

Puerto Rico's Economic Missteps

**Glenville Rawlins
Montclair State University**

INTRODUCTION

In May 2017 Puerto Rico advanced to a bankruptcy like process to seek a rearrangement of its estimated \$73 million debt (that is without even taking account of its almost \$50 billion pension liabilities that remain unfunded). This move came after its creditors had rejected a consensus solution, and had sued to seek to recoup all that was owed to them. PROMESA, the board setup by Congress to oversee recovery policies had acknowledged to the pessimistic outlook facing Puerto Rico, as opposed to the optimistic (and one might say) unrealistic growth path that was pushed by the hedge funds regarding Puerto Rico's economy for 2017 to 2024. All of this came before Hurricane Maria, inflicted an estimated \$95 Billion body blow to the island in September 2017¹.

They are several easily identifiable manifestations of this crisis. From 2006 to 2017 the population fell from 3.8 million 3.4 million, with the Exodus including many skilled professionals who saw dwindling job and business prospects. Second, after supporting the manufacturing sector on the island for more than 30 years the pharmaceutical industry abruptly declined, leading to a 50% reduction in manufacturing overall. Third very low labor force participation rates combined with the rise of the informal business sector have resulted in reduced tax revenues for the state, as well as a noticeable increase in the proportion of the population living below the official poverty rate.

There was a combination of decisions taken in Washington, poor management choices made by the government of Puerto Rico, and institutional factors relating to its political status, that brought down this once vibrant economy. This paper explores the interaction of these separate factors in causing the current state of siege in the island's economy.

This paper starts by taking a historical perspective of economic development in Puerto Rico, with an emphasis on laying out the unique institutional arrangements between Puerto Rico and the United States press you went to Puerto Rico was Commonwealth status. Next there is a section laying out some of the factors limiting economic growth. A brief analysis of the special difficulties facing Puerto Rico in the 1990's is followed by an examination of the missteps of the government. The last section lays out the current debt dilemma facing Puerto Rico. A brief conclusion follows.

SOME BACKGROUND INFORMATION

The Spanish-American war ended in 1898 with the Treaty of Paris whereby the loser Spain, ceded several territories to the US, among them Puerto Rico, for a payment of \$20 million. After a series of governors mostly appointed by the US president² Puerto Rico finally got its first democratically elected

Governor Luis Munoz Marin in 1949 and its own constitution in 1952. Plebiscites on Puerto Rico's political status in 1967 and 2012 resulted in support for Puerto Rico's special Commonwealth status, while the referendum in June 2017 resulted in support for statehood, even after the Commonwealth option had been reinserted into the ballot at the last moment by the Trump administration³. Barring action by Congress the current status is likely to continue indefinitely.

In the roughly 120 years of US stewardship several consequential changes to the relationship have been put in place. The Jones Shafroth Act of Act of 1917 extended US citizenship to Puerto Ricans without granting statehood nor the right to vote in US presidential elections. When Pres. Roosevelt's minimum wage law passed in 1938, Puerto Rico lost more than two thirds of its textile factories which could not afford the \$.25 an hour rate. The section of the Jones Act barring domestic shipping of goods between US ports by foreign ships also applied to Puerto Rico. Because of the distance to the nearest mainland port and the resulting limited availability of US shippers, Puerto Rico was saddled with uniquely high transportation costs that the other states did not have to meet.

Also, it must be mentioned that in the relationship with the US, Puerto Ricans do not pay federal income taxes and do receive some benefits from some federal social spending although at lower rates and with caps as contrasted to US states⁴.

Up until World War II Puerto Rico remained a largely agrarian economy. This started to change with Operation Bootstrap introduced by the US government and championed by Gov. Munoz Marin. This was supported by several tax concessions to mainland-based companies to get them to relocate to the island. A 1976 tax incentive bill generally freed them from local and US taxation on profits originating from Puerto Rico-based manufacturing, accompanied by an exemption from US duties when the finished products were imported back to the mainland.

