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Freeing Puerto Rico's Labor Market from Stifling Federal Intervention

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INTRODUCTION

In July 2015, the government of Puerto Rico announced that it would be unable to pay its debts and expected to default on a series of repayment obligations. In August 2015 and January 2016, two Puerto Rican public agencies defaulted. Subsequently, on May 2, 2016, the Government Development Bank for Puerto Rico missed a $400 million payment. A $2 billion payment looms on July 1, and Puerto Rico will almost certainly default on that, too.

Puerto Rico is caught in a vicious spiral. The population, economy, and assets necessary to back up the pension system are all shrinking faster than budget cuts can keep up with. A dangerous lack of economic opportunity is pushing increasing numbers of people to depend on government or leave the island altogether. As the tax base shrinks and the proportion of dependents grows, more pressure is put on the island's already bloated and mismanaged public sector. On a per capita basis, the budget of Puerto Rico is already higher than that of any state of the United States, though average income is far lower. Puerto Rico's outstanding public debt is one-half that of perennially distressed California—a state with more than ten times the population and a per capita income several times Puerto Rico's.

The House of Representatives has responded by passing H.R. 5278, the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA). This legislation may help stabilize Puerto Rico momentarily, but it would do little to address the underlying causes of the current crisis. Puerto Rico's crisis has been in the making since the 1970s, when the United States federal government imposed on Puerto Rico the same minimum wage as on the mainland. Because the average wage in Puerto Rico was (and remains) far lower than in any of the fifty states, the result was a minimum wage that constituted a far higher proportion of the average hourly wage than in the United States or virtually any other case in the economic literature. Whereas in the United States the minimum wage of $7.25 is 41.7 percent of the median hourly wage,[1] in Puerto Rico the same minimum wage is 75.4 percent of the median hourly wage.[2]

The imposition of a minimum wage set so high in relation to average wages diminished opportunities for employment in the formal economy. This would have likely created a large informal economy, if not for the near-simultaneous expansion of federal welfare benefits to levels that were higher in relation to average income than those of the U.S. mainland. This expansion of benefits led to far greater welfare dependency. Within a few years of the introduction of the food stamp program, for example, half of the population of Puerto Rico was participating, and food stamps accounted for 7.5 percent of personal income.[3] In recent decades, federal welfare has accounted for nearly 30 percent of average income in Puerto Rico.[4]

The combination of high levels of minimum wage and welfare benefits appears to have frozen increases in productivity and income, killed the investment rate, and left Puerto Rico with one of the world's lowest rates of employment and labor force participation.[5] Puerto Rico's labor force participation rate is now less than 40 percent, and its employment rate is less than 30 percent—and much of that employment is in the public sector.

The layering of massive federal welfare benefits on top of the federal minimum wage helps explain why the latter did not lead to a collapse of the formal economy in Puerto Rico, but it does not explain why a fiscal crisis took so long to materialize. With so few workers in the private sector paying income taxes, how did Puerto Rico manage to sustain such a high level of government spending for so long?

The answer to that question almost certainly lies with the enactment of section 936 of the U.S. Internal Revenue Code in the 1976. Section 936 allowed companies to operate in Puerto Rico free of federal taxation as long as they sheltered their operating profits in the local economy for a period of years and realized income in the form of dividends. Though the Puerto Rican tax regime is riddled with exemptions and incentives of various kinds, Puerto Rico has a very high corporate tax rate. More importantly, because of the overall structure of tax incentives, Puerto Rico came to depend on corporate income taxation for a far higher proportion of its general fund revenue (almost 30 percent) than the average for state and local government on the U.S. mainland (3.11 percent).[6] Section 936 was repealed in 1996 and phased out in 2006, which marks the precise point in time that the Puerto Rican economy entered its current tailspin.

Minimum wage and welfare policies have a few things in common. They both have generally redistributive effects, though the redistributive effect of a minimum wage is more complex than that of a welfare transfer. They also both have negative employment effects: minimum wage prohibits employers from hiring many people they would otherwise hire, while welfare incentivizes people not to work. (Though again, the effect is more complex in the case of minimum wage, because a higher minimum wage also draws some people into the labor force who would not otherwise work.)[7]

Puerto Rico's experience since the 1970s, and particularly in the last decade since the phase-out of the section 936 cushion in 2006, strongly suggests that the minimum wage and welfare benefits produce both redistributive and negative employment effects. However, it seems clear that the higher minimum wage and welfare benefits are set—relative to average wages—the more pronounced the negative employment effects will be relative to any redistributive effect.

