



Puerto Rico's Economic Crisis:

OVERVIEW AND RECOMMENDATIONS FOR ACTION



hispanicfederation

OCTOBER 2015

Acknowledgements

This briefing paper was authored by Dr. Hector Cordero-Guzman (CUNY Baruch College) and Jose Calderon, Stephen Calenzani and Jose Davila of the Hispanic Federation. We thank the following leaders and organizations for informing select findings of this briefing paper: El Puente, LatinoJustice PRLDEF, Make the Road New York, Urban Health Plan, Fiscal Policy Institute, National Puerto Rican Coalition, Institute for Energy Economics and Financial Analysis, New York Communities for Change, Puerto Rican Bar Association, Rockefeller Family Fund, Strong Economy for All Coalition, 1199 SEIU, 32BJ SEIU, CSEA Local 1000, Dennis Rivera, U.S. Representative Pedro Pierluisi, and U.S. Representative Nydia Velazquez.





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“If left to fester, Puerto Rico’s near-calamitous economic crisis will reverberate far beyond the geographic limits of the island.”



Introduction

Puerto Rico and its more than 3.5 million residents are in crisis. In June 2015, Puerto Rico's Governor Alejandro García Padilla declared that the Commonwealth's \$72 billion debt was "not payable." He further declared that Puerto Rico needed help from the U.S. government and creditors to restructure the debt and create a plan for sustainable economic growth.

Governor Padilla's declaration comes after years of low employment and labor participation rates, high rates of outmigration leading to a decline in population, an economic structure shaped more by tax advantages than comparative advantages, inequities in federal health care reimbursement, and unwise, predatory lending practices by hedge funds, which own an estimated 20 percent to 50 percent of Puerto Rico's debt.

Ramifications of the island's economic crisis have been far reaching. The Commonwealth of Puerto Rico has effectively run out of cash to keep the government open and has turned to unprecedented emergency measures like intra-government loans and delaying income tax refunds to keep services running. More island residents have migrated to the U.S. mainland in the last 5 years than at any time since the Great Puerto Rican Migration after World War II. One hundred and fifty public schools on the island have been shuttered during that period of time. Puerto Rico has increased the retirement age, and required heftier pension fund contributions from public sector workers, and more pain is coming. Puerto Rico passed a budget for the fiscal year beginning July 1, 2015 that increased the sales and use tax from 7 percent to 11.5 percent and further reduced public investment by \$674 million.

Yet economists argue that Puerto Rico cannot "cut and tax" its way out of the crisis. As the Krueger report* states, "the debt cannot be made sustainable without growth." Many groups such as the Center for a New Economy and Fiscal Policy Institute see a need for policies that not only advance fiscal reform, but that protect the quality of life of Puerto Ricans and offers an economic vision that fosters a climate for job growth. This approach ultimately enables the island to service its debt and grow its economy without extracting such a heavy toll on low-income communities, which comprise a majority of its residents.

* A report commissioned by the Government Development Bank, an agency tasked with developing economic strategies for the Commonwealth. The report is referenced the Krueger report for its lead author, former World Bank Chief Economist Anne Krueger.

This briefing paper seeks to inform discussions regarding Puerto Rico's path out of its crisis for concerned and key stakeholders in Washington, Puerto Rico and localities across the country. The first section provides a brief overview of what precipitated this dire situation and how Puerto Ricans are currently fairing. The report goes on to lay out select recommendations on how the federal government can potentially help Puerto Rico navigate and emerge from this crisis in improved fiscal shape.

The truth is this: Severe current and future government budget cuts threaten to undermine the already tenuous economic situation of hundreds of thousands of Puerto Ricans on the island. There is a good chance that the crisis will be increasingly felt in many U.S. states, through potential pension asset losses and a growing reliance on local social services by those who migrate to the U.S. In short, Puerto Rico's near-calamitous economic crisis, if left to fester, will almost certainly reverberate far beyond the geographic limits of the island.

Puerto Ricans and other Latinos on the U.S. mainland have been warning about the potential impact of the crisis on those living both within and without Puerto Rico's borders. As economic and financial conditions have worsened in recent months, we have partnered with community, government, philanthropic, labor and academic leaders and institutions from across the United States and the island to form a national effort to support Puerto Rico.