The consequent rise of the textile and apparel industry soon gave way to more intensive forms of industrialization such as oil refining, petrochemicals and eventually the pharmaceutical industry. The estimated annualized economic growth rate of over 5% during the 50s 60s and 70s produced a period of relative prosperity for the growing middle class, but came at the cost of a rapidly declining agricultural industry. Whereas in 1930 Puerto Rico produced almost all of the basic food staples consumed on the island, by 1990 it was importing over 80% of these agricultural produce.

Over this period several other factors served as catalysts for strong economic growth. First, there were the remittances of the first surge of migrants to the mainland. Perhaps a more telling factor (also a product of the Jones-Shafroth Act), was the financial inflow resulting from Puerto Rico being granted triple tax exempt status on bonds floated by the island government. These were similar to the triple tax exempt bonds sold by the other states but with a twist. Bondholders were exempt from state and municipal taxes even if they resided outside of Puerto Rico. Initially most of these were general obligation bonds for which the Puerto Rican constitution dictates that all available state funds must first be used to pay interest.

Things turned with two decisions in Washington. In 1986 US law explicitly banned Puerto Rico from declaring bankruptcy (every other state can)⁵ and separately in 1996 Congress passed a law mandating the phasing out by 2006 of those elements of the US tax code that had led to the inflow of mainland manufacturing firms. Following the ensuing loss of manufacturing jobs the island government reacted by increasing the level of bonds backed by government corporations and by issuing bonds backed by the sales-tax revenue. This latter move resulted from fact that by 2014, Puerto Rico had already maxed out on the general obligation bonds that traditional government revenue could support. The facility created to issue these sales tax revenue bonds was the Sales Tax Financing Corporation, known by its Spanish acronym: COFINA.

By August 2017, weeks before Hurricane Maria unemployment in Puerto Rico had risen to 12%, economic growth has been negative for all but one of the previous 12 years, the debt to GDP ratio had climbed to 70% versus an average of 17% for mainland states. This was the combination of factors that led Puerto Rico to seek the bankruptcy like process mentioned earlier.

FACTORS LIMITING ECONOMIC GROWTH

The dilemma facing Puerto Rico can be illustrated starting with changes in population. As table 1 shows there was negative population growth from 2006 to 2017, with an average annual decline of over 1%. This table also suggests that the losses are accelerating over time. Much of this loss can be accounted for by workers seeking employment on the mainland, yet despite this, the labor force participation rate plummets an amazing 10.5%, from 47.5% in 2007 to 42.5% in 2016. Also, of note is the fact that total employment in the formal sector plunges by just under 20% over the last 10 years.

Meanwhile the various austerity programs succeeded in shrinking government employment by almost 24%, with the result that by 2016 government employment as a share of total employment shrinks from 24 to 22%. As was to be expected the BLS unemployment rate was significantly elevated in the recession years of 2009 to 2011. During the Great Recession, for the US overall the unemployment rate also shot up to over 10% but has now fallen closer to just over 4%. Unemployment in Puerto Rico in 2017 at almost 12% is almost 3 times higher than unemployment on the mainland, but more interestingly it is actually higher than unemployment in 2007.

Table 2 shows that over the last decade a fairly consistent pattern of negative GDP growth obtains, with 2012 being the only year showing a very small positive growth rate of .03%. Meanwhile per capita GDP growth is also disappointing, being negative in most years since 2005 and only turning positive starting in 2011, consequent upon the intensification of the exodus of workers from Puerto Rico.

Table 3 also shows that from 2007 to 2016, fixed capital investment fell every year except for two minor increases during the recovery from the Great Recession namely 2011 and 2012. In fact by 2016 investment is 29% below its 2007 level. More tellingly, Table 3 also shows a significant erosion in investment as a percentage of GDP, falling from 13% in 2007 to 7.9% in 2017, a decrease of over 40%. Again one sees the imprimatur of the austerity programs in the 60% decline in government investment, while private spending falls from a higher level, by a more respectable (if one can say that) 34%

HEADWINDS FACING PUERTO RICO

Many developing countries faced the headwinds of the forces of what is commonly called the Third Wave of Globalization, beginning in 1980 but really accelerating in the 1992-2002 period. These included the formation of NAFTA in 1994 which removed over time many of the protected markets that Puerto Rico as a territory, and many other Caribbean nations, under the CBI (consequent to the US invasion of Grenada in 1983)⁶ had enjoyed; also in 1995 the formation of the WTO, but especially China's access to it in 2001. Of course, in the special case of Puerto Rico, the repeal of Section 936 of the US IRS code subjected Puerto Rico to an ever-broader degree of competition especially in its manufacturing industries.

