The "New Fiscal Plan for Puerto Rico" (April 19, 2018):
An Unrealistic and Misleading Path to Nowhere

J. Tomas Hexner
President of Hex, Inc. Founder and director, Science Initiative Group at the Institute for Advanced Study at Princeton, New Jersey

Arthur MacEwan
Professor Emeritus of Economics at the University of Massachusetts Boston

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ABSTRACT

The New Fiscal Plan for Puerto Rico, issued by the Fiscal Oversight and Management Board on April 19, 2018, is deeply flawed. It is based on two incompatible goals: establishing a foundation for growth of the Puerto Rican economy and assuring that the Puerto Rican government will move quickly toward meeting its debt obligations. As result of this incompatibility, the Plan is deeply flawed and should be abandoned.

The Plan imposes an austerity program, which will undermine possibilities for growth, harm the well-being of the populace, and likely undermine the government's ability to meet debt obligations. Also, the plan makes unrealistically optimistic assumptions about positive impacts of the structural reforms it imposes on economic relations in Puerto Rico.

This paper: (1) explains the austerity nature of the Plan and its negative impacts; and (2) discusses the Plan's proposed structural reforms—labor reforms, tax reforms, education and human capital reforms, and reforms of government regulations and the organization of government agencies.

Keywords: New Fiscal Plan for Puerto Rico, PROMESA, Puerto Rico debt, level playing field, austerity

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The New Fiscal Plan for Puerto Rico, which was issued on April 19, 2018, is counterproductive. What a pity that the Fiscal Oversight and Management Board, created by PROMESA, is pushing economic policies that will be destructive to the island's economy and bring increasing harm to the Puerto Rican people.

The best way to understand The New Fiscal Plan for Puerto Rico is to recognize that it was guided by two incompatible goals. On the one hand, the Oversight Board wanted to establish a foundation for growth of the Puerto Rican economy. On the other hand, the Board was intent on assuring that the Puerto Rican government would move quickly toward meeting its debt obligations. In order to set aside sufficient funds to pay the debt, the government will be required to move quickly to a surplus in its primary budget. If this is done there will be insufficient funds to support the provision of essential services and the investments that are critical for establishing economic growth. Moreover, aggregate demand will be weakened.

The Board has attempted to overcome this contradiction by making a set of unrealistically favorable assumptions regarding the speed and impact of structural changes in the economy, the availability of federal funds for hurricane recovery, and the size of the long-run impact of post-hurricane recovery. The assumptions regarding structural changes—in, for example, labor regulations, education and human capital reforms, tax collection, and government regulations and the consolidation of government agencies—are especially problematic. These assumptions rest on a view of the economy as a well-oiled machine, where the machine operators (the Oversight Board or maybe the Puerto Rican government) can simply push buttons or pull levers and the desired results will emerge. Real people are absent from the story.

In an effort to escape this conundrum created by its two incompatible goals, the Board has set forth an austerity plan. In driving the Puerto Rican economy towards a surplus in its primary budget, the plan would not only squeeze the well-being of the Puerto Rican population and undermine the bases for economic growth. In addition, it would weaken aggregate demand, bring about an increase in population decline (as more Puerto Ricans depart for the mainland), and undermine tax collection. The downward spiral of the economy would continue. Consequently, neither of the Board's goals—neither debt payback nor economic growth—would be accomplished.

The Growth and Fiscal Framework

Although the Oversight Board has made a number of unrealistic assumptions in an attempt to present a plan that achieves the contradictory goals of economic growth and movement toward meeting debt service obligations, the accomplishments portrayed in the plan are not impressive over the next five years. In the Plan's growth projections, GNP in 2023 would still be below the level of 2017 (p. 9).[*] And even with the stringent

[*] Unless otherwise stated, years noted in this paper are fiscal years, July 1 through the subsequent June 30. Thus, the hurricanes of September of 2017 fall in fiscal year 2018, not fiscal year 2017.

restraints on government spending and the excessively favorable expectations regarding tax collection, the 2023 primary budget will still not be sufficient to meet contractual debt service (p.16). Moreover, the Plan's assumptions regarding debt service obligations depend on a debt restructuring that has not yet taken place.