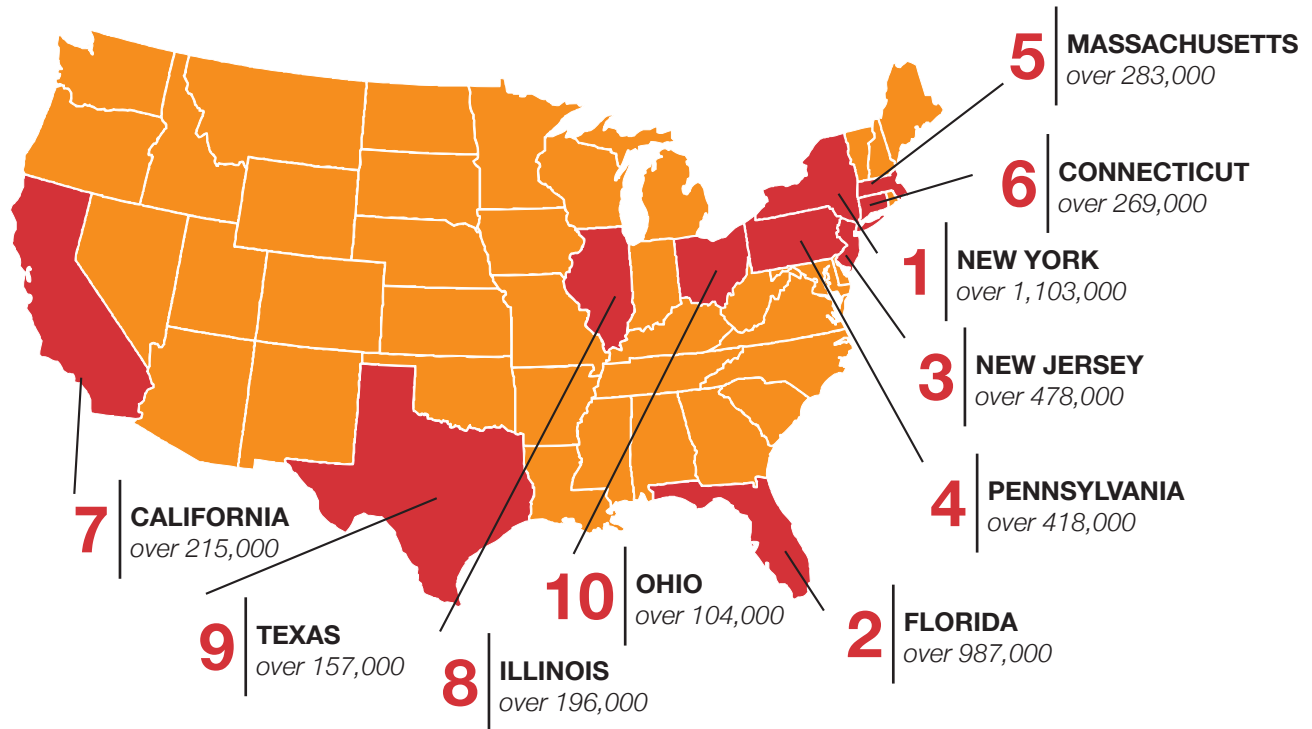
We aim to take these recommendations to our nation's leaders. Our hope is that this report will help to inform and pressure key influencers to urgently act to assist the island. To that end, we have already been engaging, educating, organizing and mobilizing stakeholders in Puerto Rican and Latino mainland hubs and in our nation's capital. Our message is clear: Millions of American citizens in Puerto Rico are in danger of losing much of what they have unless our federal government acts with bold purpose to stabilize and grow the island's economy. **The time for action is now.**



Puerto Rico by the Numbers

Source: U.S. Census Bureau 2013 American Community Survey

Largest U.S. Mainland Puerto Rican Hubs



How Puerto Rico Compares to the U.S.



Poverty	45.1%	15.4%
Unemployment	8.5%	6.2%
Labor Participation	46.1%	64.3%
Median Income	\$19,624	\$53,046

Causes of Puerto Rico's Fiscal Crisis

Background

The reasons behind the island's current economic woes are complex, with plenty of blame to go around: federal funding shortfalls and tax policies that hamper economic growth, poor budget practices by the island, predatory lending by hedge funds, and the complicated and oft unjust relationship between the U.S. and Puerto Rico, to name just a few. There are also wider forces to blame, such as the Great Recession, outmigration from the island, and escalating energy and health care costs.

