

ISSUE BRIEF

No. 4442 | JULY 27, 2015

An Economic Crisis Is the Heart of Puerto Rico's Financial Crisis

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Puerto Rico faces a severe fiscal crisis, but this is merely a symptom of Puerto Rico's primary disease: a lack of economic growth. Over the past decade, as Puerto Rico's debt has expanded rapidly, the economy has contracted more than 10 percent. If the economy were growing, Puerto Rico would be much better positioned to address its fiscal crisis and might have averted it altogether.

At \$72 billion, Puerto Rico's debt is now more than 100 percent of its gross national product (GNP). The debt does not include another \$35 billion in unfunded pension liabilities and other unfunded liabilities, which also need to be considered. Confronting this massive debt will require difficult political decisions.

Creditors who took the risk of lending to the Puerto Rican government will most likely suffer financial losses. Yet even wiping Puerto Rico's debt slate clean would not solve the island's problems. The only way to bring about lasting fiscal stability in Puerto Rico is to address the island's declining economy. Puerto Rico will not emerge from its economic or fiscal woes without the proper foundations for growth, such as a robust labor market, an attractive business climate, a non-stifling regulatory regime, and less cronyism and corruption.¹ Stopgap proposals, such as extending Chapter 9 bankruptcy to Puerto Rico's

municipalities and utility companies, also will fail to produce long-term financial stability.²

Declining Economy

Puerto Rico is not experiencing a temporary recession; it is in economic decline. Puerto Rico's real GNP has declined in seven of the past eight years, with only a slight increase in 2012.³ Real GNP in Puerto Rico fell 13 percent from its peak from 2006 to 2014. During this period, despite its own recession, GNP increased in the U.S. by almost 11 percent.⁴ (See Chart 1.)

Shrinking Population and Labor Force

Without economic growth, Puerto Ricans are fleeing the island for better opportunities. The island's population has declined by more than 250,000 (7 percent) over the past decade.⁵ (See Chart 2.)

Making matters worse is a decline in labor force participation (LFP) among the island's remaining residents. In 2013, only 50.2 percent of Puerto Rico's working-age population (ages 15–64) participated in the labor force, compared with 71.7 percent in the U.S.⁶ The gap between Puerto Rico's LFP rate and the U.S. rate amounts to more than 500,000 people, or 22 percent of Puerto Rico's working-age population.

Puerto Rico's reported LFP rate and total employment figures likely understate the true values because Puerto Rico has a significant underground labor market that does not pay taxes. A relatively high minimum wage and strict labor laws contribute to the underground economy by driving up the costs of formal employment. (See Chart 3.) For many workers, "off-the-books" jobs are either the only or the preferable option.

This paper, in its entirety, can be found at <http://report.heritage.org/ib4442>

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The U.S. minimum wage of \$7.25 applies to Puerto Rico. In Puerto Rico, however, that minimum is equivalent to 77 percent of the median wage. In most states, the minimum wage is between 40 percent and 50 percent of the median.⁷

If the federal minimum wage were not burden enough, Puerto Rico adds its own costly employment requirements such as mandatory Christmas bonuses (“el Bono de Navidad”); inability to fire employees at will without significant severance pay; and mandatory paid leave including 15 vacation days, 12 sick days, eight weeks of maternity leave, and one hour per day for breastfeeding.⁸

Doing Business

High employee costs and regulations are not the only problems confronting employers. According to the World Bank Group’s *Doing Business* rankings, it is significantly more difficult to do business in Puerto Rico than on the U.S. mainland. (See Chart 4.) The U.S. is ranked seventh out of 189 countries for ease of doing business in 2015, while Puerto Rico is ranked 47th.⁹ And the business climate in Puerto Rico has been growing worse, not better. It was ranked 41st in 2014.

Among the factors weighing down Puerto Rico’s business climate are difficulties registering

property (Puerto Rico ranked 163rd); dealing with construction permits (158th); paying taxes (133rd); and enforcing contracts (92nd).¹⁰ That means that inefficient government bureaucracy is significantly retarding growth. Improvement in these basic government services would allow more opportunities for both investors and employees in Puerto Rico.

