

PUERTO RICO'S ECONOMIC DEBACLE: CORRECTLY BLAME WASHINGTON

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ABSTRACT

The dire economic situation has been widely recognized. As it has become apparent that the Puerto Rican government will not—indeed, cannot—meet its debt obligations, the situation has received considerable attention in the U.S. Congress and media. Most of the discussion explains the crisis as the result of irresponsible actions by the Puerto Rican government. While such irresponsible actions have certainly played an important role, ultimate responsibility for Puerto Rico's economic decline lies in Washington. This federal government responsibility is formally stated in the U.S. Constitution, where territories are declared to be “property” of the United States and Congress has the authority to “make all needful Rules and Regulations” concerning territories. Moreover, the policies toward Puerto Rico established by the federal government have generated a dependence that has been at the root of the island's economic debacle. While many people, politicians and economists in the states, believe that Puerto Rico has been treated “generously” by federal programs, this view is belied by the data.

Key Words: Puerto Rico bankruptcy, debt obligations, level playing field

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When the United States invaded Iraq and brought about “regime change,” Colin Powell famously stated, “When you break it, you own it.” He meant of course, that the United States had become responsible for the situation in Iraq, problems and all. Ownership means responsibility. With Puerto Rico, U.S. ownership is not simply figurative. As a territory of the United States, Puerto Rico is literally owned by the U.S. government. According to the U.S. Constitution, “The Congress shall have Power to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States.”¹ With that ownership comes responsibility.

With the Puerto Rican economy in a ten-year recession, the government burdened with \$72 billion debt that it cannot pay, and tens of thousands of Puerto Ricans migrating to the states each year, the question looms over the island: Where does responsibility lie for this economic debacle?

Unquestionably, some of the blame rests with the atrocious mismanagement by the local government. Governments of both major parties have pursued damaging policies, borrowing excessively to finance current account spending, failing to collect sufficient tax revenue, and imposing counterproductive austerity policies as the economy has descended. Large firms based off the island, big pharmaceutical firms in particular, using the island as a tax haven, have distorted the economy for decades and thereby undermined the development of policies that might have generated stable economic growth. Just as Colin Powell, in focusing on the responsibility of the U.S. government for the situation in Iraq after the invasion, did not mean to absolve Iraqis for a good share of responsibility for what was happening in their country, these “bad actors” in Puerto Rico cannot be absolved of a good share of responsibility for the economic calamity on the island.

¹ *The Constitution of the United States*, Article IV, Section 3, Paragraph 2.

Yet, the context in which the Puerto Rican government and the large firms have operated, and thus a more fundamental share of responsibility for the economic situation, lies in Washington. The responsibility and the ownership are underscored by the limits of the political rights of Puerto Ricans on the island—U.S. citizens—who have no votes in congressional or presidential elections. On all legal matters, they are ultimately controlled by the federal government.

The Dependence of Puerto Rico

Many commentators have focused attention on the extent to which the Puerto Rican government and people have received economic support from the federal government. The “food stamps” program is often used as an example, with one-third of the island’s people receiving this form of assistance, while the figure for the states is 15%.² As the current long economic decline was beginning an article in *The Economist* dubbed Puerto Rico “Welfare Island,” and pointed out that “Federal transfer payments...make up more than 20% of the island’s personal income.”³ While *The Economist* uses the terms “generous” and “largess” to describe federal funds coming to Puerto Rico, the reality is a good deal more complicated—about which more shortly. Yet, the funds from Washington are certainly one part of the manner in which Washington has shaped the Puerto Rican economy.

Other, and quite significant, parts of the federal shaping of the Puerto Rican economy have been the special programs ostensibly designed to support the island’s economic development. Especially important was Operation Bootstrap (*Operación Manos a la Obra*), a program initiated in 1947, which involved tax incentives from the federal government (and also from the Puerto Rican government) for U.S. firms to establish operations in Puerto Rico. The program was a

² While the percentage of people receiving “food stamps” – formally Supplemental Nutritional Assistance or SNAP – varies a great deal among the states, in no state does the percentage reach 20%. These data for the states are for 2013, and are from <http://www.governing.com/gov-data/food-stamp-snap-benefits-enrollment-participation-totals-map.html>. In spite of the relatively large SNAP payment received by Puerto Ricans, those payments would be larger were Puerto Rico treated the same as the states in the program.