Setting the stage for the crisis were stagnant economic conditions in Puerto Rico over the past 10-15 years, brought about by the elimination of Section 936 of the Internal Revenue Code. Section 936 encouraged mainland companies to locate on the island. Unfortunately, when the tax breaks were eliminated by Congress, these companies moved out. The Great Recession of 2008 compounded this stagnation, leaving almost half the island's residents in poverty and unemployed. Forced to seek economic opportunity, hundreds of thousands of Puerto Ricans moved stateside to places like Florida, draining the island's tax base which funds basic public services.

However, structural economic inequalities – in part driven by Federal policies – date back long before the recent decline. A prime example is the burdensome cost of transporting goods created by the U.S. Jones Act, which has increased shipping costs by billions over many decades. In effect, the law requires every car, food item or other product that enters or leaves Puerto Rico to be carried on a more expensive U.S.-flagged vessel. If a foreign-flagged ship enters the island, high taxes and customs fees essentially double the price of transported goods.

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Puerto Rico also faces growing costs for its public services. The electricity system led by the Puerto Rico Electric Power Authority (PREPA) is more than \$8 billion in debt. A recent deal to restructure the debt still leaves the challenge of reducing sky-high energy costs to homeowners and businesses from the outdated and unhealthy use of fossil fuels, as opposed to cleaner, renewable energy systems. A recent report by the Institute for Energy Economics and Financial Analysis lays out several wise recommendations aimed at lowering energy costs through systemic reforms and switching to cleaner energy mechanisms.

Federal healthcare funding inequities have also contributed to the ongoing crisis. Approximately 60% of the island's population is enrolled in Medicaid or Medicare, both of which face an uncertain future due in part to an archaic capping of federal contributions which was imposed upon Puerto Rico. As a result, healthcare costs represent an estimated \$25 billion of its \$72 billion debt.

Declining tax revenue has forced successive Puerto Rican governments to keep borrowing to keep public utilities and local government running. Hedge funds looking for fiscal windfalls have been happy to oblige on extending huge loans with predatory interest rates to the Puerto Rican government. These same hedge fund interests were backers of changes in the island's constitution that mandated the local government to first pay debt relief before continuing to fund schools, energy and other vital public services.

Unfortunately, this focus on debt payments above all else will only help to exacerbate the current vicious cycle of outmigration, with the only certainty being more pain for Puerto Rico in the future. The following pages detail the main causes of the island's financial troubles, focusing on labor force decline, the health care crisis, and debt and debt service costs.