Puerto Rico scored low on trading across borders (84th) thanks to numerous bureaucratic requirements, and its trade is also limited by the federal Jones Act of 1920. The Jones Act limits economic growth in Puerto Rico by significantly raising the cost of shipping between Puerto Rico and the mainland.¹¹

Debt

From 2005 to 2014, real Puerto Rican government debt per capita increased from about \$13,900 to almost \$19,000 (37 percent).¹² (See Chart 5.) Debt will continue to rise because the island’s \$72 billion in debt does not include roughly \$35 billion in unfunded pension liabilities, which will soon affect the island’s budgets and further increase the debt.

Tax Increases Are Not Working

Puerto Rico has turned to tax increases to alleviate its debt problems. (See Chart 6.) In March, the

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1. Salim Furth, “Progressive Paradise Lost,” *The Daily Signal*, July 1, 2015, <http://dailysignal.com/2015/07/01/progressive-paradise-lost/>.
 2. Rachel Greszler, “Allowing Puerto Rico to Declare Bankruptcy Is Giving It a Federal Bailout,” *The Daily Signal*, July 8, 2015, <http://dailysignal.com/2015/07/08/allowing-puerto-rico-to-declare-bankruptcy-is-giving-it-a-bailout/>.
 3. Puerto Rico Planning Board, *Statistical Appendix of the Economic Report for the Governor and Legislative Assembly*, April 2014, <http://www.gdb-pur.com/economy/statistical-appendix.html> (accessed July 23, 2015).
 4. U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts Tables, <http://www.bea.gov/iTable/iTableHtml.cfm?reqid=9&step=1&isuri=1> (accessed July 23, 2015).
 5. U.S. Bureau of the Census, Population Division; Puerto Rico Department of Health; and Puerto Rico Planning Board, *Statistical Appendix*.
 6. The World Bank, “Labor Force Participation Rate (% of Total Population Ages 15–64),” 2015, <http://data.worldbank.org/indicator/SL.TLF.ACTI.ZS?page=1> (accessed July 23, 2015).
 7. Heritage Foundation calculations based on data from U.S. Department of Labor, Bureau of Labor Statistics, Occupational Employment Statistics, <http://www.bls.gov/oes/> (accessed July 23, 2015).
 8. Antonia Escudero Viera, Alfredo Hopgood, and Miguel Rivera-Arce, “Puerto Rico Labor and Employment Law,” *LawForChange*, October 2012, <http://www.lawforchange.org/images/lfc/PuertoRicoEmployment.pdf> (accessed July 23, 2015).
 9. World Bank Group, *Doing Business 2015: Going Beyond Efficiency*, 2014, <http://www.doingbusiness.org/-/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB15-Chapters/DB15-Report-Overview.pdf> (accessed July 23, 2015).
 10. *Ibid.*
 11. Brian Slattery, Bryan Riley, and Nicolas 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>.
 12. Puerto Rico Planning Board, *Statistical Appendix*, and U.S. Bureau of the Census, National Income and Product Accounts, <http://www.bea.gov/iTable/iTableHtml.cfm?reqid=9&step=1&isuri=1> (accessed July 23, 2015). These figures are in real 2014 dollars computed using Puerto Rico’s GNP deflator.
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island government raised the import tariff on crude oil by 68 percent, from \$9.25 per barrel to \$15.50 per barrel.¹³ In May, the government raised the sales tax from 7.0 percent to 11.5 percent—a 64 percent hike.¹⁴ The tax increases will do more harm than good in an already declining economy. Rather than raising taxes, Puerto Rico should seek to boost economic growth, which in turn would drive up tax revenues.

Conclusion

Puerto Rico's problems are much larger than its \$72 billion of debt. As the situation in Greece has shown, economic growth is necessary for fiscal sustainability.

Although Congress can do a few things to stimulate economic growth, such as freeing the island from Jones Act shipping restrictions and the federal minimum wage, Puerto Rico needs to do its part to retain and attract businesses and people by making it easier to employ workers and by reducing regulatory and tax burdens. Without an economic turnaround, Puerto Rico will never become fiscally stable.