³ “Puerto Rico: Trouble on 'Welfare Island',” *The Economist*, May 27, 2006.

major success in transforming a largely traditional agricultural economy into a relatively modern industrial economy and in generating rapid economic growth through the 1950s and 1960s.⁴

Yet, notwithstanding these successes, Operation Bootstrap generated what would be a long-lasting structural distortion of the Puerto Rican economy, an extremely large reliance on manufacturing and a heavy reliance on externally based firms, especially U.S. based firms. The impact of Operation Bootstrap was continued in more recent years by other federal programs, most notably Section 936 of the U.S. tax code, which again gave special tax treatment to U.S. firms in Puerto Rico. After Section 936 was phased out between 1996 and 2006, the firms could generally continue their tax advantages under the Controlled Foreign Corporation (CFC) provision of the tax code.

Section 936, while much touted as a great boon for Puerto Rico, did little to generate either jobs or economic growth. It did, however, provide a substantial boon for the profits of the U.S. firms—large pharmaceutical companies, in particular—taking advantage of the tax provisions. For example, in the early 1990s, when 936 was in full force, for the pharmaceuticals operating in Puerto Rico, proprietors' income (profits, interest, etc.) accounted for 94% of value added.⁵ (With the end of 936 and the shift of several firms to CFC status, the employment impact was even smaller.)

These tax advantages for manufacturing firms left the island's economy with manufacturing accounting for over 40% of GDP and net domestic income, but only about 11% of employment.⁶

⁴ The success of Operation Bootstrap was also highly dependent on Puerto Rico's access to the U.S. market and on the free movement of "excess population" to the mainland United States. As economies around the world have since gained access to the U.S. market, this Puerto Rican advantage has long been eliminated. Also, it should be noted that prior to Operation Bootstrap, U.S. control of its Puerto Rican territory had contributed to establishing an agriculture based in large part on U.S. owned plantations, a sugar monoculture.

⁵ Angel L. Ruíz and Edwin Meléndez, "The Economic Impact of Repealing Section 936 on Puerto Rico's Economy," in *Economic Impacts of the Political Options for Puerto Rico*, edited by Edwin Meléndez and Angel L. Ruíz, Universidad Interamericana de Puerto Rico, San Germán, Puerto Rico, 1998, p. 135. The authors point out that the relatively small labor share in value added of 936 firms "is particularly relevant when considering that the wage component is the most important contribution of Section 936 investment to the economic welfare of the island."

⁶ These data are of 2007, just as the long recession was getting underway, and are from *Informe Económico al Gobernador, 2011*.

They also left the economy highly dependent on businesses based off the island, which to a significant degree pre-empted the development of a strong business class based within Puerto Rico. For Puerto Rico, Section 936 and the approach to development that it represented was a failure that became a myth

And one further way that the federal government shaped economic activity in Puerto Rico, a policy directly connected to the emergence of the current debt crisis: federal law has made Puerto Rican bonds exempt from federal and state taxes. Along with exemption from Puerto Rican taxes, these bonds have a triply advantageous tax position. This tax advantage was one factor, not the only one of course, that facilitated the buildup of the current debt burden, as it made the costs of debt lower relative to the difficulties of raising revenue through taxation.

Is Federal Support for Puerto Rico Really So “Generous”?

There is no question but that funds from the federal government play a major role in the Puerto Rican economy. Federal transfers to individuals in Puerto Rico account for about 25% of personal income. These federal transfers to individuals plus federal grants to the Puerto Rican government, amount to about 27% of GNP.⁷ However, there are also important federal programs (about which, more below) providing funds to the state that are either not available to Puerto Rico or in which the funds for Puerto Rico are more restricted than for the states. If Puerto Rico were treated the same as the states, about \$2 billion annually would be injected into the island’s economy, adding another 3% to GNP.

The term “welfare island” is, however, inaccurate, unless several states are also dubbed “welfare states.” It turns out that, when federal support for Puerto Rico is compared with federal support for the states, several states receive more “generous” support.

To begin with, Puerto Ricans are excluded from the federal Earned Income Tax Credit (EITC). The EITC was created to offset the burden of payroll taxes (Social Security and Medicare) on

⁷ The data for 2013 show \$15.6 billion of federal transfers to individuals. Social Security and Medicare account of \$10.6 billion of this. Federal grants to various levels of government (about 60% to the central government) were \$3.8 billion, with Department of Education and Department of Health grants by far the largest. Personal income in 2013 was \$63.4 billion and GNP was \$70.7 billion. Data are from *Informe Económico al Gobernador, 2013*.

low income families, to reduce poverty, and to encourage participation in the labor force. Yet, Puerto Ricans pay Social Security and Medicare taxes, the poverty rate is much higher in Puerto Rico than in any state, and the labor force participation rate is exceedingly low.