However, while most other developing countries were free to shape economic policies, both wise and unwise, to respond to these developments Puerto Rico was largely blocked from crafting any coherent response on account of the institutional arrangements of its relationship with the US.

Specifically, as much of the earlier account has made clear, Puerto Rico is hamstrung by various institutional arrangements, involving the US that do not serve its best interests. As per US Code Title 3, if Puerto Rico were to walk away from its debt, it would promptly be sued in federal court, as happened in 2016. This is principally because Puerto Rico is not a state. The fact that it is not a country like the other Caribbean republics, means that it cannot on its own apply to the IMF for structural adjustment funding. Finally, its territorial status bars it from attempting to stimulate its macro economy by manipulating the money supply either to impact interest rates, or to stimulate domestic spending, or to manipulate the exchange rate to spur exports.

The relationship between the US and Puerto Rico has recently been compared to that between Greece and the Euro Zone. This is not an apt comparison. One big difference is that almost all of Puerto Rico's debt is privately held while a large proportion of Greece's obligation is to public entities like other European governments, and multilateral agencies such as the IMF. Further, over the last several years the

fear of contagion has driven the other Euro Zone countries to repeatedly address Greece's debt, while there is no parallel concern in Washington with respect to Puerto Rico's debt⁷.

MISMANAGEMENT AND MISALIGNED DOMESTIC POLICIES

Beyond the constraints within which Puerto Rico had to operate, clearly bad decision making made matters worse. First, is the multiplicity of municipalities in Puerto Rico (78), each complete with the mayor and an executive committee, all subsidized by taxpayer funds⁸. By way of comparison of the administrative branch of government, the nearby island of Jamaica, had 14 parish administrations, with an additional handful of mostly unpaid mayors in individual towns. Next, salaries in government bear little relationship to the task at hand; for example, while a teacher's salary starts at \$24,000 legislative advisors starts at \$74,000

Further the treasury habitually publishes annual financial reports sometimes as much as 15 months after the end of the fiscal year. Thus weak accounting and oversight systems diminish the reliability of government's forecast of expenditures. Complicating matters was the fact that there was a general inability to collect owed sales taxes, to the tune of an estimated 44% of balances. Finally, the treasury was not very efficient in matching taxpayers reported income with that reported by the employer on W-2 forms⁹.

PREPA, the state monopoly power provider furnishes free electricity to local governments some of which have wasted this on outlandish projects; case in point: the mayor of Aguadilla used free power to build a skating rink. Meanwhile the PREPA actively resisted efforts to modernize its aging oil-fired plants in the years leading up to hurricane Maria, and has books that are replete with delinquencies.

The application of the US minimum wage of \$7.25 to Puerto Rico does work as a major disincentive to recruiting new workers, as this wage is about 75% of the median wage on the island, as contrasted with a 40 to 50% average on the mainland. In addition, there are various costly customs at play in the Puerto Rico labor market, including a high severance pay rate, the payment of an obligatory Christmas bonus, together with a more extensive pattern of paid leave for sick days and vacation than obtains in the states.

Further the accumulation of various forms of payment from welfare do serve as a further disincentive to work. It is estimated that a family of three would be eligible for tax-free welfare and utility subsidies that could rise to as much as \$1743 per month, which is in excess of Puerto Rico's median family after-tax wage.

In fact, the heritage foundation has contended that Puerto Rico is not facing a recession, but rather economic decline. They contend that what is needed is a strong labor market, the business climate that attracts outside investment and a reduction in regulation of businesses, together with a concerted attack on cronyism and corruption.