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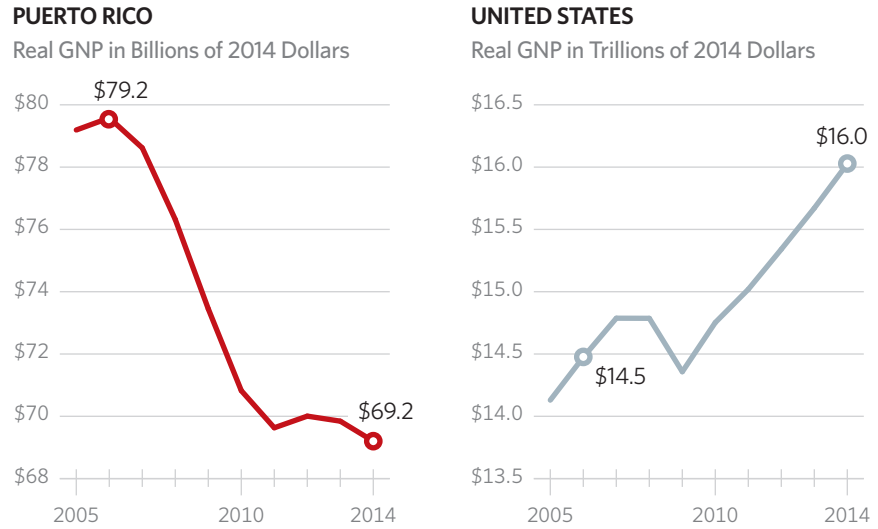
13. Associated Press, "Puerto Rico: Legislators Approve Much-Debated Sales Tax Increase," NBC News, May 27, 2015, <http://www.nbcnews.com/news/latino/puerto-rico-legislators-approve-much-debated-sales-tax-increase-n365256> (accessed July 23, 2015).

14. Michael Oleaga, "Puerto Rico Economy 2015: Gov. Alejandro Garcia Padilla Signs Tax Increase; More Tax Hikes Coming," *Latin Post*, June 4, 2015, <http://www.latinpost.com/articles/57488/20150604/puerto-rico-economy-2015-gov-alejandro-garcia-padilla-signs-11.htm> (accessed July 23, 2015).

CHART 1

Puerto Rico's Economy in Persistent Decline

Puerto Rico's real GNP has declined by 13 percent from 2006 to 2014. During that same period, GNP in the U.S. rose by 11 percent.



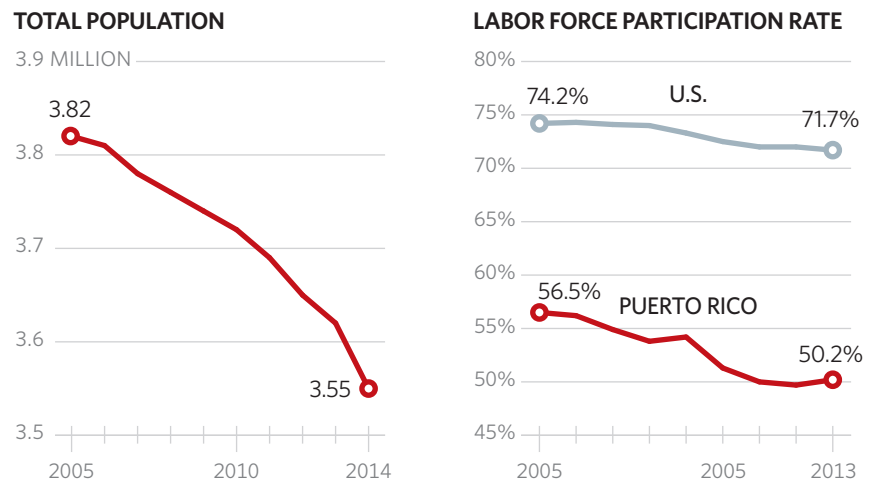
Sources: Puerto Rico Planning Board, *Statistical Appendix of the Economic Report for the Governor and Legislative Assembly*, April 2014, pp. A1-A2, Table 1, <http://www.gdb-pur.com/economy/statistical-appendix.html> (accessed July 23, 2015), and U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts Tables, <http://www.bea.gov/iTable/iTableHtml.cfm?reqid=9&step=1&isuri=1> (accessed July 23, 2015).