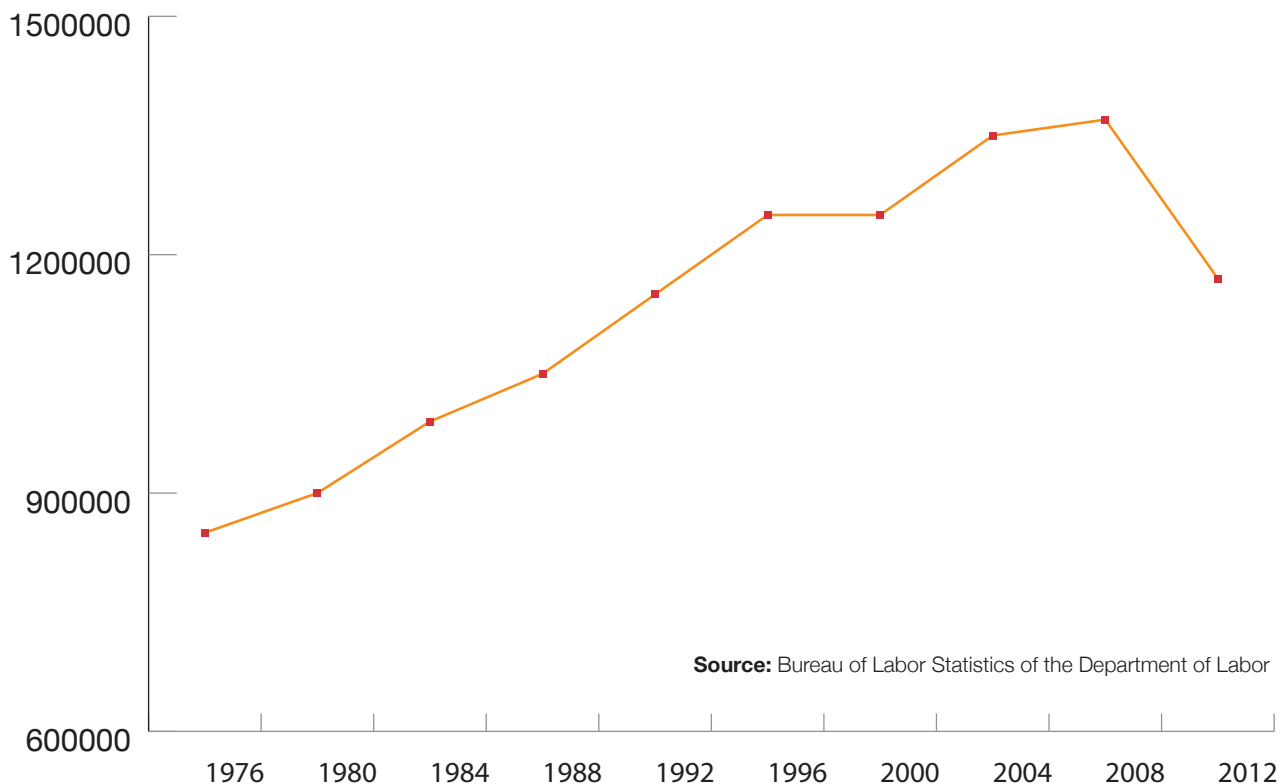
DID YOU KNOW?

Puerto Ricans have been U.S. citizens since 1917.

Precipitous decreases in Puerto Rican labor force...

The most significant manifestation of the financial crisis has been a precipitous decline in the number of persons employed on the island. **Figure 1** from the Bureau of Labor Statistics of the Department of Labor shows the labor force trend between 1976 and 2014. As we can see in the chart below, the size of the Puerto Rican labor force grew from around 850,000 in 1976 to a peak of about 1.4 million workers around 2005 – 2006, but has declined precipitously to almost the level it was in 1990. The result? Close to 22 years of labor market growth appears to have been wiped out in eight years of steep decline. Because of this, the government is now the largest employer on the island.

Figure 1:
Labor Force Trends from 1976-2012



DID YOU KNOW?

3.5 million U.S. citizens reside in Puerto Rico.

... and the current and looming health care crisis...

Inequities in the federal funding of healthcare systems have greatly contributed to the ongoing financial crisis in Puerto Rico. Approximately 60% of the island's population is enrolled in Medicaid or Medicare, both of which face an uncertain future due in part to an archaic and unfair capping of federal contributions which was imposed upon Puerto Rico due to its status as a territory. As a result, healthcare costs which the island is forced to pay represent an estimated \$25 billion of Puerto Rico's \$72 billion debt.

Forty-five percent of the island's population relies on Medicaid (known locally as *Mi Salud*) for their healthcare. If current funding levels persist, the program will run out of funds three years earlier than anticipated, causing 900,000 islanders to lose their coverage at the end of 2016.

Further exacerbating the healthcare crisis in Puerto Rico are the pending cuts to the Medicare Advantage (MA) program to the tune of 11% (as opposed to increases by 3% for the states). The proposed cuts will be disastrous to Puerto Rico's aging population, seventy-five percent of whom have selected a Medicare Advantage plan, as opposed to only 26% in the states. Puerto Rico's Medicare Advantage program is currently funded at 60% of the average program rate in the states, making any further reduction to program funding extremely harmful to the tens of thousands of Americans that depend on this program for medical coverage on the island. Given the fact that Puerto Rico residents pay the same amount of Medicare payroll taxes as residents of the states, Congress should grant and require equitable funding. It is a matter of just treatment for the U.S. citizens living in Puerto Rico that has life and death implications.

“ Approximately 60% of the island's population is enrolled in Medicaid or Medicare. Healthcare costs represent an estimated \$25 billion of Puerto Rico's \$72 billion debt. ”



DID YOU KNOW?

5 million Puerto Ricans reside on the U.S. mainland.