The Plan's projections of economic growth are highly dependent on a combination of assumptions about the impact of the austerity it would impose on the Puerto Rican government's fiscal operation and of the structural reforms it proposes. That is, in a very few years—clearly by 2023—the Plan projects that the positive impact on economic growth of the structural reforms will outweigh the negative impact of austerity. The unrealistic impact of the structural reforms will be taken up below.

The austerity imposed by the Plan, if implemented, would have significant negative effects on economic growth and would have those effects relatively quickly. By 2020, government spending would be cut by over 2% of GNP (relative to the pre-New Fiscal Plan baseline), and by 2023 the cut in government spending would be as much as 4% of GNP (relative to the baseline). In addition, by 2023 taxes would be increased by 0.8% (above the baseline), contributing further to the reduction in aggregate demand (p. 4). In the context of Puerto Rico's economic decline over more than a decade, this is austerity with a vengeance. Even with the Plan's assumptions about the positive impact on growth of structural reforms, by 2023 the primary fiscal surplus would be 2% of GNP (p. 16).

It challenges one's imagination to understand how such austerity policies might support economic expansion, regardless of structural reforms. Both in theory and practice, government primary surpluses aggravate economic decline, sometimes to a near disastrous degree. The demand reduction generated by government spending cuts and tax increases can contribute to a downward spiral, as demand reductions undermine economic growth and curtail private investment, leading to population reduction (out-migrations), reduction in tax revenue, further spending cuts, and a new round of demand reductions. The example of recent years is the situation in Greece, which, in spite of the significant differences from the Puerto Rican situation, provides a cautionary tale.

Structural Reforms

The New Fiscal Plan elides such a destructive outcome by positing that structural reforms will more than offset any negative impacts of fiscal consolidation. These reforms, the Plan claims, will lead to substantial increases in GNP and will do so relatively quickly: "The New Fiscal Plan proposes a series of major reforms ('structural reforms') to fundamentally improve the trajectory of the economy and drive growth" (p. 3). By 2023, the cumulative impact of these reforms, the Plan projects, will add over $1 billion to GNP. An examination of a few of the proposed reforms, simply as examples, leads to considerable skepticism, to say the least, regarding the speed with which they will have their impact and the extent of this impact. Moreover, the Plan's failure to discuss why structural problems exist and the barriers to change appears to demonstrate a lack of understanding of how structural changes might be implemented.

Labor Reforms

Consider first the labor reforms, which the Plan views as the “most critical” of its list of reforms (p. 2). These reforms involve several changes that (with the exception of the EITC change) come at the expense of Puerto Rico’s workers, including (along with the dates of their proposed implementation):

- Institution of at-will employment (effective by January 1st, 2019)
- Reduction of mandated paid leave, including 50% reduction in sick leave and vacation pay (effective immediately);
- Shift of Christmas bonus from mandatory to voluntary status (by January 1st, 2019);
- Earned Income Tax Credit (starting July 1st, 2018);
- Increase minimum wage for workers 25 and over by $0.25 per hour (effective with Christmas Bonus elimination); and
- PAN [Nutritional Assistance Program] work requirement and work bonus (effective by January 1st, 2019).

The Plan ignores the question: How would workers react to these reforms? On the basis of recent experience—for example, the reaction of teachers to the large reduction in the number of schools—it seems unlikely that these changes would be accepted without conflict. Workers, through their unions or independently, are likely to resist most of these changes, which significantly reduce their incomes and job-security.[†] Conflict and the economic disruption that comes with conflict would reduce, if not eliminate, the benefits of these changes to economic growth. Moreover, the benefits that would be reduced apply only in the formal sector, and thus their elimination would reduce the incentive for workers to move from the informal to the formal sector. Insofar as these changes were effective, they would also increase the incentive for Puerto Ricans to leave the island for the states. Finally, these changes would tend to increase income inequality in Puerto Rico, which is already greater than in any state. In addition to ethical objections to worsening the distribution of income, considerable evidence exists (including from the International Monetary Fund) that, at the levels of inequality in Puerto Rico, increases of inequality tend to yield slower economic growth.