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CHART 2

Puerto Rico Struggling with Fewer People and Fewer Workers

Puerto Rico's population has declined by 273,000 since 2005, and the share of its working-age population with jobs or looking for jobs has dropped to around 50 percent.



Note: Labor force participation rate is for workers age 15 to 64.

Sources: U.S. Census Bureau, Annual Estimates of the Resident Population for Selected Age Groups by Sex for the United States, States, Counties and Puerto Rico Commonwealth and Municipios, <http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?src=bkmk> (accessed July 21, 2015), and The World Bank, "Labor Force Participation Rate (% of Total Population Ages 15-64)," 2015, <http://data.worldbank.org/indicator/SL.TLF.ACT1.ZS?page=1> (accessed July 23, 2015).

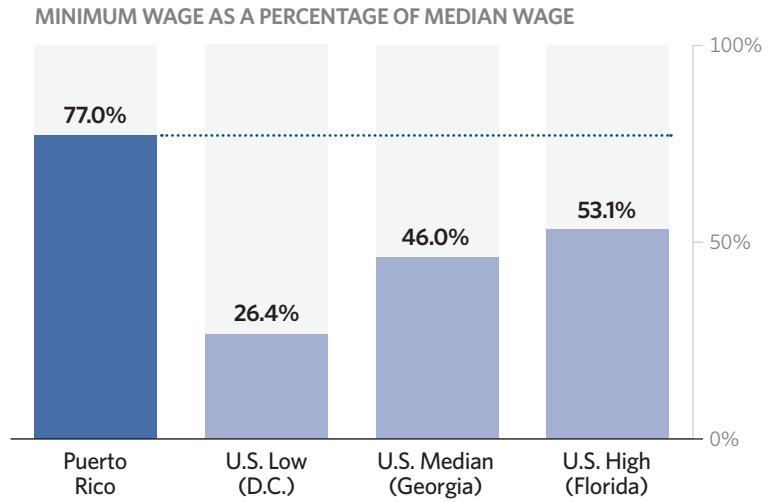
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CHART 3

Relative Minimum Wage Highest in Puerto Rico

The federal minimum wage of \$7.25 per hour applies to Puerto Rico, but its median wage is \$9.42 per hour. This means the minimum wage is 77 percent of the median, far higher than any state in the U.S.

Source: Heritage Foundation calculations based on data from the U.S. Department of Labor, Bureau of Labor Statistics, <http://www.bls.gov> (accessed July 21, 2015).