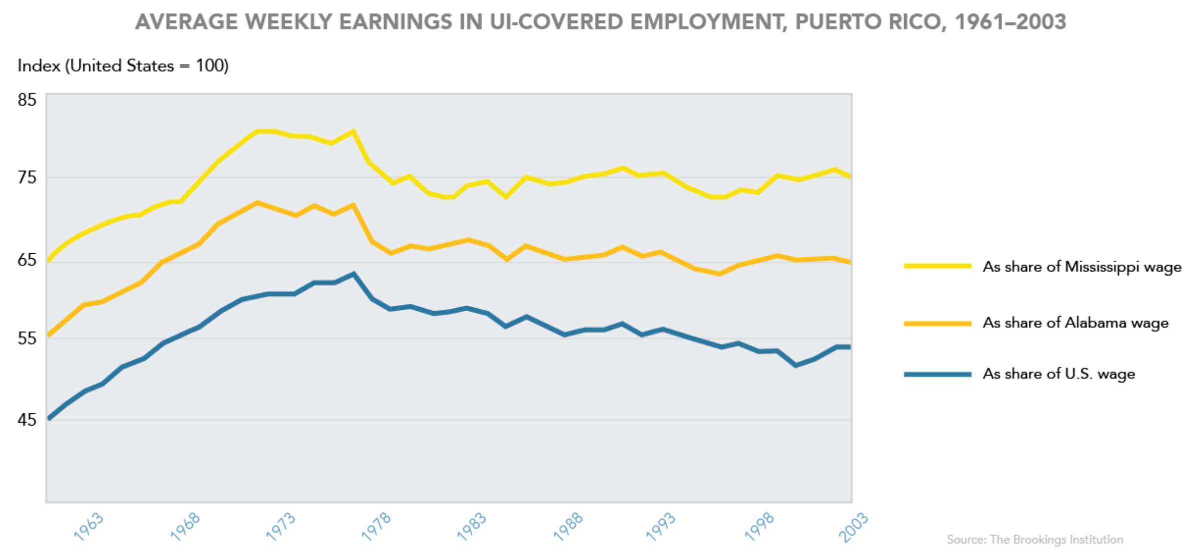
This report urges leaders in Puerto Rico and on the mainland to approach the fiscal crisis as an opportunity to enact structural reforms that are designed to restore economic freedom in the Puerto Rican economy and lay the foundations for a dynamic free market on the island. Merely restructuring Puerto Rico's debt will not solve its debt crisis or the underlying economic malady. With the right free-market reforms and the revival of a competitive labor market, Puerto Rico could return to rapid growth quickly. This could provide a valuable example of what policies might work in other areas, such as Detroit, plagued by low labor force participation and high levels of debt.

THE DECLINE AND FALL OF PUERTO RICO'S ECONOMY

When Spain ceded the territory of Puerto Rico to the United States at the start of the twentieth century, Puerto Rico became more integrated into the American economic and legal system. With territorial status came an effective guarantee of political and economic freedom, property rights, a stable financial market, and the rule of law.

The combination of free markets and rule of law allowed remarkable economic growth. In the decades after World War II, Puerto Rico's advances in economic production and educational attainment were comparable to those of the Asian Tigers in the 1990s. Puerto Rico's GDP per capita rose from 30 percent of U.S. GDP in 1950 to 75 percent in 1980. Even Puerto Rico's GNI per capita (a measure that offers a more accurate picture of how much income actually accrued to people on the island), rose from just 20 percent of U.S. GNI in 1950 to 40 percent by the early 1970, when it was catching up to the poorest U.S. states.[8]

Unfortunately, just as Puerto Rico was approaching levels of education and affluence more typical of the developed world, the United States imposed on Puerto Rico a series of labor regulations and welfare benefits that included minimum wages and welfare benefits set far too high by comparison with local average wages. Federal transfers jumped from about 5 percent of total personal income in 1964 to about 20 percent in 1974.[9] The economy has been largely stagnant ever since, and GNI is now just 30 percent of U.S. GNI.[10] Tellingly, whereas raising the minimum wage often has the effect of increasing average hourly earnings—at least for those lucky enough to keep their jobs—in Puerto Rico, average hourly earnings actually declined.



Though consistently underperforming compared to the U.S. mainland since the 1970s, the Puerto Rican economy's upturns and downturns have generally tracked those of the mainland U.S. economy. This time is different. According to a 2012 report by the Federal Reserve Bank of New York, the latest downturn "started earlier and was much steeper than that on the U.S. mainland, and to date, the economy has shown no strong sign of recovery."[11] This strongly suggests that the current crisis has been driven by factors largely unrelated to those which drove the U.S. and global financial crisis. While the U.S. economy has grown 12 percent since the bottom of the financial crisis in the United States, the Puerto Rican economy has contracted a further 10 percent. If Puerto Rico's economy had kept pace with mainland trends, it would be nearly 30 percent larger than it is today.

Despite much evidence of mismanagement by Puerto Rico's government, the major driver of Puerto Rico's economic stagnation since the 1970s and dizzying decline in the last decade is almost certainly a combination of three federal policies: the minimum wage, welfare, and section 936 of the U.S. Internal Revenue Code.

One clear lesson that emerges from the following discussion is that the higher an economy's minimum wage and welfare benefits are set relative to average income, the more pronounced the cost in disemployment effects will be relative to any benefits from the redistributive effect.

