

# **SHOULD THE U.S. GOVERNMENT DO MORE? WHY PUERTO RICO'S ECONOMIC CONDITIONS MATTERS TO THE UNITED STATES**

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### **ABSTRACT**

In 2016, the federal government established the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) to deal with the Puerto Rican economic crisis. However, PROMESA did not provide substantial and direct support for the island's economy—i.e., no funds. Should the U.S. government do more? Puerto Rico has an economy larger than several states, and it has a substantial level of trade with the states. Thus, the states have an economic interest in the well-being of Puerto Rico. Aside from narrow economic interests, the federal government has a responsibility to protect its people, whether danger comes from crime, disease, severe weather, or economic collapse. Puerto Ricans, as U.S. citizens, deserve the same protection as their fellow citizens in the states. In terms of human rights, the *de facto* colonial status of Puerto Rico is in conflict with avowed principles of the U.S. government and has resulted in relatively poor treatment by the federal government. There are several actions that the U.S. government could take to do more for Puerto Rico; for example, including Puerto Rico in federal programs in the same manner as the states are included and providing U.S. Treasury guarantees for new Puerto Rican bonds, which would supply funds to catalyze a new era of economic growth.

**Key Words:** Puerto Rico, PROMESA, Puerto Rico bonds, sovereignty

**JEL classification:** O1, O2, Z32

It is well recognized that the Puerto Rican economy is in crisis. GNP has been falling virtually steadily over more than a decade, and is now down 15% since 2006 (inflation adjusted). Perhaps a more accurate measure of the decline, the Government Development Bank's Economic Activity Index is down 20% in this period.<sup>1</sup>

The clearest sign of Puerto Rico's economic distress, is the large population decline. The island's population in 2016 was 11% below its 2005 peak. The decline has been brought about primarily by a mass exodus, as Puerto Ricans have moved to the states. Yet, in addition, the birth rate has declined and the death rate has risen, yielding a decline in the natural annual rate of increase from 0.53% in 2006 to 0.12% in 2015.

As economic activity has dropped, the government has built up a debt of almost \$70 billion, roughly the same as GNP, on which annual debt service obligations are in excess of \$4 billion. And these debt figures do not include the some \$40 billion in underfunded public pensions.

Recognizing the economic crisis in Puerto Rico—and concerned that the debt, much of which is held by funds and individuals in the states, will not be repaid—the U.S. Congress in 2016 established a process for overseeing economic policy in Puerto Rico. The process contained in the Puerto Rico Oversight, Management, and Economic Stability Act (or PROMESA) focuses on improving the Puerto Rican government's economic policy and, perhaps, finding a means to restructure and alleviate the debt burden. It does not provide and does not hold out a promise of providing federal funds.

Should the U.S. government do more?

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<sup>1</sup> Data used here are available in the *Informe Económico al Gobernador, Puerto Rico, 2015*. However, the Economic Activity Index is available on the web site of the Government Development Bank, <http://www.gdb-pur.com/economy/GDB-Economic-Activity-Index.html>.

## The Economic Interests

Although Puerto Rico is not a state, it is part of the United States as a “territory.” Its economy is larger than several states—fourteen in 2013, see the table below—and is heavily integrated with the U.S. economy. In 2015, Puerto Rico imported \$22.3 billion of goods and services from the states and exported \$51.4 billion of goods and services to the states. In a national economy of over \$17 trillion, these are not large numbers. However, the jobs that are created by sales to Puerto Rico and the activities that are dependent on the imports from Puerto Rico—which include, for example, large amounts of pharmaceuticals, medical devices, and chemicals—are not trivial or irrelevant to the well-being of people in the states.

**Gross Domestic Product of Puerto Rico and of States with Smaller GDPs than Puerto Rico, 2013 (billions of dollars)**

Vermont	\$28,838	Alaska	\$57,276
Wyoming	\$41,782	Delaware	\$60,816
Montana	\$43,006	Idaho	\$61,117
South Dakota	\$44,673	New Hampshire	\$68,701
North Dakota	\$51,048	West Virginia	\$70,595
Rhode Island	\$53,300	Hawaii	\$75,095
Maine	\$54,609	New Mexico	\$90,828
Puerto Rico		\$102,450	
(Puerto Rico GNP)*		\$69,945	

Source: *Statistical Abstract of the United States 2015* and *Informe Económico al Gobernador, Puerto Rico, 2015*.

