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Puerto Rico Could Cut Spending to the Bone - and Still Never Recover.

- **Federal oversight board to consider governor's ideas March 30**
- **A hurricane, a recession and then a regimen of deep cuts**

Puerto Rico's hard times are about to get harder.

Almost six months after Hurricane Maria, Governor Ricardo Rossello is proposing what, for many, might seem unthinkable after a decade of recession: austerity.

His plan to consolidate government departments and reduce municipal and university aid underscores just how bad things have gotten since the September storm. The sober reality: The government was kept afloat by borrowed money for years, and now the spigot is shut off. The U.S. territory is bankrupt, running a deficit and creditors are fighting in bankruptcy court for the $74 billion they're owed.

If the federal panel that oversees Puerto Rico's finances approves the governor's plan by March 30, self-imposed discipline is bound to increase the pain, much as it did in Greece. For bondholders and the 3.3 million residents, the question is whether the move will do more harm than good, or help Puerto Rico overhaul its economic engine and repay more of its debt.

"It's not like things will magically get better," said Jason Bram, a New York Fed research economist. "Hard decisions are made. People are upset."

Enfeebled Island

Investors, bond-insurance companies, the oversight board and island officials have been discussing how to write down the burden through mediation that's part of the island's bankruptcy. Rossello's fiscal plan estimates the central government may be able to repay almost half the $41 billion of principal it owes, an amount that has left creditors unsatisfied.

But Puerto Rico's economy has been feeble for years despite the rich diet of debt that, absent vigorous private investment, maintained the island in a recessionary torpor. The bankruptcy and storm brought it to a crisis, but Rossello's cure is no sure thing.

Greece's economy shrank by a quarter after the government slashed spending in 2010, reformed pensions and hiked taxes after the financial crisis. That wasn't enough to prevent the biggest sovereign debt restructuring in history in 2012 — as well as two further bailouts. The last came after Prime Minister Alexis Tsipras swept to power on an anti-austerity wave in 2015, only to agree to more cuts.

Civic Unrest

There were protests and riots as unemployment rose as high as 27 percent in 2013, and more than

one in five workers remain jobless. In Puerto Rico, unemployment in January was 10.9 percent, but about a quarter of the commonwealth's workers are employed by governments and agencies that stand to be slashed.

Rossello believes his plan will inspire businesses to invest. It aims to cut and simplify tax rates and structure, and speed sluggish permitting and registration. The governor also wants to lower electricity costs and build a more reliable power grid through private investment.

"It's transformational, based on structural reforms that we're proposing," Rossello said in an interview.

Unspeakable Word

Rossello may not like to call it austerity — "Austerity will never get us out of this situation," he said — but his plan also imposes deep spending cuts.

The goal is to whittle 118 executive-branch departments to 35 and 35 school districts to seven. The central government plans to reduce allocations to municipalities and the University of Puerto Rico by $1.4 billion through 2023. In all, there would be $3.4 billion of savings by fiscal 2023, according to the plan.

"It would make sense if they could get back on their feet in the wake of the hurricane and then engage in the necessary steps to address their fiscal problems," said Mark Zandi, chief economist at Moody's Analytics Inc.

Rossello's proposed savings are more than 3 percent of the projected gross national product, which could create an economic drag of more than 4 percent, according to Brad Setser, a former Treasury Department official who worked on a Puerto Rico rescue law enacted in 2016.

"The fiscal plan doesn't just assume a near-term rebound, it assumes a sort of almost permanent change in Puerto Rico's growth trajectory, which seems overly optimistic," said Setser, a senior fellow at the Council on Foreign Relations.

Driven Away

Puerto Rico stopped repaying bondholders in 2016 to free cash for other operating expenses. Rossello's plan doesn't include principal and interest payments until 2020. In the past few years, the commonwealth has consolidated schools, boosted the retirement age, increased workers' pension contributions and raised taxes.

"There have been cuts in health care and education, in all kinds of social services," said Mark Weisbrot, co-director of the liberal Center for Economic and Policy Research in Washington, and an austerity opponent. "They lost a lot, and that's why so many people have left the island as well."

"The recession and the hurricane together have destroyed a great deal of the economy's productive capacity, so the priority has to be actually returning to growth first," Weisbrot said.

The commonwealth's economy has been a shambles for years. It fell into recession in 2007 after federal tax breaks for pharmaceutical and other manufacturers ended, prompting companies to leave or reduce operations. It's posted only one year of growth since. More than 400,000 residents left even before Hurricane Maria struck on Sept. 20, and the exodus has only grown.

While Puerto Rico needs to stop spending money it doesn't have, reducing that sharply now will

hurt, Zandi said. “It will be a negative for the economy, at least when the cuts are taking effect,” he said.

Half Measure

But Rossello’s plans may not go far enough, said Natalie Jaresko, executive director of the federal oversight board. The board will seek a 10 percent cut in pension costs by reducing payments in the face of a $49 billion unfunded liability, she said. The panel also wants Puerto Rico to transfer teachers and judicial workers into a 401(k)-like retirement plan.

The system, she said, must be “affordable, but predictable and transparent.” It also could mean less support for the economy at large.

Puerto Rico has requested $94.4 billion of federal assistance that would restore homes, rebuild infrastructure, provide services — and help offset Rossello’s cuts. Washington has approved about $50 billion, although Congress doles out the relief in portions and the U.S. Treasury has yet to extend disaster loans.

“Without help, it’s hard to see Puerto Rico finding a bottom at least anytime soon without just tremendous pain and without the island’s population being hollowed out,” Zandi said.

Jaresko said pain strengthens. With the right plan, the commonwealth will emerge “with a different ground for businesses to operate in, with a different set of conditions. If we do not do the structure reforms, you can’t come out of this.”

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By Michelle Kaske

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