For example, they argue that a high minimum wage and strict labor laws feed the underground labor market, with the result that the 2013 difference in the labor force participation rate between Puerto Rico and the mainland of off 50.2% versus 71.2% translates into an employment gap of over 500,000 workers.

In addition, changes in tax policies to make up for lost government revenue further slowed down the economy; examples of these include a 68% increase in the duty on imported crude oil (from \$9.25 to \$15.50), and a 64% increase in the sales tax (from 7% 11.5%) also in 2015.

ISSUES RELATED TO THE MANAGEMENT OF PUERTO RICO'S DEBT

As mentioned earlier, Puerto Rico's bonds were especially attractive to investors. But by the early 1970s the government in Puerto Rico had shifted from issuing bonds solely to promote industrialization to using the proceeds to fund recurrent government expenditure, to balance budgets and sometimes even the refinancing of unexpired bonds with newly issued ones that actually paid higher interest rates.

The phasing out of Section 936 of the US Internal Revenue Service Code dealing with the incentives to companies, 1996 to 2006 led to tax revenue shortages as manufacturing employment declined leading to an unusually rapid pace of bond issuance to maintain government services especially in the area of

health. One reason for this was that back in 1968 Congress placed a cap on Medicaid funding to territories so that today's benefits accruing to Puerto Rico amount to \$373 million while Mississippi with a population of 2.9 million gets \$3.6 billion. By 2017 an estimated 60% of Puerto Ricans receive either Medicare or Medicaid, with 41% of the population living below the poverty level.

In February 2014 all three credit rating agencies downgraded Puerto Rico bonds to junk status. When Gov. Garcia Padilla declared in June of 2015 that the debt was unpayable, this triggered various acceleration clauses which made the debt immediately payable instead of over a period of years.

About 42% Puerto Rico's debt is owned by residents of Puerto Rico and about 70% of US municipal bond funds own Puerto Rico bonds. But since most of these funds are fairly diversified it is thought that the actual exposure is somewhat limited¹⁰.

Puerto Rico's government responded to the crisis by raising the rates of most taxes, establishing new ones and moving up the retirement age from a possible 47 to 55 and up to 62 for new hires.

PROMESA as recommended by the Obama administration and approved by Congress was an appointed seven-member board which meets in Manhattan, and is charged with taking direct management of Puerto Rico's budgetary process, and choreographing a restructuring of Puerto Rico's debt. When PROMESA was set up, the understanding was should such a restructuring fail there would be an automatic institution of legal process similar to a bankruptcy. Further PROMESA extended the moratorium on lawsuits to May 2017, giving the new government time to craft a fiscal turnaround and an agreement with bondholders on a restructuring. None of this includes the estimated \$54 billion of pension liabilities for which the three public pension funds had an estimated \$2 billion of assets in 2014.

Upon his inauguration in January 2017 Gov. Rossello also proposed cutting government pensions by 10% (Puerto Ricans do not receive Social Security), cutting government spending across the board by 10% and offered \$.25 on the dollar to the bondholders. This offer was roundly criticized by labor unions who labeled him a sellout, but was also rejected by creditors who on their first opportunity on May 2nd. filed for full repayment.

Meanwhile in March 2017 the board accepted Gov. Rossello's 10-year fiscal plan. The deep cuts imply 10 years of austerity, with a slight level of economic growth returning only in 2024. In addition there is no indication of additional resources to pay off the bonds. Many have attacked the plan as being based upon unrealistic assumptions because it keeps the current growth projections without taking into account the impact of the reduced spending plans on actual growth.

As part of the restructuring of Puerto Rico's debt various proposals called for setting up a Super Bond, have all the previous bondholders take a haircut, have a third-party administer the Super Bond with the funds from a lockbox of Puerto Rico's tax collections. This was rejected by the hedge funds. Instead A report on the debt commissioned by 34 hedge funds said that this was a deficit not the debt problem and included among its recommendations improved tax collection methods, reduced spending especially on education, (including the closing of 154 schools), the monetization of government assets: for example seaports and airports.