MINIMUM WAGE

The 1938 Fair Labor Standards Act (FLSA) established minimum wages that applied throughout the United States, including Puerto Rico. It quickly became apparent that imposing a minimum wage requirement on Puerto Rico would devastate the island's economy, so in 1940 Congress exempted Puerto Rico (and other U.S. territories) from the minimum wage by creating sector-specific "industry committees" empowered to set lower minimum wages. The minimum wage also did not apply to farm labor in the United States until the late 1960s. However, starting in 1974, Congress expanded coverage and enacted automatic increases until Puerto Rico's minimum wage reached the mainland minimum wage in 1983.[12]

When the full minimum wage was phased in, Puerto Rico's average wages were still far below those on the mainland. Not only did average wages in Puerto Rico not increase relative to the mainland as a result of phasing in the full federal minimum wage, they actually decreased and then stagnated. This seemed to confirm Congress' initial expectation, in the midst of World War II, that applying the full minimum wage to Puerto Rico would have devastating effects.

When considering the impact of the minimum wage on employment, it is crucial to consider the relation of the minimum wage to median wages. On the mainland, where the median hourly wage is $17.40,[13] the minimum wage is only about 41.7 percent of the median hourly wage. The median hourly wage in Puerto Rico, by contrast, is only $9.61.[14] With the federal minimum wage at $7.25 per hour, Puerto Rico's effective minimum wage is 75.4 percent of the median wage. By comparison, Australia, which reportedly has the world's highest national minimum wage,[15] was at 62 percent of the median wage in 2014.[16] By comparison, if the United States set its minimum wage to 75.4 percent of the median hourly wage, the minimum wage would be $13.11 per hour.

It's important keep in mind that in a minimum wage economy, median and average wages are partly an artifact of the minimum wage. Any minimum wage, regardless of its impact on employment, can be expected to raise median and average wages, because it will either eliminate or raise the value of a large fraction of data points for income earners at the bottom of the bell curve. One key factor is the impact on Gross National Income (GNI). If after raising the minimum wage, average and median wages rise but GNI falls, then it is almost certainly the case that the lowest income earners have been pushed out of the labor force altogether. Puerto Rico's Gross National Income (GNI) per capita, a measure that reflects the value of goods and services produced in Puerto Rico (and excludes purely "accounting profits" claimed by tax shelter corporations) grew from 20 percent of the U.S. average in the 1950s to 40 percent by the 1970s, and then fell back 30 percent of the U.S. average.[17]

Minimum wages set at 70 percent to 90 percent of average wages are common in the developing world, where they are used to provide an income base and reduce income inequality. However, developing countries often lack the administrative capacity to enforce minimum wage laws. As a result, the minimum wage in such countries tends be enforced only in the modern parts of the economy, while most employment persists in the informal economy. For this reason, the minimum wage in developing countries often has little real effect.[18]

Puerto Rico is thus in a uniquely burdensome position: its minimum wages are set at high developing-nation levels, and it has strong developed-world administrative enforcement. This stands in contrast with an earlier period such as the 1950s, when according to economists Lloyd Reynolds and Peter Gregory, a much lower minimum wage had driven increases in wages without notable disemployment effects.[19] A more recent study confirms a marked combination of disemployment effects following introduction of the federal-level minimum wage in Puerto Rico.[20]

WELFARE BENEFITS

Had the minimum wage been introduced at federal levels by itself, the disemployment effects (with respect to the formal economy, at least) would likely have had a catastrophic impact on living standards. But, as is now clear, the simultaneous introduction of federal welfare benefits on a massive scale likely cushioned the blow. Today nearly half of all Puerto Ricans on the island qualify for some kind of federal assistance.

Federal direct transfer payments to residents and federal grants to the government together account for nearly half of Puerto Rico's GNP.[21] Puerto Rico's sales tax is thus increasingly important relative to other taxes because it allows the government of Puerto Rico to tap into a larger tax base—namely that created by federal direct transfer payments.

During the decades when section 936 artificially inflated corporate operating income in Puerto Rico, the public sector had a ready source of income. Puerto Rico's income tax rates had long been 39 percent for corporations and 33 percent for individuals.[22] The electrical utility, PREPA, which accounts for an outsized portion of public sector spending, charges directly for providing electricity, but should be deemed part of the budget because its operating losses and debts are chargeable to the government of Puerto Rico, and the same used to be true for Puerto Rico's government-owned telephone company, which was privatized in the 1990s. When section 936 was phased out, corporate income fell, and Puerto Rico's tax revenue fell correspondingly. The "sales and use" tax, introduced in 2006 and modified in 2015, has partially made up for this.

Federal transfer payments today account for 40 percent of Puerto Rico's GNP, and perhaps half of its GNI. About a quarter of Puerto Rico's population is on food stamps. These figures do not include federal fiscal assistance to the government of Puerto Rico, which amounts to roughly 10 percent of GNP (See Page 13).

Starting in the mid-1970s, federal transfer payments increased rapidly. Taking into account Social Security, Medicare, unemployment insurance, and similar programs, government benefits increased from 14.9 percent of Puerto Rican personal income in 1974 to more than 30 percent less than five years later. From 1990 to 2005, government benefits accounted for 25 to 28 percent of personal income.[23] In 2012, 5.9 percent of Puerto Rican households received public assistance, more than twice the national average, and significantly higher than any state in the United States.[24]

Welfare as described thus far has a major impact on the incentive to work. A brief comparison to the United States begins to give a sense of the social impact of these benefits. In 1974, government benefits accounted for about 10 percent of Americans' personal income and were still barely above that figure when Barack Obama was elected president.[25] Since then, the share of Americans' personal income coming from direct transfer payments has increased several percentage points—and labor force participation has dropped to its lowest levels since the 1970s. But despite Americans' dramatically increased level of dependency on government in the Obama era, the levels are still nowhere near Puerto Ricans' level of dependency on government.