Similarly, Puerto Ricans do not receive the Child Tax Credit (CTC) unless they have three or more children, while families in the states receive the CTC if they have one, two, or more children. There is no apparent rationale for this discrepancy.

Puerto Rican's exclusion from the EITC and the full CTC makes a big difference for families and for the Puerto Rican economy. For example, in 2011, a married couple with two children in Puerto Rico earning \$25,000 before taxes would end up with \$23,587.50 after paying federal taxes—i.e., Social Security and Medicare taxes. An identical family in the states, after paying all federal taxes, would also receive an EITC of \$4,426.00 and a CTC of \$2,000.00, and would thus end up with an income after federal taxes and credits of \$30,013.50—\$6,426.00 more than the Puerto Rican family.⁸

Also, with regard to both Medicare and Medicaid, Puerto Rico is not treated as well as the states. For example, Medicare reimbursement rates are lower in Puerto Rico for doctors and hospitals, and Medicaid payments do not cover some services that are covered in the states. Moreover, total annual federal funds for Medicare in Puerto Rico are “capped” at a lower amount than would be available were residents of the island treated in the same manner as residents in the states. The poor treatment with regard to these programs takes place in spite of the fact that Puerto Ricans pay Medicare taxes at the same rate as do people in the states; also, as previously noted, the poverty rate is especially high on the island and poverty is the target of Medicaid. Correcting the unequal treatment of Puerto Ricans in these two programs would generate an injection of over \$100 million a year to the economy.⁹

⁸ Similar disparities exist for other family structures, other levels of income, and other years. These figures were obtained using TurboTax 2011.

⁹ See, for example, the speech of Representative Pedro Pierluisi to the Puerto Rico Health and Insurance Conference, March 10, 2016, <http://pierluisi.house.gov/sites/pierluisi.house.gov/files/3.10.16%20Keynote%20Speech%20at%20the%202016%20Puerto%20Rico%20Health%20and%20Insurance%20Conference.pdf>.

Exclusion or poor treatment relative to the states in these and other programs affecting the availability of federal funds tends bring skepticism to the widespread belief that Puerto Rico is treated “generously” by the U.S. government. The data overall on funds going to Puerto Rico and the states bears out this skepticism. In terms of federal payments per capita, Puerto Rico receives about half of the average for the states and ranks below all fifty states and Washington, D.C. Also, and especially significant, in terms of *net* federal expenditures per capita—that is, expenditures going to a state or territory minus taxes coming from a state or territory—Puerto Rico ranks below several states. For example, in 2010, Puerto ranked lower in terms of net federal expenditures per capita than 18 states and Washington, D.C. Data for other years show a similar ranking.¹⁰

Insofar as the dispersal of federal funds has a relation to real needs, it might be expected that Puerto Rico with its high poverty rate would do better by these measures. And, indeed, some of the country’s lowest per capita income states are higher in the net expenditure per capita ranking—e.g., West Virginia, Mississippi, and Alabama. But the dispersal of federal funds is also affected by political clout in Washington. With no voting members in Congress and no votes in presidential elections, Puerto Rico’s clout is virtually non-existent.

Regardless of Puerto Rico’s relatively poor treatment in federal economic programs, the reliance of the island’s economy on the U.S. government is large. The economy has been shaped by federal actions over many decades, and the funds coming from Washington, while not what they would be were Puerto Rico treated unequally with the states, have a large impact on the functioning of the economy. Puerto Ricans play no role, except as supplicants, in the determination of these actions and funding decisions. The decisions and therefore the responsibility lies in Washington.

¹⁰ Computed for 2010 from the *Consolidated Federal Funds Report for Fiscal Year 2010, State and County Areas*, U.S. Department of Commerce, Economics and Statistics Administration, U.S. Census Bureau, Issued September 2011; and for personal income for the states *Statistical Abstract of the United States 2012*, and for Puerto Rico Junta de Planificación de Puerto Rico, Apéndice Estadístico, www.jp.gobierno.pr. Tax revenue from *Internal Revenue Service Data Book, 2010*, Department of the Treasury, IRS, <http://www.irs.gov/pub/irs-soi/10databk.pdf>.

Thus the concept of Puerto Rican “sovereignty” has no real meaning under the current circumstances. To be sure, the local government has thoroughly mismanaged economic affairs. Yet it has been allowed to do so—indeed, in important ways, pushed to do so—by the territory’s owner, the U.S. government. The U.S. tax code and other U.S. regulations have been used to favor the interests of powerful U.S. firms, from “Big Pharma” to Wall Street. Today, the “tenants” of this U.S. property, the Puerto Rican people, are paying the price for the mismanagement. Again, it is the owners that bear ultimate responsibility.