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Saving Puerto Rico

The causes and remedies for mounting debt are clear

Richard A. Rahn

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Ultimately, if you continue to spend more than you take in — whether you are an individual, business or government — there will be a day of reckoning. Puerto Rico is likely to reach that day by Dec. 1.

Back in June, the governor of Puerto Rico, Alejandro Garcia Padilla, announced that the government debt of $73 billion had grown so large that it was no longer "repayable." At that time, many of us who have had experience with countries in fiscal crisis made recommendations (see my commentary "Puerto Rico is America's Greece," June 23) to avoid what is now almost certain to happen. Puerto Rico is a partially self-governing U.S. possession. It is required to follow the U.S. Constitution and many, but not all, federal laws and regulations.

As is its pattern, the Obama administration waited until the last minute — this past week — to unveil its "solution," dubbed "Super Chapter 9." Chapter 9 is a provision in the U.S. bankruptcy code that allows local governments in U.S. states, but not the states themselves (including Puerto Rico), to declare bankruptcy. The Obama administration's proposal would allow both Puerto Rico and its municipalities to declare bankruptcy under something akin to Chapter 9. This proposal would deny bondholders their existing constitutional protections, while, at the same time, do little to address the real problems that caused the fiscal crisis in Puerto Rico. If the proposal is adopted, bond markets would likely read it as a precedent that would destroy bondholder rights and wealth in mismanaged states, including debt-stressed Illinois and California. The result would likely be higher borrowing costs for all states owing to the increase in risk to bondholders. It is for these and other reasons that the Republicans are likely to reject it. The administration's proposal could rightly be characterized as too little, too late, and too poorly thought out.

Puerto Rico should be very rich — but it has suffered from too much local government populism and socialism, and some destructive U.S. government regulations. The government has a number of state-owned companies that are poorly managed, such as the power company, which runs huge deficits, despite charging electricity rates many times higher than most mainland Americans pay. The minimum wage in the United States is about 28 percent of the average wage, while it is 77 percent in Puerto Rico. The result of destructive labor policies is that Puerto Rico has a labor force participation rate a third lower than the mainland (where it is at a 40-year low). The economy has been shrinking over the last decade, and as a result all too many of the island's most well educated and productive citizens (i.e., young adults) have left and are now working in the U.S. mainland. Meanwhile, many of the older and poorer dependent population remain in Puerto Rico on various forms of government assistance. This, in turn, makes an economic recovery more and more difficult.

The good news is that real economic reform would cause a rapid and sustainable increase in economic growth. Many of the British former and current overseas territories that had far less going for them than Puerto Rico, including Hong Kong, Singapore, Bermuda and Cayman, now enjoy much higher real incomes than Puerto Rico(and even the United States, in some cases). Puerto Rico should adopt an internationally competitive tax and regulatory system — as the above-mentioned British-created political entities have done. It needs to install a debt brake (in reality a spending brake) as the Swiss have done. It needs to reduce the cost of doing business (e.g., a new company in Estonia can be created in only 18 minutes). It needs to create a voucher system for education as the Swedes have done. The point is that many places around the world have solved problems that now plague Puerto Rico, so there is no need to reinvent the wheel.

Puerto Rico's bondholders are justifiably likely to resist attempts to deny them their rights by changing the rules, unless they see that pro-growth improvements in economic policy will be made. High growth greatly increases cash flow to the government — even with much lower tax rates — while decreasing the demand for government services, thus increasing the government's ability to service old debt.

A temporary "control board," much like the one installed in New York decades ago and more recently in the District of Columbia to deal with the urgent fiscal problems, should be immediately put in place. At the same time, an economic reform and growth commission needs to be established to specifically identify the problems that caused the existing situation, pinpoint the impediments to economic growth (including U.S. government regulations), and then present solutions, including global best practices. The commission should be given a very short time — three months — for its report, given the urgency of the situation. The only thing that is hard about "saving" Puerto Rico is the political will to enact the obvious and necessary solutions.

Richard W. Rahn is a senior fellow at the Cato Institute and chairman of the Institute for Global Economic Growth.