A close look at the food stamp program sheds still more light on the enormous transformation that federal benefits have wrought in Puerto Rican society. Prior to 1974, there was no food stamp program in Puerto Rico. By 1980, just six years later, more than half of all Puerto Rico residents received food stamps, providing an amazing 7.5 percent of Puerto Rican personal income. By comparison, food stamps have never provided more than 0.5 percent of the personal income of Americans on the U.S. mainland.[26]

SECTION 936 AND OTHER SUBSIDIES

Former section 936 of the U.S. tax code, enacted in 1976, explicitly exempted dividend income earned by U.S. firms operating in all U.S. possessions. According to the U.S. Senate Finance Committee's accompanying report, the goal of section 936 was "assisting the U.S. possessions in obtaining employment." But in the case of Puerto Rico, the hoped-for employment gains seemed not to materialize.[27]

Given its significant cost to the U.S. federal government relative to the small number of jobs created and investments made in Puerto Rico, the law was amended several times. However, in a 1993 report, the Government Accounting Office continued to cite "concerns about the tax benefits in relation to employment generated."[28]

With the benefit of hindsight, it is possible to see that section 936 likely did have a significant employment-generating effect. In 1980, Puerto Rico's total employment was about 750,000.[29] That year, the total direct and indirect employment attributable to operations under section 936 is estimated to have been 131,637—nearly 20 percent of total employment.[30] The law's job-creating effects appear to have substantially absorbed the disemployment effects of the new minimum wage and welfare policies.

Much of that job creation was a function of the corporate tax incentives. As Scott Greenberg and Gavin Ekins of the Tax Foundation explain, section 936 was in effect a bonus for investment from outside Puerto Rico:

> *Because section 936 made foreign investment in Puerto Rico artificially attractive – creating, in effect, an economic bubble – it left the island vulnerable to a crash if the tax provisions were ever to be repealed. . . . Ultimately, in 1996, President Clinton signed legislation that phased out section 936 over a ten-year period, leaving it to be fully repealed at the beginning of 2006. Without section 936, Puerto Rican subsidiaries of U.S. businesses were subject to the same worldwide corporate income tax as [any] other foreign subsidiary.*
>
> *Not coincidentally, 2006 also marked the beginning of a deep recession for Puerto Rico, which has lasted until today. Puerto Rico's high corporate taxes on domestic corporations along with low taxes on U.S. subsidiaries had skewed the Puerto Rican economy toward foreign investment from the U.S. When section 936 was repealed in 2006, foreign investment began to flee. Without a strong domestic corporate presence to fill the void, the economy began to contract, along with tax revenues.*[31]

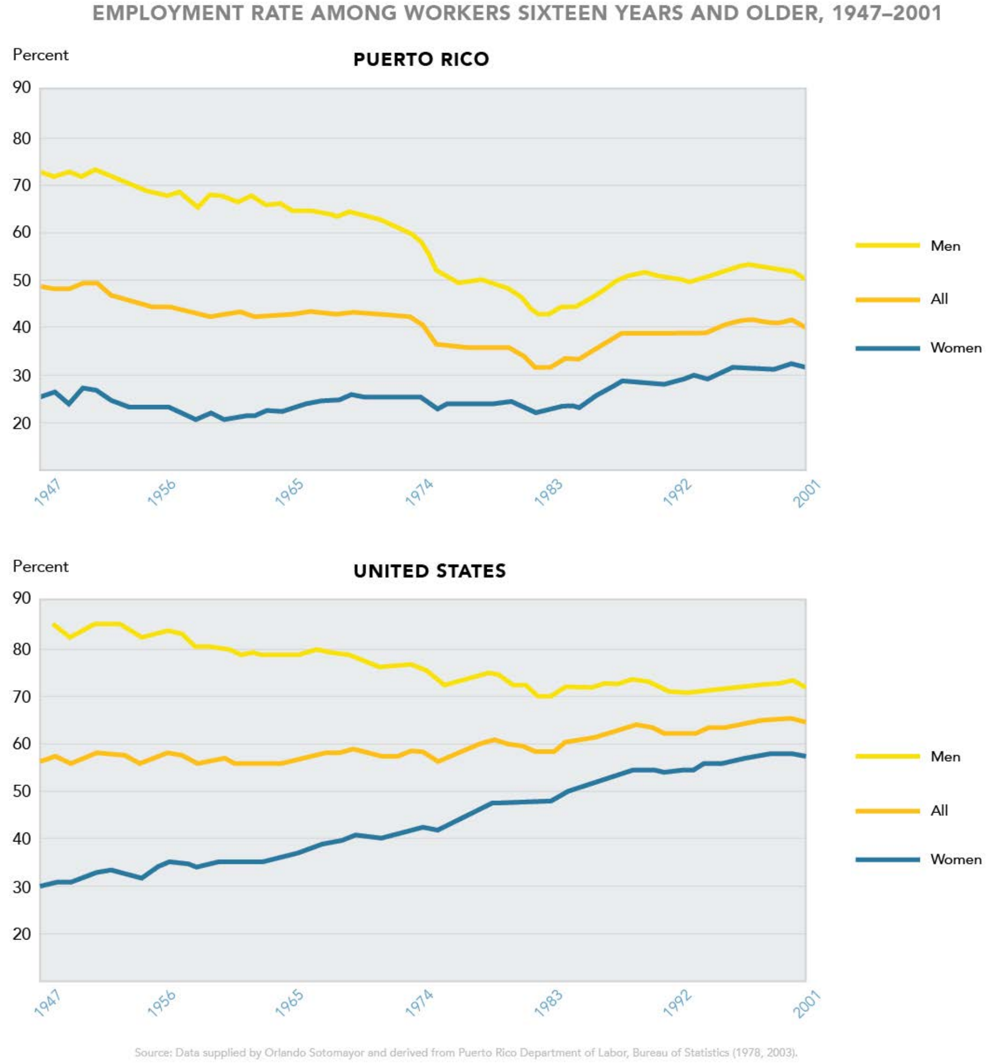
As an exemption for *dividend* income of companies that were at least 80 percent foreign-owned, section 936 incentivized the proliferation of wholly owned subsidiaries of foreign corporations that would feed income back to the parent in the form of dividends. Puerto Rico offered major exemptions for 936 subsidiaries but taxed the dividends. This tax incentive structure drew the attention of both corporate operations and their accountants. It generated a huge amount of corporate operations expenditure in Puerto Rico and a huge amount of global corporate profits for the parent corporations, which were "routed" through Puerto Rico by clever accounting. This accounting distortion has been credited for the wide gap between GDP, which includes the latter sort of revenue, and GNI which does not.