These problems with the labor reforms do not mean they cannot be implemented. They do mean, however, that much greater attention would need to be given to how and how quickly they could be implemented and have their hoped-for impact.

[†] The increase of the minimum wage in exchange for elimination of the Christmas bonus would not be beneficial to most Puerto Rican workers, in large part because most workers in the formal sector, earning more than the minimum wage would have no direct benefit from the minimum wage increase.

Education and Human Capital Reform

As with workers' likely reaction to labor reforms, the Plan's proposals for education, along with the Puerto Rican government's actions, are likely to meet with considerable resistance—as the teachers' actions noted above indicate. Furthermore, with some individual schools' accomplishments notwithstanding, system-wide educational changes do not take place quickly. Both teachers and the educational bureaucracy have considerable inertia in their practices, and attempts to rapidly change school practices will often be ineffective. Most important, the Plan appears to ignore the social context in which the schools operate. The poor performance of students who go through Puerto Rico's educational system is surely affected by the high degree of economic inequality and poverty on the island.

Also, the Plan's expressed expectations regarding how quickly educational and human capital formation reforms will have an impact on economic growth defy credulity. The Plan claims that these reforms will increase by $64 million by 2021 and $247 million by 2023 (p. 33). This is hardly enough time for the reforms to be implemented, let alone have a substantial impact. Even if changes in the schools are implemented effectively immediately, students entering high school in 2019 will have just entered the workforce by 2023 (though there could be some small impact in this period from reforms of training programs and other aspects of the Plan's proposed programs).

Tax Reforms

Another striking example of the Plan's unreasonable expectations about the impact of structural reforms is in the realm of tax collection. While it is widely believed that there is considerable tax avoidance and tax evasion in Puerto Rico, the Plan's proposals for dealing with these issues is wholly inadequate and the expectations regarding results are unrealistic.

The problem is revealed in the first sentences in the Plan's section on "Tax Law Initiatives": "Puerto Rico's current tax system suffers from its structural complexity, instability, internal inconsistency, inefficient administration and inadequate enforcement. This has fueled *a culture of tax evasion*, promoted by a lack of adequate enforcement personnel, technology and process" (p. 97, emphasis added). Yet, having recognized that the tax collection problems are rooted in a culture of tax evasion, the Plan fails to take into account the difficulties, particularly the time it takes, to alter a cultural problem. Even if the particular proposals—tax rate changes, more effective enforcement, etc.—are implemented, the change in the culture of tax evasion will be slow to follow. For example, one aspect of this culture is the practice of payments for services often taking place in cash, making tracking of service providers' incomes difficult. The Plan's proposals do not mention this issue, let along offer means for dealing with it.

Furthermore, it seems likely that political factors contribute in two ways to Puerto Rico's tax collection shortcomings. First, it appears that there has long been a reluctance of the government to pursue tax collection (perhaps through prosecution) of high income, well-connected tax evaders. Second, many of the particular changes in the tax system proposed in the Plan exist because of the power of special interests. Neither of these factors, affecting any effort to effectively reform the tax system, is addressed in the Plan.

Government Regulations and the Consolidation of Government Agencies

As with other realms of reform, there is no dispute over the need for changes in government regulations and the organization of government agencies, and the Plan cites several regulations that have negative economic impacts. However, the proposals in the Plan ignore the complexities of eliminating or altering regulations and fails to distinguish between useful and inappropriate regulations. Instead of using a scalpel approach, the Plan seems to be advocating blowing up Puerto Rico's regulatory system.