\* For Puerto Rico, GDP is a problematic measure of economic activity, so GNP is also shown here. By the standard of GNP, the Puerto Rican economy was still larger than the economies of eleven states in 2013 (the latest year for which full data are readily available).

Beyond trade, Puerto Rico has been the site for substantial investment by U.S. firms. Although data are not available on the extent of U.S. investment, U.S. based firms have long had major operations on the island. As a site for U.S. pharmaceutical firms, Puerto Rico has been especially important. According to the Puerto Rico Industrial Development Company (PRIDCO), “With 49 FDA-approved pharmaceutical plants scattered across the island, Puerto Rico is home to top

multinational pharmaceutical companies, including [the U.S. based firms] Abbott-Abbvie, Bristol-Meyers Squibb, Merck, Pfizer, Eli Lilly and numerous others.”<sup>2</sup>

U.S. service firms and retail firms are conspicuous on the island, including, for example, Microsoft, Walmart, McDonalds, The Gap, Banana Republic, Sears, Citibank, and numerous mortgage companies and insurance firms. The successful operation of all these U.S. firms—the returns they can bring to their investors—are dependent on the conditions of the Puerto Rican economy.

And then there are the investment in Puerto Rican bonds. Puerto Rican government bonds have paid high, tax free returns to U.S. investors, largely through mutual funds. Again, as with direct investment, the success of these portfolio investments depends on conditions of the Puerto Rican economy. At present, and while the crisis continues, with the economy failing to grow, these bond investments are in danger. Not only are the returns to U.S. investors threatened, but in addition the failure of the Puerto Rican bonds could cause systemic damage.

All in all, simply in economic terms, the United States has substantial interest in the improvement of the Puerto Rican economy. Promoting “good” policies is not enough. At best, new policies cannot be implemented quickly and their positive impacts will not follow immediately from their implementation. If Puerto Rico were a sovereign nation, it could turn to the International Monetary Fund and the World Bank for support. It is, however, only a territory of the United States. It has nowhere to turn by to the federal government.

### **The Political Interests**

Perhaps the most fundamental interest the U.S. government has in providing support for the Puerto Rican economy lies, as with any government, in protecting its citizens. Whether the danger to its citizens is crime, disease, or economic collapse, the first responsibility of a government is to provide protection. Clearly, the people of Puerto Rico, U.S. citizens, are now in

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<sup>2</sup> <http://www.pridco.com/industries/Pages/Pharmaceutical.aspx>.

need of protection from economic collapse. More, because of the worsening economic situation, both disease and crime are also threatening Puerto Ricans. Prior to the emergence of the current economic crisis, the conditions of people on the island were poor relative to their fellow citizen in the states—with per capita GNP about one-third of that in the states and the poverty rate around 50%. Over the last several years, however, the situation has gotten worse—though the worsening has been hidden by some measures.

A seeming paradox exists in that while between 2006 and 2015 real GNP fell by 15%, real personal income was virtually unchanged. Indeed, in 2016, real personal income was slightly higher than in 2006. The paradox disappears, however, when transfers from the federal government are considered. Between 2006 and 2015, real federal transfers to individuals in Puerto Rico rose by about 25%. The \$16.7 billion of these transfers to individuals were 24% as large as the \$68.5 billion GNP. (Of the \$16.7 billion, Social Security benefits, medical benefits, and veteran benefits accounted for 80%.) In other words, personal income in Puerto Rico was maintained in spite of the economic decline only because of the transfers from the federal government.

The transfers, however, did not alter other signs of economic distress—in particular, the severe decline in the labor force participation rate and the rise of the unemployment rate. Between 2006 and 2015, the unemployment rate rose only from 11.0% to 13.0%, but the labor force participation rate plummeted from 48.6% to 39.9%. (Even the 2006 labor force participation rate was very low by international standards and by comparison with the states, where the rate was 66.2% in 2006.) If the decline in the participation rate is considered *de facto* unemployment, the rate of unemployment would be 21.7%.

These data and the data presented earlier (the out migration in particular), underscore the extent of the humanitarian crisis that is part of the economic decline in Puerto Rico. From simply a humanitarian perspective, the federal government would need to respond to the situation in order protect U.S. citizens living in Puerto Rico.