Prior to the start of the crisis, Puerto Rico depended on corporate income taxation for a far higher proportion of its general fund revenue than state and local government in the U.S. mainland. In 2002, for example, Puerto Rico drew nearly 30 percent of its general fund revenue from corporate income tax.[32] By comparison, the average proportion of state and local budgets on the U.S. mainland drawn from corporate income tax in 2002 was 3.11 percent.[33] By 2009, with section 936 fully phased out, the proportion of Puerto Rico general fund revenue derived from corporate income tax had fallen below 20 percent, and the budget deficit was exploding.

Hence, section 936 may be properly viewed as life support for an economy left in critical condition by the combination of minimum wage and welfare enacted in the 1970s. Once the life support was removed in 2006, the economy went into its current tailspin. Employment in Puerto Rico reached a peak of nearly 1.28 million in December 2006 and then started hemorrhaging about 10,000 jobs per month.[34]By the time the financial crisis exploded in August 2007, employment had fallen to 1.21 million. It fell under 1 million in October 2013. Employment has remained at about 1 million since then.

LABOR FORCE AND POPULATION IMPACTS

A comparison of historical labor force participation rates in Puerto Rico and the United States clearly shows the impact of the full federal minimum wage in 1974 and the introduction of massive federal welfare benefits in the 1970s, starting with food stamps in 1975.



As economist Carlos E. Santiago has written:

> *The labor market adjusted very rapidly into the higher and more uniformed minimum wages. The employment-population ratio and labor force participation rates, already exhibiting slow downward trends, fell sharply. The unemployment rate increased to unprecedented levels, reaching 20% before 1979. These are not transitory changes since they showed remarkable stability in the face of cyclical economic movements.*[35]

Since the 1970s, Puerto Rico has had a remarkably low labor force participation rate. Barely 40 percent of Puerto Rico's population is in the labor force, compared with 53 percent in Greece, 56 percent in France, 62.1 percent in the United States, and 65.2 percent for the Caribbean as whole.[36] When unemployment rate is factored in, Puerto Rico's employment rate (ratio of employed workers to population) is close to 30 percent. According to one study, "In 2000 only 31% of the overall population was employed, giving the island the lowest employment-to-population ratio in the Americas and the Caribbean, if not the world."[37]

The picture gets worse still after disaggregating private and public sector employment. According to the Bureau of Labor Statistics, Puerto Rico's total nonfarm employment of roughly 910,500 included 232,300 in the "government" category; 129,300 in the "education and health services" category (which is mostly public sector); and 178,000 in trade, transportation, and utilities (which is substantially public sector[38]). This implies that something approaching half of Puerto Rico's total nonfarm employment is public sector.

Hence, out of a total population of 3.5 million, Puerto Rico's total private sector employment is roughly less than 500,000. These workers make one-third as much in average wages as workers on the U.S. mainland, and they support a level of state spending that is higher, on a per capita basis, than any state in the United States.

Puerto Rico's low labor force participation is concentrated in particular demographic segments. The divergence between Puerto Rico and U.S. mainland labor force participation rates is largest in the age groups of 16 to 24 years and 45 to 64 years, particularly at the extremes. It is also more pronounced among women of every age category than among men. "In seeking explanations for the differences in Puerto Rican and U.S. participation patterns, then," write economists Gary Burtless and Orlando Sotomayor, "it makes sense to focus on factors that can account for low participation early and late in workers' careers and incentives that affect women more than men."[39]

One would expect to see any negative employment effects from imposition of the minimum wage to be concentrated among the young and old and least skilled. The higher the minimum wage, the more those groups will be affected, and the higher up the skill ladder the negative employment effects are likely to be felt.

