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RESEARCH SUMMARY

ORIGINS OF THE PUERTO RICO FISCAL CRISIS

Puerto Rico is facing a severe fiscal crisis. Observers agree that the island's public entities are unable to repay their debts on time and in full, making default and debt restructuring inevitable. Puerto Rico's heavy public-sector debt burden appears to be the unintended consequence of a series of policy decisions extending back to the US takeover of the island in 1898. Rather than placing Puerto Rico on a path to statehood in the very beginning, Congress imposed a series of unique governing structures on the island that have contributed to its current debt burden and fiscal mismanagement.

A new paper for the Mercatus Center at George Mason University takes a close look at why this crisis is happening. Relative to the US states, Puerto Rico's government has poor fiscal transparency, low levels of public employee pension funding, and excess government staffing. To address these problems, Puerto Rico will require a federal financial control board, debt adjustment, constitutional reform, and the privatization of state enterprises.

To read the study in its entirety and learn more about its authors, Marc D. Joffe and Jesse Martinez, see "Origins of the Puerto Rico Fiscal Crisis."

HISTORICAL FACTORS CONTRIBUTING TO THE CRISIS

The Commonwealth of Puerto Rico has a long history of domination by foreign powers: first by the Spanish, then by the United States. These governments gave the island relatively little debt at first, but New Deal–style public corporations began issuing large volumes of revenue-backed bonds in the 1940s. After 1948, elected governors rapidly expanded the island's tax-supported debt. A translation error in Puerto Rico's 1952 constitution and a 1961 constitutional amendment effectively gutted restraints on debt accumulation.

The US Congress also contributed to Puerto Rico's crisis through the unintended consequences of several policies:

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- Congress granted a nationwide tax exemption to interest on Puerto Rico bonds, making them more attractive to investors. This facilitated government borrowing.

- Puerto Rico's unique institutional arrangement includes freedom for residents to emigrate to the mainland United States. This situation has been beneficial for Puerto Ricans, and it also provides an important signal to the federal government as more and more residents have chosen to "vote with their feet" by leaving the island because of its declining fiscal condition. In other words, the population drain is a warning mechanism—one that lawmakers should have paid closer attention to.

- The Merchant Marine Act of 1920 mandates that only US vessels may ship goods between Puerto Rico and the mainland. This increases prices on the island and makes goods produced in Puerto Rico less competitive on the mainland.

- The Internal Revenue Code exempted corporate income earned in Puerto Rico from federal taxation, but this exemption was phased out starting in 1996. A recession followed the phaseout period.

- Congress explicitly excluded Puerto Rico entities from Chapter 9 municipal bankruptcy protection. This limits their options for addressing fiscal distress.

OTHER CURRENT BUDGET ISSUES

In 2015, the president of the Puerto Rico senate commissioned a report to find and quantify government inefficiencies and bureaucratic overlap. The report, which has not been publicly released, identified over $150 million in possible spending cuts for FY 2017. Major cost-cutting opportunities are available in the commonwealth's Department of Health and Department of Corrections.

- *Inefficiencies in the Department of Health.* The Department of Health has redundant facilities, a system that hampers efficient resource procurement, and excessively high Medicaid administration costs.

- *Inefficiencies in the Department of Corrections.* The Department of Corrections suffers from an excess of space, administrative redundancies, and a refusal to take advantage of savings available through private subcontracting.

Other serious issues affecting Puerto Rico's finances are a lack of fiscal transparency and inadequate pension funding.

- *Fiscal transparency*. Puerto Rico's audited financial reports often appear late. For the fiscal year that ended June 30, 2014, audited statements were unavailable as of early 2016. Substitute information is provided irregularly and in inconsistent formats.

- *Public employee pension funding*. Puerto Rico's public pensions are severely underfunded. The commonwealth resorted to pension obligation bonds in 2008, essentially gambling that the investment returns on borrowed funds would exceed borrowing costs.

POLICY ANALYSIS AND RECOMMENDATIONS

In June 2015, the governor of Puerto Rico finally admitted that the commonwealth's debt is "unpayable," signaling an intention to default. Even if a new administration were elected that is more friendly to bond investors, capital markets are unlikely to provide funding at affordable interest rates. Puerto Rico would have to run surpluses for several years to pay down existing debt. Given its history and current political climate, this seems unlikely.

To address its problems, Puerto Rico will require a federal financial control board, debt adjustment, constitutional reform, and the privatization of state enterprises.

- *Debt restructuring and financial oversight*. A federally appointed financial control board should bring the island's finances into balance. The 1990s' Washington, DC, oversight panel is the most-cited precedent, but it may be useful to look further back in time for a closer analogy in Newfoundland's Depression-era royal commission. This body took over the island's budgeting process and freed it from an unsustainable debt burden. A Puerto Rico financial control board should have the authority to implement savings from all areas of the budget—including debt service. This means that bondholders may have to face extended payment terms or reduced interest.

- *Constitutional reform*. Regardless of whether Puerto Rico is offered a path to statehood, gains full autonomy, or remains a commonwealth, its constitution should be revised to take advantage of the best spending and debt control practices followed by US states. These include strong and well-defined constitutional spending and borrowing restraints as well as language specifically mandating the payment of actuarially determined pension contributions in full each fiscal year.

- *Privatization of state enterprises*. Policies related to public corporations should follow the best practices of Great Britain's Thatcher era: these corporations should be privatized, with shares spread widely among the public to avoid cronyism. Creditors of Puerto Rico's public corporations may also be given equity in the newly privatized entities as an alternative to a full cash settlement.

New crises will be almost inevitable in the absence of major institutional changes in Puerto Rico. History has bequeathed the island inefficient state-run enterprises and a government unable to balance its budget, but Puerto Rico could have a bright future if it undertakes the right reforms.