THE BOND BUYER

Commentary: Betting on Puerto Rico?

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Puerto Rico has been in the news like never before in history. With the territory trailing only California and Illinois in outstanding municipal bond debt, a looming ratings downgrade to junk territory would have a substantial impact on investors, borrowing costs of states and municipalities, and of course, its dwindling number of residents. Some investors have given up and closed their positions, while others hope for economic growth (or a government bailout).

Yet, with towering debt, largely unfunded pension liabilities, out-migration, and a falling birth rate, they may end up on the losing side. Some analysts and fund managers argue that the fiscal house is being put in order and while there is some truth in the observation, it ignores the connection between fiscal and economic policy. In fact, the Island's short-term problems are tied to a Greece-like debt trap whereby policies aimed at reducing its fiscal deficit deepen a recession that further widens the deficit, with no end in sight to the vicious cycle.

Recent editorials in leading newspapers suggest dealing with the Island's political relationship to the U.S. or re-balancing the economy away from manufacturing to tourism. Unfortunately, these recommendations ignore Puerto Rico's core problem: social and labor market policies better suited to a rich-country than a developing economy. t the same time that a high minimum wage discourages employment creation, high public transfer replacement rates and implicit taxes on work discourage labor market entry among the low-skilled, and encourage early-life withdrawal among all. In combination they generate one of the lowest employment ratios in the world. Only 27% of the population is gainfully employed. Blame also lies in local eagerness to adopt policies with short-term political benefit but long-term economic costs, and on government's focus on patronage rather than on improving individual and social capabilities.

Education is a case in point. Even though income levels are half as high as in the U.S. mainland, private school attendance is twice as high. Among families with incomes above two times the poverty threshold, only 40% of children go to public school, compared to 85% in the US. A large part of society has voted with its feet and deemed its public education system a failure. Yet, there is little pressure for reform, perhaps because individuals do not feel their efforts will come to fruition. The few charter schools that exist operate under very similar rules to those of regular public ones. School vouchers have been ruled unconstitutional. Information on school performance is out of date, sparse, and difficult to find. At the Federal level, pressure is also lacking. After two instances of dismal performance in the national education assessment test, our school system requested a permanent exemption and our children have not been officially tested since. Recently, a large number of exemptions from the No

Child Left Behind law was requested and granted.

This is a shame because without improved education, there is no hope of alleviating this conflict between policy and reality, and therefore of economic growth and debt repayment. Higher productivity resulting from improved schooling would make the local minimum wage as harmless as it is in the Mainland. The same can be said of productivity effects on disincentives provided by public transfers including retirement benefits.

Changing the state of affairs is a daunting political task. Less than half of the voting-age population is economically active and fiscal adjustment has to date fallen on the Island's tiny business sector. The top corporate tax rate has been raised to 40% and along with a new tax based on sales, effective rates can fall north of 80%. Washington DC politics are not far behind, with budget battles making economic aid a near impossibility. Interestingly, if Puerto Rico does not make it, it will be Congress' problem to solve since the territorial clause of the U.S. Constitution gives it final power and ownership of the island. Loss of liquidity could result in a sort of Federal receivership as states or territories cannot file for Chapter 9. Congress would then be responsible for making the painful fiscal and economic adjustments, a lose-lose proposition moreover shrouded in colonial overtones. Of course, it could also dispose of the territory, granting it unilateral independence and in the process leaving bondholders and millions to an even worse fate.

Is there a better scenario for all concerned? Yes, but only once it is recognized that social change does not happen without its difficulties and that most countries do not make tough choices with ease, as the recent compromise in Washington, D.C., shows. What Puerto Rico needs today is pressure to reform its school and public transfer systems. It also needs economic aid to break the debt trap and begin growing for the first time in seven years. Both needs can be reconciled through a request for temporary assistance to the Federal government to stimulate aggregate demand, but also for funding initiatives geared towards improving the quality of education, raising labor force participation, reducing high school dropout rates, among others.

Assistance would be conditioned on meeting performance criteria proposed by the local government in the request. These would surely need to include labor market, schooling metrics, and others deemed necessary for long-term survival. Depending on what is offered by the local government, Federal aid would be forthcoming and then annually contingent on meeting goals. The program would focus minds, reward good policy and experimentation, and do the opposite to patronage and improvisation. Conditional transfers have proved valuable at the microeconomic level. At the macroeconomic level, they can give Puerto Rico a fighting chance.

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