The historical trend in wages shows an even more dramatic pivot. Average weekly earnings in sectors of employment covered by unemployment insurance (i.e., relatively high-earning brackets) rose steadily from 1961 to 1977. This occurred both absolutely and as a share of U.S. mainland weekly earnings.[40] Interestingly, average earnings in Puerto Rico continued to rise briefly even after the oil shock of 1973–74, which created a deep recession in both the mainland and Puerto Rico and caused electricity rates to soar.

Soon thereafter, however, even as recovery set in, Puerto Rico average weekly earnings declined steadily as a share of U.S. average weekly earnings. Interestingly, the downward trend continued despite the crash in oil prices starting in 1982, which was generally a boon to advanced economies elsewhere.

The missed opportunity is evident when comparing rates of educational attainment in Puerto Rico to rates of the mainland. In 1940, the average Puerto Rican had just 2.7 years of schooling, while the average American had about 8. By 2000, Puerto Rico had almost caught up, with 11 years of schooling, compared with just over 12 for the U.S. mainland.[41] It is highly unusual for average wages to decline persistently even as educational attainment increases. By 2000, Puerto Rico attained the average level of education of attained by the mainland United States in 1973—but had only a third of the mainland's real wage.

One explanation posited by Burtless and Sotomayor is that Puerto Ricans accumulate work experience—and the related skills—far more slowly than their counterparts on the mainland because of the low labor force participation among young people. The gap in experience logically indicates a gap in productivity and in turn a gap in wages.[42]

As the Federal Reserve Bank of New York explains in a 2012 report:

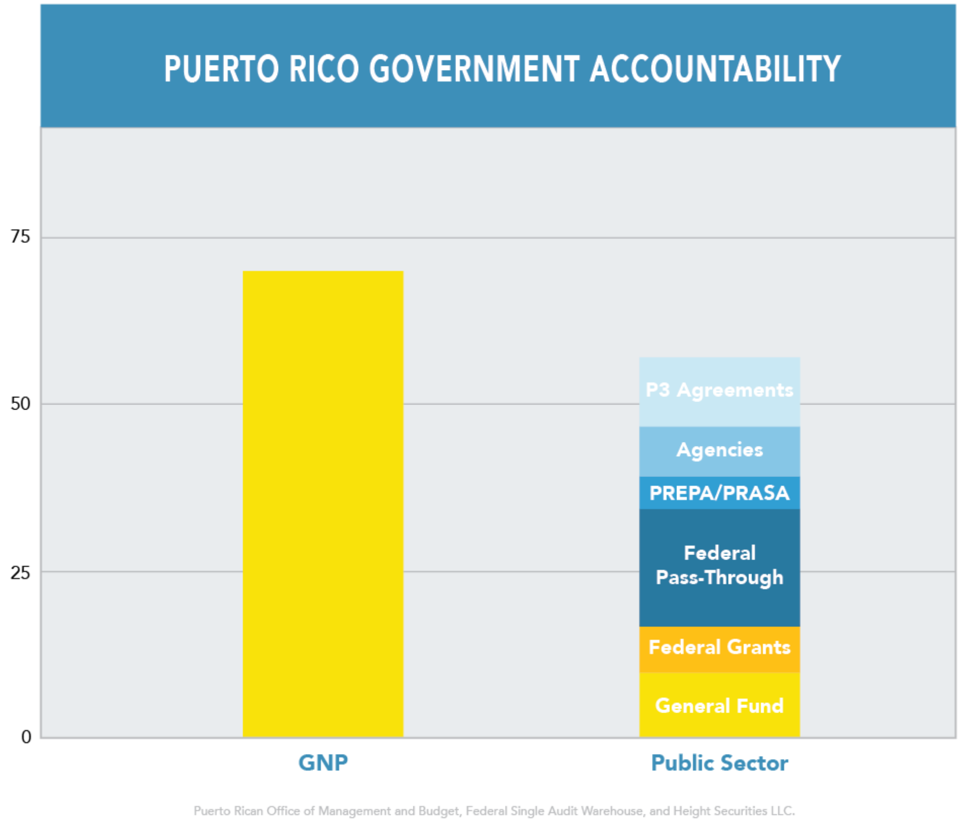
> *The Island's persistently low labor force participation rate indicates a strikingly high degree of underutilized resources. . . . In many ways, Puerto Rico's high unemployment rate and low labor force participation rate are the clearest evidence of a lack of competitiveness and economic progress. The poor performance of the labor market is, in part, the result of a slowing in growth and, at the same time, a major contributor to the Island's economic problems. The failure to utilize a large part of the workforce has been a characteristic of the Island for some time. The lack of significant progress in improving the labor market suggests that fundamental structural impediments are at work throughout the economy that are keeping Puerto Rico from realizing its full potential.*[43]

Puerto Ricans have voted with their feet. Some 1,500 Puerto Ricans leave their beautiful island every week. A staggering 3 percent of the population has left in the last year. Since 1990, the only state that has lost more than 1 percent of its population in one year was Louisiana, which lost 6 percent of its population after Hurricane Katrina.[44] The population of Puerto Rico has fallen by 300,000 since 2007, a decline of nearly 10 percent. An even more painful fact is that total employment has fallen by almost as much in the same period. Hence, the population that Puerto Rico is losing consists principally of active workers—precisely the demographic it needs most right now.