...has led to increased Puerto Rican debt and debt service costs.

Significant declines in employment, disproportionate outmigration – including over 400,000 to Central Florida over the last decade – and increasing health care costs are clear signs of Puerto Rico social and economic crisis. It has led to increased borrowing by Puerto Rico, its instrumentalities and agencies to cover operating expenses and debt service. **Figure 2**, taken from a report by the Federal Reserve Bank of New York, describes the composition of Puerto Rico’s \$72 billion debt including general obligation, COFINA (Puerto Rico’s bond-issuing entity), debt of municipalities, tax revenue notes, and the debt of Puerto Rico’s public corporations and agencies. (This figure does not include unfunded pension liabilities for retired government workers or other promises made by the Commonwealth.)

Figure 2:
Composition of Puerto Rico’s Outstanding Debt

Puerto Rico: General Government Debt ¹ As of December 2013	\$US Billions	Percent of total
General Obligation and/or full faith and credit debt ²	15.8	22.0
COFINA	15.6	21.7
Municipalities and other	13.2	18.4
Tax revenue anticipation notes	1.1	1.5
Public corporations and agencies	26.2	36.4
Total	71.9	100

Sources: March 2014 Series A Prospectus, p. 33; public corporation debt is sourced from Quarterly Report dated February 18, 2014, p. 36.

¹ In March 2014 Puerto Rico issued \$3.5 billion of debt securities. After refinancings and deductions, total debt rose to \$72.8 billion

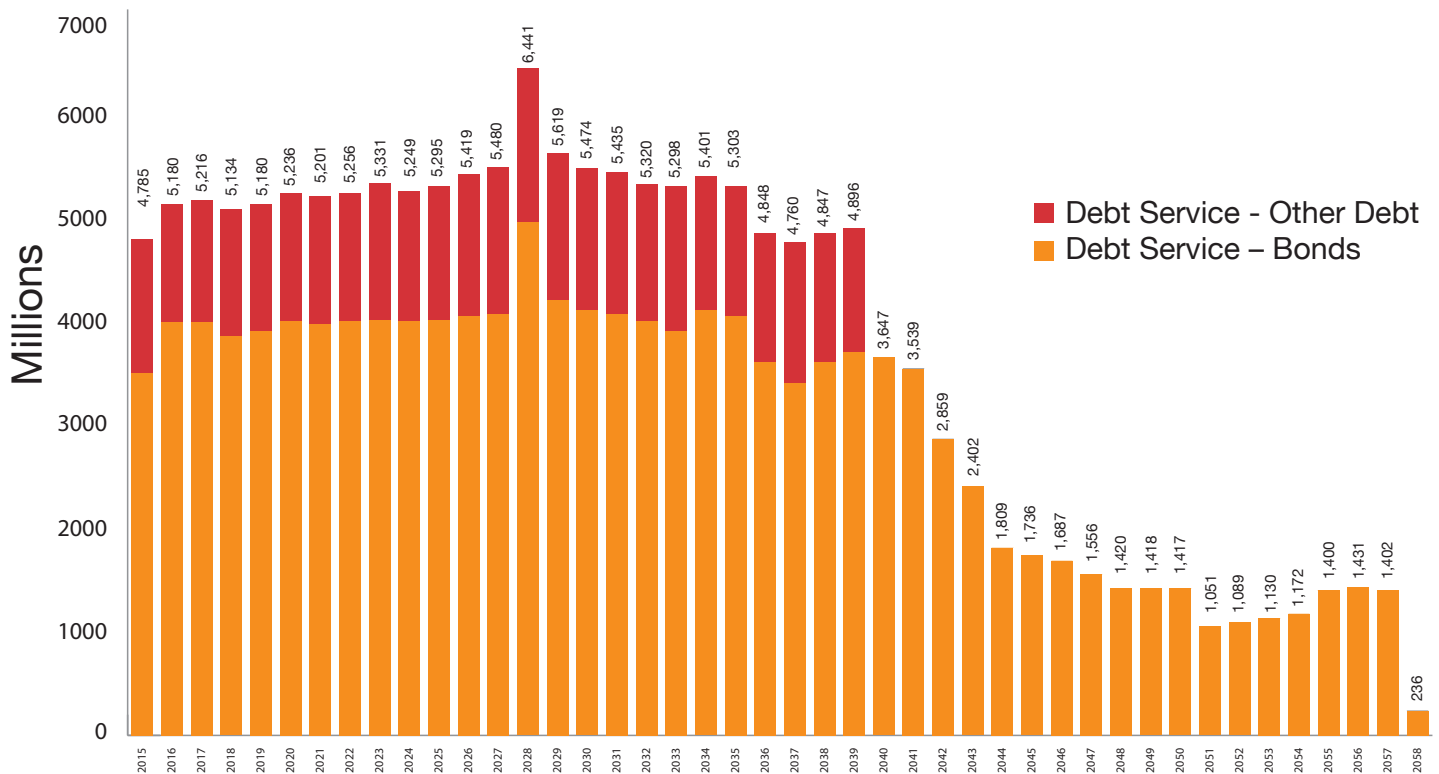
² Debt payable from revenues from “internal sources,” that is, income taxes, is guaranteed by the Puerto Rican constitution

