PUERTO RICO'S MACROECONOMIC SITUATION

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This report was commissioned by the Government Development Bank

- Objectives:
  - Assess the current macroeconomic situation
  - Analyze future prospects on current trajectory
  - Suggest policies to improve outlook

Main findings

- Macroeconomic situation has deteriorated and will continue to do so without changes
- Real economic activity has been declining for more than a decade
- Efforts to offset the decline have been financed with deficits

Main findings (continued)

- Without improved growth prospects, debt issues cannot be resolved
- Without addressing fiscal issues and policy reforms, growth will not resume

Context

- Puerto Rico’s status: not a country and not a state
- Potential is huge but largely unrealized

Current situation is dire:

- Debt high
- Fiscal position unsustainable
- Population and labor force are falling
- Negative real growth
- Cash balances critically low
- Delays will make things worse

Factors retarding growth: external

- Removal of tax breaks triggered start of decline
- Until 2008, the economy had recession and recovery; 2008 recession hurt but no recovery
- Oil price hikes hurt
- Minimum wages, Jones Act, other federal measures harm economic growth

Factors retarding growth: internal

- Domestic labor legislation: 13-month bonus, short probation, long vacation and sick leave
- Welfare system makes employment unattractive: 40 percent labor force participation rate
- Energy and transport costs high for external and internal reasons
- Doing Business index is poor in many aspects

Results

- Outmigration
- Loss of tourism share
- Manufacturing is high value/low weight/capital intensive industries
- Firm-specific inducements to firms have cost revenue and are detrimental to growth
- No growth for a decade

Causes have included

- Institutional weaknesses; statistical data are late and weak
- Effort to offset what was thought to be recession
- Budget projections overly optimistic
- Lack of expenditure control and payroll verification
- Practice of bargaining with individual companies: “closings” and tax amnesties; numerous tax credits

Fiscal Accounts

- The General Fund understates fiscal deficit
  - Commonwealth credit status is not independent of other debt
  - We use Central Government including all public sector except municipalities, retirement funds, state insurance fund and the three large enterprises
  - Fiscal deficit = net debt issued to private sector + payables accumulation + rundown of cash balances and other assets

Size of Deficits

- Deficits are larger and more serious than had been recognized despite government efforts
- FY 2015 budget plan was balanced; outcome was a deficit as primary surplus of only $752 million with interest and amortization of $2.7 billion
- Employee retirement funds and the 3 big state enterprises are also running large deficits
- They will land on central government

Fiscal Projections

- Overall deficit was around 5 percent of GNP in FY2013-14[(1)]
- Near-term prospects are poor
- With 1 percent nominal growth, debt-GNP ratio is rising
- Real output will fall 1 percent
- Inflation will be no more than 2 percent
- So overall nominal GNP growth would be about 1 percent
- This is very optimistic and we estimate fiscal outcomes

(1) Includes deficits at PREPA, PRASA, HTA, and the retirement funds

Debt build-up in that scenario

- An annual financing need deficit of just under 4 percent of GNP over FY2016-FY2020 (taking sales tax increase into account)
- Risks are mostly downside (loss of ACA funding, need to pay down arrears)
- Near-term prospects are poor
- Government debt could more than double in 5 years

Closing Gap

- Gap must be closed; that requires both growth and fiscal adjustment
- Delicate balance: too much austerity and greater fall in GNP; too much fiscal overhang and no growth
- Structural adjustment measures take time to take hold
- Failed partial solutions of past mean comprehensive program is needed

Puerto Rico must do a lot and it will be politically difficult

- But if nothing is done on debt side, growth won't come
- New institutions are needed for budget discipline, adequate data provision, changes in labor laws, and cuts in fiscal deficits
- Federal inertia needs to be challenged

Needed structural reforms

- Labor market
- Ease of Doing Business
- Move to uniformity of tax treatment
- Revalue property

Desirable federal changes

- Welfare payments are generous relative to per capita income
- Minimum wage is high relative to per capita income
- Jones Act raises costs

Fiscal adjustment possibilities: taxes

- Choose things that do least harm to growth
- Move toward more uniform incentives
- The proposals could yield increases by \$1 billion in 2016, \$3 billion annually by 2020 and \$4 billion by 2025
- Taxes could go up even more if informal sector shrank

Fiscal adjustment possibilities: taxes (continued)

- Could achieve overall fiscal balance by FY2021 and fully cover amortizations by FY2023 if structural measures are also taken

Fiscal adjustment: expenditures

- Could reduce by $2 billion by 2020 and more by 2025
- Renew Law 66 and freeze remaining spending in real terms saves $1 billion annually by 2020
- Education expenses are high; primary/secondary students are down and teachers up

Fiscal adjustment: expenditures (continued)

- U of PR subsidy could be cut with higher tuition and more scholarships, saving $500 million annually
- Cuts in Medicaid (to minimum federal standards) could save $150 million annually
- Higher growth path could yield another $1 billion in tax revenue

Need for Debt Relief

- Much more fiscal adjustment would reduce growth
- So large financing gap remains
- Debt relief supporting reforms could lead to larger return than continuing present path
- Chapter 9 would help

Need to strengthen institutions

- Fiscal oversight board
- Timely and transparent fiscal data
- Statistics for wider economy need great improvement

Conclusions

- No easy path
- Letting things drift will mean a poorer economy and less ability to pay
- A comprehensive approach is urgent; a worldwide lesson is that delay costs parties
- Fiscal adjustment, structural measures, institutional reforms, and debt restructuring must go together