A society in which only one-third of working age people are working is likely to have major social problems, but Puerto Rico's case is even worse. The population of Puerto Rico is 300,000 lower now than it was in 2008, and nearly all of that drop is reflected in the drop in overall employment during the same period. That means Puerto Rico's unemployment rate, though far higher than that of the mainland United States, is artificially low. If Puerto Ricans couldn't easily move to the mainland, and the entire drop in employment were reflected in the unemployment rate, Puerto Rico's unemployment rate would have skyrocketed to well over 25 percent just in the last five years.

FISCAL CRISIS

One of the most remarkable features of the Puerto Rican economy is the gargantuan size of its public sector. More than $60 billion of its $70 billion GNP[45] comes from the public sector.



Puerto Rico's debt now exceeds 100 percent of GNP. Debt service as a percentage of the state's budget is double that of the next most distressed state of the United States and swallows up one-third of government revenue. To get a sense of the scale of Puerto Rico's fiscal crisis, consider that its public debt is one-half the size of California's, a state with more than ten times the population, and several multiples of Puerto Rico's income per capita.[46]

Puerto Rico's public sector is bloated. Its budget of $29.1 billion is nearly half the entire economy. That figure implies state and local spending of nearly $10,000 per inhabitant. In Texas, which has nearly ten times the population, the state budget is only about six times that of Puerto Rico. The Texas budget is only about $4,000 per inhabitant, and Texas has several times the income per capita of Puerto Rico.

Pensions are another major problem. Puerto Rico's three pension programs are insolvent and will have to be paid for entirely by current revenue ("pay-as-you-go") as early as 2018.[47] Liquid assets in all three retirement systems are projected to be exhausted this year. Together with debt service, pension obligations will soon be eating up about 40 percent of General Fund revenue.[48]

Yet another problem is the "favorable" tax treatment of Puerto Rico's public debt. Bond investments from outside the island have long been subsidized by the special "triple-tax-exempt" treatment for Puerto Rico bonds, which makes Puerto Rican debt more attractive than more intrinsically valuable debt, including Puerto Rican private-sector debt. The law thus led to a significant exposure of U.S. bondholders to Puerto Rican public debt and incentivized the Puerto Rican government to depend more heavily on borrowing.

Puerto Rico's financial system is another major structural problem. One of the lessons of the currency crises in developing countries in the 1990s is that a deep, stable domestic financial market is essential to the growth of a developing economy.[49] Puerto Rico's local banks (*cooperativas*) are not insured and are holding a lot of Puerto Rico's public debt.[50] If Puerto Rico defaults on its debt payments, the *cooperativas* may find themselves insolvent overnight.

In sum, Puerto Rico's fiscal situation may actually be significantly worse than the already dire situation that has been widely reported.

UNLOCKING PUERTO RICO'S POTENTIAL

Some have argued that Puerto Rico should have access to Chapter 9 bankruptcy for relief from creditors; others argue that would violate the rights of investors who bought Puerto Rico's government debt on the basis of legal incentives that included triple-tax-exemption exclusion from Chapter 9.

Regardless, the debate over whether to extend chapter 9 has ignored the underlying causes of Puerto Rico's fiscal crisis, namely a bloated public sector and remarkably low labor force participation—owing principally to federal welfare and minimum wage policies.

Any reform must address the inordinately high levels at which welfare and minimum wage levels are set in relation to average wages and other prevailing economic conditions in Puerto Rico. An approach that does not solve those problems will only avoid addressing the core problems while the underlying economic fundamentals continue to deteriorate.

ADDRESSING THE FISCAL CRISIS

Under current law, Puerto Rico would have to restructure its debt through an uncertain and incomplete framework, to which the alternative is litigation and a disorderly default. The House of Representatives has passed H.R. 5278, sponsored by Rep. Sean Duffy (R-WI), a bill that would provide for the orderly restructuring of Puerto Rico's debt.

Any change in the legal treatment of any category of debt should respect the rule of law. If the U.S. bond market starts to discount the debt of state and local entities that might be subject to ex post facto changes in their credit characteristics, the effects may negatively impact all such borrowers moving forward. This could increase the borrowing costs of all state and local entities in the U.S.

Moreover, Puerto Rico's government should be encouraged to pursue a fiscally responsible path. A confusing variety of government institutions issue separate debts, with apparently conflicting priorities. Streamlining the debt issuances of Puerto Rico government entities should be a first priority. An oversight board imposed by Congress to run Puerto Rico's budget will be able to accomplish such reforms quickly.

But an oversight board appointed in Washington, D.C. is understandably "viewed as a neocolonial infringement on local autonomy."[51] According to the *Wall Street Journal*, "Democrats have said any control board must respect the island's self-rule." They are correct. Indeed, the entire federal government should respect the island's self-rule. Puerto Rico should be allowed to determine its own welfare benefits and minimum wage.