Puerto Rico's difficulty in balancing its budget and paying for all the services and expenses of the state has been a daily topic of conversation in the financial press. Between FY 2010 and FY 2015, Puerto Rico made \$4.3 billion in debt payments consisting of around 7% of its annual budget. Yet since FY 2015, the percentage of the budget dedicated to debt repayments increased to 1.1 billion paid just in FY 2015 alone, or a stunning 12% of the budget, and to an even more shocking \$1.5 billion or 16% of the budget in FY 2016. These almost incomprehensible amounts led the government of Puerto Rico to declare in August 3, 2015, that it was in official default after failing to pay over \$57 million due.

Figure 3 below presents an estimate of Puerto Rico's debt service obligations (from FY 2015 through FY 2058), and shows how the residents of Puerto Rico are likely to experience great difficulties in coming up with the resources needed to make a dent in debt payments while continuing to pay for needed education, health and security services.

Figure 3:

Estimated Debt Service (with a \$73 billion debt)



Source: http://www.caribbeanbusiness.pr/prnt_ed/the-true-value-of-the-krueger-report-to-puerto-ricos-economy-11407.html

Responding to Puerto Rico's Fiscal Crisis

The depth and scope of Puerto Rico's economic crisis has forced leaders on the island to make difficult and painful choices. The Commonwealth has already laid off over 30,000 employees, raised utility and college tuition prices, raised taxes, cut public health and pension benefits, closed schools, and raised the retirement age. On September 8th, the Governor announced a new round of austerity measures that call for additional cuts to social services, layoffs and reductions in job protections. All while Puerto Rico is bracing for a health care crisis with federal funds rapidly diminishing and no clear plan on how to keep island residents covered in the coming years.

Puerto Rico is considering reforms to all aspects of its economy and governance, including taxes, labor laws and administrative practices. Negotiations are underway to explore debt restructuring and other options, but financial interests are resisting payment reductions. However, despite the current and planned cuts and the pain they are causing millions of American citizens on the island, the same hedge fund interests who urged the Commonwealth to continue to unwisely borrow well beyond its means are now calling for further severe austerity and privatization measures to guarantee their sizeable financial profits. Meanwhile, there are estimates that this year's \$5 billion principal and interest payments alone would require \$1,400 in increased tax levies for every resident of the island, roughly 9% of per-capita income.

According to a report by economists Anne O. Krueger, Ranjit Teja and Andrew Wolfe called "Puerto Rico – A Way Forward," (known as the Krueger report), austerity measures and tax cuts alone will not put Puerto Rico on a path of sustainable growth. The report 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." As the latest report by the Center for a New Economy discusses, were it to eliminate operating deficits in the general fund and public authority budgets, Puerto Rico still cannot service its debt without