But there is a political issue as well as a humanitarian issue. Internationally, Puerto Rico is widely viewed as a colony of the United States. The U.S. government and many Puerto Rican officials do not accept this colonial designation. Yet, the reality of this widespread international view continues to exist and works to the detriment of the United States in world affairs. To hold areas as colonies is seen as quite negative, involving a denial of basic human rights.

If, however, a colony is prosperous and its people economically thriving, the negative view of the country that holds the colony is significantly attenuated. For example, in the decades following World War II, when the Puerto Rican economy was growing rapidly, the view that it was a colony did not establish a nasty blot on the U.S. record. Observers may have opposed the holding of a colony in principle, but the reality of an advancing economy undermined criticism of the United States.

Today the situation is different. The alleged colony is in distress. It is increasingly becoming a nasty blot on the U.S. record. As the situation continues, as the economy of Puerto Rico continues to decline, U.S. credibility as a paragon of democracy weakens. U.S. effectiveness in world affairs is damaged.

### **What Can the Federal Government Do?**

The economic and political interests of the United States, then, call for the federal government to take action to improve the economic situation in Puerto Rico. Policy improvements are desirable—indeed, essential. Yet, they are not sufficient to put the island's economy on an upward path of development. In particular, while the public debt and debt service obligations remain so high, there is little hope for economic growth.

Puerto Rico cannot declare bankruptcy. Moreover, the Puerto Rican constitution requires that payment on a large share of the debt be given priority over all other categories of government expenditures—education, health, public safety, infrastructure investment, etc. The federal

government, however, can nonetheless do a great deal to reduce the Puerto Rican government's debt burden.

A moderate course of action would be for the federal government to establish a procedure for *de facto* bankruptcy on that share of the debt—the majority—that is not covered by the constitutional protection. (A more extreme course, would include the constitutionally protected portion, but a great deal can be accomplished through the moderate course of action.) If, for example, restructuring the portion of the debt that is not constitutionally protected could result in the annual debt servicing be halved, about \$1.3 billion could be saved annually—i.e., made available for supporting government activities that would be crucial for economic expansion.

Yet, more funds will still be needed to support meaningful expansion. In part, these additional funds could be obtained on the bond market at a reasonable rate if the federal government would provide guarantees of these new bonds. With the oversight of PROMESA-created Oversight Board and Revitalization Coordinator, there would be substantial assurance that these funds would be used in a productive manner, generating the economic growth for their repayment.

Furthermore, the federal government could and should provide funds to Puerto Rico and the U.S. citizens in Puerto Rico simply by treating them under important federal programs in the same manner as states and citizens in the states are treated. Examples include the Earned Income Tax Credit, the Child Tax Credit, Medicare and Medicaid, Supplemental Nutritional Assistance, and several others. (The programs that do not apply in Puerto Rico as they apply in the states are listed and explained in the report of the PROMESA-created Task Force.)

These are examples of modest proposals, ways that the U.S. government could provide a foundation for a renewal of the Puerto Rican economy. More could be done, but these action would provide a useful beginning.

Still, such proposals are often opposed with a broad argument against providing more federal support for Puerto Rico. According to this argument, the economic crisis has been the result of policies (or lack of policies) adopted by the Puerto Rican people's elected government. Puerto

Ricans themselves, according to this argument, have thus created the crisis, and it is not the job of the federal government to bail them out. Indeed, to do so, the federal government would be sending a message to state and local governments that, failing to operate in a financially prudent manner, they needn't worry; Washington will bail them out.

While these concerns are real, it should also be recognized that the economic and political interest of the U.S. government in Puerto Rico's economic condition, as described above, tend to dominate. Furthermore, the situation of Puerto Rico is different than that of the states. States have a degree of sovereignty greater than Puerto Rico, and, what's more, have representation in Washington that is denied to Puerto Rico. The states are more fully responsible for their own economic conditions. Puerto Rico lacks the power to fully manage its economic affairs, and, whether the island is viewed as a "territory" or a "colony," the U.S. government bears a different responsibility with regard to Puerto Rico than it does with regard to the states.

Indeed, according to the U.S. Constitution (Article IV, Section 3, Paragraph 2), "The Congress shall have Power to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States." Thus, as a territory, Puerto Rico is *property* of the U.S. government—that is, Puerto Rico is *owned* by the U.S. government. With that ownership comes responsibility.