Any congressional effort to deal with Puerto Rico's fiscal situation that falls short of giving Puerto Rico minimal freedom to determine its labor and welfare policies will fall short of a providing lasting solution. H.R. 5278 will protect Puerto Rico from recent Department of Labor regulations expanding overtime benefits and would also permit a lower "first minimum wage" up to the age of 25 (as opposed to 20 on the mainland) for the first 90 days of employment. These provisions should be expanded to cover more people for a longer period of time.

ADDRESSING THE ECONOMIC DYSFUNCTION

The Obama administration's push for a $10.10 national minimum wage would push the minimum wage in Puerto Rico far above the current average wage on the island. President Obama made no provision to exempt Puerto Rico from the impacts of this proposal. As this report demonstrates, increasing the minimum wage in Puerto Rico would push another significant fraction of its dwindling workforce into dependency on the government. Raising the minimum wage would be the wrong thing to do.

Some have advocated for extending the Earned Income Tax Credit (EITC) to residents of Puerto Rico.[52] The EITC is a redistributive tax device designed to offset the disemployment incentives of welfare at lower income levels by shifting income from those who pay federal income tax to those who do not earn enough to pay income tax but earn enough to lose marginal welfare benefits. Puerto Ricans are not now eligible for the EITC because they do not pay federal income tax at all. But such a reform would only throw good money after bad. Puerto Rico's economy is already subsidized far too heavily. Its current problems clearly do not result from insufficient subsidies, but rather from too much subsidization. Moreover, introducing a federally funded EITC to Puerto Rico is manifestly unfair, given that Puerto Ricans don't pay federal income tax.

Proponents of uniform federal welfare benefits and labor standards seek to eliminate what they see as the evils of disparate living standards in different cities, states, and regions. From that point of view, the imposition of uniform federal welfare and labor standards serves to "equalize" social disparities.

But there is ample evidence that uniform welfare and labor standards often have the opposite effect. The combination of minimum wage and welfare creates adverse consequences, which only increase as benefit levels are set higher in relation to average wages in the local economy.

The adverse consequences of setting welfare and minimum wage levels too high is particularly pronounced and destructive when a local recession drives down average wages. This increases the disemployment effect, driving up unemployment and driving down labor force participation. The very same combination of welfare and minimum wage also freezes the reallocation of labor market assets (i.e., workers finding new jobs) that is vitally necessary to recovery and increased employment (which the Bankruptcy Code is designed to make as rapid as possible, in order to restore asset values and income levels as rapidly as possible). Competition is thereby prevented from reaching the sector of the labor force that needs it most desperately.

The conclusion appears inescapable, that these negative effects increase the higher the minimum wage and welfare are set, relative to marginal product and average income. The implications go far beyond Puerto Rico. Other poor areas of the United States, such as Detroit, could be suffering from a federally imposed straightjacket of minimum wage and welfare set too high for local conditions.

The implications for Puerto Rico are clear. Officials in the United States and Puerto Rico alike must seriously consider ways to make both minimum wage and welfare benefits more flexible. In the meantime, as a direct result of federal policy, Puerto Rico will continue to suffer from an artificially constricted income tax base.

RECOMMENDATIONS

- **The government of any state or territory of the United States should have the authority to petition the Department of Labor for relief from minimum wage restrictions for areas where the employment rate is unusually low. The waiver should be granted except in unusual circumstances.**
    - *Any oversight board proposed in such a financial crisis should have the power to grant broad waivers from application of the federal minimum wage, and it should have the power to recommend policy reforms, including the reorganization of government institutions.*
- **Welfare benefits should be "flattened" by lowering benefits for those who are not working and increasing benefits for those working at the bottom of the income ladder so as to eliminate the "welfare cliff."**
- **Until such time as federal transfer payments can be reduced to levels commensurate with mainland United States, the Puerto Rican government should transition from corporate and personal income taxes to a sales tax as its primary revenue source. This way its finances are not restricted to the current artificially constricted tax base.**

CONCLUSION

Educating political leaders and the public about the dangerous effect that public policy tools such as minimum wage and welfare can have is an urgent task. Those who support maintaining the full federal minimum wage and welfare benefits for Puerto Rico are no doubt motivated by the best of intentions. However, public policy must be judged not by intentions but by real-world impact.

Puerto Rico shares something in common with places like Cuba, Detroit, and Gary, Indiana. In each case, a half-century of destructive government policy stands in tragic contrast to an earlier time in which the uplifting power of freedom, innovation, and hard work led to significant human progress. The key to unlocking Puerto Rico's potential is to revive that formula and let Puerto Rico's people create their own future.

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[5] María Enchautegui and Richard B. Freeman, "Why Don't Puerto Rican Men Work: The Rich Uncle (Sam) Hypothesis," in *The Economy of Puerto Rico*, ed. Collins, Bosworth, and Soto-Class, 154. Employment rate is the proportion of the population that is gainfully employed, while the labor force participation rate is the proportion of the population that is either gainfully employed or actively looking for work. Hence, the labor force participation rate includes both the employment rate and the unemployment rate, as the unemployment rate measures only those who do not have jobs but are actively looking for work.
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