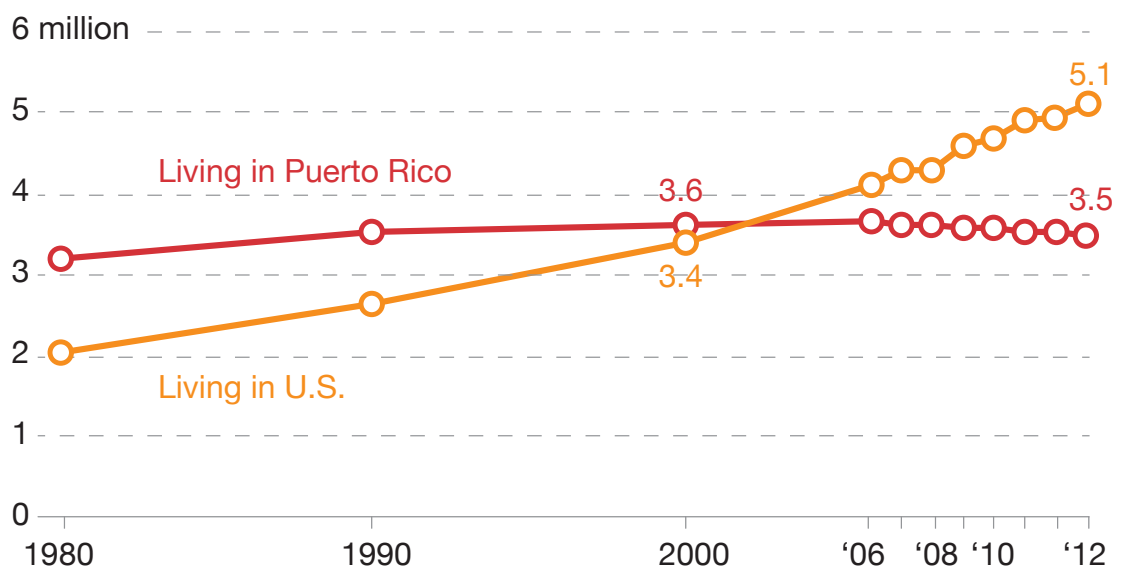
“The Commonwealth has already laid off over 30,000 employees.”

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robust economic growth many percentage points above the average 1% nominal growth of the past three years.

So what is the “way forward”? The Fiscal Policy Institute, in their memo on Puerto Rico, favors an approach that pushes fiscal reforms to appropriate and realistic levels, protects the quality of life of Puerto Ricans and its workforce, and offers an integrated economic vision that can foster a new climate for investment and job growth. While there will undoubtedly be further fiscal pain for the families of Puerto Rico, we do not believe the island can or should cut its way through this crisis. Further reductions to government services and pensions threaten to undermine the Puerto Rican economy so deeply that it may take generations to recover. Any realistic solution must instead include debt restructuring and relief, immediate federal investment and reforms, and a long-term economic growth and diversification strategy that will create living-wage jobs, grow small businesses, improve infrastructure and provide opportunities for local residents.

Figure 4:
Puerto Rican Population Grows on the Mainland, Declines on Island



Notes: “Living in Puerto Rico” is based on Hispanics of Puerto Rican origin for all years except 1980 and 1990, when based on total population in Puerto Rico.

Source: Pew Research Center analysis of American Community Survey (2006-2013) and Decennial Censuses (1980, 1990, 2000), Integrated Public Use Microdata Series (IPUMS).

Washington Must Act Immediately

It is critical that the U.S. government act with a deep sense of urgency around the scale of the Puerto Rican economic crisis. Getting the island through this fiscal emergency and on a path to economic recovery will require deep and sustained coordination on the part of our national government. Both Congress and the President have a moral, legal and economic obligation to do so and do so immediately. Over 3.5 million U.S. citizens on the island – and over 5 million Puerto Ricans on the mainland – are counting on it. Below are select key actions the Federal Government can undertake to offer resources and enact reforms to assist Puerto Rico through this fiscal and economic crisis.

Policy Recommendations:

Bankruptcy Protection

Congress should pass legislation granting Puerto Rico the right to declare Chapter 9 bankruptcy in order to renegotiate the debt and establish a fair repayment plan. *See Puerto Rico Chapter 9 Uniformity Act-H.R. 870, introduced by Representative Pedro Pierluisi (D-PR) and Senators Richard Blumenthal (D-CT) and Charles Schumer (D-NY).*

Debt Renegotiation & Relief

President Obama should convene a Working Group on Financial Markets, as proposed by Rep. Nydia Velazquez (D-NY), to bring all parties to the table in order to negotiate a fair debt repayment and relief deal. In doing so, the President could sit down with all relevant stakeholders and explore a Federal Reserve loan or any other bridge or gap financing options for the Commonwealth of Puerto Rico. In addition, the President should exercise his authority to convene both the Government of Puerto Rico and its creditors, and urge the parties to find an orderly negotiated resolution of this crisis in order to avoid further costs to the vulnerable residents and populations in Puerto Rico.