THE WAY FORWARD

This paper has provided both a contemporary and historical analysis of Puerto Rico's dilemma. On the basis of this analysis is fair to say that Puerto Rico has entered a period of secular not cyclical decline. The last 10 years have seen exceptional declines in real GDP, the population, labor force participation rates, real fixed investment, together with rising unemployment, informal sector participation, and poverty rates.

The provision by the U.S. Congress of a special version of a triple tax-exempt status for Puerto Rico's bonds, made them irresistible to both the writers and the buyers of these bonds, to the point where Puerto Rico is now landed with a debt that most observers now agree that it cannot repay in the foreseeable future. Additionally, a tax incentive provision, and later removal of this by Congress gave the island an economic left as hordes of mainland companies moved in, but also a devastating economic jolt as the manufacturing sector collapsed when they left.

The paper also demonstrated how vulnerable the economy was to decisions made in Washington with little input from Puerto Rico, at a time when the absence of access to standard economic policies available to most of the Caribbean republics, tied the hands of policy practitioners in Puerto Rico.

Finally, the paper has pointed to several important changes that are required in order to arrest this state of economic decline. The first of these is a final decision on Puerto Rico's political status. The state of limbo, better known as Commonwealth status of the last 70 years, has not worked in Puerto Rico's favor. However, one must recognize the reality that a Congress that is fairly equally divided between Democrats and Republicans is not likely to get anywhere near the 66% necessary for admitting Puerto Rico as the 51st state anytime soon.

Second, a consensus along the lines of that proposed by PROMESA, that gets the bondholders to accept more than just a token haircut, together with real and painful reform of Puerto Rico's government, would perhaps facilitate the resumption of real economic growth sometime in the early part of the next decade. These domestic reforms include a reorganization of the public sector human resource management, a revamping of the tax collection systems, a rethinking of the municipal government system, and a strengthening of public reporting systems.

Economic growth can be restored. However each of the stakeholders, government bureaucrats, politicians, labor unions, taxpayers, bond holders, must be prepared to make sacrifices.

DEBT BY THE NUMBERS

Current Debt Level

\$72 Billion, of which \$17.5 Billion General Obligation and \$17.5 COFINA bonds. Unfunded public pension liabilities: \$54 Billion.

US Hedge Funds

US Hedge Funds hold 25% of PR debt. Chief among them: Autonomy Capital, FCO Advisors and Aurelius Capital Management.

US Bond Mutual Funds and Private Individuals

300 US bond mutual funds and private individuals hold the remaining 75% of PR debt. Chief among them: Oppenheimer Funds, Franklin Templeton, Goldman Sacks, Black Rock, T Rowe Price. About 40% of this debt is held by Puerto Ricans.

TABLE 1
SELECTED DEMOGRAPHIC STATISTICS - FISCAL YEARS

	2007	2008	2009	2010	2011	2012	2013	2014r	2015r	2016p
Population as of July 1st (In thousands)	3,783	3,761	3,740	3,722	3,679	3,634	3,593	3,535	3,474	3,411
Labor Force	1,413	1,355	1,325	1,285	1,245	1,208	1,180	1,159	1,130	1,134
Participation Rate %	48.6	46.6	45.5	44.1	42.8	41.7	41.0	40.5	39.9	40.3
Unemployment Rate %	10.6	11.2	13.7	16.3	16.2	15.2	14.0	14.3	13.0	11.7

Source: Puerto Rico Planning Board, Program of Economic and Social Planning
Subprogram of Economic Analysis

TABLE 2
SELECTED SERIES OF INCOME AND PRODUCT, TOTAL AND PER CAPITA: FISCAL YEARS

	2007	2008	2009	2010	2011	2012	2013	2014r	2015r	2016p
Millions of \$										
Gross domestic product at current prices	89,524.1	93,639.3	96,385.6	98,381.3	100,351.7	101,564.8	102,450.0	102,445.8	103,143.5	105,034.5
Millions of \$										
Gross domestic Product at constant prices	11,088.4	10,883.9	10,671.4	10,627.3	10,589.2	10,592.3	10,559.8	10,434.1	10,318.0	10,049.1
Gross domestic product per capita constant prices	2,923	2,885	2,845	2,848	2,862	2,896	2,922	2,928	2,945	2,920
Increase in gross domestic product (%)										
At current prices	4.8	3.6	1.5	1.1	2.2	3.6	1.3	-0.2	1.1	0.8
At constant prices	-1.2	-2.9	-3.8	-3.6	-1.7	0.5	-0.1	-1.8	-0.7	-1.1