The blow-it-up approach could be especially problematic because of the Plan's advocacy for a very rapid approach to regulatory reform: "To achieve the New Fiscal Plan's growth projections, ease of doing business reforms must be implemented *immediately*, with targeted operationalization of most initiatives by FY2019" (p. 48, emphasis added). This virtually cavalier approach is likely to wipe away valuable regulations—e.g., regulations that are intended to protect the natural environment (of which there seems to be no mention in the Plan)[‡]—as well as those regulations that have negative impacts.

Furthermore, in advocating speed in the implementation of regulatory reform, and in basing its estimates of impact on the assumption that the implementation will, indeed, be rapid, the Plan ignores the problems of bringing about change in government bureaucracies—which, after all, are staffed by real people. Simply excising a regulation from a list does not mean that actual practices will be immediately altered.

This lack of appreciation of the limits of change—and especially on the speed of change—in government bureaucracies is also apparent in the Plan's assumptions regarding what can be accomplished through the consolidation of government agencies. At least in the short run, the disruption of agency consolidation is likely to create costs, and simply bringing different agencies into one operation is unlikely to quickly have positive efficiency impacts. The Plan's problem in this regard is illustrated by the following statement: "… DDEC [Department of Economic Development and Commerce] should reduce front-line personnel by 20% to ensure a streamlined, efficient organization, leading to $5.4 million in annual savings by FY2023" (p. 85). Apparently, it is assumed that this reduction in personnel will automatically reduce redundancies. This assumption, however, at best reveals a naivety regarding the operation of

[‡] The Plan's lack of attention to the natural environment is underscored in its discussion of PREPA by the absence of consideration of alternative energy sources—e.g., solar and wind electricity generation. Also, except for a mention of the possible desirability of considering microgrids (p. 52), the connection between protecting the power system from the impact of future hurricanes, action that would likely be associated with the development of alternative energy sources, appears to be ignored.

bureaucracies. More likely, this is an illustration of the Oversight Board's effort to overcome the incompatible assumptions that lie at the foundation of its Plan.

Conclusion

Much more could be said about the unrealistic assumptions of the Plan. For example, in light of the relative neglect of Puerto Rico by the federal government in the post-hurricane period, the Plan's assumptions about both the quantity and timeliness of federal recovery funds are unlikely to be realistic. The same could be said about the Plan's favorable assumptions regarding the economic boost that will come (partly via these federal funds) from hurricane rebuilding. As to the failure of the Plan to take account of real people's likely reaction to particular proposals, the 2017 strikes at the University of Puerto Rico (UPR) are relevant (p. 4). The Plan proposes cuts in appropriations to UPR (p. 4), leading to the questions: Will students again react as they did in 2017? And, if so, what will be the impact on the proposed educational and human capital reforms? Similar questions could be raised about the Plan's proposal for reducing appropriations to municipalities (p. 4) and pension changes (Chapter 18).

The problems with the Fiscal Plan are much more than a long list of mistakes. The unrealistic and misleading nature of the Plan results from the incompatible goals of its mandate from Congress. As noted at the beginning of this paper, it will not be possible to both put Puerto Rico on a path to economic growth and to assure that debt obligations will be met.

The only way out of this conundrum is for Congress to provide financial support for Puerto Rico.[§] This could be, at least in part, accomplished without providing a debt "bailout" for Puerto Rico. Congress could enact laws and regulations that would, in effect, start treating U.S. citizens in Puerto Rico in the same manner as U.S. citizens in the state with regard to all federal programs—for example, Medicare, Nutritional Assistance, the Earned Income Tax Credit, and the Child Tax Credit Such action, putting Puerto Rico on a level playing field with the states, would generate an inflow of funds to the island and would begin to make it possible for the island to achieve both economic growth and servicing the debt.

Such changes could lead toward a meaningful fiscal plan for Puerto Rico. The Fiscal Plan of April 19 leads nowhere and should be abandoned.

[§] Another conceivable way out of the conundrum, though highly unlikely, is that the court, currently hearing Puerto Rico's de facto bankruptcy case, would issue a finding highly favorable to Puerto Rico. The courts possible actions seem to be ignored in the New Fiscal Plan.