Health Care

Congress should bolster Puerto Rico's health care safety net by passing legislation that will eliminate the annual Medicaid/*Mi Salud* funding cap on Puerto Rico in favor of funding based on FMAP per-capita income. Congress should include all U.S. territories in this legislation. Congress should also improve the formula for the Medicare Disproportionate Share Hospital Program, reduce by 50% the fee on insurers in the territories, and establish a floor for Medicare payments. In the interim, the President should establish a multi-billion dollar health care program as has been done in some states to ensure vital health care services continue past 2017, when existing funds will run out. See *Improving the Treatment of the U.S. Territories Under Federal Health Programs Act of 2015 - H.R. 2635* introduced by Representative Pedro Pierluisi (D-PR).

“Over 8.5 million U.S. citizens are counting on Washington to act immediately.”

Energy & The Environment

President Obama should direct the Department of Energy (DOE) and Environmental Protection Agency (EPA) to engage in a full review and collaborative analysis of all federal policies and programs that apply to Puerto Rico in the areas of clean energy generation and environmental cleanup. This will ensure the development of a comprehensive policy plan that addresses the energy, clean environment, safety and health needs of Puerto Rico, including the cleanup of toxic sites within the island municipalities of Vieques and Culebra.

Tax Policy

Following the loss of Section 936 tax incentives, the Federal Government should institute tax policies that foster economically-diverse and living-wage job creation. President Obama should also support local government implementation of an Earned Income Tax Credit (EITC) that rewards work and supplements earnings to low-income workers in Puerto Rico.

Jones Act

The President should grant a temporary waiver and Congress should pass legislation that amends the costly shipping mandates dictated by the Jones Act, which unfairly increases the prices of imports and exports to and from Puerto Rico. Any funds from foreign-vessel fees should also be directed to the Puerto Rico Treasury.

Federal Policy & Funding Formula Assessment

There should be a full Administration and Congressional review of all federal policies that apply (or not) to the Commonwealth of Puerto Rico. This review should seek to eliminate or reduce the impact of federal policies that put the island at an economic disadvantage, as well as look for ways to expand access to Federal investments and programs.



Conclusion

Puerto Rico and its citizens are inextricably intertwined with the United States by history, emigration and economics. Puerto Ricans, both on the island and stateside, have fought valiantly in every war since World War I, and its citizens have contributed to this nation in innumerable ways. Its diaspora – five million strong, still intimately connected to the island – are a visible presence in communities throughout the fifty States of the Union. Just as significantly, three out of every four municipal funds in the country hold Puerto Rico's bonds.

Because of these intimate interconnections, what affects Puerto Rico affects the U.S. The fact that Puerto Rico faces the worst economic crisis in more than a century should be of the highest concern to all Americans. If Puerto Rico is forced to enact even more draconian cuts to its budget, the island will almost certainly spiral into an even deeper crisis. Given the interpenetration of the Puerto Rican population and economy with the U.S., this will have incalculable repercussions on communities, towns and cities stateside.

The time to debate or assign blame is past, as is any hope that the U.S. could avoid economic fallout from this crisis. The real question is, do we have the will to act in order to ameliorate its very worst effects?

To do so, we urge the Administration and Congress to resist calls by hedge funds to force more cuts to social services. We urge Congress to give Puerto Rico the ability to file for bankruptcy protection and to pass legislation rectifying economic inequities including the Jones Act and Mi Salud. We urge the President to call for a full federal agency review of policies that are economically harmful to Puerto Rico, including health care reimbursement, and convene his Working Group on Financial Markets to develop an in-depth debt relief, repayment, and investment plan to stabilize the island's economy. A focus on sustained growth and prosperity for the people of Puerto Rico must be at the core of this fiscal reform plan.

We urge the President and Congress to take strong, substantive and constructive action now to stabilize Puerto Rico and protect the current and future livelihood of millions of American citizens living on the island.

IT IS TIME TO ACT

For more information or to get involved please contact:



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