Source: Puerto Rico Planning Board, Program of Economic and Social Planning Subprogram of Economic Analysis

TABLE 3
GROSS DOMESTIC FIXED CAPITAL INVESTMENT

	2007	2008	2009	2010	2011	2012	2013	2014r	2015r	2016p
In Millions										
TOTAL	11,674.4	10,974.3	9,699.0	8,918.5	9,605.1	10,356.1	9,672.7	9,031.3	8,663.9	8,262.7
Private investment as a % of GDP	10.53	8.98	7.77	7.41	7.68	7.79	7.56	7.35	7.18	7.00
Public investment as a % of GDP	2.51	2.74	2.29	1.66	1.89	2.40	1.88	1.46	1.22	0.86

Source: Puerto Rico Planning Board, Program of Economic and Social Planning Subprogram of Economic Analysis

ENDNOTES

1. This estimate came from Moody's Analytics.
2. In fact, Puerto Rico's first governors under American rule were military governors with wide administrative powers.
3. It is important to note that the 2017 turnout of 24%, was the lowest of the five plebiscites on the issue, coming after the pro Commonwealth party had staged a boycott of the referendum.
4. In addition, Puerto Rico does not participate in the Federal social security scheme.
5. It was when the Chapter 9 state bankruptcy laws were up for review in 1984, that Senator Strom Thurmond inserted an amendment barring all territories (not just Puerto Rico) from ever declaring bankruptcy.
6. Several Caribbean countries had joined the Reagan administration when it sent troops to oust a Cuban linked government that had ousted the Grenada government. In exchange the US set up the Caribbean Basin Initiative which encouraged American firms to manufacture products in these countries with unusually generous support.
7. See the Skimm's Guide to Puerto Rico's Debt Crisis, 11/12/2017.
8. See Lizette Alvarez, op. cit.
9. See NotiCel op. cit.
10. Professor David Kass of the University of Maryland has estimated that Puerto Rico bonds, would represent no more than 1-2% of the typical municipal bond fund.

REFERENCES

- May, A.A.K. (2016). Why is Puerto Rico in Trouble? *The Economist*.
- Alvarez, L. (2016, July 27). *How Many Mayors Can Puerto Rico Afford? Tradition and Budgets Collide*. The New York Times,
- DePersio, G. (2017, May 31). The Origins of the Puerto Rican Debt Crisis. <http://www.investopedia.com>.
- Egan, M. (2017, September). Who Owns Puerto Rico's Mountain Of Debt? You Do. <http://money.cnn.com>.
- Greszler, R., & Furth, S. (2015, July). *An Economic Crisis Is At The Heart Of Puerto Rico's Financial Crisis*. In REPORT Markets and Finance, the Heritage Foundation.
- Heath, T. (2017, October 10). To the Average Investor, Puerto Rico's Debt Crash Is More Whimper, Less Bang. *The Washington Post*.
- Krueger, A. O., Teja, R., & Wolfe, A. (2015). *Puerto Rico- A Way Forward*. San Juan: Government Bank for Puerto Rico.
- Merling, L., Cashman, K., Johnson, J., & Weisbrot, M. (2017, July 2017). Life After Debt in Puerto Rico: How Many More Lost Decades. *Center for Economic Policy and Research*.
- NotiCel. (2013, March 15). Hacienda espera recaudar \$500 millones; mientras, atiende masiva evasion. <http://www.noticel.com>
- Walsh, W., & Mary, M. (2017). How Puerto Rico Is Grappling With The Debt Crisis". The New York Times.