were intended to help.

Without economic freedom, Puerto Rico will continue to see its working population emigrate and its prospects diminish. Congress should give local lawmakers the space to make the right decisions by relaxing federal mandates that have harmed Puerto Rico.

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