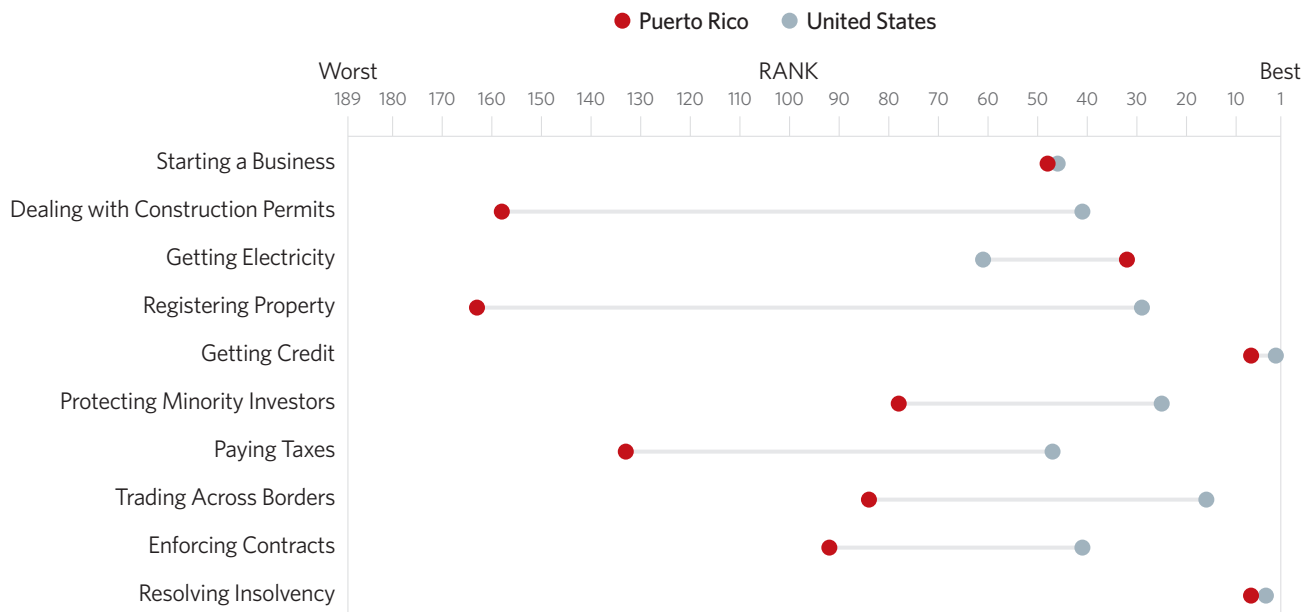


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CHART 4

Puerto Rico a Challenging Place to Do Business

Puerto Rico lags significantly behind the U.S. in six of the 10 metrics the World Bank uses to rank countries in its “Doing Business” report. Overall, Puerto Rico ranks No. 47 in the world out of 189 countries while the U.S. ranks No. 7.



Source: World Bank Group, “Doing Business 2015: Going Beyond Efficiency,” October 29, 2014, Economy Rankings, <http://www.doingbusiness.org/rankings> (accessed July 16, 2015).

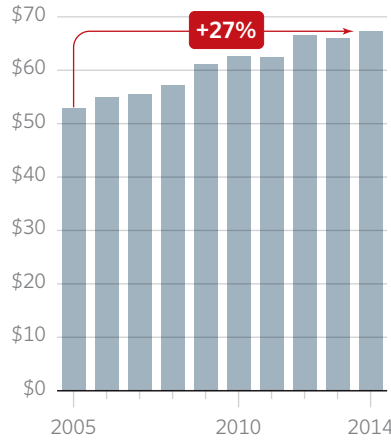
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CHART 5

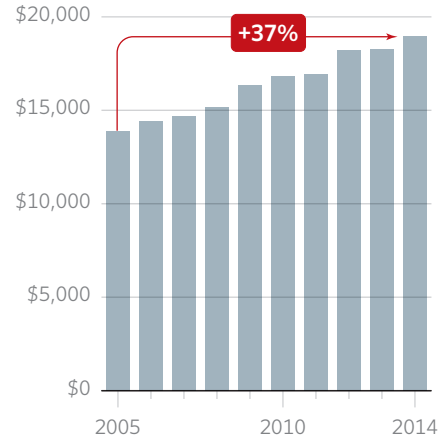
Puerto Rico Plagued by Rise in Debt

Since 2005, Puerto Rico's total debt burden has increased by 27 percent, and debt per capita is up 37 percent.

TOTAL DEBT
 In Billions of 2014 Dollars



DEBT PER CAPITA
 In 2014 Dollars



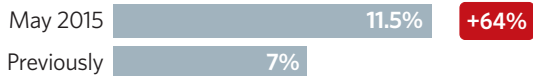
Note: Figures have been adjusted for inflation using Puerto Rico's GNP deflator.

Source: Puerto Rico Planning Board, *Statistical Appendix of the Economic Report for the Governor and Legislative Assembly*, April 2014, p. A8, Table 4, p. A57, Table 29, and p. A60, Table 31, <http://www.gdb-pur.com/economy/statistical-appendix.html> (accessed July 23, 2015).

CHART 6

Puerto Rico Responded to Economic Crisis by Raising Taxes, Tariffs

SALES TAX



OIL TARIFF (per barrel of crude oil)



Source: Michael Oleaga, "Puerto Rico Economy 2015: Gov. Alejandro Garcia Padilla Signs Tax Increase; More Tax Hikes Coming," *Latin Post*, June 4, 2015, <http://www.latinpost.com/articles/57488/20150604/puerto-rico-economy-2015-gov-alejandro-garcia-padilla-signs-11.htm> (accessed July 23, 2015).